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MSA - Q2 2015 MSA Safety Inc Earnings Call

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## PRESENTATION

### Operator

Good day and welcome to the MSA second quarter earnings conference call. At this time all lines have been placed in a listen-only mode and the floor will be opened for questions following the presentation.

(Operator Instructions)

It is now my pleasure to introduce your host, Ken Krause. Please go ahead.

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**Ken Krause** - *MSA Safety Incorporated - Executive Director - Global Finance and Assistant Treasurer*

Thank you Joe, good morning, everyone. Welcome to our second quarter earnings conference call for 2015.

I am Ken Krause, Executive Director of Global Finance and Assistant Treasurer for MSA. Joining me on the call this morning are Bill Lambert, Chairman, President and Chief Executive Officer; Stacy McMahan, Senior Vice President and Chief Financial Officer.

Our second quarter press release was issued last night and is available on our website at [www.msasafety.com](http://www.msasafety.com). This morning, Bill Lambert will provide his commentary on our quarter. Stacy will then review our financials and then Bill will conclude with his closing comments. After that, we will open up the call for your questions.

Before we begin, I need 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 Securities and Exchange Commission including our most recent Form 10-K which was filed on February 25, 2015. You are strongly urged to review all such filings for a more detailed discussion of such risks.

Our SEC filings can be obtained at no charge at [www.sec.gov](http://www.sec.gov) and on our Investor Relations website. MSA undertakes no duty to publicly update any forward-looking statements made on this call, except as required by law.



In addition, we have included certain non-GAAP financial measures as part of our discussion today. These non-GAAP financial measures should not be considered replacements for GAAP results.

Reconciliations to the most directly comparable GAAP measures are available on our Investor Relations website at [investors.msasafety.com](http://investors.msasafety.com) within the Quarterly Results section under the Financial Information header.

And with that, let me introduce MSA's Chairman, President and Chief Executive Officer, Bill Lambert.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Thank you, Ken, and good morning, everyone. As always, I want to begin by saying thank you for joining us this morning on this conference call and for your continued interest in MSA. Presumably, all of you have seen our second quarter press release that was issued last night and you have our financial figures with all comparisons corresponding to the equivalent period in 2014.

This morning I will review our second quarter results with you and provide an update on our business as we head into the second half of 2015. After that I will turn the call over to Stacy for review of our financial results, then we'll open up the call for your questions.

As you saw in our press release, sales in the second quarter from continuing operations were \$287 million, reflecting local currency growth of 11% from a year ago. For the quarter, sales from our core product lines grew by 10% compared to a year ago. And now they reflect 78% of our overall sales.

Leading this growth, breathing apparatus sales were up 41% on a consolidated basis and up 90% in North America as order activity remained robust and we have made significant progress in our efforts to continue to ramp up production of our revolutionary new product, the G1 SCBA.

As you might recall from previous calls, we expected manufacturing and delivery ramp up for the G1 SCBA to take about six months after our December launch. We are on track with this process and you're seeing this increased level of production coming through our second quarter results.

In fact, June was our biggest production month yet for the G1 representing a 30% increase compared to where we were in April, at the beginning of the quarter.

Overall, the results we continue to see from our SCBA product group are certainly encouragingly and I'm especially pleased with how the G1 is helping us to not only retain customers, but also gain new customers by converting them to the MSA technology.

Consider our recent win to supply G1 SCBA's to Baltimore County, Maryland. This contract is a conversion of a key competitor account and we look forward to providing Baltimore County with a customer experience like no other. Looking at our conversion rate of about 60% on all orders taken to-date. It is clear that this kind of trend is not an isolated occurrence.

We believe we're clearly taking market share because the G1 is an outstanding and innovative design and it represents a simply superior product offering. It is the most comfortable streamlined, balanced and customizable SCBA on the market today from any manufacturer.

