Babcock: The Market Did Not React To The Decline In The Oil Price

- I believe that the company's share price should decline as a result of the decline in the oil price.
- The SEC initiated an investigation. Investors need to know it.
- Two stakeholders own a large amount of Babcock's debt. In my opinion, there may exist conflict of interest.
- In my view, it is very likely that minority shareholders lose money.

Babcock & Wilcox Enterprises (BW) is executing a turnaround, and the market expects profitability in 2020 and 2021. However, minority shareholders may not benefit from the expected EBITDA increase. I am worried about the recent increase in the share count and new convertible securities. Additionally, the market has not reacted to the decline in the oil price, which will most likely damage Babcock's sales. Finally, I sincerely hope that the company finds new financing to continue its operations.

The Decline In The Oil Price Could Damage The Business Model

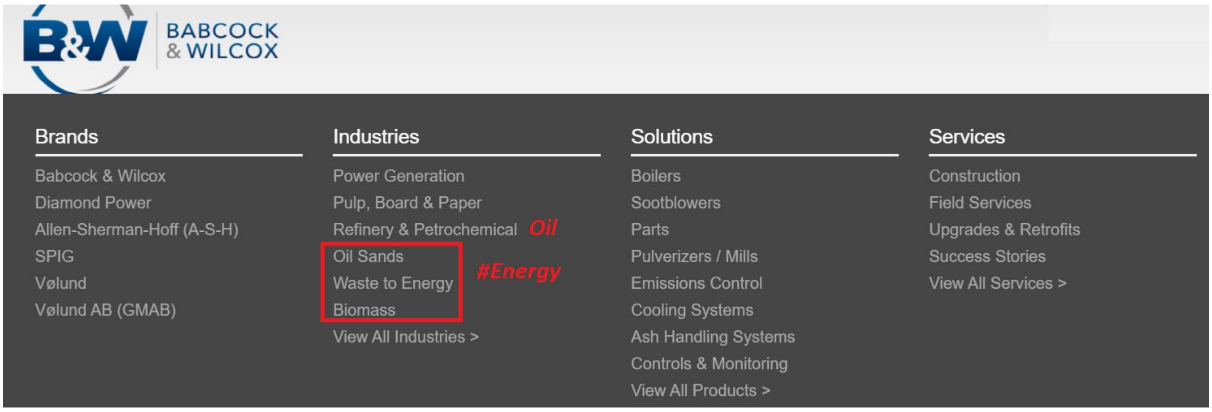
In April, most investors sold shares of oil companies when the oil price collapsed. That's not all. With a diminishing demand for gasoline, oil and gas companies expect a decrease in 2020 sales. They are selling less and at a smaller price than in 2019.

The market did well by selling oil & gas stocks. However, in my view, not many investors executed due diligence on other industries and corporations suffering from the decrease in oil prices. One of these stocks is Babcock & Wilcox Enterprises. As a result of the coronavirus, in March, the share price declined from $4 to $1. Notice that the company was seriously impacted by the spread of the coronavirus:

"Our business has been adversely impacted by the measures taken by local governments and others to control the spread of this virus. Our headquarters and the headquarters of our Babcock & Wilcox segment in Akron, Ohio, the headquarters of our Vølund & Other Renewable segment in Denmark and the headquarters of our SPIG segment in Italy (among other locations where we and our customers, vendors and suppliers operate) are currently subject to lock-down or shelter-in-place orders under local ordinances, with employees continuing to work remotely if possible. While some of our employees can work remotely, many of our customers and projects require our employees to travel to customer and project worksites." Source: 10-k

With that, I am unable to explain why the share price did not decline one month later. Oil futures went to negative territory, but the company's share price stayed at $1.9-$2.05.

Babcock & Wilcox offers custom technologies, aftermarket services, and engineered solutions to various power generation and industrial clients. The company's most relevant clients operate in the energy, oil, petrochemical, and renewable industry:



Source: Company's Website

In 2019, Babcock & Wilcox segment generated 80% of the total amount of revenue. This segment offers services for power generation. Given the most recent oil price collapse, I expect that the power generation industry will suffer a decline in revenue. As a result, Babcock & Wilcox Enterprises will most likely suffer a decline in sales.

