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MSA - Q1 2019 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the 2019 First Quarter Earnings Webinar. We do apologize for this delay. At this time all lines are in listen-only mode and the floor will be open for questions following the presentation. (Operator Instructions). And it is now my pleasure to introduce today's host, Elyse Lorenzato, Director of Investor Relations. Please begin.

Elyse Lorenzato - MSA Safety Incorporated - Director of IR

Thank you Kelly. Once again, our apologies for the delay. We had some technical difficulties here this morning, but we appreciate you sticking with us. Thanks for your patience. Welcome to MSA's First Quarter Earnings Call for 2019. With me here today are Nish Vartanian, President and CEO; and Ken Krause, Senior Vice President, CFO and Treasurer. Our first quarter press release was issued this morning and is available on the MSA website at www.msasafety.com. Before we begin, I'd like to remind everyone that the matters discussed on this call, excluding historical information are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to all projections and anticipated levels of future performance. Forward-looking statements involve risks, uncertainties and other factors that may cause our actual results to differ materially from those discussed here. These risks, uncertainties and other factors are detailed in our filings with the SEC, including our most recent Form 10-K filed in February of 2019. MSA undertakes no duty to publicly update any forward-looking statements made on this call, except as required by law. We've included certain non-GAAP financial measures as part of our discussion this morning. Reconciliations to the most directly comparable GAAP measures are available on our Investor Relations website at investors.msasafety.com. With that, I'll turn the call over to our President and CEO, Nish Vartanian.

Nishan J. Vartanian - MSA Safety Incorporated - President, CEO & Director

Thanks Elyse, and good morning, everyone. The MSA team got off to a solid start for 2019 realizing adjusted earnings growth of 13% on a 3% constant currency revenue increase. It was good to see strong incremental supporting the margin expansion and earnings growth. Looking at the topline it is important to note that we shut down production for several days in our U.S. facilities in January as we implemented the systems associated with the legal and operational realignment that we announced in the second half of 2018. Good momentum in our incoming order pace drove our book-to-bill ratio of 107% resulting in backlog increasing by 15% from year end. Ken will provide more insight into the drivers of our quarterly results. I want to briefly highlight some of the exciting investments we're making in the area of connectivity and cloud computing across our business and all with a common focus of one simple vision, improving workplace safety. A growing portion of our R&D investments today are focused on developing groundbreaking connectivity technologies across our fire service and industrial markets. A good example of this is the new technology we showcased 2 weeks ago at the annual Fire Department Instructors Conference in Indianapolis, better known as the FDIC. At the FDIC which is the largest fire department trade show in the world, our team introduced the foundation of MSA's Firefighter Internet of Things, aptly named the Connected Firefighter in a future key component of this system called LUNAR. A Connected Firefighter ecosystem consists of our very successful G1 SCBA, the MSA hub and the MSA cloud platform. As software modules are developed, this configuration will allow for cloud



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based asset management as well as a remote incident command viewing. For the first time in the market this system will enable a large fire department to view multiple active fire scenes simultaneously. More importantly, utilizing the cloud will allow for critical data storage and analytics, leading to automated reporting and safety critical insights. We also introduced to the market the LUNAR. This connected product with built-in cellular technology which combines handheld thermal imaging camera with cutting edge point-to-point directional ranging technology which can be invaluable in search and rescue scenarios. It also includes integrated accountability with both GPS and a motion sensitive man down system offering incredible utility and flexibility in 1 product. LUNAR can be used with or without an SCBA which will allow for all firefighters on the scene to be part of the incident command system. LUNAR is just one exciting example of how MSA is focused on life saving safety innovation. Ken and I both attended the FDIC and we are pleased to report the market response to LUNAR and the Connected Firefighter ecosystem was exceedingly positive and enthusiastic. Simply put, firefighters want this technology. Speaking of technology, the MSA cloud was developed to serve both our fire service and industrial customers. We first showcased this new platform within our Safety IO subsidiary launched in 2018. The initial offering from Safety IO utilized connectivity solutions to provide real-time remote monitoring in fleet management services through MSAs portable gas detection products. While continuing to organically invest in and grow our software as a service portfolio, we also recently announced an agreement to acquire Sierra Monitor, an industrial Internet of Things solutions provider. Ken will talk more about the transaction in his commentary, but I want to briefly highlight this acquisition as an important step in accelerating our Safety IO investment. Sierra Monitor solutions provide an opportunity to expand our connectivity capabilities to fix gas and flame detection systems where our installed base is in the hundreds of thousands of units across the world. We expect this deal to close in the second quarter. While the connectivity investments I discussed are longer term plays, the R&D investments we have made to develop market leading products are supporting our results in the current quarter. Our sales vitality exceeded 35% in Q1 which reflects the portion of our overall sales and products developed and launched in the past 5 years. The most meaningful contributors to that metric were the G1 SCBA, the Fast-Trac III Suspension system in the V-Gard hard hats, the ALTAIR 4XR portable gas detector, the X and S5000 gas monitors, and the many fall protection products we've launched over the past 18 months. If you recall, we've talked about the investments behind these new products on past investor calls and now, they are driving MSAs business and the ability to maintain a price leadership position by delivering superior innovation and cost of ownership advantages to our customers. Lastly, as we've mentioned on different occasions, one of the pillars of our growth and focus platform is people. When we discuss innovations like LUNAR and other technologies that you'll find across the portfolio I think it is important to remember we have approximately 400 highly engaged and dedicated associates in our engineering function globally, all of whom have disdain for the status quo and are on the leading edge of product development to enhance worker safety. We featured our 2018 Inventor of the Year on the cover of our annual report this year to highlight our commitment to innovation and the very strong NPV pipeline that our entire engineering team is driving globally. With that, I'll turn the call over to Ken for a financial review. Ken?

