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Millionaire Factory emerges from first half with bulging net profits

Peter Stiff

Macquarie, the Australian banking group, has reported a 45 per cent increase in first-half net profits, but told investors that equity markets might not be as favourable during the rest of the year.

Dubbed the Millionaire Factory because of its generous bonuses, the group's A$1.06 billion (£819 million) net profit was driven by a 70 per cent increase in income from international operations.

Allan Moss, Macquarie's chief executive, said that results during the second half would be in line with last year's A$733 million, "but down on a very strong first half this year".

It was too early to make a definitive forecast for the full year because of the difficulty in forecasting market conditions, he said.

Shares in Macquarie fell by nearly 4 per cent to A$79 as investors who had been betting on an upgrade to earnings forecasts reacted negatively. Mr Moss said: "Market conditions are generally very volatile and, frankly, somewhat nervous."

The bank restated that it had no exposure to sub-prime mortgage loans in the United States, no material-problem credit exposures, no exposures to structured investment vehicles and US$300 million (£145 million) holdings of collateralised debt obligations rated triple A and double A.

Mr Moss said: "We are not involved in sub-prime in the US at all. There is going to be some stress for sub-prime borrowers . . . We are not unduly pessimistic about the US economy at this stage."

Mr Moss said that the Asian time zone, including Australasia, contributed two thirds of total income and continued to perform strongly. The Asia-Pacific region was "largely unaffected by the credit market disruption", he said.

Macquarie, which started as a tiny outpost of the London merchant bank Hill Samuel, acquired National Grid's wireless business this year for £2.5 billion and is advising Rio Tinto on an approach from BHP Billiton.

Macquarie's first half gained from asset sales unlikely to be replicated in its second half and some businesses are likely to be affected by seasonal factors.

As well as its traditional investment bank operations, Macquarie manages A$224 billion of infrastructure assets, including airports and toll roads such as the M6, which it bundles into listed and unlisted funds.

The bank is gaining from increased equity market volatility, which raises trading volumes, while competition from private equity funds for deals has decreased as they grapple with higher funding costs amid the credit crunch.

Road to riches

— Macquarie, Australia's largest investment bank, owns a number of toll roads, including the M6 Tollway in the Midlands. Its concession expires in 2054

— In January 2006, Macquarie attacked the record and performance of the board of the London Stock Exchange, for which it is bidding £1.5 billion

— The bank outbid the Qatar Investment Authority to win Thames Water in a surprise £8 billion deal in October 2006

— Macquarie lead a consortium in a US$7.4 billion (£3.6 billion) takeover of Puget Energy, of the United States, last month

Australia's Macquarie a moneymaker, but is it skating on thin ice?

FABRICE TAYLOR
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When Jim Chanos poormouths a stock, investors around the world listen. Mr. Chanos runs a hedge fund but made his fame, and a good part of his fortune presumably, by short selling Enron into the ground. So when Mr. Chanos tells investors **Macquarie Group Ltd.** looks like a house of cards, markets and financial journalists, rightly or wrongly, get excited.

Australia-based Macquarie isn't a well-known name here, although it runs a couple of Canadian income funds. But given **Brookfield Asset Management's** plan to transform itself into something that looks like Macquarie, we thought it might be interesting to highlight Mr. Chanos's criticisms, and Macquarie's response (such as it is).

They call Macquarie the millionaire factory because of the money it pays its executives. Macquarie is an investment bank but a big part of its business is setting up and managing infrastructure funds. The bank raises money from institutions and creates pools that buy stable, cash-flow-producing assets like toll roads, power plants and so on. These funds pay dividends with this cash flow. There is huge demand among pension funds for this kind of investment because a big bulge of workers are nearing retirement and there aren't enough quality bonds to go around.

Macquarie makes a lot of money setting up and managing these funds, not only through management agreements but also for mergers and acquisition fees and debt refinancing. Its bankers therefore make huge bonuses, hence the moniker. Over the past two years, the bank has paid more than $200-million Australian ($175-million Canadian) in bonuses.

So Macquarie's executives have a personal financial incentive to increase the asset base they manage, and therefore the fees they earn. As is always the case, such incentives can conflict with the interests of other parties. There are some who think it's happening at Macquarie.

Case in point: In 2004, a Macquarie-controlled fund led a group that bid on and won a lease to operate Chicago's Skyway toll road. Macquarie bid $1.8-billion (U.S.). That's $140-million per kilometre. It's also a full billion more than the second-highest bid. Macquarie has a long record of managing and financing toll roads. In fact, its largest fund is the biggest owner of the 407 toll road north of Toronto, which has proven to be a fantastic investment.

But is it really so efficient that it can pay 120-per-cent more than the next highest bidder on the Skyway? Or are the bankers so eager to increase the asset base that they're happy to overpay for the assets to fatten their bonuses?

You can't get away with overpaying in business for long, of course. That's especially true of an income fund, because it has to write cheques to its owners every month. It has to have the cash. And Macquarie's record of distributions is, as far as we can tell, unblemished.

But scratch beneath the surface and you find that all is not necessarily well. Macquarie Infrastructure Group, the biggest fund, is paying its distributions by borrowing more money.

Distributions to unitholders exceeded free cash flow by more than half-a-billion Australian dollars over the past couple of years. The difference was made up with more debt. So the fund is borrowing to make distributions. How does it get more debt? By having its assets revalued on a routine basis and refinancing them (which means more fees for the bankers).

This is somewhat akin to U.S. homeowners refinancing their homes as the bubble inflated, only in this case the value of the fund's assets haven't crashed.

More worrisome, though, is that not all the fund's debt appears on the balance sheet. It shows $2.6-billion (Australian), but we get about $9-billion by looking at the balance sheets of both the parent company and the assets it owns. Mr. Chanos and others have made this point.

Macquarie responds to critics of its off-balance-sheet debt pile by saying, on the subject of borrowing to pay distributions, among other things, that the assets it owns need investment today but that will pay off in the form of more cash in the future. That seems borne out by the facts. The fund tends to buy, invest and jack up prices. The question is whether the funds are being prudent enough, and you can't answer that without keeping in mind that the bankers get rich off transactions, whether or not they're good for the funds.

As for Brookfield, it recently announced a big step in its transformation into an asset manager. The company created is spinning off an infrastructure fund consisting of various assets it owns to shareholders. Brookfield will manage the fund, which will trade on the markets, and earn fees.

Investors now have a benchmark against which to judge that investment's merits.