(In thousands)	Year ended December 31, 2019	2018	$ Change
Revenues:			
Babcock & Wilcox segment — Services for steam-generating, environmental and auxiliary equipment for power generation and other industrial applications.	$ 688,340	$ 754,576	$ (66,236)
Vølund & Other Renewable segment -> For the waste-to-energy and biomass power generation industries.	121,861	181,182	(59,321)
SPIG segment -> Cooling systems for steam applications	80,729	153,625	(72,896)
Eliminations	(31,819)	(26,995)	(4,824)
	$ 859,111	**$ 1,062,388**	**$ (203,277)**

Source: 10-k

In its most recent annual report, Babcock & Wilcox Enterprises noted that volativel oil and natural gas prices would push demand for the company's products down. Taking into account this fact and the decline in the oil price in April and May, I believe that there is downside in the share price:

"Demand for our products and services has been, and we expect that demand will continue to be, subject to significant fluctuations due to a variety of factors beyond our control, including macroeconomic and industry conditions. These factors include, but are not limited to, the cyclical nature of the industries we serve, inflation, geopolitical issues, the availability and cost of credit, volatile oil and natural gas prices, low business and consumer confidence, high unemployment and energy conservation measures." Source: 10-k

Diminishing Sales, But Massive Cost Cutting

Babcock & Wilcox Enterprises is undertaking a turnaround of its business, which started way before the coronavirus hit. The income statement shows a decline in sales since Babcock sold several business units. 2019 sales were 19% less than 2018 sales. In the same time period, costs of operations declined by 26%, and restructuring activities were equal to $11.07 million. Babcock & Wilcox is really working hard to push its profits up. As a result of the company's efforts, the operating loss increased from -$426 million to -$29 million.

(in thousands, except per share amounts)	Year ended December 31, 2019	2018
Revenues	$ 859,111	$ 1,062,388
Costs and expenses:		
Cost of operations	698,853	1,192,032
Selling, general and administrative expenses	151,069	204,706
Goodwill and other intangible asset impairment	—	40,046
Advisory fees and settlement costs	27,943	18,625
Restructuring activities and spin-off transaction costs	11,707	16,758
Research and development costs	2,861	3,780
(Gain) loss on asset disposals, net	(3,940)	1,438
Total costs and expenses	888,493	1,477,385
Equity in income and impairment of investees	—	(11,603)
Operating loss	**(29,382)**	**(426,600)**

Source: 10-K

A quick look at the bottom line reveals that interest expenses increased significantly in 2019. It may be a concern for conservative investors. With that, the company is still not reporting positive net income. Babcock lost $121 million in 2019, $3.87 per share:

Operating loss		**(29,382)**		**(426,600)**
Other (expense) income:				
Interest expense		(94,901)		(49,613)
Interest income		923		244
Loss on debt extinguishment		(3,969)		(49,241)
Gain (loss) on sale of business		(3,601)		39,815
Benefit plans, net		22,800		(42,123)
Foreign exchange		(16,602)		(28,542)
Other – net		285		259
Total other expense		(95,065)		(129,201)
Loss before income tax expense		**(124,447)**		**(555,801)**
Income tax expense		5,286		102,224
Loss from continuing operations		**(129,733)**		**(658,025)**
Income (loss) from discontinued operations, net of tax		694		(66,832)
Net loss		**(129,039)**		**(724,857)**
Net loss (income) attributable to non-controlling interest		7,065		(435)
Net loss attributable to stockholders	$	**(121,974)**	$	**(725,292)**
Basic and diluted loss per share - continuing operations	$	(3.89)	$	(47.62)
Basic and diluted earnings (loss) per share - discontinued operations		0.02		(4.83)
Basic and diluted loss per share	$	**(3.87)**	$	**(52.45)**

Source: 10-K

The market consensus is that sales will decline to $567 million in 2020, and EBITDA will creep up to $21 million and $62 million in 2020 and 2021 respectively. Given the efforts made in 2018 and 2019, I do believe that the company could be profitable in two years. Even if the oil price does not increase from its current level, in my view, Babcock & Wilcox will most likely be profitable. Keep in mind that the company is selling non-performing business units. With that, perhaps, shareholders may not profit from the turnaround. Shareholders should monitor the share count, the amount of debt, and the actions of management. That’s what matters on this name.