Kenneth D. Krause - MSA Safety Incorporated - Senior VP, CFO & Treasurer

Thanks Nish, and good morning everyone. Before I begin the P&L review and discuss the quarter in more detail, I'd like to step back and provide a few key highlights. Revenue growth was just over 3% in constant currency terms with 4% revenue growth in our core products. As Nish indicated, we lost a few days of shipping in the quarter associated with the systems change and this systems change had an impact on our revenue to the tune of about \$10 million to \$15 million. With that said, we had good underlying strength in our order activity in the quarter with a book-to-bill ratio of 107%. It was good to see the stronger order activity in areas like gas detection which had order growth of 11% in the quarter. Turnout gear and fire helmets also had good order activity with global growth up 8%. Profitability remained very strong in the quarter. Operating margin increased by 110 basis points in the quarter and adjusted earnings were up 13%. Free cash flow followed the normal seasonal trend that we have seen in the past. Our first quarter cash flow was typically lighter and this quarter was no exception. We made higher variable compensation amounts that were accrued at year end and saw an uptick in invoicing in March that drove receivables higher and built inventory to support the delivery of our strong backlog pipeline. Now, I'd like to walk you through our first quarter financial results. Total revenue increased just over 3% in the quarter in constant currency with growth in nearly all 4 product areas. We had a 3% foreign currency headwind on revenue in the quarter or about \$10 million largely related to the weaker euro and Brazilian real compared to this time last year. We continue to see solid results in head protection and fall protection in the quarter. We've often talked about hard hats being a proxy for global economic conditions. With that in mind, it's encouraging to see global growth of 6% in hard hats and over 20% growth in fall protection. In the fire service area of our business we had 4% growth in SCBA this quarter and we continue to see ongoing benefits from the U.S. replacement cycle and good performance in our International segment. And revenues in emerging markets increased 8% in constant currency terms driven by very healthy levels of demand in China and Latin America.

Gross profit was 46%, in the quarter up 80 basis points from last year. The new product launches coupled with our ongoing efforts on the pricing side of our business are providing a tailwind to margin. SG&A expense was \$78 million dollars in the quarter or 24.1% of sales, compared to \$80



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million or 24.6% of sales a year ago. In constant currency terms, SG&A increased less than 1% while revenue was up over 3%. We continue to take steps in the quarter to streamline our cost structure including executing restructuring programs in our International segment. As I indicated on the February earnings call, we have anticipated making progress on our footprint rationalization project and now is expected to drive non-cash charges related to the write off of currency translation adjustments and our initiative progressed as planned in the quarter and we finalized the closure of our MSA locations in South Africa. While these decisions are always difficult, we are confident in our ability to continue to serve the Africa region through our channel partners and utilize a more efficient go-to-market strategy. The non-cash charge of approximately \$15 million relates entirely to the reclassification of currency translation out of shareholders equity and into the P&L in the quarter. We also finalized plans for other restructuring programs across the International segment in our continued effort to improve profitability and incurred restructuring charges totaling \$6 million. GAAP operating income was \$32 million or 9.9% of sales on the quarter. Excluding foreign currency, restructuring, strategic transaction costs, and product liability expense, adjusted operating margin was 17.9% up 110 basis points from a year ago on improved gross margin and operating expense leverage partially offset by investments in R&D. On a segment level, adjusted operating margin was up 170 basis points in the Americas with good improvement across the P&L. New products pricing and productivity all had an impact. International adjusted operating margins were off 110 basis points driven primarily by weakness in the Middle East. We had good improvement in Europe with earnings growing 7% on revenue that was up 3%. The weakness in the Middle East is primarily due to lower revenue performance as we built a substantial backlog of project business that should ship in the second half of this year and provide upside opportunity on margins. Our GAAP effective tax-rate was just under 28% for the quarter which includes the impact of the non-cash translation adjustment I discussed a moment ago, as this expense is non-deductible for tax purposes. On an adjusted normalized basis our quarterly effective tax rate was 24%. GAAP net income was \$23 million which includes the non-cash foreign currency charge associated with our foot-print optimization program and restructuring spend associated with our efforts to improve the productivity of our International segment. Quarterly adjusted earnings were \$44 million or \$1.14 per share up 13% from a year ago and a 3% constant currency revenue increase.

