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Nuclear option

Before Babcock & Wilcox Co. (BWC on the Big Board) got into the nuclear power business, it was in the coal-fired power business, and before it became the Navy's virtual nuclear power monopolist, it was outfitting the engine rooms of President Teddy Roosevelt's Great White Fleet. Now unfolding is a bullish analysis of an underachieving stock.

Founded in 1867, B&W has a string of engineering firsts to its credit. But McDermott International Inc. (MDR), which acquired B&W in 1978, seems to have overlooked the fact that the company's innovative boilers were sheathed with asbestos. Faced with the wrath of the mesothelioma bar, McDermott cast B&W into bankruptcy in 2000, from which judicial kerosene bath B&W emerged in 2006. In 2010, the parent spun off its problem child to McDermott shareholders, one share of BWC for every two shares of MDR.

Today, B&W operates in four segments: power generation (54% of 2012 revenues), nuclear operations (33%), nuclear energy (10%) and technical services (3%). The sum of the parts is more valuable than the whole, we are about to contend.

The power generation group is the company dray horse. It makes boilers and related equipment for converting coal into steam, as well as equipment to reduce the toxicity of coal-fired emissions. The business isn't quite the relic it may seem. While low natural gas prices today preclude the construction of new coal-fed boilers, there's continuing demand for aftermarket parts and anti-pollution products. Alas, a recent court ruling has pushed back the timetable for the federally mandated installation of pollution-attenuating equipment that B&W would have been happy to produce and sell. Bulls live in hope that the Environmental Protection Administration will rewrite the rules that the courts have found defective, and thereby create more B&W power-generation customers through governmental edict.

The nuclear operations group is B&W's crown jewel. It makes reactors and components for the Navy's nuclear propulsion program.

The nuclear energy group is the company sleeper. It supplies commercial nuclear energy systems and components to public utilities. In addition—this is where the option comes in—it is developing small modular reactors (henceforth, SMRs) to compete with much bigger, much costlier conventional installations.

The technical services group, which protects top-secret nuclear sites, has become the company laughingstock. Last July, the B&W unit was on guard at the Y-12 National Security Complex at Oak Ridge, Tenn., when an 82-year-old nun, among others, walked through its supposedly impregnable defenses. B&W may or may not get to keep that particular government contract.

Babcock & Wilcox shares are quot-

Best is yet to come

source: The Bloomberg

Babcock & Wilcox Co.
(in $ millions, except per-share data)

	2012	2011	2010	2009	2008
Power generation	$ 1,786	$ 1,542	$ 1,425	$ 1,658	$ n/a
Nuclear operations	1,098	1,043	996	914	n/a
Technical services	108	120	90	120	n/a
Nuclear energy	326	321	196	175	n/a
Adjustments & eliminations	(26)	(74)	(18)	(12)	n/a
Total revenue	3,291	2,952	2,689	2,855	3,399
Pretax profit	319	94	220	272	(53)
Net income	228	78	140	172	16
Diluted EPS	$1.91	$0.66	$1.19	$1.46	$0.14
Diluted shares (in millions)	119	118	118	117	117
Total assets	$ 2,840	$ 2,789	$ 2,501	$ 2,604	$ 2,507
Net debt	(363)	(401)	(385)	(459)	(265)
Pension, other post retirement	650	667	663	805	773

source: company reports

ed in the stock market at 11.9 times the 2013 estimate, in line with such comps as KBR Inc. and Fluor Corp. But, as colleague Evan Lorenz points out, B&W is not quite comparable. True, results of the power-generation group cyclically fluctuate, but the crown jewel is winningly stable. "We love the nuclear business—the naval nuclear business," a B&W investor, who asks to remain anonymous, tells Lorenz. "It's the kind of business that—they would never want me to say this—but it is basically a monopoly. They are the only ones able to build these naval nuclear reactors. They are the only ones who can go in and refuel them. We think that it is one of the most protected programs out there."

"How should the market value the nuclear operations group?" Lorenz asks. And he answers himself: "Non-cyclical companies like Procter & Gamble and Colgate-Palmolive command multiples of enterprise value (equity cap plus debt minus cash) to EBITDA (earnings before interest, taxes, depreciation and amortization) in the neighborhood of 14 times. While B&W's nuclear operations group may lack the brand cache of P&G or Colgate, it has staying power, and, arguably, even more predictable cash flows than such all-American brands as Crest or Science Diet can generate.

"But let us capitalize the $258 million of EBITDA that B&W produces in the nuclear operations group not at 14 times but at 10 times," Lorenz goes on. "Such a multiple would imply per-share value of $22.59, the lion's share of the current share price of $27.20."

