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Babcock & Brown's $2.5bn trigger puts it in banks' gun but shots are on hold

The waiting game is preferable to the certain losses forced asset sales would produce.

MALCOLM MAIDEN

BABCOCK & Brown's savage share price descent is superficially about debt levels, but it also flags uncertainty about asset values — in Babcock and many other companies.

Babcock's banks can rely on yesterday's 27.5% dive in Babcock's sharemarket value below $2.5 billion to initiate a review of Babcock's finances and operational strength. As Babcock stressed in a statement yesterday afternoon — about the time its value was falling through the $2.5 billion barrier — the event gives its banks an option they are not obliged to exercise. If they do, a strictly prescribed and lengthy process will begin.

Babcock told its banks late yesterday that the $2.5 billion barrier appeared to have been crossed by the share price plunge, and was told the banks would probably take until next week to reach a decision about a review.

If the banks decide on a review, it will run for four months, and will not result in any action if Babcock's share price recovers by its conclusion to above the market capitalisation trigger.

If the share price is still below the trigger at the end of the review, Babcock will have two options: it can do what the banks require to stabilise the parent company and the $2.8 billion debt load it is shouldering (asset fire sales would almost certainly be part of that solution), or it can decline to take the medicine, in which case a two-thirds majority of the two dozen or so banks that have provided $2.8 billion, including Australia's Big Four trading banks, can serve notice on Babcock to repay the money within 90 days.

Babcock has some share capital in reserve that it may be able to mobilise to influence the outcome. Based on its 333.3 million shares on issue, a share price of $7.51 was needed to keep Babcock above the $2.5 billion market trigger. Yesterday's extraordinary plunge ran straight over that hurdle: Babcock closed 27.5% lower at $6.90, and hit a low of $6.81. But there are 50 million convertible shares held by Babcock's US executives, and Babcock staff hold 33 million options capable of being converted in the next few months.

Theoretically, those blocks could be converted to ordinary shares, boosting Babcock's issued capital to 416.6 million shares, pushing the $2.5 billion market capitalisation trigger down to $6.01.

But $7.51 was the trigger yesterday, and it was breached. Either formally or informally, the group's banks will be reviewing their exposure to Babcock — and when they do, it is the quality of Babcock's assets that will be the key focus, not the weight of its debt.

Remember that the same banks agreed only two months ago to not only renew Babcock's parent company debt facility, but extend it, from $2.5 billion to $2.8 billion. They did so not because they had a fixed view about Babcock's market value, but because they had a view about the quality of Babcock's business model, the assets it controls, and the amount of debt the assets can support.

> "Only the $2.8 billion head loan has recourse to the listed parent, but the total debt in the empire is awesome."

The Babcock asset portfolio extends far beyond the listed parent company, because Babcock chief executive Phil Green and his colleagues have created an empire of listed and unlisted investment vehicles, one of which, Babcock & Brown Power, acted as catalyst for this week's sell-off, as the disruptions to gas supplies in Western Australia sideswiped it and complicated closure of its $2.7 billion debt refinancing.

Only the $2.8 billion head loan has recourse to the listed parent, but the total amount of debt in the empire is awesome. Credit Suisse estimates that it exceeds $46 billion, including another $7.7 billion that is on Babcock & Brown's balance sheet, but on a non-recourse basis.

The larger debt total supports a global asset portfolio. Some assets are considered high quality — wind farms in Europe, commercial property in Japan, ports in Britain and the former Alinta gas assets in Babcock & Brown Power are examples. Some are less highly regarded, including Babcock Capital's Irish telecommunication company, eircom.

The key is that the entire global asset portfolio generates cash flow for the various Babcock satellites and, ultimately, for the head company, Babcock, in the form of fees from the management, purchase and sale of assets. Asset values are therefore central to the maintenance of revenue and to debt service capacity — in the satellites and, finally, in the parent company.

But as the subprime debt crisis continues to play out, asset sales have slowed to a crawl. There are plenty of companies looking to sell assets, including Babcock. But buyers are hard to find in an environment where cash is being hoarded, and funding lines are still constipated, because the debt markets have not fully reopened, and because banks are rationing loans.

