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Blue Harbour's Activism at Babcock & Wilcox (B)

It was early June 2017, and Blue Harbour Group (Blue Harbour) was preparing to exit its position in BWX Technologies, Inc. (BWXT). Robb LeMasters (MBA '05) couldn't help but be pleased: BWXT's stock had risen over 120% since it was spun off from parent Babcock & Wilcox on July 1, 2015 following the suggestion of LeMasters and Blue Harbour (see **Exhibit 1** for BWXT's stock performance). LeMasters joined BWXT's board following the spinoff and had worked on value creation initiatives that were part of Blue Harbour's initial investment thesis, which Blue Harbour founder and CEO Clifton Robbins had first publicly presented at an investment ideas conference in April 2014.

LeMasters recalled the lukewarm market reaction right after the spinoff occurred and how he and Blue Harbour had looked at the opportunity after the spinoff: "Now you've got a clean company that should be valued very differently than the old company." Any lingering doubts after the spinoff that LeMasters and Blue Harbour could actively help improve BWXT after the spinoff had been wiped away as LeMasters helped the new company as it rethought its balance sheet, revamped its executive ranks, and developed a capital markets communications strategy.

With Blue Harbour about to exit, LeMasters reflected on the work that he and Blue Harbour did after the spinoff to increase BWXT's value.

Executing on the Board

Changing Guidance

BWXT presented ambitious guidance at its June 17, 2015 investor day, guiding to high-single to low-double digit EPS growth over the next three to five years. To LeMasters, it was BWXT's major first step in changing perception of the new defense company. Such an aggressive multi-year target proclaimed to investors and employees alike that this new company would aggressively pursue a growth strategy and would not be standing still. BWXT followed through on that confident posturing during its August 9, 2016 second quarter earnings call, when it decided to raise its 2016 guidance. Chairman John Fees provided the updated target and rationale:

Due to our impressive first-half results and the strength of our operations, we are increasing our non-GAAP EPS guidance range by \$0.07 per share to be between \$1.57 and

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\$1.67 for the full year of 2016. The increase is primarily driven by higher-than-expected operating income in the nuclear operations business due to favorable timing of long lead material, as well as contract improvements. As a result, we are increasing our consolidated revenue guidance range by \$50 million and now expect \$1.45 billion to \$1.5 billion of revenue for the year.¹

The company justified its optimistic guidance when it released its annual results for 2016 on February 27, 2017. EPS for 2016 was \$1.76, above BWXT's guidance and 24% higher than the prior year's pro forma EPS, as consolidated revenue grew 9.5% to \$1.55 billion.² After several quarters of successful execution, the management team raised the floor to their longer range expectations for EPS growth above the previous "high single digits" level, saying in their earnings release: "Beyond 2017, we anticipate an EPS CAGR in the low double digits over the next 3-5 years based upon our robust organic growth strategy and remaining balance sheet capacity." In response, BWXT's stock rose 8.6% the next day, the largest single day jump in price since the spinoff, standing at \$46.44.³ LeMasters saw it as an inflection point for BWXT in terms of market reaction: "It really solidified how strong the business was, how committed BWXT was to properly deploying capital and how confident the company would be at finding new avenues for growth."

Finding the Right CEO

One of the most pressing issues for LeMasters and the board of BWXT to address was identifying Baker's successor. The next CEO would need to have experience working with the government, have public company experience interacting with shareholders and be able to think strategically about how to get BWXT into a higher gear of growth.

The board moved quickly to hire Rex D. Geveden as COO, and Baker's apparent successor as CEO, making the announcement on October 7, 2015. Geveden was an executive vice president at industrial conglomerate Teledyne Industries, and concurrently served as president of Teledyne DALSA Inc., a commercial digital imaging and semiconductor producer.⁴ He also spent 17 years working at the U.S. National Aeronautics and Space Administration (NASA), serving at the administration's COO.⁵ Geveden became BWXT's CEO on January 1, 2017.⁶ LeMasters and the other board members also filled out the rest of the board (see **Exhibit 2** for BWXT's board of directors).

