those high 2007 levels soon, these stocks looked washed out, so much so that it won't take much good news to give them a jolt. If other sectors will benefit from the recovery, why wouldn't refiners?

McDermott International (MDR) has long been an unwieldy combination of two seemingly unrelated and disparate businesses: J. Ray McDermott, the oil-service division, and Babcock & Wilcox, which supplies power-generation equipment and nuclear components to the military.

So last Dec. 7, when the parent announced it planned to split along those lines into two separately traded companies later this year, the stock quickly jumped nearly 25%, to more than 26 from under 21. Investors anticipated that the conglomerate discount would recede and that each unit's performance would be more visible alone and fully recognized in their stock prices.

More subtly, they expected—with merger and acquisition activity showing signs of new life, particularly in the oil patch—that McDermott's current $5 billion market cap would split into two nice bite-sized acquisition targets.

The stock, however, has since fallen back down to 22 on no particular news, and that presents a buying opportunity, for reasons that have not changed significantly, argues Mark Minichiello, a money manager at Los Angeles-based QCA Capital Management. QCA has been accumulating a stake in McDermott in recent weeks.

With oil prices hovering between $70 and $80 a barrel, J. Ray—which provides engineering, construction, pipelines and sundry other services for offshore oil and gas platforms—continues to do well, says Minichiello. He figures it can generate $3.5 billion in revenue and $400 million in operating income this year, or $1.30 a share. "Put a 12 P/E, still conservative [compared with the sector P/Es of 20], on that and you get $16 per share for that unit."

With 90% of J. Ray's revenues coming outside the U.S., the division has diverse exposure geographically, and it sits in the sweet spot of demand, as oil exploration and production firms search around the globe in ever-more remote places for oil and gas. Offshore exploration is one of the fastest growing sectors in oil service.

McDermott should also benefit from the shift in investment allocation at the large integrated oil majors, which are switching some capital spending to E&P and away from refining and marketing, adds Steven Fisher, a UBS analyst. J. Ray has a "robust list of offshore projects."

The power side is no slouch. Minichiello expects B&W to produce about $2.5 billion in sales and $300 million in operating income, or 84 cents a share, this year. A P/E of 13 brings that unit's value to almost $11 a share. That adds up to a combined value of nearly $27 per McDermott share, without any takeover premium, he maintains.

That valuation doesn't take into account B&W's new 125-140-megawatt modular nuclear reactor, which potentially could be add-on power sources to existing nuke plants. There are plenty of regulatory hoops the reactor design must jump through yet, and "it might be two years before we know," adds Minichiello, but they have growing appeal to utilities.

A nuclear-power module, which costs about $700 million, can be built in half the time of conventional nuclear plants and is cheaper; can be designed for facilities that have nuclear permits allowing another plant or two; and such designs are already in use in nuclear submarines and aircraft carriers, he notes.

The spinoff makes strategic sense, says Minichiello, who values McDermott at $26.50 a share. Fisher uses a slightly higher P/E and gets a target price of McDermott at $30. He concurs that once separated, McDermott's segments could become takeover targets.

Takeover appeal could provide frosting to a fundamentally attractive story. Such a scenario is realistic given the flurry of recent M&A activity in the oil-services patch, where, for example, there is too much capacity, particularly onshore in North America. That's less important for J. Ray, but the growing prominence of national oil companies, which prefer to deal with suppliers that have a more complete suite of services, suggests that even big oil-service companies will have to scale up and it bodes well for further M&A in the oil services sector.

The biggest risk to McDermott, as with all oil stocks, is the price of crude. If oil stabilizes or rises, McDermott earnings should improve, and as the split comes closer, it should be reflected in the stock price. With a 20% takeover premium, McDermott could be worth $32, Minichiello adds. McDermott's fourth-quarter earnings will be released March 1, after the close, so investors should get an updated operational picture soon. ■

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