In that environment, it is difficult for companies like Babcock and their lenders to work out what the asset base is. Companies cannot confidently mark assets to market value if there is no market for the assets — and this is an issue not just for asset structurers and traders such as Babcock and Macquarie, but all companies that have borrowed against chunky, unlisted assets. Australia property trusts are a high-profile example.

One result of the uncertainty is that the banks are being patient. They have given companies including Centro and Allco time to restructure, and may well do the same with Babcock. The waiting game lengthens the uncertainty, but it is preferable to the certain losses that forced asset sales would produce.

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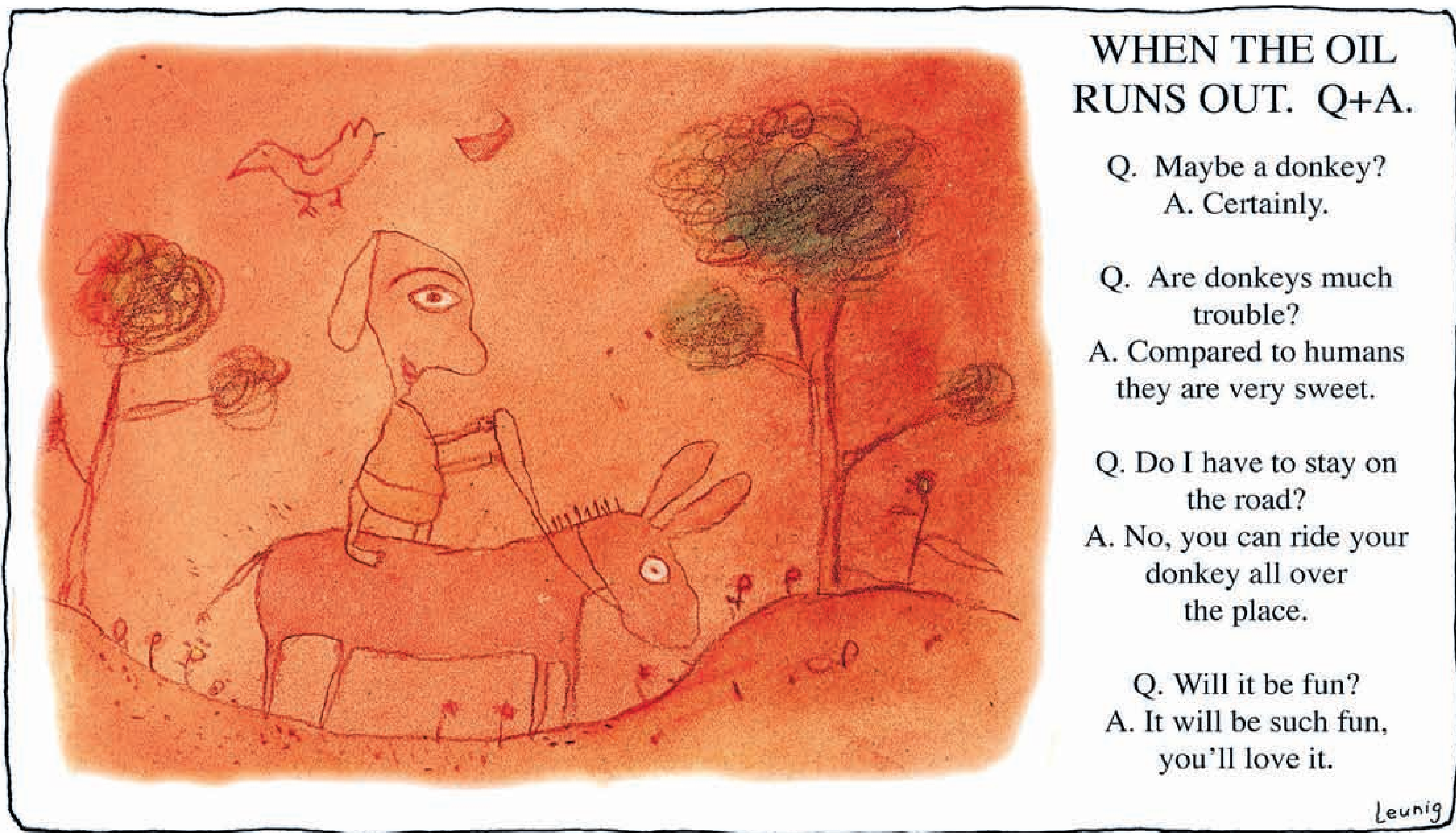

RACV heading down the wrong road

The organisation has been deceiving its members, writes **Elliot Fishman**.