Free cash flow was a use of \$4 million in the quarter compared to a source of \$14 million a year ago. When looking at the comparison it's important to note that the current quarter includes \$12 million of net outflows from product liability. Compared to prior year that reflected net inflows of \$12 million. We finished the quarter with working capital just under 26% of sales, about 200 basis points higher than year end, but a 200 basis point improvement from this time a year ago. As I indicated at the start of my commentary, lower cash flow converted and is typical for MSA in the first quarter. We continue to target 100% free cash flow conversion for the full year. Debt-to-EBITDA is 1.4x at the end of the quarter, relatively consistent with year end. We remain very well positioned to continue to execute our strategy and invest in our business. As an example, we are pleased to recently announce the agreement to acquire Sierra Monitor for approximately \$33 million. As we indicated in the announcement, Sierra Monitor has revenues of about \$20 million and we expect a synergy of adjusted EBITDA of about 7x over the next 12 months. The acquisition reflects a step forward in our goal to enhance workers safety through the use of connectivity and cloud technology. In addition to accelerating our own organic investments in Safety IO and in software as a service offerings, Sierra Monitor's SGSD line enables us to better serve end markets where we do not have leading positions. We expect the transaction to close in the second quarter. It was good to see the double-digit earnings growth and strong operating leverage in the quarter.

We are positioned well heading into the second quarter and our balance sheet is strong in overall activity as well as backlog continued to be very healthy. We remain focused on driving improvements in productivity and cash flow while continuing to invest in programs and products that will continue to fund profitable growth. With that, I'll turn the call back over to Nish for some concluding commentary. Nish?

Nishan J. Vartanian - MSA Safety Incorporated - President, CEO & Director

Thank you, Ken. As we think about the outlook, leading indicators are positive. Economic conditions in our key markets continue to track favorably, Fire Service funding remains healthy, energy prices have recovered nicely, and the commercial construction investment arena continues to be solid. With these business conditions at our at our key end markets, and our strong order book, MSA remains well positioned to continue to driving towards our growth and margin expansion goals in 2019. Thank you for your attention this morning. And at this time Steve Blanco, Vice President and President of MSA's Americas segment has joined Ken and I in the room, and we'll be glad to take any questions you may have. Please remember that MSA does not give guidance. Having said that, we'll now open up the call for your questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question we have is from Larry De Maria from William Blair.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

It was kind of hard to hear everything, so forgive me if I'm repeating something you guys said, but trying to understand the underlying strength in the business. I think you said \$10 million to \$15 million didn't ship in the quarter. If it did the book-to-bill would be more like 1.03 not 1.07 and the backlog wouldn't be up 15%. So can you talk about -- maybe the actual backlog level and why we shouldn't think underlying demand is not as robust as it sounds when we make those adjustments? And secondly, is that 10 to 15 that didn't ship was that in Europe and is that part of the reason why the European performance was not as strong? Thank you.

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

So Larry, a couple of questions in there. First of all, most of that backlog that didn't ship in the first quarter was in the U.S. area. So you saw some lower growth in the U.S. areas around gas detection and head protection. Fall protection was strong, but the backlog continued to build there also and that was because we lost a few days of production. The backlog build was predominantly in the U.S. based on that. The underlying business what we saw across the business was fairly good strength. The first 6 weeks of the quarter, the incoming business was a bit soft, but we really saw business pick up significantly from week 7 on through today, where the incoming business has been very strong. That's what gives us confidence in and our longer range outlook of the business for the balance of the year.

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO & Treasurer*

The only thing I would add there Nish is, with respect to Europe, I think Larry, you had a question on Europe and in my prepared comments I talked specifically about Europe growing 3% revenue wise and 7% on the earnings line. And so we still see good robust levels of growth coming out of there. With that said, order activity was up 8% in the quarter in Europe and as Nish had indicated the shipping and backlog that we saw associated with the systems change was primarily in the U.S. So we saw good healthy demand coming out of Europe in the first quarter.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

And then this is my second question, and I'll let it go, you guys talked about LUNAR and obviously we saw that the -- at the fire show recently, I'm curious, can you just remind us on the regulatory approval time frame and the commercialization time frame for that product?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

For that particular product Larry there is no approval process and that's just a matter of getting the product to market. We anticipate launching that product sometime in 2020. Hopefully, we're in a position to take orders at next year's FDIC. That's the goal for the product. But that's on us as far as getting that product to market. That's really not an approval situation that holds us up.