And the positive feedback that we continue to hear from our customers both new and existing, tells me that we've really hit the mark with this platform and I credit that to our extensive voice of customer process used during product development by our R&D team.

While we have seen solid results on the G1, in many ways, we're just getting started. We're connecting the G1 to other core products such as our portable gas detection instruments and our thermal imaging cameras, and leveraging advanced technology in those areas. We're collaborating with Motorola Solutions to enable Bluetooth, wireless radio communication on the fire ground.

At the FDIC show in Indianapolis and the recent INTERSCHUTZ fire safety show in Germany, you saw an integrated thermal imaging camera prototype that is a groundbreaking advancement in the TIC space, which is integrated into the G1. Additionally during the quarter, the G1 received approval



to the European Norm or the EN standard. And we expect to begin shipments from our Berlin facility by the end of the year. The EN approval is an important milestone that solidifies the G1 as a truly global product.

Shifting gears a little, I'm also pleased to report that fixed gas and flame detection sales increased 10% for the quarter as we were able to clear several large project orders from the backlog.

Another highlight was our sales of our fire helmets, which increased 11% for the quarter on the success of our new F1XF firefighter helmet in Asia. The performance we're seeing in this area of our business is quite encouraging.

Moving through the core, our fall protection business for the quarter was flat when compared to the same period from a year ago, but saw high single-digit improvements in North America.

Finally, and as many of you are well aware, there are those parts of our core product portfolio that are more closely aligned with the energy market vertical and more specifically employment levels within that industry. As we expected and discussed on our first quarter investor call, we continue to see weakness in the global oil and gas markets.

Without question, this weakness continues to provide headwinds in quarterly revenue performance in industrial head protection and portable gas detection, which were down 9% and 5% respectively.

As we had discussed on our last conference call, we expected challenging conditions in these areas to persist in the second quarter and they did. Clearly that was the case. Even though our second quarter sales in industrial head protection increased slightly over Q1 on a sequential basis. But these results were still below our internal plans and they continue to drag on revenue.

Stacy will provide a little more insight into our order book and the outlook for our oil and gas related business in her comments in just a bit. When thinking about overall consolidated sales growth of 11% in the quarter, it's important to understand the impact of large orders in both fixed gas and flame detection and ballistic helmets.

So excluding those large orders, our sales were up 7%. While this growth has certainly been driven by the continued success of our G1 launch and the related ramp up in production, we're feeling the effects of a slower growth environment within our energy-related markets and certain emerging markets like Brazil and China.

During our first quarter call in April and on our year-end call in February, I indicated that we expected local currency revenue growth in the mid single-digit range for 2015 and through the first six months I'm pleased that we've been able to deliver 7%.

Our ability to continue to deliver this level of growth will depend on continued success with our G1 SCBA platform and some of our other exciting new products, as well as our ability to continue to weather the oil and gas slowdown and its related impact on our FGFD business as well as lower sales of head protection and portable gas detection, which are employment level driven in this vertical. It will also depend on the severity of the continuing weakness we see in emerging markets like Brazil.

As you know, prioritizing and optimizing investments for growth in emerging markets is a key pillar of our corporate strategy. While we're seeing weakness in certain emerging markets, we continue to see strong results in a number of other emerging economies including Mexico, the Middle East and much of Latin America excluding Brazil.

Specifically, we achieved very strong double-digit growth in the Middle East, in Mexico and in Latin America excluding Brazil. The recessionary conditions in Brazil continue to persist and drove a 20% local currency decline for us in that market. So excluding weakness in Brazil, local currency revenue growth in emerging markets was up 15% in the quarter and is tracking at plus 12% year-to-date.

Its clear certain emerging markets remain healthy. But we temper our growth optimism due to the continued headwinds associated with economic challenges in Brazil and weakness related to the stronger dollar and low commodity prices within other elements of our emerging market portfolio.



Nevertheless, we view these headwinds as a short-term challenge and we see our presence in these areas as critical over the long-term, in order to drive shareholder value.