The Financial Position Is Worrying - The Coronavirus Did Not Help

As of December 31, 2019, cash and cash equivalents were equal to $43 million. The most significant assets are accounts receivables, equal to $165 million, and contracts in progress worth $91 million. Babcock doesn’t seem to be paying very fast. Thus, the company had to finance its operations with a significant amount of debt.

(in thousands, except per share amount)		December 31, 2019		December 31, 2018
Cash and cash equivalents	$	43,772	$	43,214
Restricted cash and cash equivalents		13,169		17,065
Accounts receivable – trade, net		142,201		197,203
Accounts receivable – other		23,263		44,662
Contracts in progress		91,579		144,727
Inventories		63,103		61,323
Other current assets		27,044		41,425
Current assets held for sale		8,089		—
Total current assets		412,220		549,619
Net property, plant and equipment, and finance lease		97,053		90,892
Goodwill		47,160		47,108
Intangible assets		25,300		30,793
Right-of-use assets		12,498		—
Other assets		24,966		27,085
Non-current assets held for sale		7,322		—
Total assets	**$**	**626,519**	**$**	**745,497**

Source: 10-k

Including the revolving credit facilities, the term loans and the pension liabilities, I get a total sum of $571 million. It is way below the current amount of cash. Besides, notice that the company's asset/liability ratio is under one. Conservative individuals may pass on the company because of the current financial position.

Revolving credit facilities	$	179,000	$	145,506
Last out term loans		103,953		30,649
Accounts payable		109,913		199,882
Accrued employee benefits		18,256		19,319
Advance billings on contracts		75,287		149,367
Accrued warranty expense		33,376		45,117
Operating lease liabilities		4,323		—
Other accrued liabilities		68,848		122,149
Current liabilities held for sale		9,538		—
Total current liabilities		602,494		711,989
Pension and other accumulated postretirement benefit liabilities		259,272		281,647
Non-current finance lease liabilities		30,454		—
Non-current operating lease liabilities		8,388		—
Other non-current liabilities		20,850		29,158
Total liabilities		**921,458**		**1,022,794**

Source: 10-k

The most worrying about Babcock's financial situation is the sale of business units. I believe that the company is very desperate to obtain cash. In 2019, the company sold a material handling business in Germany for $11.4 million. According to the 10-k, the business sold generated $30 million in revenue. In my opinion, selling businesses for 0.38x sales does not look good.

"Effective May 31, 2019, we sold all of the issued and outstanding capital stock of Loibl, a material handling business in Germany, to Lynx Holding GmbH for €10.0 million (approximately $11.4 million), subject to adjustment. Prior to the divestiture, Loibl was part of the Vølund & Other

Renewable segment and had revenues of approximately $30 million for the year ended December 31, 2018." Source: 10-k

In the last annual report, Deloitte, the auditor, noted that the company would continue as a going concern. It was clearly stated by Deloitte that from May 11, 2020, the company would need to refinance its financial obligations.

Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has uncertainty regarding its ability to refinance its Credit Agreement by May 11, 2020, which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Source: 10-k

As of May 12, 2020, Babcock & Wilcox Enterprises communicated that it was preparing an announcement of an agreement with creditors. In my view, even with a new debt agreement, the total amount of debt is very significant. Bankers are taking over the company. Minority shareholders will most likely lose money on this stock:

B&W Provides Update on Refinancing

May 12, 2020

- Company expects to make a definitive announcement regarding a longer-term financing package by May 15, 2020

(AKRON, Ohio – May 12, 2020) – Babcock & Wilcox Enterprises, Inc. (NYSE: BW) ("B&W" and the "Company") announced today that the Company is nearing the completion of its financing process and expects to make an announcement regarding its debt refinancing on or before the May 15, 2020 deadline under its current amended Credit Agreement. The Company and its lenders are in the process of finalizing a definitive agreement for a longer-term credit extension.