Operator

And our next question we have is from Mr. Edward Marshall from Sidoti.



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Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Hey guys, how are you? The one thing that stuck out was the margin in the International business. You talked about kind of, you framed out the Middle East, and maybe you could kind of elaborate on maybe what that project work was, how much that cost in revenue and then ultimately earnings. And then what country that product was going to or will be going to later this year?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Hey, good morning, Ed. Yes, really the shortfall and the challenges we had when we are in International were predominantly around the Middle East as Ken mentioned earlier. The good news with the Middle East is the fact that the backlog has built up there significantly in the issues around fixed gas and flame detection. So the backlog built up quite nicely in that area. We have a very large backlog for fixed gas and flame detection going into the second and third quarters of the year. So we'll start to see that ship throughout the year. And there is some optimism that that business continues to pick up for us in that part of the world. So, we see that as some upside to the margin for International as we go forward.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Are you willing to quantify the revenue and earnings impact that you saw in the quarter?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

We had margin improvement in Europe, we had margin improvement in China and in Southeast Asia. We had good margin improvement across that swath of business. The challenge we have is in the Middle East. It is very much dependent upon project oriented business and FGFD oriented business. If those projects don't come through or aren't shipped, they have a pretty big impact, and as you know, the margins on these businesses are very healthy. We have a backlog in that business, a backlog that we haven't seen since 2017 quite frankly, so we have a very healthy backlog. And we think over the coming quarters we'll start to see a reduction in that backlog, most likely the second half of the year.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

And I just want to be clear, this is more to do with timing not to do with geopolitical or economic conditions in any particular country, so for instance, Turkey.

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Absolutely. It's a matter of timing of business and it's all project-based and so what we're seeing is fairly normal cycles.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

And the other thing that kind of stuck out in the release was the fall of projection. You had some really good growth in the Americas, constant currency growth internationally. I just wanted to be certain and I don't think there is and you talked about the backlog and the order trend, so it doesn't sound like it, but is there any seasonal trends within fall protection that we should be - we should be aware of, kind of in the first quarter of the year that might impact the growth?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

No, not at all. Actually that growth we're seeing is really robust and really when you look at fall protection seasonality, it should improve second and third quarters. The incoming business is really strong. We've really hit the mark on these new products that we've developed and launched

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over the last 18 months. Our sales organizations hitting a stride with customers and winning some business. We feel really good about the fall protection space and the investments that we've made there and the stride we're hitting.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

And just to get a sense as we kind of work through some of this backlogs, where do you -- let's look 3 years out, where's the business today from a percent of revenue of the quarter and where do you anticipate that business will go?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Yes, obviously the core business continues to grow and become a larger portion of our overall business. We continue to see that trend moving in that direction. Clearly, we're making significant investments in those core products and the growth of the core product areas is outpacing the adjacent product areas. We just see that trend continuing and any adjacent will become a smaller piece of the business as we go forward. We do quite well in the core as you know from a profit standpoint and market share standpoint, we're pretty optimistic about that.

Operator

(Operator Instructions) All right, we do have another question. This is from Garo Norian from Palisade Capital Management. Please go ahead with your question.

Garo Norian - *Palisade Capital Management*

Hey guys, I was just curious on the cost side, you guys continue to show really great cost control. Was there anything kind of either more one time or short term in nature related to the strong cost control in the first quarter or is that the kind of expectation we should have going forward?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Hey, Garo. No there wasn't anything in there from a one-time standpoint. We just continue to look for opportunities to improve our efficiencies throughout the organization and I think what you saw in the first quarter was a result of that. So, as we go forward we continue to look for those opportunities to leverage our capabilities around the world and look for those efficiencies. There was nothing unique in the quarter.

Garo Norian - *Palisade Capital Management*

And then just on the acquisition announcement, is there any approximate way of thinking about the accretion that's likely to come from that over, I don't know, it is either the first 12 months or after you've gotten to your synergies or what is the new way of thinking how that's going to contribute?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO & Treasurer*

Hey Garo, its Ken. Thanks for the question. What we have disclosed today is that the synergy adjusted multiple to be around 7x. So we do expect some accretion in the first 12 months. What we'd like to do is to get through the closing activity. We intend to close it at some point probably in mid to late May. And once we do that we'll provide more definitive guidance around what we would expect on the accretion and cost to capital returns over time.



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Operator

All right, thank you. And it looks like we have no further questions at this time.

Elyse Lorenzato - MSA Safety Incorporated - Director of IR

Okay, thank you Kelly. Thank you everyone for being with us this morning. If you missed a portion of the call, an audio replay and transcript will be available on our investor relations website for the next 90 days. Again on behalf of our entire team here, thank you again for joining us and we look forward to talking with you again soon.

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