From a strategic initiative perspective, we continue to see nice results from our restructuring investments and especially those we have made over past quarters in Europe.

In 2014, our operating margin in Europe was up over 800 basis points over a five-year period and has increased further this year. In the second quarter, European operating margin was 12.5% up 130 basis points from a year ago and up nearly 1,000 basis points since we started to invest in restructuring this segment years ago.

At this point, I would like to turn the call over to our CFO, Stacy McMahan, who will provide an overview of our second quarter financial performance and after Stacy finishes with her report, I'll provide some closing comments and then we'll open up the call for your questions. Stacy?

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Thank you, Bill and good morning. It's my pleasure to share further insight into our second quarter financial performance. Additional information will be available when we file our Form 10-Q with the Securities and Exchange Commission later today.

Sales from continuing operations in the second quarter were \$287 million up \$5 million or 2% from the prior year on a reported basis and up 11% on a local currency basis. The headwinds that we saw in the quarter related to weaker foreign currencies were significant, 9% on revenue.

In the second half, we should see some reprieve in this area, as foreign currency rates started to weaken in the third quarter of 2014 and further weakened in the fourth quarter.

As we indicated on the April call, we expect the full year FX headwind on revenue to approximate 5% to 6%. We saw 10% local currency growth across the core products during the quarter and 11% overall sales growth. Large orders mostly within FGFD and ballistic helmets contributed about 4% to our total sales growth in the quarter.

The remaining 7% of our quarterly growth was largely supported by our higher G1 SCBA shipments in North America. Offsetting the weaker results in portable gas detection and industrial head protection, products that are more closely aligned with the energy market vertical.

Looking at the sequential quarter comparison, local currency sales increased 13% from the first quarter. Core products grew 9% on the ramp up of G1 deliveries and strong shipment activity within FGFD coupled with seasonal upticks across most other products.

Non-core products were up 28% in the sequential comparison, largely driven by higher ballistic helmet shipments in Europe and clearing of backlog in other non-core products.

As we have discussed on past calls, parts of our business are more exposed to the oil and gas industry. We've reviewed the details behind that exposure on previous earnings calls. But for those who are new to this story, I will take just a moment to review our prior commentary.

We estimate approximately 35% of our business is in the energy market vertical. But as you know, not all of this business is at risk and it is essential to understand the detail behind the exposed areas. About 10% to 15% of our consolidated revenue, primarily in industrial head protection and portable gas detection is more exposed with pull back in employment trends across the energy markets.

The spring turnaround season was historically weak this year as refineries continue to take advantage of lower oil prices and run at near full capacity. This trend coupled with the general pull back in spending continued to provide headwinds in portable gas detection and industrial head protection in the quarter.



The incoming order pace remained relatively slow in these areas throughout the quarter and of course oil prices remained depressed, indicating that we will continue to feel the impact of lower employment levels within the energy market as we head into the third quarter.

Now breaking down the exposure further, another 5% to 10% of our revenue, primarily in the FGFD product line, is exposed to a pullback in capital equipment spending. We reported 10% local currency revenue growth in the quarter in FGFD driven by higher large order project business that for the most part was related to large projects started prior to this significant decline in energy prices we had late last year.

The order pace in this area is somewhat choppy, but overall holding up against our internal plans and current FGFD backlog is relatively healthy. We continue to see project related opportunities in international markets, where the cost of extraction is more favorable.

But in markets like the Gulf Coast region of the United States, we have and continue to see significant weakness.

Furthermore, while the backlog is solid right now. We had a very strong second half in 2014 in this area, which creates a challenging basis for comparison, while lower oil prices present a headwind in this market.

We continue to monitor trends across the oil and gas markets closely.