THE soaring crude oil market has sparked an energetic focus from the Prime Minister to take action as petrol prices strangle household budgets.

The Government has declared that the forthcoming tax review will assess whether the GST on the fuel excise should stay. The RACV has been campaigning on this issue for several years.

The time this particular issue has consumed, in the media and Parliament, encouraged in large part by the RACV, is troubling. Focusing on this issue, rather than the factors that have led oil to double in price in the past year is a dangerous distraction that will only make the pain at the pump much worse in the long run.

The RACV has deceived its members by constantly claiming that petrol will not rise very much higher than whatever it happened to be at the time.

In the middle of 2004, for instance, it claimed oil had peaked at about $US44.50 a barrel and we would not need to pay much more than $1.08 a litre. With oil now around $US130 a barrel and the price at the pump exceeding $1.60, Victorians have a right to ask why the RACV got it so wrong.

Serious oil supply limitations are the central cause of the skyrocketing petrol price. Consider the following facts:

The year in which the most oil was discovered was 1964. Since then, geologists have been searching the globe, but finding less and less each year.

We now consume four barrels of oil for every one discovered. It's a little bit like telling your financial planner you have been spending four times more money than you have been earning, and this has been going on for several decades.

Yet despite these facts, published for many years by the world's leading energy agencies and Big Oil, the RACV continues to haggle over a couple of cents a litre.

This will look even sillier if Goldman Sachs analyst Arjun Murti is correct in his prediction that oil could cost $US200 a barrel oil in as little as six months. According to our analysis, that would put the pump price at about $2.33 a litre, depending on the exchange rate.

The RACV has also let down its members by continuing to urge the Government to subsidise the biofuel industry.

This has been a major reason for spiralling food prices. Land once used to grow crops such as rice and wheat is being converted to fuel. This has led the United Nations top adviser on food to demand a halt to biofuel investment. The RACV has ignored the fact that its members are also consumers of food. The RACV's constant campaigning for biofuel subsidies will lead to pain at the pantry, as well as the pump.

The RACV is in a difficult position. It came into being when car ownership was low and good-quality roads were few and far between. In its 100-year-plus history, there has been an astronomical rise in car ownership, length of paved roads, fuel consumption and greenhouse gas emissions. Now governments around the world are trying to fight climate change and scrape the bottom of the oil barrel.

The RACV needs to accept this reality and either step aside, so real solutions can be brought to the table, or adapt and advocate practical, sustainable solutions.

It could start by suggesting that a portion of the fuel excise be put towards a sustainable transport infrastructure fund — to build first-class rail and cycle networks. Giving Victorians attractive alternatives to the car is the sensible way to beat pain at the pump.

Elliot Fishman is director of the Institute for Sensible Transport, an independent policy research group providing advice on oil vulnerability.

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Damage to B&B may well turn out to be terminal

The asset manager has gone the way of its imitators MFS, Allco and Rubicon. The banks can step in.

MICHAEL WEST

THE fate of Babcock & Brown is in the balance. Although the immediate focus will rest on a credit "review" triggered by the collapse of the stock price beneath $7.50 yesterday, the damage to the Babcock brand may be irreparable.

A financial engineer, Babcock relies on market confidence to gear up, buy assets, revalue and repackage them, and spin them off.

The model is busted. Whether CEO Phil Green and his troops can dance their way out of strife with a restructure is as sure as the toss of a coin. Babcock has gone the way of its own imitators MFS, Allco and Rubicon. The banks now have a right to step in.

Their first concern is the structure and the debt in the mother ship. Can the cash flows from underlying operations fund the repayment of the loans? It would appear to be line ball. There is more than $50 billion in debt across the Babcock empire of listed and unlisted satellites.

