Brookfield's Accounting Magic at Dalrymple Bay Coal Terminal

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Dalrymple Bay Coal Terminal and Brookfield's Accounting Magic

Brookfield purchased Dalrymple Bay Infrastructure (DBI) from the defunct Australian YieldCo firm Babcock & Brown in the wake of the GFC.

DBI is a rare instance where investors can follow the asset from purchase, Brookfield stewardship through IPO as a public company. Over time, one can see Brookfield extracting excessive amounts of cash using related party transactions, and ultimately, putting the asset to the public at inflated values. Over the course of this journey, Brookfield shows its considerable accounting chops. Creative accounting is used to extract cash, create equity out of thin air and make debt disappear into the ethersphere. The effort made a company that was effectively plundered appear viable.

It also highlights BIP's flawed governance which translates into financial risk for unitholders. BIP's board does not owe unitholders fiduciary duties. As a result, the board can take third-party interests into consideration, which they appeared to do in the DBI IPO. Despite being majority owners and controlling shareholders, BIP unitholders were at the back of the line when exit liquidity was limited.

A Lesson in Creative Cash Extraction

DBI, formerly known as Dalrymple Bay Coal Terminal (DBCT) is a coal loading terminal serving the Bowen Basin in Australia. At the time of purchase, Brookfield Infrastructure Partners (BIP) owned 71% and a Brookfield-managed private equity fund the remaining 29%. From an investment perspective, it is more a financial investment than operating company, and produces steady, predictable cash flow within its regulatory context. However, sometimes steady and predicable is not enough. Steady, predicable and much bigger is better, and that's what Brookfield aimed for, extracting much more cash than the business could reasonably support.

Brookfield's ability to extract maximum cash from DBI was predicated on two elements. Debt was structured as a series of non-amortizing bullet loans limiting financial outflows to the cost of interest**. Brookfield also used a related-party loan strategy to extract more cash than may have been possible under Australian regulations**.

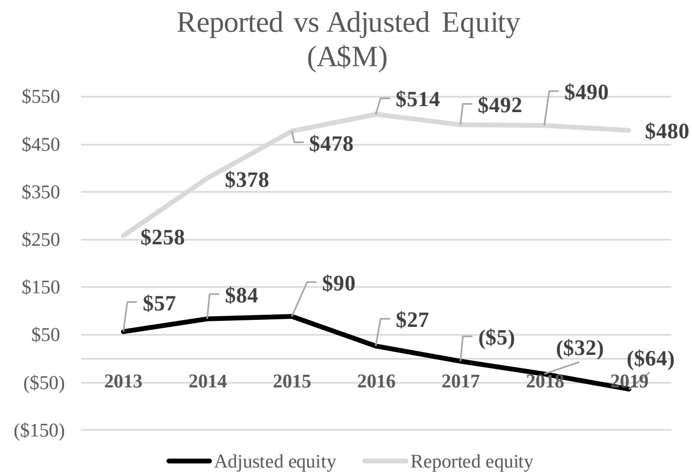
Australian rules prohibit the payment of dividends if the payer is or will be put into a negative equity position following the distribution. Loaning money, however, even on a related-party basis which will never be repaid, creates equity.

DBI made loans to its immediate parent is BPIH Pty Ltd, an intermediate holding company considered by some to be a tax dodger in Australia. BPIH, in turn, upstreamed the loan proceeds as cash dividends to owners via Bermuda HoldCos.

Between 2010 and 2019, DBI upstreamed A$1.023B to its parent. Of that, 53% or A$544M was in the form of a related-party loan. The strategy allowed Brookfield to continue to extract in excess of A$100M annually from DBI despite a declining regulatory revenue base. **Moreover, as shown in the chart below, the strategy allows Brookfield to create the illusion of growing shareholder equity as they stripped the asset.**

Chart below shows DBI's equity as reported and estimated assuming all cash was paid as distributions.

DBI: Equity, Reported and Adjusted for RP Loan



Source: DBI and estimates.

The chart shows how the related-party loan manufactured equity as the asset was being plundered, deftly avoiding declining and eventually negative equity.

The related-party loan is an effective strategy maximized cash flow, but created both immediate and future accounting problems.

The table below shows summary balance sheet information for DBI as reported in BIP's 2019 form 20-F and DBI's (shown as DBCT) audited statements filed with ASIC in Australia. I convert BIP's USD to Australian dollars for comparative purposes.

