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Babcock & Wilcox Change Looms as Blue Harbour Takes 6% Stake

By Antoine Gara

NEW YORK (TheStreet) -- Energy solutions specialist and mission critical defense contractor **Babcock & Wilcox** (BWC) is quietly becoming a target of value-seeking hedge funds after years of cost overruns and weak stock performance.

Blue Harbour Group, a hedge fund started by **KKR**-alum Cliff Robbins, recently disclosed a 6% stake in Babcock & Wilcox shares and its intent to engage with management over issues such as the company's capital allocation and its investments. However, as activist investors take an increasingly vocal role on Wall Street, Blue Harbour may be able to accomplish its objectives without making much of a fuss.

Babcock & Wilcox is in the process of dramatically reducing its investment in a struggling mPower nuclear reactor project, which has weighed on shares amid spiraling costs, obscuring the company's stronger performing nuclear energy, operations, and services businesses. The mPower unit cut \$81 million from Babcock & Wilcox's 2013 total segment income and \$27.7 million in the fourth quarter, a significant hit to both full-year and fourth-quarter profits.

While Babcock & Wilcox had been shoveling about \$100 million a year into mPower and initially provided guidance of between \$60 million and \$70 million of investment in 2014, those forecasts were revised by management in mid-April to just \$15 million a year. That reduced spending plan for mPower caused analysts at **William Blair** and **UBS** to increase their full-year estimates for Babcock & Wilcox's earnings.

For Blue Harbour, which began buying Babcock & Wilcox shares in early March, the company's reduced mPower spending is just one move the company can take to improve its earnings and stock performance.

Besides mPower spending reductions, Babcock & Wilcox may be able to better manage its coal-related businesses to stem

declining margins. Given its low debt load, Babcock & Wilcox may also be able to take up its leverage as a means to buy back stock, potentially increasing the value of its shares when that turnaround plan is complete.

Blue Harbour, which has had discussions with Babcock & Wilcox since taking a stake in the company, is optimistic about change. In late April, Blue Harbour's head Cliff Robbins, presented the fund's analysis of Babcock & Wilcox at the **IMN Active-Passive Investor Summit**.

"We think Babcock & Wilcox will make all the right choices to expedite the process to mitigate what is weighing on their valuation," Robb LeMasters, a managing director at Blue Harbour, said in a telephone interview with *TheStreet* on Friday.

Babcock & Wilcox is currently in a net cash position, given its year-end long-term debt level of just \$225 million. A leveraging of the company to just one times net debt-to-earnings before interest, taxes, depreciation and amortization (EBITDA) would imply as much as a 20% reduction in Babcock & Wilcox's share count.

"We think they should reduce the share count today," LeMasters said.

In April, Babcock & Wilcox said its 2014 priorities included increasing margins in its commercial business segment as a means to address challenges in the company's coal and nuclear businesses. Babcock & Wilcox identified a 2%-to-3% improvement in margins in the company's power generation segment and a 10% operating income margin at its nuclear energy business by the end of 2015.

Babcock & Wilcox's guidance stated it would reach decision on the best path forward for mPower by mid-2014, and that the company would leverage its balance sheet to support "a more aggressive return of capital to our shareholders."

“Babcock & Wilcox has a longstanding policy of open communications with its shareholders. We appreciate Blue Harbour’s support of our management team and their confidence in our strategies for enhancing shareholder value,” Aimee Mills, a Babcock & Wilcox spokesperson said in an e-mail Tuesday.

“We look forward to maintaining an open dialogue with all of our shareholders, including Blue Harbour, as we focus on delivering advanced engineering, manufacturing, and construction solutions to meet the demands of our global customers,” Mills added.



No Board Seats, Strong Reviews

Change may just be beginning at Babcock & Wilcox, but don’t expect to hear too much about the company’s turnaround.

Blue Harbour, which has \$3 billion in firm-wide assets, has proven a capable value investor targeting corporate change. However, the fund has never needed to take a board seat to accomplish its objectives, whether it was strategic and financial changes at **PVH Corp.** (PVH), a securitization deal at **Domino’s Pizza** (DPZ), balance sheet realignment at defense contractor **CACI Systems** (CACI), or the promotion of a franchised restaurant model at **Jack in the Box** (JACK).

“We have never needed a board seat but we have been offered

a board seat by several of the companies we have invested in,” LeMasters said.

The fund’s Web site almost reads like a five-star **Yelp** (YELP) review of corporate activism.

“We are pleased to have had Blue Harbour as a major shareholder in CoreLogic,” **Corelogic’s** chairman D. Van Skilling is quoted as saying on the firm’s Web site. “They were the type of investor that any Board and management group would welcome,” Van Skilling added.

“Blue Harbour has been a thoughtful lead shareholder in Phillips-Van Heusen. They have been very helpful as we consider both strategic and financial alternatives to build value for our shareholders,” PVH CEO Emanuel Chirico adds.

The list goes on.

Recent successes for Blue Harbour include an investment in **Akamai Technologies** (AKAM) and defense contractor CACI International, two strongly-performing stocks that Robbins presented at the **Ira Sohn Investment Conference** in 2013.

“We try to take a friendly approach to activism,” LeMasters, the Blue Harbour MD, said.

Other Hedge Fund Investors

Babcock & Wilcox has also caught the eye of other large and oftentimes vocal hedge funds. In fact, the company count’s two hedge funds run by someone with the last name of Robbins as a large investor.

Larry Robbins-run **Glenview Capital Management** holds a 5% stake in Babcock & Wilcox shares, while **Mason Capital Management** currently holds an about 10% stake and David Einhorn-run **Greenlight Capital Management** holds a 3.61% stake, according to SEC filings compiled by *Bloomberg*.

Starboard Value, **Shapiro Capital Management** and **Silvercrest** Asset Management are other hedge fund investors in Babcock & Wilcox shares. Mutual fund firm **T. Rowe Price** is Babcock & Wilcox’s largest shareholder with an about 14.5% stake in the company’s shares.

Babcock & Wilcox shares have gained over 2% yea-to-date and over 20% in the past-12 months.

-- *Written by Antoine Gara in New York.*



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