The visible stuff rounds off at about $46 billion: comprising $2.8 billion full recourse debt to the parent, $7.7 billion non-recourse, $31 billion within the listed funds and their assets, and $4.8 billion in the GPT joint venture. The unlisted stuff remains the subject of conjecture.

The maze of guarantees and cross-guarantees, the loans between various vehicles, the management agreements and the legal minutiae of the entire structure will have to be evaluated.

Babcock & Brown has become a political issue. It will survive for some time at least — and there will be trading opportunities for the savvy and the foolhardy. It could recover. You can bet its financiers will pull out every stop to restructure and recapitalise, for this one is almost too big to fail.

Not only does Babcock control a host of essential services in energy and transport, but the mother ship and its satellite stocks are owned by hundreds of thousands of small investors.

Many are elderly investors who acquired the stocks for the handsome yield. Pity it was a manufactured yield in most cases, paid that is from capital rather than cash flow.

The small investors, and indeed the super funds, were sucked in by the lure of a fancy yield of 7% or so — it appeared to be great value for investing in a solid infrastructure play.

The reality was quite different. These were always high-risk propositions because of their sheer leverage. Some of the satellite yields are now up to 25%. When the mayhem in the financial engineers is past — and they are dead or recapitalised and restructured — the Macquarie-inspired infrastructure fund model, which allows distributions to be paid out of capital from a trust, will probably be deemed a policy disaster. This fund model has already claimed the scalps of Centro, Allco, Rubicon and MFS, and now Babcock is perilously close to the edge.

What the whole party has done, however, is enrich a handful of top executives and their hangers-on at the expense of thousands of small investors who have collectively dusted billions. Much of the executive pay was ripped out of capital, up front, when the deals were struck.

The selling in Babcock yesterday was heavy and appeared to be retail-led as CommSec has dominated selling volumes for the past two days. In fact, selling from a major shareholder in Barclays started the rout a couple of days ago. Ironically, Barclays was the last big fund to head for the door of MFS before it collapsed, though it only slimmed down its Babcock holding by a modest amount.

As buyers deserted the trading screen and the parent company spiralled helplessly, almost self-fulfillingly, towards its "review" threshold, the contagion engulfed every Babcock satellite.

Most of the selling came from existing shareholders. Some selling will have come from investors who took up stock in the Babcock placement in April pitched at $13.65 a share. Other selling will have been margin-call related as the B&B securities lending is pitched on an LVR of 75%. The further it falls, the more forced sellers get flushed out.

A spokeswoman said that besides the 333.3 million shares on issue in the parent, another 50 million were held in Babcock & Brown International Pty Ltd (BBIPL), which represents 13% of issued capital.

She confirmed that these shares could be converted into ordinary equity and be included in the trigger-point calculation for the banks — as could some 33 million zero-priced options and other pre-IPO options issued at $5 at the float.

With the BBIPL stock, the price of the review event would come down to about $6.58 a share. Babcock shares would have to trade above $6.58 at the four-month point before the banks could demand their money back.

Elsewhere, the plugging of holes proceeded apace yesterday in Babcock & Brown Power. The stock came out of a trading halt mid-morning and was driven down to 77¢ before a late pick-up to close at 90¢, still down 40.5¢.

While BBP's banking syndicate has agreed to the $2.7 billion refinancing, another $300 million to $400 million must be found, from somewhere, for working capital. It could be from the parent.

The explosion at Apache's Varanus plant does not help. But ratings agency Fitch has also caused concern. Fitch has assigned a BBB rating on the $2.7 billion secured facility — a notch above junk status.

However, equity investors should also pay attention to the Fitch "issuer default rating" for BBPF, which is a non-investment-grade rating of BB+ — junk status in other words.

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Bell IXL tries to ring in changes as soaps plot thickens

Pay attention! This story is twistier than a politician's policy statement.

IAN McILWRAITH
LANCELOT

LANCELOT has always liked the fact that TV soaps and "reality" shows are so heavily advertised by the networks you can follow the plots without watching the programs.

Sadly, no one has found a way of replicating this for corporate sagas. Trying to remember who is up whose share register, and how far, has often had Lancelot scribbling corporate genealogical trees only slightly less complex, and possibly truthful, than the House of Windsor — and enough to send him screaming to the bar at the Libertines Club in need of a G&T, or three.