2019: Discrepancies Between Reporting

	BIP Reported			
(millions)	**USD**	**AUD**	**DBCT**	**Difference**
Current assets	139	199	199	0
Intangible assets	1,758	2,511	2,067	444
Other long-term assets	236	337	995	(658)
Total assets	2,133	3,047	3,260	(213)
Total liabilities	2,035	2,907	2,780	127
Equity	98	140	480	(340)

Source: Company filings and estimates.

Current assets as reported by BIP are the same as reported by DBCT; total assets, however are A$213M less than reported in Australia. Examination of two accounts shows how the discrepancy is created. **Other long-term assets as reported by BIP are A$658M less than reported in Australia. At the end of the year the total related party loan balance was A$672M.** The difference between reported amounts at the entities likely results from the elimination of the loan on consolidation.

Simply eliminating the loan would create negative equity. Perhaps to avoid that, **Brookfield accountants valued the intangible asset at A$2.51B at the BIP level, compared to $2.07B in Australia, adding A$444M in asset value**.

Total liabilities reported by BIP were A$127M above DBCT's reported amount, suggesting that possibility of additional debt at an interim HoldCo.

The net result of the differences is that equity declines from A$480M to A$140M on consolidation. Were the intangible asset carried at the value recorded in Australia on both balance sheets, DBCT would have had an Australian dollar carrying value of (A$304M) at the BIP level.

The comparison of differently sourced DBI statements shows Brookfield accounting its way out of a negative equity position by revaluing the intangible asset. It is the same asset, same owners, same accounting standard. The only difference is that Brookfield recorded it in Canada at a 22% premium to what it valued at in Australia.

The Complex End Game

Solving the accounting issues that the related-party loan strategy created later in the asset's life was more difficult, requiring sharper pencils, more thoughtful accounting, and a time-out from the auditor.

The related-party loan proved problematic when it came time to liquidate DBI.

The related-party loan was a material asset for DBI and a liability for BIP and the BAM private fund. Since the loan was taken to pay distributions, they likely never intended to repay it. Further, repayment would have lowered returns and potentially required a cash outflow on sale. The question then was how to extinguish the loan without repaying it or leaving DBI with negative equity?

To illustrate the problem, if DBCT was sold for IFRS carrying value or A$481M, BIP's portion of the proceeds would be A$341M. BIP's portion of the loan repayment, however, would be A$477M, leaving the LP with a (A$135M) cash outflow on the transaction.

Brookfield initially attempted to sell DBI to private buyers, but bids were far from the offer. Brookfield then pursued both a private sale and IPO simultaneously. Private buyers did not go for the bait. Although the IPO was a difficult process, DBI eventually made its stock market debut in December 2020 in Australia as one of the largest, but worst performing IPOs of the year.

There were a series of creative accounting maneuvers in preparation for the IPO that eliminated the potential problems associated with the related-party loan.

In the exhibit below, I show a summary balance sheet from DBCT's audited 2019 statements along with a summary from the unaudited pro forma balance sheet in the prospectus and the audited 2020 statements. Deloitte is the auditor in both cases.

Impact of Major Restructuring Adjustments

($A millions)	Audited by Deloitte 2019	Unaudited Prospectus Pro Forma Adjustments	Unaudited Prospectus Pro Forma 2Q20	Audited by Deloitte 8/7 to 12/31
Current assets	199		72	188
Intangible assets	2,067	***860***	2,942	3,110
Related party loan	672	***(672)***	-	-
Other non-current	322		371	264
Total non-current	3,062	187	3,313	3,374
Total Assets	3,260		3,385	3,562
Total liabilities	2,780		2,514	2,692
Equity	480		871	870

Source: DBCT statutory statements, DBI prospectus and annual report.

Although DBI had been a continuously reporting entity in Australia for many years, the IPO was an asset purchase with a restructuring. It appears as if the transaction structure disrupted the accounting continuity. There is 7-months and 7-days following the 2019 audit that are unaudited.

It is in this dead-zone, between the tick of one audit and the tock of the next, that the magic takes place.

The first adjustment of $860M is tagged in the prospectus as being related to the purchase of identifiable assets at fair value. The second adjustment of (A$672M)[1] is identified as settlement of the loan.

The intangible asset was written-up 42% on the unaudited pro forma statements from the 2019 audit. The 'settlement of the loan' makes one think the related-party loan could have been repaid, but the language is vague. Readers of the pro forma statements are referred to footnote 2, which I reproduce below.

DBI Prospectus Footnote

2. Settlement of loans reflects the intercompany receivable from a Brookfield entity that will be settled by way of an in-specie distribution and settlement of intercompany payable on exit from the Brookfield TCG (Tax Consolidation Group).