Of course, we are naturally disappointed and concerned about the industry dynamics we're seeing, but it's essential to consider MSA's diverse portfolio when thinking about the business as a whole. While we're feeling pressure in oil, gas and petrochemical segment,

we're excelling in the fire service with our G1 SCBA ramp up and despite all these puts and takes, sales are tracking on the high end of our mid single-digit growth targeted range for the year-to-date period on a local currency basis.

While I give a high level review of our sales today, please refer to the exhibit in our press release highlighting quarterly and yearly growth by segment and product for additional detail. Let's jump into the segment performance.

In North America sales in the second quarter were \$156 million increasing 13% from the same quarter a year ago and 14% on a local currency basis. Core sales comprised 83% of total segment sales and were up 15% from a year ago, on a 90% increase in breathing apparatus revenue, as we increased production of our G1 SCBA and chipped away at our backlog.

Fixed gas and flame detection was also strong in the quarter, growing 6% on large order shipments in Mexico. This growth was partially offset by the energy related weakness I just discussed with portable gas detection down 18% and industrial head protection down 8%. Non-core sales representing 17% of the business were up 10% on strong shipment activity within respirators and thermal imaging cameras.

Our European segment reported second quarter sales of \$75 million up 16% in local currency terms. Core sales comprised 70% of total sales in the segment and increased 9% on strength in the Middle East from higher large orders within FGFD and strong performance in portable gas detection.

Non-core sales representing 30% of overall revenue were up 35% on continued shipments of ballistic helmets in Western Europe on the large military order received last year. I think it's noteworthy to take a closer look at the revenue growth in Europe. Excluding the ballistic helmet business and other large orders underlying quarterly local currency growth was 4%.

Lastly, continuing sales of \$56 million in our international segment were down 3% in local currency terms. Core sales comprised 75% of total sales and were flat from a year ago. Fire helmet sales more than doubled on success of our F1 XF helmet in Asia and strong performance in portable gas detection throughout Latin America.

But this was offset by broad weakness across all other products. We continue to see recessionary conditions in Brazil, one of our largest international affiliates. Excluding Brazil from internationals results, we realized 3% overall sales growth in the segment.

Non-core products representing 25% of sales are down 11% in the quarter on a lower level of sales of mining related products.



Our gross profit rate for this quarter was 45.5%, a decline of 40 basis points from last year. While product margins remained healthy in many of our core product areas. We saw pressure on overall margin due to the mix of SCBA compared to portable gas detection and head protection.

As you know, SCBA has a lower margin profile than other core products. We anticipated and discussed with you on the last call that the ramp up in G1 shipments would be dilutive to gross margins because of the profile and mix impact.

However, the additional volume is certainly accretive to operating margin, as we leverage our operating cost structure more efficiently. As is the case, with any new product, we'll be evaluating ways to improve profitability and working through our value engineering process in the months and quarters to come.

Selling general and administrative cost were \$78 million in the quarter, down \$5 million from a year ago.

In local currency terms, cost grew 2% on the 11% increase in revenue reflecting higher non-cash expense on our overfunded pension plan and higher selling costs offset by lower spend on corporate initiatives.

Our investment in research and development this quarter was \$13 million or 4.5% of sales, as we continue to innovate and create new technologies for the G1 platform and other core areas. As you saw in our press release last night, our sales vitality metric continues to improve reflecting a strong yield on our R&D investments.

Operating margin in the second quarter was 13.9% of sales, up 150 basis points from a year ago on the higher sales volume and leverage over operating expenses.

Our effective tax rate this quarter was 34.6% up from 30.7% a year ago due primarily to non-deductible losses in certain jurisdictions. Excluding \$8 million of European exit taxes recorded in the first quarter our base effective tax rate for the year-to-date, is 33.4%.

For the full year, we'd expect our effective tax rate to approximate 32% assuming renewal of the R&D tax credit and of course excluding the European exit taxes.

Net income from continuing operations was \$24 million in the second quarter or \$0.62 per diluted share, up 7% from a year ago. Excluding restructuring, foreign exchange losses, asset-related losses and self-insured legal settlement charges, adjusted earnings were \$25 million or \$0.67 per diluted share, increasing \$0.07 from a year ago.

