

Buy, the analysts said, and exposed the fatal flaws in their models The failure was in techniques that focused too much on earnings and not enough on debt.

Market shocks changed the rules, writes **Malcolm Scott**
ALLCO Finance Group, ABC Learning Centres and Babcock & Brown were rated “buy” at the start of the year by most of the equity analysts who tracked the Australian companies.

Allco and ABC Learning are now in receivership, and Babcock is struggling to avoid the same fate. The analysts’ failure to see the strain that tightening credit markets put on the indebted firms stems from their use of valuation techniques that focused too much on earnings and not enough on debt, Professor David Feldman of the University of NSW, says.

“Models are a tremendous simplification of reality, and if circumstances change, the model will not be effective,” Feldman, a specialist in asset pricing, says. “The shock to the market changed the rules of the game and that made the models useless.”

The likes of Allco and Babcock gorged on cheap US debt to buy assets such as wind farms and aircraft and have been among the worst hit as global credit costs soared and bankers forced assets to go on the block even as prices slumped.

Allco, which last year led the failed takeover bid for Qantas, handed operations to outside managers on November 4. Two days later, lenders seized ABC Learning, the world’s largest child-care centre operator.

Babcock received \$150 million of loans last week, giving it time to sell assets and work with bankers to avoid collapse. Its shares have tumbled 99 per cent this year, the worst performance on the 1696-member MSCI World Index.

Babcock was a “buy” for seven of the eight analysts who rated it at the start of 2008, according to data compiled by Bloomberg. Only a team at Wise-Owl.com, including Tim Morris, a 23-year-old analyst in his first full-time finance job, was telling investors to sell.

Models favoured by most analysts, such as discounted cash flows, are “fundamentally flawed” as they double count some revenues, and valuation ratios such as price-to-earnings are “worthless” as they don’t capture profitability, Roger Montgomery, a fund manager at Clime Asset Management, says.

“No model will capture the potential damage to balance sheets of asset repricing,” he said. “That requires analysis.”

In today’s climate, Feldman says, analysts need to search for items that aren’t featured on corporate balance sheets, spend more time identifying liabilities and determine how exposed the company is to varying market conditions. Unfortunately, there’s no “miracle model,” he says.

The bullish forecasts also raise questions about whether investment banking links have an effect on the objectivity of the research, Stuart Wilson, chief executive officer of the Australian Shareholders Association, says.

Babcock has been involved in 78 deals worth \$US33.8 billion since it became a publicly traded company in October 2004, according to Bloomberg data. “Babcock & Brown was very active in the marketplace, so there may have been some reluctance by analysts to take a negative view,” Wilson says. “Shareholders have always been quite sceptical of the cosy relationship between the analysts and the companies they cover.”

His 8000-member group warns of the pitfalls of following analysts’ advice.

Analysts at Macquarie Group and Credit Suisse rated Allco a buy at the start of 2008, when the shares were at \$6.20. They tumbled 98 per cent before McGrathNicol & Partners was appointed voluntary administrators.

Andrew Hills of Brisbane’s Wilson HTM cut Allco to “hold” from “buy” in November last year. He was the first analyst to turn bearish on the asset manager but the shares had already tumbled 49 per cent from their February peak by then.

Having learned from the collapse, Hills says he now pays closer attention to funding issues and looks at companies from the perspective of a creditor, rather than an equity owner.

In hindsight, “I would have paid more attention to the corporate structure, the stuff you don’t see,” he says. “But there’s no real change in the tools used, it’s just that the tolerance levels on them have come down.”

ABC Learning shares started the year at \$5.18. Wilson analyst Andrew Dalziel, who had a “buy” rating on the stock, said on February 7 that the company had “a good





track record for making astute acquisitions". The company gave up control to outside managers as debt piled up after it expanded in the US and Britain.

Montgomery said he avoided ABC, Allco, and Babcock by studying their profitability relative to debt and equity, rather than just looking at price-earnings ratios.

"It's not the dollar that comes out that's important, it's how many dollars that go in to generate that dollar," he says.

Morris says he and three other analysts meet each Thursday with founder Phillip Shamieh to discuss companies.

In Babcock's case, they saw a deteriorating economic outlook, rising interest rates, tighter credit markets and Babcock's elevated price-earnings ratio relative to peers. They cut the stock to "sell" from "buy" on November 21, 2007, and kept the call since.

"We do use certain valuation models, but we realise they are flawed," he said. "The valuations are only as good as the rubbish you put into them."

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