So it was this week when one of Hedge-et-Money Partners' valued clients rang to ask whether it was time to claim the tax losses on the shares in Life Therapeutics Lancelot had recommended they buy for $1 about this time last year, and are now trading at a tick over 8¢. Not only that, said the client, but there was a willing buyer — Newcastle stock exchange-listed Bell IXL Investments — which has just called a meeting to try to tip out the Life board.

After checking the Lancelot Superannuation Fund to make sure it was Life Therapeutics-free, Lancelot discovered Bell was run by Carey old boy Massimo Cellante, a member of the Cellante property family.

Lancelot remembers Cellante made an innovative bid for mining contractor Macmahon Holdings a few years back, offering shares in his unlisted $1 private company, which he then planned to list. The gambit was lost, but an undeterred Cellante is still trying to buy himself an ASX listing, mostly aiming at moribund companies with near-cash assets and deeply discounted share prices.

Call it opportunist, call it vulture, the approach was elevated to an art form by one-time trans-Tasman raider, asset stripper and ardent cricket fan, Ronald Alfred Brierley in the 1980s. Cellante has paid his own tribute to the 1980s, cutely naming Bell IXL for two of the "great" entrepreneurial companies run by Australian idols of that era Robert Holmes a Court and John Elliott.

Now pay attention, because the next bit is twistier than a politician's policy statement.

Bell is trying to get control of GoldLink IncomePlus that last financial year lost an impressive $106 million and most of its market value. It still has quite a few million in the bank — hence the amazing race by Bell, and others, to control it. Bell and a company called New Opportunity Ltd have each managed to acquire control of 20% of GoldLink, and called shareholder meetings to replace the board. The first meeting in April ended in a one-all draw: Bell's nominee, Tony Lewis, became a director and Peter Thomas for NOL also signed on.

The two companies are not good neighbours and another GoldLink meeting has been called for Wednesday. Bell and NOL want to remove each other's board representatives and put their own in control.

NOL — which started as Pineapplehead in the days of the tech boom, before the rough end of the market got inserted into its future — delisted from the ASX in December after failing to find a purpose in life for the $2 million it still had in the bank. Controlled by former brokers Tim Kestell and Peter Pynes, NOL has changed its name again in the past couple of weeks, to Emerald Capital, and hopes to relist.

Cellante is trying to stymie that with a share swap takeover offer for NOL — but he's not offering shares in Bell, that would be too easy.

He wants NOL investors to exchange their shares for stock in Boris Ganke's Longreach Oil. Bell controls about 57 million Longreach shares, some through option agreements, if NOL investors flood it with acceptances. NOL's Kestell reckons there's been no sign of that. (Bell has also just requisitioned a Longreach meeting to depose that board.)

Cellante thinks he can dance his way to a combined 40%, and control, of GoldLink's $28 million in the bank using the non-performing Longreach stock. Kestell and Pynes beg to differ.

Like GoldLink, Life Therapeutics has had a horror year — the speed of its decline so breathtaking that in another jurisdiction investors would quite probably have launched a class action.

Once hailed as a local biotech success story, it is now effectively liquidating itself. It had real businesses in the form of plasma fractionation and blood diagnostics. Last year it tried to sell the former, but couldn't nail the deal and provoked a law suit. Life's share price collapsed and a convertible note on its books turned from being helpful financing to the equivalent of the Titanic's iceberg.

Now its future is hostage to Octapharma, a Swiss big brother that loaned it $US37 million to pay off all other financiers and settle the lawsuit. Octapharma has Life in a squirrel grip — lender, major customer and managing its US operations. Curiously, though, Life has just been hit with a default notice from Octapharma that claims the Australian company short-changed it on plasma deliveries "in the first trimester of 2008" and owes it $US11 million, after allowing for exchange rate movements.

If that weren't enough, Octapharma reckons that should the shortfalls continue for the life of the agreement, Life will be up for $US155 million. Octapharma's threats emerged just days after Cellante lobbed on Life's share register and called the meeting to toss out the board.

Frankly, if Lancelot was a Life Therapeutics director, he'd hand Cellante the keys to the boardroom and go home to watch TV.