Share Repurchase and the Balance Sheet

After the spinoff, LeMasters encouraged BWXT to engage in an aggressive accelerated share repurchase scheme given the strong core business. The improved capital allocation through the share repurchase was an important step for LeMasters, both because it was a step to rationalizing BWXT's balance sheet and as a good investment of excess capital in an undervalued asset whose risks and opportunities the Board thoroughly understood. LeMasters approached the board saying, "Presently, your core business doesn't have a lot of on-strategy M&A targets that make sense to pursue. Therefore, [you have] a steady company, generating a lot of cash, what are you going to do with it? Maybe we return some of that cash to shareholders and buy back stock at good prices. That would be value enhancing."

LeMasters recognized the potential backlash if EPS growth would only be generated with aggressive share repurchases but he knew the new company had a slew of organic growth projects that would bear fruit: "Your business needs to be growing organically and not solely manufacturing earnings growth through retiring shares." As a result, there was some deliberation on the board prior to the announcement of the repurchase program, as LeMasters recalled:

There was a lot of discussion on the board. "Well, we don't know what the stock price will be, we don't want to look silly, we're not sure about the precise intrinsic value, so let's spread it out." My view was, we can arrive at that decision right now, we can sit down and think about whether this is a good investment now, and if we want to allocate \$300 million, let's do it now.

From its spinoff to the end of the first quarter of 2016, BWXT repurchased just over \$100 million in stock.⁷ BWXT also announced a \$300 million accelerated share repurchase program on February 26, 2016, which analysts at investment bank William Blair expected to "account for the largest portion of BWX's current capital allocation."⁸ The accelerated program was a result of the discussions LeMasters had on the board, and he said that the program had a positive effect on market sentiment.

mPower

Although BWXT had announced that it was cutting funding for the mPower modular nuclear reactor project to less than \$15 million annually, the company's continuing involvement in the project was up for discussion. Some within BWXT's management believed that the project was still worthwhile, but LeMasters wanted the company to drop it and focus on nuclear operations.

LeMasters worked to understand the business and financial issues of continuing with the research project, asking management and the rest of the board, "Is there a reasonable business case behind spending this money? How sure can we be that revenue in 2025 could be X or Y and if you can't have strong conviction in that, well then you need to spend a lot less or nothing [on the project]." Blue Harbour and LeMasters went to the board with an open mind, knowing that this was the best way to approach the future of mPower: "We went to the board and said, 'Look, we're happy to be convinced if there's a great investment case here, behind investing in an R&D project, we're all ears. That could be the next leg of growth. But we've all got to be convinced this is a good use of capital.'" LeMasters and the board eventually asked BWXT's management to find an investor for the project; "If it [the opportunity] is so huge, then other people should be willing to put their money behind it," reasoned LeMasters.

Eventually, BWXT entered into a new agreement with its original partner on the mPower project, Bechtel, over the future of mPower on March 2, 2016 that gave it flexibility to continue with the project if a new investor was found. Under the agreement, Bechtel had one year to find a third-party investor in the project, be they from the public or private sector. If Bechtel found such an investor, then it would take over management of the project from BWXT, and BWXT would be responsible for in-kind development costs of \$60 million, capped at \$12 million per year. If Bechtel could not find an investor, then the mPower program would end, and BWXT would be responsible for a \$30 million settlement charge to Bechtel.⁹

In the end, Bechtel and BWXT were unable to find a third party investor.

