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INVESTMENT

End of the Toll Road? Borrowing to buy infrastructure looked like a goldmine—until the credit caved in

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THE FINANCIAL ALCHEMISTS AT MACQUARIE Group, Australia's biggest investment bank, never managed to turn lead into gold, but they hit on the next best thing: turning asphalt into cash. In May, the bank's shareholders welcomed a $1.3 billion profit, thanks largely to a new way of looking at highways, airports and power stations.

The idea behind the Macquarie model is to borrow a lot of money cheaply, buy infrastructure assets with a guaranteed cash flow, then sell those assets to the public, letting shareholders take over the debt. Macquarie and imitators like Australia's Babcock & Brown make money at every step, with fees for the deal, for advice, and for managing the assets. Macquarie runs toll roads in America, bridges in Portugal, French autoroutes, a tunnel in Germany, and airports from Sydney to Copenhagen. About 290 million people ride its buses each year, and 17 million light its gas.

For investors, all this looked good, because roads and bridges with little competition should produce a steady return via tolls for generations. But with asset prices falling and easy debt a thing of the past, some believe the Macquarie model is in for a shakeup. JP Morgan's Brian Johnson says it is "likely dead."

Macquarie insists that its distributions to shareholders are paid strictly from cash, but other analysts say they're often funded by new rounds of refinancing. Steve Johnson, a former Macquarie staffer turned financial adviser, says the bank has managed to borrow ever-rising sums against its assets because "credit markets were more and more willing to lend. That game is over."

Macquarie's investments are much broader than infrastructure, and new CEO Nicholas Moore argues that with little exposure to Wall Street's problems and $14 billion in cash, the bank can easily refinance debts. The recent credit crunch, however, has made the market cautious. On Oct. 14 Macquarie Group's shares were trading at around $24 ($A35), two-thirds off their peak of $85 in May 2007. And Babcock & Brown had tumbled from around $28 to $1.20.

B&B runs $55 billion worth of infrastructure assets, including ports in Britain, an Irish phone company, real estate across Italy, France, Germany and Japan, a fleet of jets, Australian gas, American rail stock, even a telecom cable under San Francisco Bay. Now the credit crunch is forcing it to sell off assets to cut its debt, estimated to total $35 billion.

"They built their house on the beach," says Tim Morris, an analyst with stockbroker WiseOwl.com. "Now that the storms have come, they can't help but watch their house subside into the ocean." And Macquarie? More diverse sources of revenue mean "it's better built to weather the storm," Morris says. But the borrow-to-buy infrastructure model "is dead in the water."

Hard times *Analysts say the Macquarie model needs an overhaul*

High debt levels aren't the only problem with the Macquarie-model funds, according to a tough review by corporate governance service RiskMetrics. It found that the funds also pay too much for assets and charge too much in fees, and that their operations lack transparency. "Our real concern is disclosure," says director Dean Paatsch. "The investment funds are asset vehicles that have outsourced 100% of the assets' management to a third-party company, but the terms ... are not known."

Paatsch says that in the current market turmoil, the lack of such information erodes confidence. Investors whose shares in a fund lose most of their value would normally want to sack the manager, but with the Mac model, "you don't know what your options are." In the case of B&B Power, for example, "if you sack the manager you'd end up in the ridiculous situation where you'd pay them 25 years' worth of management fees—that's crazy." The review also noted that the funds are allowed to act in ways that normal companies are not, paying dividends, for example, from capital or borrowings rather than profit.

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In B&B's case, warnings had been sounded for some time, including from inside the company. In an internal memo published in Australia's Fairfax newspapers in August, a disgruntled executive complained of a "culture of greed." In other companies, he wrote, "acquired projects are actually required to generate a certain benchmark return before bonus payouts take place. Instead, we have created an environment where senior people are rewarded for ... ginning up rosy projections to justify their rewards."

B&B says it's got the message that it needs to change, but it doesn't agree the Mac model is dead. It is sacking a quarter of its 1,600 staff and selling off assets like Spanish wind farms and a Tasmanian power station. New CEO Michael Larkin says deals will be curtailed and executive pay based solidly on "investment outcomes." It remains to be seen if those remedies have come in time to save the patient. ■

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