Source: Press Release

Risk Of Dilution And A Reverse Stock Split

When bankers take over a company, many times it does not go bankrupt straight away. Instead, the company issues a significant amount of convertible securities like warrants, convertible debt, or equity rights, which gives the company a small amount of time. However, it reduces the intrinsic valuation of each common stock. Babcock & Wilcox Enterprises appears to be exactly at this point in time.

The company issued warrants and non transferable subscription rights to acquire a significant amount of shares:

“On July 23, 2019, 1,666,667 warrants were issued to certain entities affiliated with B. Riley in connection with the Equitization Transactions described in Note 19. Each warrant can be converted to one share of our common stock at an exercise price of $0.01 per share. As of December 31, 2019, all 1,666,667 warrants remain unexercised.” Source: 10-k

The Black-Scholes option pricing model key assumptions are as follows:

Stock price (1)	$	0.385
Exercise price	$	0.010
Time to expiration		3 years
Annualized volatility		121.00%
Annual rate of quarterly dividends		—%
Discount rate - bond equivalent rate		2.30%
Expiration of option		April 5, 2022
Warrant value	$	0.380

Source: 10-k

Notice also that debt holders are receiving shares in return. The company commenced to convert debt into equity. It is quite worrying. Minority shareholders may see an increase in the share count in the next few years. Yes, it does not matter that EBITDA increases in 2020 and 2021. If the total amount of shares increases, the share price will most likely decline:

The 2019 Rights Offering resulted in the issuance of 13.9 million common shares as a result of the exercise of subscription rights in the offering. Gross proceeds from the 2019 Rights Offering were $41.8 million, $10.3 million which was used to fully repay Tranche A-2 of the Last Out Term Loans and the remaining $31.5 million was used to reduce outstanding borrowings under Tranche A-3 of the Last Out Term Loans. Concurrently with the closing of the 2019 Rights Offering, and in satisfaction of the Backstop Commitment as described in Note 19, the Company issued an aggregate of 2.7 million common shares in exchange for a portion of the Tranche A-3 Last Out Term Loans totaling $8.2 million, to B. Riley, a related party, as described in Note 26. The 2019 Rights Offering was pursuant to the April 5, 2019 Letter Agreement and the Equitization Transactions described in Note 19 and were approved by stockholders at the Company's annual stockholder meeting on June 14, 2019.

Source: 10-k

On the top of it, in 2019, Babcock & Wilcox Enterprises executed a reverse stock split. Instead of focusing on building a better business model, Babcock pushed the share price up by reducing the total amount of shares outstanding:

"On July 11, 2019, the Company's board of directors approved a reverse stock split of one-for-ten on the Company's issued and outstanding common stock which became effective on July 24, 2019." Source: 10-k

Shareholder Class Action Litigation And SEC Investigation

I also discovered a shareholder class action litigation against Babcock & Wilcox Enterprises, which shareholders need to know. The plaintiff alleged fraud, and misrepresentation. As a result, the company paid $19.5 million to several investors. I wonder whether many more shareholders may receive money if they start an additional class action:

Stockholder Class Action Litigation

On March 3, 2017 and March 13, 2017, the Company and certain of its former officers were named as defendants in two separate but largely identical complaints alleging violations of the federal securities laws. The two complaints were brought on behalf of a class of investors who purchased the Company's common stock between July 1, 2015 and February 28, 2017 and were filed in the United States District Court for the Western District of North Carolina (collectively, the "Stockholder Litigation"). During the second quarter of 2017, the Stockholder Litigation was consolidated into a single action and a lead plaintiff was selected by the Court. Through subsequent amendments, the putative class period was expanded to include investors who purchased shares between June 17, 2015 and August 9, 2017. The plaintiff in the Stockholder Litigation alleged fraud, misrepresentation and a course of conduct relating to certain projects undertaken by the Vølund & Other Renewable segment, which, according to the plaintiff, had the effect of artificially inflating the price of the Company's common stock. The plaintiff further alleged that stockholders were harmed when the Company later disclosed that it would incur losses on these projects. The plaintiff sought an unspecified amount of damages.