Reflecting on the Investment

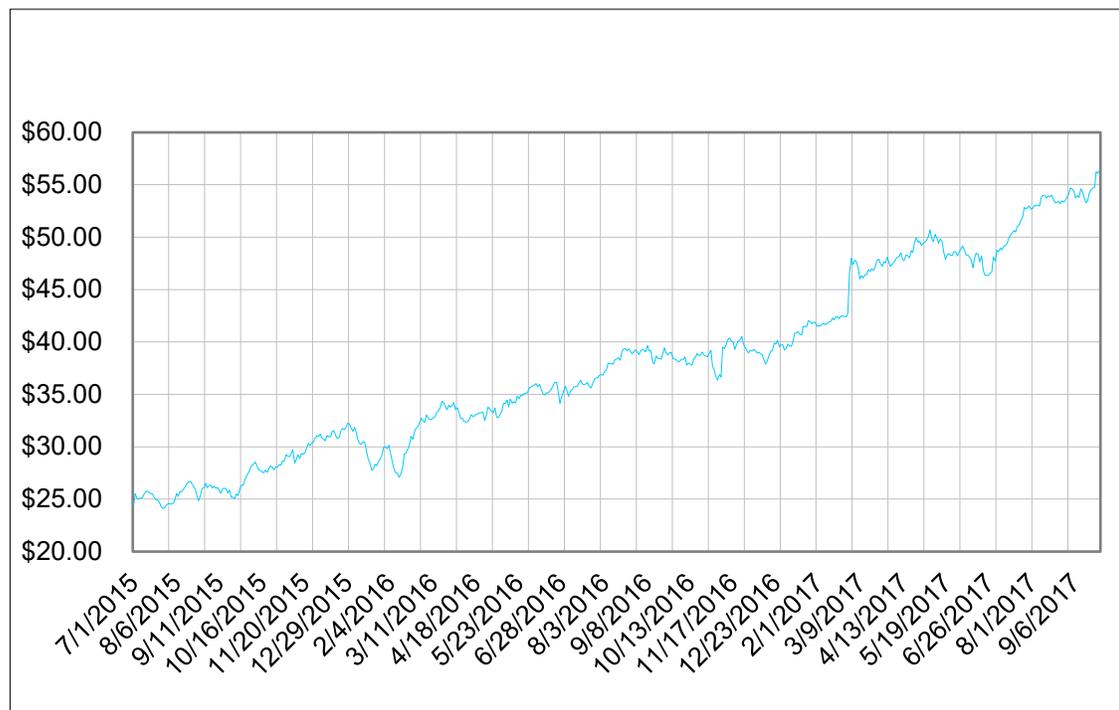
In the second quarter of 2017, BWXT continued to raise expectations, increasing its full year 2017 EPS guidance by \$0.12 to \$1.97 to \$2.07 off its results in the previous six months and a strong backlog of orders, which stood at \$3.8 billion.¹⁰ At the midpoint of the new guidance, BWXT would again be calling for double digit earnings growth of 13% year over year. In the previous six months, operating income had risen 4.4% to \$92.3 million while margins increased to 22.5% (see **Exhibits 3-5** for BWXT's financials).¹¹ LeMasters thought back to right before joining the board:

There were times where I thought, "You know, I hope this list [of value-creating initiatives] generates value. You never know whether everybody knows that mPower is likely to be less of a headwind. Stocks are only reflective of the future earnings of the company. It seemed obvious to me that earnings would expand because mPower would shut down, but I didn't know whether other people assumed that or not. It seemed obvious to me that you had a major balance sheet lever now that this was a clean company with plenty of stability for a board to do a host of actions such as instituting a dividend, buying back stock, ramping up investment in their core business and pursuing accretive acquisitions but sometimes we just have to wait and wait until the market wakes up to it.

Blue Harbour judiciously sold down its position over several quarters until finally fully exiting its position in September 2017. LeMasters remained on the board to assist where necessary. Since the spinoff, BWXT's stock price had increased over 120%, surging on the strength of its nuclear operations. Robbins believed that the future of the company was bright, but explained why Blue Harbour decided to exit and the role of activist investors: "This stock is likely to go higher, and we're rooting for them. But we're in the risk/reward business—the activist part is over, our job is done. The risks are not the same at \$53 a share as they were at \$26."