Our cash balance at the end of the quarter was \$88 million composed primarily of cash outside of the United States and our debt balance was \$270 million. Quarterly operating cash flow was \$24 million versus \$6 million a year ago, while we used cash flow in inventory and receivables on the growth in our business.

We converted in excess of 100% of net income into operating cash flow. We continue to deploy capital to return value to shareholders. During the quarter, we issued \$12 million in dividends or 50% of net income and we used \$7 million to repurchase 150,000 shares of MSA common stock under our newly authorized repurchase plan.

We also paid down \$4 million of debt in the quarter and our balance is \$19 million lower than at this same time a year ago.

While we're discussing capital deployment, I just want to take a moment to remind you of MSA's four-pronged strategy regarding capital allocation. First and foremost, our priority is to utilize cash flow to grow the business and to improve the profitability of our business.

We've made strong investments in organic activity focused on new products and restructuring activities that have driven value for our shareholders.

Additionally, we have a good history with our General Monitors' acquisition back in 2010, with driving value inorganically. These areas get our priority.

Secondly, we have and continue to return cash to shareholders in the form a strong dividend yield. As you know, we've paid a dividend for nearly 100 years and increased that dividend every year for nearly 50 years up to and including the 3% increase we announced in May.

Our payout ratio over the past 10 years has averaged about 50% and we remain committed to paying a meaningful dividend going forward. Our third priority in deploying cash is to service our debt obligations.

We're currently at about 1.5x debt to EBITDA. And we continue to successfully de-lever from the peak 3.5x in 2010 following our acquisition of General Monitors, which was accretive almost immediately.

Lastly, we have recently started buying back our own stock as I mentioned before. Right now the \$100 million repurchase plan is designed to offset dilution related to employee stock compensation. But we have the flexibility to expand the scope in the future.

So in summary, the quarterly results were driven by an uptick in G1 SCBA sales and increased large order activity within FGFD and ballistic helmets. I'm pleased with the strong quarter, but we definitely have headwinds heading into the second half. As I think about the second half, while the fourth quarter has historically been a strong quarter and as you might remember, we had a record fourth quarter to finish 2014.

The third quarter can be challenging on a sequential quarter basis as much of our European segment has its regular holiday season. Furthermore, the weakness we continue to see throughout energy markets in Brazil and across parts of Asia are expected to present challenges.

Accordingly, we continue to focus on looking at how we might adjust our operating cost structure in light of these headwinds. Bill, back to you.

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Thank you, Stacy. Although some headwinds continued in the quarter from an end market and geography perspective, we executed well in this uneven macro environment.

Supported by our G1 launch, top line growth was strong and we were able to leverage that into 150 basis points of operating margin improvement and a double-digit increase in adjusted earnings.

While we expect the slower growth environment to persist as we move into the second half of 2015, the G1 backlog is sizable and will help to mitigate the impact of weakness in the energy markets. Thank you for your attention and interest in MSA this morning.

At this time, Nish Vartanian has joined Stacy, Ken and me and we'll be happy to take any questions that you might have.

Please remember that MSA does not give guidance and that precludes more discussion related to our expectations for future sales and earnings. Having said that, we will now open the call to your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions)

Our first question is coming from Edward Marshall



**Edward Marshall** - *Sidoti & Company - Analyst*

I was looking at, you called out China, you called out Brazil as some of the weaker points in your business. I think you gave the local currency on Brazil. I'm not sure you did for China. Could you provide that? If you have it available.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Sure, Ed. Sales in China, local currency terms were up 4% from a year ago.

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**Edward Marshall** - *Sidoti & Company - Analyst*

They were up 4% and sequentially, do you have that?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

I don't know that I have that sequentially. Ken, do you have it? It's 5% year-to-date in China, up local currency sales were up 5% year-to-date, Ed. I don't know sequentially.

