
Bristlemouth takes on Babcock and Brown – day one

It's times like this you wish you'd done more. Babcock and Brown's share price is in freefall and Mr Market is in a panic. Some of the panic seems justified and some of it not. Either way, the share price has been smashed, falling from an all-time high of \$34.78 one year ago to today's \$6.21. I don't know enough to make a call about this somewhat-complicated business at the moment, but it's time to do a lot more work.

Every day for the next 10 days I'll research one aspect of our 10-point test (see below). I'll publish a blog entry (on [The Intelligent Investor](#) and [Bristlemouth](#)) by lunch and then it's your turn to add your comments and thoughts. On Friday 4 July we'll have covered the final point and I'll need to make a decision: cheap, expensive or one for the 'too hard basket'.

The non-banking investment banking industry

So let's get cracking by taking a look at the industry. While Babcock is often called an investment bank, it's not a bank. It's not regulated by APRA, can't accept retail deposits and doesn't have access to the Reserve Bank of Australia (or any other reserve bank for that matter). It's business is corporate advisory, fund development and fund management, none of which requires a banking licence.

And it's not really an industry per se. Typically when researching this question we're looking at, for example, the grocery business or the banking business, and trying to get a feel for the general economics of the industry. Is it capital intensive? Is it competitive? Is it cyclical?

Putting Babcock to the 10-point test	1. The industry	23 June
	2. Babcock's business	24 June
	3. Management	25 June
	4. Financial performance	26 June
	5. Track record	27 June
	6. Regulation	30 June
	7. Downside risks	1 July
	8. Upside potential	2 July
	9. Capital structure	3 July
	10 Debt levels	4 July

It's impossible to pigeon-hole Babcock into any particular category. But without getting into the specifics of Babcock's business – we'll get onto that tomorrow – we can attempt to answer the same general questions about its business model and competition.

Corporate advisory is a competitive but potentially highly lucrative business. Most 'wanna be' corporate advisors struggle, but the few that rise to the top can generate hundreds of millions of

dollars in fees without bearing any risk.

Most of the successful players, including the likes of [Macquarie Group](#) and UBS, bring balance sheet and underwriting capabilities to the table, which gives them an edge when it comes to the big deals. They also bring their conflicts of interest, which has allowed the likes of Carnegie Wiley and Gresham Partners (part owned by [Wesfarmers](#)) to carve out successful businesses on the back of independence.

Most of Babcock's advisory fees are generated from its own managed funds – a locked-in client is as good as any – but it does have specific industry knowledge that is sometimes used by external clients.

Fund development – the lynch pin

The most important cog in the Babcock wheel seems to be its ability to generate new funds by taking assets onto its own balance sheet for a period of time, before creating a listed fund and selling it the assets at a profit. It's been obscenely profitable over the past few years thanks to booming equity markets – it didn't seem to matter what asset you bought, you could flog it off at a profit – and every investment bank around the world has been getting in on the act.

While a lot of participants think they are geniuses when the wind is at their back, my guess is that if there is any sort of competitive advantage in this business, it would come from an ability to identify assets that are cheap. As of, well, now, the pass the parcel game is over, and anyone caught with overvalued assets on their balance sheet has a problem. But if you've identified assets that are cheap, or even reasonably priced, it shouldn't matter if you have to hang on to them for a few years.

Again, we'll come to the specifics of Babcock tomorrow but it seems they've done some intelligent and somewhat contrarian things over the years, especially before they listed (think Japanese property, German property and wind farms before they became the latest craze).

While distinguishing skill from luck is nigh on impossible, it is conceivable that some participants could have a competitive advantage.

The managed fund gravy train

Not only have Babcock been selling their assets at huge profits, they've been selling them to listed funds under lucrative long-term management contracts with, you guessed it, Babcock. While generating new business was only possible while the stockmarket was dishing out cash like the late Kerry Packer in a casino, the funds already created will remain lucrative as long as the contracts stay in place.

As far as economic returns go, there aren't many better businesses than funds management. Especially ones where the funds are locked in (while Babcock will get lower fees if the value of its funds falls, you can't redeem your investment, you can only sell it to someone else). Once you cover your fixed costs – how hard can it be to buy a wind farm and hold it for the next 25 years? – everything flows through to the bottom line.

So, after all that, I'd sum up the Babcock business model as follows:

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- a) potentially lucrative for the bigger players;
 - b) capital intensive but with the potential to earn excellent returns on capital;
 - c) highly dependent on financial markets and therefore highly cyclical; and
 - d) a people business – long-term returns are driven by quality of staff and risk management.

Tomorrow I'll publish my thoughts on the Babcock business itself. But in the meantime, why not post your own thoughts on Babcock's industry – and my assessment of it – in the comments area below.