Robbins further reflected on the investment:

It was perfect because it was misunderstood, not well covered, in the right size for us, and we had so many levers—you don't often find so many levers... And, of course, the best thing about it was we were able to be successful. Because it's easier to find it than to convince them to do it... The separation [of the two companies] was clever, but the real money's been made at BWXT since the separation. Making acquisitions, getting out of businesses they shouldn't have been in, their capital structure. So it really was the perfect storm—a pleasant storm, really.

Exhibit 1 BWX Technologies, Inc. Stock Price

Source: S&P Capital IQ.

Exhibit 2 BWX Technologies, Inc. Board of Directors, 2015

Name	Biography	First Year on Board	Holdover from B&W Board
John A. Fees (Chairman)	CEO of McDermott, 2008-2010, and CEO of Babcock & Wilcox, 2007-2008. Former president and COO of BWX Technologies, then a subsidiary of Babcock & Wilcox.	2010	Yes
Robert L. Nardelli	Founder and CEO of investment and consulting firm XLR-8. Formerly the chairman and CEO of Chrysler LLC and chairman, president, and CEO of Home Depot, Inc. Nardelli held several senior executive positions at General Electric, and served on the boards of Home Depot, Coca-Cola, Chrysler, and Pep Boys.	2014	Yes
Richard W. Mies	Retired Admiral, U.S. Navy. Mies served in the Navy for 35 years, most recently as Commander in Chief of the U.S. Strategic Command from 1998-2002. After his Navy service, Mies served as senior vice president of Science Applications International Corporation. Board member of Exelon Corporation and Mutual of Omaha Insurance Company.	2010	Yes

Name	Biography	First Year on Board	Holdover from B&W Board
Robert W. Goldman	Former senior vice president and CFO at Conoco Inc., predecessor to ConocoPhillips, 1998-2002. Former vice president of finance at the World Petroleum Council. Board member at Parker Drilling Company and Tesoro Corporation. Former board member of McDermott and El Paso Corporation	2010	Yes
P. Sandy Baker	CEO and president of BWX Technologies following the spinoff of the company in July 2015. Formerly the president of Government and Nuclear Operations for Babcock & Wilcox.	2015	No
Robb A. LeMasters	Managing director at Blue Harbour Group. Former founding partner at Theleme Partners and partner at the The Children's Investment Fund.	2015	No
Jan A. Bertsch	Executive Vice President and CFO of Sigma-Aldrich Corporation, a life science and technology company. Former vice president, controller, and principal accounting officer of Borg Warner, Inc., and former senior vice president, treasurer, and CIO for Chrysler Group, LLC.	2013	Yes
Charles W. Pryor	Former chairman and CEO of Westinghouse Electric Company. Board member of DTE Energy Company and former chairman of Urenco USA. Spent 25 years with BWXT, serving as president of the Nuclear Power division.	2015	No

Source: BWX Technologies, Inc. Proxy Statement 2016. BWX Technologies, March 18, 2016, p. 7-10.

Exhibit 3 BWX Technologies, Inc. Income Statement, 2015-2017 (Millions USD)