Which brings us to the company sleeper, the division that houses the B&W effort to produce the aforementioned pint-size reactor. The design, called mPower, is a 180-megawatt, light-water unit only one-fifth to one-tenth the size of conventional reactors. No need to plant mPower near a big body of water: it's designed to be cooled by air as well as by water. And no need to cart away the spent fuel: mPower's can be stored on site. As to refueling, once every four years will suffice, compared to the standard 18 to 24 months for the kind of reactor that powers such legacy nukes as Indian Point Energy Center north of New York City or Calvert Cliffs Nuclear Power south of Annapolis. Then, too, the mPower is designed to be planted underground, a likely deterrent, notes Lorenz, against octogenarian nuns or crashing planes.

B&W is conducting tests and preparing for the day it might install the first mPower plant at the Clinch River site of the Tennessee Valley Authority at Oak Ridge, Tenn. The company holds a clear lead in SMR technology. B&W, and B&W alone, was chosen last year to receive Department of Energy funds to build a prototype—the DoE had intended to bestow the funds on two contestants, but could identify no credible runner-up to Babcock & Wilcox. It's not a matter of technology but of time, the bull argument goes. "They will get up and running in 2020," our informant says. "How much do you want to pay for that? How many of these things do you think will get sold?"

Not an easy question. To reply, just venture an accurate forecast of the price of natural gas six years hence. Or take a stab at the hypothetical demand for clean electrical power in China and India a half-decade down the road. Or on the U.S. government's demand for power sources for far-flung military bases in the not foreseeable future.

In the meantime, B&W spends real—not hypothetical—money to finance research and development. It laid out $113 million in 2012. Another $85 million to $95 million is in the budget for 2013, over and above federal grants. Well aware of these costs is the front office.

"At current valuations, the market is assigning a value of just about zero to mPower," Lorenz observes. "It seems the wrong value. Say that the project proves to be a dead end, and one day B&W stops funding it. At that moment, EPS would climb by 52 cents. Assuming that the shares continue to trade at 11.9 times earnings, this would add $6.19 to the BWC price. Maybe, though, the technology will come into its own. 'These things would sell like candy in China,' a bullish partisan says. Well, yes—maybe.

"So mPower could deliver a lift to the stock price either by adding value through future sales or by meeting a timely end. The risk to the shares is that the project neither immediately fails nor ultimately succeeds, but drags on and on."

B&W is one year into the regime of CEO E. James Ferland. The former head of the America division of Westinghouse Electric Co., a subsidiary of Toshiba Corp., Ferland has announced plans to cut expenses by $40 to $50 million a year by mid-2015; the one-time cost of the economy drive is $60 million. On Nov. 7, Ferland unveiled a $250 million share-buyback program and an $0.08 per-quarter dividend (current yield 1.2%). While these are steps that any proper fiduciary could or should take, there is something to be said for doing the thing.

As to the balance sheet, B&W has net cash of $363 million, but an underfunded pension plan; $579.2 million is the actuarial deficit, while other post-retirement benefit obligations foot to $71.2 million. Management has taken a number of steps to mitigate its pension problem. For one thing, it has frozen the plan, effective in 2015. For another, it has rejiggered plan accounting such that plan losses are recognized as soon as they are incurred. (In this way, past amortization charges no longer weigh on current results.) Finally, the government reimburses B&W for pension costs of those employees who work on Navy contracts. Though the savings do not show up in the GAAP accounts, government assistance reduces B&W's underfunding by about two-fifths.

If you, gentle reader, were in CEO Ferland's shoes, would you not write a check to buy some B&W stock in the open market to express both your conviction about the future and your solidarity with the public investors? You might—we certainly would—though Ferland, as of the last report, had not.

And if you were running a business engaged in, among other needful activities, carbon dioxide control, particulate and dust control, mercury control and sulfur dioxide control, would you be content with generating all but 11% of your top line in the United States and Canada? Certainly not. You would outfit the sales force with gas masks and send them to China. As it is, the People's Republic accounts for just 1.4% of revenue. "We have a number of specific activities under way internally to try to grow our international presence," Jenny L. Apker, treasurer, vice president-investor relations, advises Lorenz. "We are actively exploring the best entrée for B&W in the Chinese environmental market." Good to hear.

And as for mPower, surely there's an opportunity outside the great state of Tennessee? "While we see potential for our SMRs in the U.S. market, we are not just building this for the U.S. market," Apker comments. "We think there are strong markets for our mPower product outside of the U.S. We have identified markets—Asia, specifically, and the Middle East. In the Middle East, the power needs for desalinization plants are huge and today they are supplied by oil. The major oil producers would rather not be burning their assets if there is an equally cost-effective way for producing power for desalinization. Another market with great potential is China, but there are [also] other markets across Asia, the Middle East and Europe."

Thus, for B&W, it's onward and upward—and, if all goes according to plan, outward, too.

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