

Lincoln Market Comment 17 March 2009 Babcock & Brown (BNB)

The unfortunate failure of Babcock & Brown Ltd (BNB) was finalised on 13 March 2009 as the company appointed a voluntary administrator to oversee its closure in order to facilitate the best outcome for stakeholders.

While such events are most regrettable and disappointing, it highlights the absolute importance of assessing a company's financial health when committing to an investment, particularly within these turbulent times. At Lincoln we strongly advocate that financial health must form the basis of all investment decisions, and should be the cornerstone for any investment strategy. We recognise this by ranking financial health as our first and most important Golden Rule for successful investing.

Lincoln's financial health assessment

Babcock & Brown is an international investment and specialised fund and asset management group with long-standing capabilities in structured finance and the creation, syndication and management of asset and cash flow-based investments.

Lincoln's confidence in BNB first waned following the release of its 2007 interim figures which showed that debt levels had increased significantly. The company lost its Stock Doctor Recovery 'Star Stock' status as its gearing levels resulted in a 'Marginal' Total Liabilities to Total Tangible Assets (TLTAI) ratio and a financial health rating of 'Early Warning' for the period. Cash Balance to Total Liabilities (CBTL) were also at an 'Early Warning' position. This persisted in the next two reporting periods. It appeared that failure for BNB was inevitable if it did not address its high debt levels immediately.

While subsequent results showed the company continued to earn profits, it would maintain its high risk ranking throughout the periods that followed, mainly due to high gearing levels and poor cash flow ratios. Sentiment weakened further when the market capitalisation review clause contained in the company's corporate debt facility kicked in on September 2008. The clause applied if the market capitalisation fell below \$2.5 billion at the close of trading. The corporate facility lenders later agreed to remove this clause and the share price somewhat rallied as a result. This provided short term support to the business however it was obviously unsustainable given that the business was still subject to the difficult market conditions.

The company's profitability also weakened as the global economy slowed down and asset values fell. This resulted in negative cash flow from operations which yielded 'Marginal' Operating Cash Flow to Total Tangible Assets (OCFTAI) and Operating Cash Flow to Current Liabilities (OCFCL).

On 16 September 2008 Lincoln featured BNB in its 'Star Gazing' series as a 'Space Junk' due to its continued poor financial health. While the company was more positive about its outlook believing that its Infrastructure Division could provide an upside, we expressed our doubts going forward as to how BNB would fuel its profit growth given more difficult and more expensive access to credit markets globally. We also highlighted that the debt which contributed much to its growth had become its biggest thorn.

Wind up

BNB advised the market on 10 February 2009 that a Delisting Event (triggering requirements which ultimately lead to Babcock & Brown subordinated note holders becoming entitled to request repayment) had occurred following the suspension from trade of the Babcock & Brown Limited ordinary shares for a

period of 20 consecutive business days. Management also said that any restructuring proposal relating to the notes would be subject to special resolutions to be put to holders of the notes issued in Australia and the holders of notes issued in New Zealand and the restructuring being able to be implemented by 15 March 2009, the next interest payment date for the New Zealand notes.

The company was left no option but to be placed under administration following the absence of any restructuring of said subordinated notes. This completed its fall from grace which saw share price once reach an intraday high of \$34.78 per share back in 19 June 2007, to last trade at \$0.325.

Lessons to be learned

As with any disaster there are lessons to be learned from the BNB demise. If a company has a very high debt level and is generating negative cash flow from its operations, then it will not be able to survive in the long term – ultimately, cash is a finite resource that businesses well and truly realise is essential. Companies with 'potential' in the future can raise the money through placements, however if companies fail to deliver and the 'potential' disappears then they will find things difficult.

In the current volatile market we are experiencing at the moment, it is much more difficult to obtain credit. Examples such as BNB highlight the absolute importance of Lincoln's Golden Rule Number One – Financial Health, and why investors should never have been exposed to these companies. Lincoln's Stock Doctor clients who understand the importance of financial health as the basis for all investment decisions would not have been exposed to these disasters.

Investors need to be focused on companies which are healthy, profitable, efficient, undervalued and growing. Businesses must have manageable debt levels, as well as achieve sufficient cash flow from operations in order to fund their activities. BNB will not be the last example of a failed entity and therefore investors need to be better equipped when making investment decisions. Knowing the true financial health of a business means you do not invest blindly.

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