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**Edward Marshall** - *Sidoti & Company - Analyst*

Okay.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

So when we talk about some challenges in headwinds in China. I mean, clearly we were feeling a bit of slowdown there from past quarters in past years, but it's still positive growth, which is not quite as robust as what we have seen in past years.

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**Edward Marshall** - *Sidoti & Company - Analyst*

So of the two, I imagine I guess just looking at the numbers. Brazil seems to be the bigger problem child for you in the near term or?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Unquestionably. In the emerging markets, unquestionably. Ed it's, as I said down 20% in the second quarter, down 18% year-to-date and the recessionary conditions there are quite severe.

We've made adjustments, we continue to make adjustments to the business to right-size it for those extreme headwinds, but that's the challenging area. The other areas though of South America as I indicated to you, Spanish speaking Latin America for instance up 10% in the second quarter up 12% year-to-date.

Mexico up 35% year-to-date in the quarter, up 60%. Eastern Europe up 12% in the quarter, up 16% year-to-date. The Middle East up 35% in the quarter, up 11% year-to-date.

So a lot of the emerging markets are quite healthy, quite strong and but Brazil is an area and China, we're seeing some slowdown. So those are the areas that Stacy highlighted in her commentary.

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**Edward Marshall** - *Sidoti & Company - Analyst*

Okay, when I look at SBCA manufacturing you know, you hit the highest rates so far in June. Is there more to come or are we at full production at this point?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well, we continue to ramp up production here in North America at Murrysville, Pennsylvania plant. We're nearing kind of peak performance out of that plant. But we did as we indicated in an earlier press release.

We did achieve approvals in Europe out of our Berlin factory and the Berlin factory is now coming online as well. And so we'll begin shipping from that plant later this year and that will additionally add capacity to our G1 capability.

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**Edward Marshall** - *Sidoti & Company - Analyst*

Bill, if I'm not mistaken. Europe is a much smaller market for you than, say, North America.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well it is, but Europe provides SCBA and much of the world has adopted. Much of the international emerging markets have adopted the EN standards, the European Norm standards. So there is capability for sales outside of Europe as we think of it.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Ed, I would say that. I'll add to that, that the replacement cycle that we're seeing here in the US is a key driver is a less so in Europe. So you're not having that exceptional bump.

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**Edward Marshall** - *Sidoti & Company - Analyst*

Okay and when I think about the margin of the product line. I mean presumably you're running in a lower than optimal levels in those manufacturing line, you're still ramping up.

I'm just kind of curious as to, what we might be able to see as that full production kind of takes over here in North America and maybe what, from a margin perspective that might mean on a go-forward basis.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well the G1 is coming in right around where we thought from a gross margin standpoint. But as Stacy indicated in her commentary, SCBA is at the low range of our core product gross margins.

Although, it's above the corporate average and so because of that, we're seeing some headwinds in gross profit from a product mix standpoint.

However, the higher sales volumes in G1 are driving higher operating margin, as we've realized that incremental margin improvement and opportunity from the G1. As was the case with any new product, we'll be conducting our value engineering processes to enhance profitability over the next several months.

We'll be getting some of these start-up issues behind us and we fully expect that the G1 margins will continue to improve over the coming quarters. There's no doubt in my mind. I mean there is a high confidence level that we'll begin to see the improvements in operating margins, in gross margins on the G1 going forward.

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**Edward Marshall** - *Sidoti & Company - Analyst*

And will that be noticeable to the core business as a whole, I mean the consolidated business. Significantly, I'm trying to put a perspective to maybe the consolidated margin and what that might do.

I mean, small product line, but at the same time it's, I imagine there is a drag, lower than optimal manufacturing and as you ramp up production. You see the higher sales rate as well.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Ed, I would say that the consolidated mix within the gross margin is probably even more impacted by the fall off of industrial head protection and portable gas detection, which that is very much a key to recovery of gross margin on a consolidated basis.