	2015	2016	LTM June 2017
Revenue	1,415.5	1,550.6	1,621.6
Other Revenue	-	-	-
Total Revenue	1,415.5	1,550.6	1,621.6
Cost Of Goods Sold	1,027.4	1,074.5	1,128.3
Gross Profit	388.1	476.0	493.4
Selling General & Admin Exp.	207.8	216.5	218.9
R & D Exp.	10.5	6.4	5.8
Depreciation & Amort.	-	-	-
Other Operating Expense/(Income)	-	-	-
Other Operating Exp., Total	218.3	222.9	224.7
Operating Income	169.8	253.2	268.7
Interest Expense	(10.2)	(8.4)	(12.5)
Interest and Invest. Income	30.3	0.7	0.6
Net Interest Exp.	20.2	(7.7)	(11.9)
Income/(Loss) from Affiliates	13.4	16.1	15.0
Currency Exchange Gains (Loss)	(1.7)	0.4	0.4
Other Non-Operating Inc. (Exp.)	0.2	(29.3)	(10.3)
EBT Excl. Unusual Items	201.9	232.6	261.8
Restructuring Charges	(16.6)	-	-
Impairment of Goodwill	-	-	-
Gain (Loss) On Sale Of Invest.	(3.6)	1.8	1.9
Gain (Loss) On Sale Of Assets	(0.4)	13.6	0.0
Legal Settlements	65.7	-	-
Other Unusual Items	(26.0)	9.3	9.3
EBT Incl. Unusual Items	221.1	257.3	273.0
Income Tax Expense	80.4	73.7	80.5
Earnings from Cont. Ops.	140.6	183.6	192.6
Earnings of Discontinued Ops.	(9.2)	-	-
Extraord. Item & Account. Change	-	-	-
Net Income to Company	131.4	183.6	192.6
Minority Int. in Earnings	0.0	(0.6)	(0.6)
Net Income	131.5	183.1	192.0

Source: S&P Capital IQ.

Exhibit 4 BWX Technologies, Inc. Balance Sheet, 2015-2017 (Millions USD)

Balance Sheet as of:	12/31/2015	12/31/2016	6/30/2017
ASSETS			
Cash And Equivalents	154.7	125.6	147.9
Short Term Investments	3.5	14.5	4.4
Total Cash & ST Investments	158.2	140.2	152.4
Accounts Receivable	419.1	492.7	546.4
Other Receivables	22.3	25.2	10.1
Total Receivables	441.4	517.9	556.6
Inventory	-	-	7.9
Restricted Cash	15.4	6.1	7.1
Other Current Assets	32.3	29.4	21.6
Total Current Assets	647.3	693.6	745.5
Gross Property, Plant & Equipment	846.9	922.6	946.0
Accumulated Depreciation	(578.1)	(623.0)	(647.7)
Net Property, Plant & Equipment	268.8	299.7	298.2
Long-term Investments	38.2	51.9	50.4
Goodwill	168.4	210.8	214.9
Other Intangibles	58.3	114.7	113.0
Accounts Receivable Long-Term	1.7	1.7	-
Deferred Tax Assets, LT	181.4	194.5	182.8
Other Long-Term Assets	11.2	13.0	19.9
Total Assets	1,375.4	1,579.8	1,624.7
LIABILITIES			
Accounts Payable	74.1	100.0	68.5
Accrued Exp.	112.6	153.9	98.6
Curr. Port. of LT Debt	15.0	27.4	27.6
Unearned Revenue, Current	138.6	147.1	185.8
Other Current Liabilities	13.5	11.5	12.2
Total Current Liabilities	353.8	439.9	392.8
Long-Term Debt	278.3	497.7	489.3
Pension & Other Post-Retire. Benefits	378.9	376.1	359.8
Other Non-Current Liabilities	84.8	115.7	118.6
Total Liabilities	1,095.8	1,429.4	1,360.4
Common Stock	1.2	1.2	1.3
Additional Paid In Capital	22.7	22.0	87.7
Retained Earnings	739.4	885.1	982.0
Treasury Stock	(498.3)	(762.2)	(813.3)
Comprehensive Inc. and Other	0.8	3.8	6.3
Total Common Equity	265.7	150.0	264.0
Minority Interest	13.9	0.4	0.4
Total Equity	279.6	150.4	264.3
Total Liabilities And Equity	1,375.4	1,579.8	1,624.7

Source: S&P Capital IQ.