Following denial of defendants' motion to dismiss the Stockholder Litigation and a period of additional discovery, the parties reached an agreement in principle to settle the Stockholder Litigation at mediation on April 16, 2019. The agreement required defendants to pay or cause to be paid $19.5 million into a settlement fund. Following the Court's preliminary approval of the settlement, the $19.5 million payment was made by certain of our insurance carriers. The Court held a hearing to consider final approval of the settlement on December 16, 2019 and entered its final order approving the settlement on December 20, 2019.

Source: 10-k

The SEC is investigating the case, in which Babcock & Wilcox decided to pay $19.5 million. If the SEC decides that the company needs to pay more money, the share price may decline even more:

"The U.S. SEC is conducting a formal investigation of the Company, focusing on the accounting charges and related matters involving the Company's Vølund and Other Renewable segment from 2015-2019. It is reasonably possible that the SEC may bring one or more claims against the Company and certain individuals. Due to the stage of the investigation, we are unable to estimate the amount of loss or range of potential loss of any claim. However, there can be no assurance that such claims will not have a material impact on the Company." Source: 10-k

Related Party Transactions - Debt Holders Took Control

Investors need to study carefully who appointed the directors in the Board. In this particular case, it is very relevant. One shareholder owns approximately 17% of the share count and a significant amount of debt. This large shareholder pushed the company to hire the current CEO. Please notice that the CEO of this financial institution is also the CEO of Babcock & Wilcox Enterprises. I see a lot of conflict of interests arising from the current situation:

Transactions with B. Riley

B. Riley became the beneficial owner of greater than five percent of our common stock in May 2018, upon completion of the 2018 Rights Offering described in Note 18. Based on its Schedule 13D filings, B. Riley beneficially owns 17.9% of our outstanding common stock, inclusive of the warrants further described in Note 16, as of December 31, 2019.

B. Riley is party to the Last Out Term Loans as described in Note 15 and Note 19 and was a party to the Equitization Transactions described in Note 19, which included providing the Backstop Commitment to the 2019 Rights Offering described in Note 18 and Note 19 and receiving warrants as described in Note 16 and Note 19. B. Riley is also party to the Backstop Commitment Letter where it has agreed to fund any shortfall in the Refinancing as described in Note 14.

We entered an agreement with BPRI Executive Consulting, LLC, an affiliate of B. Riley, on November 19, 2018 for the services of Mr. Kenny Young, to serve as our Chief Executive Officer until November 30, 2020, unless terminated by either party with thirty days written notice. Under this agreement, payments are $0.75 million per annum, paid monthly. Subject to the achievement of certain performance objectives as determined by the Compensation Committee of the Board, a bonus or bonuses may also be earned and payable to BPRI Executive Consulting, LLC.

Source: 10-k

Another financial institution is holding 33.9% stake in the company and is also owning term loans. Minority shareholders should be aware of the clear conflict of interest. I wonder whether the company's debt agreements with these institutions were in the best interest of Babcock & Wilcox Enterprises and its minority shareholders:

Transactions with Vintage Capital Management, LLC

Based on its Schedule 13D filings, Vintage beneficially owns 33.9% of our outstanding common stock as of December 31, 2019.

Vintage was a party to Tranche A-1 of the Last Out Term Loans as described in Note 15 and Note 19 and was a party to the Equitization Transactions described in Note 19, which included participation in the 2019 Rights Offering described in Note 18 and Note 19 and conversion of Tranche A-1 of the Last Out Term Loans in the Debt Exchange as described in Note 15 and Note 19. Prior to the Debt Exchange, $6.0 million of Tranche A-1 had been transferred or sold to affiliates of B. Riley and the remainder was held by Vintage.

Source: 10-k

Conclusion

Minority shareholders may be in trouble. Firstly, the decline in oil price didn't create a decline in Babcock's share price. It may happen in the following months. Additionally, the market believes in the company's turnaround. The EBITDA may increase in 2020 and 2021. However, with the increasing share count and the current debt level, minority shareholders may not see an increase in the share price. Finally, two large shareholders own a significant amount of debt. I believe that many conflicts of interest can arise from this situation.