Source: DBI Prospectus

The cryptic footnote appears to say that the loan will be repaid via some script when the purchase happens. Seeking clarity on the rationale for the material write-up in the value of the intangible asset and what happened to the related-party loan, I contacted DBI investor relations.

Regarding the asset write-up, the IR person sent a screen shot from the prospectus stating that the intangible asset was valued using IFIRC12 with no further detail. **Since DBI's audited 2019**

[1] The number is slightly different in the prospectus because it starts from unaudited 2Q20 statutory statements. I use audited 2019 statements.

financial statements use the same standard, it remains a mystery as to why the asset was worth A$2.1B on December 31, 2020 and A$2.9B 6-months later.

Similarly, I was sent a screenshot of cryptic footnote number two (above) as an explanation for the related-party loan.

Given neither of my major questions were answered, I sought clarification again. In an attempt to be as precise as possible, I sent the following email to investor relations.

Email to DBI

From: Keith Dalrymple <keith@dalrymplefinance.com>
Sent: Wednesday, December 16, 2020 6:45 PM
T[redacted] <[redacted]@dbinfrastructure.com.au>
Subject: Re: Investor Query

[External Email]

H[redacted]

Thank you for the reply, but the answers provided do not clarify if or how the related party loan will be repaid or why the DBCT concession became more valuable.

1. Regarding the related party loan. You state it was "fully repaid", but the note from the prospectus says the settlement reflects a receivable "that will be settled" by way of an in-specie distribution. Please explain what the "in-specie" distribution is/was and how it is reflected on the DBI balance sheet.

If it is easier, feel free to simply list the series of accounting entries that led to the elimination of the asset on the balance sheet.

2. Similarly with the intangible asset. DBCT's audited financial statements log an intangible asset of $2.066B while the DBI prospectus lists $2.94B. Both sets of statements state that the valuation is based on IFRIC 12 Service Concession Arrangements. Given the same accounting rules are being used for the same asset, the 42% increase in value in the DBI prospectus indicates that there must have been a material change in the underlying assumptions. What were the specific assumptions that changed between the audit and the prospectus to warrant such a large write-up of the asset?

Thank you,

Keith

I believe the IR person was genuinely trying to help. The immediate response to my second request was that he would seek and answer from DBCT accountants and get back to me. Eventually, I received this:

Email from DBI

[redacted]@dbinfrastructure.com.au> Dec 20, 2020, 11:45 PM
to me

Morning Keith
Further to your questions below the information we have disclosed in the prospectus is complete and accurate.
Thanks
[redacted]

The email is an example of master-level semantic jujitsu using circular reasoning where they answer a question regarding an obfuscating disclosure by referring to the obfuscating disclosure.

I consulted DBI's 2020 audited statements when they became available to see if any explanation was offered. Strangely, the balance sheet contains figures for only one year – 2020. There is no side-by-side presentation of annual balance sheets as I have seen in almost every other set of audited statements I have examined. Without the comparison with 2019, there was no indication that related-party loan existed in 2019, nor any indication the asset had been significantly revalued. **One asset disappeared and another materialized all without explanation.**

Conclusion

Brookfield's accounting paved the way for DBI's IPO, but it got little buy-in from investors. There were two notable examples. The QIA, the investment arm of Queensland, agreed to be a cornerstone investor. On the one hand, it is odd that Queenslsand would purchase DBI given it the government had sold DBI to Babcock & Brown. On the other hand, it might not be surprising given DBI's chair is the former Treasurer of Queensland.

Similarly, I was surprised to see fellow Canadian and storied investor Prem Watsa as a material shareholder via Fairfax Financial when the IPO concluded. Australia seems out of Fairfax's wheelhouse, though I am no expert there. Then again, it might not be surprising. As noted here, the Chairman of Brookfield Fund Management Ltd was also a board member of Fairfax.

Perhaps as a result of muted demand from real investors, Brookfield could not fully exit the position. Despite BIP being the controlling shareholder with 71%, the Brookfield private equity investors appear to have been given liquidity preference. The private fund investors sold their entire 29% stake. BIP only sold 22% of its stake, leaving it with 49%.

The IPO was priced at A$2.57 and immediately traded down to ~A$2.00. It took nearly 3-years for DBI to trade at and above its IPO price. As long as a wait it was to get even, perhaps BIP unitholders should count themselves lucky it wasn't Latch Inc. (LTCH), another Brookfield IPO of similar vintage.