Exhibit 5 BWX Technologies, Inc. Cash Flow, 2015-2017 (Millions USD)

For the Fiscal Period Ending	12/31/2015	12/31/2016	6/30/2017
Net Income	131.5	183.1	192.0
Depreciation & Amort.	55.3	48.4	51.9
Amort. of Goodwill and Intangibles	1.9	2.2	2.2
Depreciation & Amort., Total	57.2	50.6	54.1
(Gain) Loss From Sale Of Assets	26.4	(13.6)	0
(Gain) Loss On Sale Of Invest.	2.1	-	-
(Income) Loss on Equity Invest.	1.9	(1.0)	3.4
Stock-Based Compensation	31.7	15.4	16.4
Net Cash From Discontinued Ops.	21.5	-	-
Other Operating Activities	15.6	16.3	16.3
Change in Acc. Receivable	97.3	(31.9)	17.5
Change in Acc. Payable	(24.0)	19.5	(17.6)
Change in Inc. Taxes	(7.0)	13.2	18.5
Change in Other Net Operating Assets	(19.0)	(11.6)	(69.7)
Cash from Ops.	335.2	239.9	230.9
Capital Expenditure	(68.3)	(52.6)	(62.9)
Sale of Property, Plant, and Equipment	0.1	0.0	0.1
Cash Acquisitions	-	(117.8)	(117.8)
Divestitures	-	-	-
Invest. in Marketable & Equity Secur.	(7.2)	(18.6)	10.3
Net (Inc.) Dec. in Loans Originated/Sold	-	-	-
Other Investing Activities	3.6	9.2	(2.0)
Cash from Investing	(71.9)	(179.7)	(172.2)
Short Term Debt Issued	-	-	-
Long-Term Debt Issued	177.4	539.5	-
Total Debt Issued	177.4	539.5	613.1
Short Term Debt Repaid	-	-	-
Long-Term Debt Repaid	(177.4)	(305.9)	-
Total Debt Repaid	(177.4)	(305.9)	(385.8)
Issuance of Common Stock	7.3	18.3	18.0
Repurchase of Common Stock	(74.3)	(302.3)	(219.2)
Common Dividends Paid	(34.5)	(37.4)	(38.5)
Total Dividends Paid	(34.5)	(37.4)	(38.5)
Special Dividend Paid	-	-	-
Other Financing Activities	(312.9)	(1.2)	(1.2)
Cash from Financing	(414.4)	(88.9)	(13.6)
Foreign Exchange Rate Adj.	(7.1)	(0.4)	5.1
Net Change in Cash	(158.2)	(29.1)	50.1

Source: S&P Capital IQ.

Endnotes

¹ BWX Technologies Second Quarter 2016 Earnings Call Transcript. BWX Technologies, August 9, 2016, p. 6, via Thomson ONE/Thomson Reuters.

² BWX Technologies Fourth Quarter 2016 Earnings Call Transcript. BWX Technologies, February 28, 2017, p. 3, via Thomson ONE/Thomson Reuters.

³ S&P Capital IQ.

⁴ "BWXT Names Rex D. Geveden as Chief Operating Officer." BWX Technologies, October 7, 2015, <http://www.businesswire.com/news/home/20151007006474/en/>.

⁵ Ibid.

⁶ "BWXT announces Rex D. Geveden as next President and Chief Executive Officer." BWX Technologies, November 29, 2016, <http://www.businesswire.com/news/home/20161129006228/en/>.

⁷ Chase Jacobson and Paul A. Dircks, "BWX Technologies, Inc.L Visibility for Growth Remains; Expect Share Repurchases to Continue." William Blair, February 25, 2016, via Thomson ONE/Thomson Reuters.

⁸ Ibid.

⁹ Chase Jacobson and Paul A. Dircks, "BWX Technologies, Inc.: mPower Agreement a Net Positive; Provides Clarity and Defines Financial Obligations." William Blair, March 4, 2016, via Thomson ONE/Thomson Reuters.

¹⁰ BWX Technologies Second Quarter 2017 Earnings Call Transcript. BWX Technologies, August 8, 2017, p. 3, via Thomson ONE/Thomson Reuters.

¹¹ Ibid.