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Value Investor INSIGHT

The Leading Authority on Value Investing

The following excerpt, reprinted with permission, is from an interview with Cliff Robbins as part of a feature titled "Activism: What's Next?" in the March 31, 2016 issue of *Value Investor Insight*.

INVESTOR INSIGHT

Cliff Robbins
Blue Harbour Group

"There are three things of particular interest: mergers and acquisitions, operational overhauls and sum-of-the parts plays."

Activist money managers wouldn't have attracted the assets they have without putting up good numbers. Are there any general trends in recent years that you think have supported that performance?

Cliff Robbins: There's been a sea change in the corporate-governance environment in the last five years that I think has been critical to activist strategies becoming even more effective. Large state pension plans, the largest stockholders in America, have started pushing for the democratization of shareholder rights. Giant passive investors have been much more engaged with companies and more supportive of activists. Proxy advisory firms like Institutional Shareholder Services have become more important. The result is that it's well established practice today that if a current or prospective large stockholder wants to meet with the board and/or company management, that meeting is going to happen. This makes for an environment conducive to activism. You can have the greatest ideas in the world but if you can't get a company to listen to you, it's to little effect.

Are there cyclical aspects to activism?

CR: Not so much to activism in general, but more to the tools in the activist toolbox. We've been doing this for 12 years, and not every value-unlocking approach works all the time. One of the skills of a good activist is to be able to use the tools appropriate to the time.

What do you think those tools are today?

CR: There are three things of particular interest. One is around mergers and acquisitions. This isn't particularly new, but we expect strategic buyers to remain active, driven by confidence returning to the boardroom and by low financing costs making it much easier for acquisitions to be accretive to earnings per share. Whether in acquisitions or divestitures, activists can help lay the groundwork for deals that may otherwise be missed.

A second area of opportunity would be operational overhauls. When the economy is less robust it's very important for companies to improve their margin profile. This is an area where credible activists can make a real difference to better position companies for upside when the growth environment improves.

We also still see potential in sum-of-the-parts plays. The market can be inefficient in valuing a company in different industries, due to lack of knowledge, lack of effort, or both. We've had good success in identifying companies where value can be unlocked through focus, say by splitting the company in two or spinning out one or more divisions. I expect this to continue to be a fruitful theme.

Is Babcock & Wilcox, which you highlighted last time we spoke [*VII*, April 30, 2014], a good example of such a sum-of-the-parts play?

CR: This has been a classic Blue Harbour investment. We got involved two years ago because we didn't believe the market was accurately valuing the company's two very different businesses. One was a jewel of a defense business, making propulsion systems for aircraft carriers and submarines under long-term contracts with high margins and recurring revenues. The other was a lower-growth but still decent business that made coal-fired power plants and parts and equipment for power-plant maintenance and repair. The business is doing better than you might expect, given what's happened in coal, because companies are spending to upgrade their plants to meet tougher environmental standards. We argued that the two business separately would be valued more highly than they were together, which was at a lackluster 6x EBITDA and 12x P/E.

We ultimately built a 10% stake and the board accepted our recommendation to split the company. The defense business, called BWX Technologies [BWXT], now trades at more than 20x earnings. The power-plant business, Babcock & Wilcox Enterprises [BW], trades at a normal multiple for such a power company. The two pieces together have appreciated 45%, and we still own both and have further ideas for unlocking value.

We noticed one of your partners is on BWX Technologies' board. Have you changed your view, expressed two years ago, that you didn't want to go on boards?

CR: We still expect to have limited direct board involvement in our investments. We like having the flexibility to trade more freely, and given that we're almost always backing management, our being on the board is less necessary. In the case of BWX, we thought that since the board was being wholly reconstituted as part of the spinoff, it made sense for us at least initially to be on that board.

You don't hear of activists being involved that often with banks. Describe your interest in Investors Bancorp [ISBC].

CR: This is a New Jersey-based regional bank with $3.8 billion in market cap that operates in one of the best markets in the country in terms of concentration of both businesses and deposits. It does community banking, focused on small businesses and small business owners with which it can develop deep relationships. It's exceedingly well run by a management team that has been in place for about a decade and it sailed through the financial crisis without a hitch. Profitability and loan quality are excellent. They're opening branches, diversifying the customer base and gaining share in the markets they target. In 2015 loans grew 12%, deposits were up 15% and net income increased 20%. That's a good starting point.

What's unique here is that the company in 2014 did what's called a second-step conversion from mutual ownership, resulting in it raising $2 billion in a public offering at $10 per share. (We bought stock in the offering as well as subsequent to it, and we now own close to 9% of the shares outstanding.) That money is largely just sitting on the balance sheet, making up more than half the current market cap. Our recommendations, which management has been receptive to, are straightforward and simply focused on returning much of the excess capital to shareholders, through buybacks, dividend increases and special dividends.

How do you see that translating into upside for the shares, now trading at $11.60?

CR: Because of all the cash sitting there not earning a return, the stock today trades at about 115% of tangible book value. That compares with peers trading at more like 160% to 180% of tangible book. We're arguing that through returns of capital they should take their tangible capital equity ratio from the current 15.4% to a more normal 10% or lower. We estimate the combination of returned capital and the resulting revaluation of the shares should generate a roughly 30-50% IRR over the next few years.

Beyond that, once the stock value is up, we could imagine the company using equity as currency for acquisitions. They bought distressed assets during the financial crisis and we have confidence that management would be good stewards of capital on the M&A front if opportunities present themselves.

You've noted that companies have become more introspective and are taking activist initiatives themselves. Do you worry that puts you out of business?

INVESTMENT SNAPSHOT

Investors Bancorp
(Nasdaq: ISBC)

Business: Consumer and commercial bank with $20 billion in assets and a network of more than 140 branches located mostly in New Jersey, New York City and Long Island.

Share Information (@3/30/16):

Price	**11.61**
52-Week Range	10.77 – 13.13
Dividend Yield	2.1%
Market Cap	$3.81 billion

Financials (TTM):

Revenue	$609.2 million
Operating Profit Margin	47.8%
Net Profit Margin	29.8%

Valuation Metrics
(@3/30/16):

	ISBC	S&P 500
P/E (TTM)	21.1	23.5
Forward P/E (Est.)	20.0	17.5

Largest Institutional Owners
(@12/31/15):

Company	% Owned
Blue Harbour Group	8.5%
Vanguard Group	6.6%
Fidelity Mgmt & Research	6.1%
BlackRock	5.3%
Fuller & Thaler Asset Mgmt	4.5%

Short Interest (as of 3/15/16):

Shares Short/Float	4.4%

ISBC PRICE HISTORY

THE BOTTOM LINE
The company is extremely well run, showing strong growth in loans, deposits and earnings, but Cliff Robbins says the unique aspect of the investment thesis is its over-capitalized balance sheet that he recommends be used to return capital to shareholders. He believes doing so could generate a 30-50% IRR on the stock over the next few years.

Sources: Company reports, other publicly available information

CR: No. We only invest when we believe there are a series of levers that management can pull to unlock value. Even with more companies aware of the importance of practicing "self-help," it's rare even for the best-managed companies to pull all the levers without a push from external capital. And very often we want the value-enhancing changes to be bigger, bolder and faster. Do a bigger buyback. Cut costs much deeper. Sell the division now, not after a year-long McKinsey study. There always will be a need for that outside catalyst.

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