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**Edward Marshall** - *Sidoti & Company - Analyst*

In the ramp in SCBA, it seems to be faster than you expected. Is that, first, is that accurate? And second, how do you the backlog seems relatively strong.

I mean, how do you, you're up full production now. What's the plan as we move forward? I mean, I don't think you expect that this type of response is immediate as it has become, especially with market share gains.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well I think that, the part of what you said there. I would agree with. I think that the response has been more favorable than we had anticipated and the conversion rate is higher than we anticipated. But we knew we had a great product here.

The market research that we had conducted, the voice of customer research in designing and building the product we had conducted gave us great confidence, but it has been a bit better and a bit stronger than we had expected.

As we mentioned in previous conferences and webcast. There was a very strong significant firefighter grants that went into the market back in the 2002- 2006 time period and almost \$3 billion of assistance to firefighter grants flooded the market in that time period.

And we estimated that a roughly 30% of that, maybe a third of that \$3 billion was used to purchase SCBA over that 5-year period.

So we're constantly trying to better quantify that market opportunity as it relates to it. But there is definitely a replacement cycle opportunity that we're seeing right now.

And we think we're on the front end of that replacement cycle. We believe it to be significant and it could last moving out a number of years and that's why we invested so heavily in R&D over the last 5 years to bring this product to market, in anticipation of that replacement cycle.

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**Edward Marshall** - *Sidoti & Company - Analyst*

Great. Guys, it's good to hear. Thank you and I appreciate it.

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**Operator**

Thank you. Our next question is coming from Richard Eastman

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Bill, congratulations on being named Chairman at MSA.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Thank you very much, Rick.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Just a couple things. Can I just, really quickly on China. Given the investment we've made there over the last 3 years. The slower growth rate. Are we comfortably profitable in China on the volume as it exists today given the investment we made?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well, I think we're comfortably profitable in China. There's - we're always looking for the opportunity to improve that profitability even further and to see the operating leverage that we like to see from that organization.

With a slower growth, we've had to temper some of the investments that we make going forward and to restructure that operation a little bit. But you know longer term, looking at this market opportunity longer term. We still see great opportunities there. Stacy, I look to you comment on that.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Yes, Rick you have to realize too that China is a manufacturing site that supplies lots of Asia and so it does have some volume pushed through outside of the China end demand.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay, but unlike Brazil where we're taking some serious cost actions presumably to keep it profitable, but China we're not in that situation.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

We're in the early stages of evaluating how to monitor the fixed cost infrastructure in China.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay and then can I also ask, what - I saw the EU approval for the G1 work in a ramp production in Berlin. But what's the market opportunity for the G1, in Europe now?

**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

From the market opportunity. Well, it doesn't have the replacement cycle impact that the North American market does as Stacy had indicated earlier.

So we have to kind of look at it very differently contextually from what's happening here in the US. But you know the European SCBA market is still a very significant market and then when we look beyond Europe to international markets, that require the EN approvals, you know it's meaningful and it's very important.

For instance, we were just - we just won approval internationally here of the G1 SCBA down in Chile and shipping that product into Chile now.

But the EN standards and the European G1 closely resembles the North American NFPA compliant G1. The platform is the same and most of the components are the same.

So there is some leverage opportunity for us and as we ramp up production, not just in Murrysville, Pennsylvania but also in Berlin, Germany.

It gives us greater opportunity here to take this platform product and really apply it globally. So we're pretty pleased by it, the response that we had at the INTERSCHUTZ, which was just held last month in Germany was overwhelmingly positive.

So we think, what we're pretty optimistic about what our opportunities are there and we'll begin shipping out of the Berlin factory by the end of the year.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

And your share of the SCBA market in the Euro zone so to speak. Is it much small? I presume Draeger is probably the primary competitor there.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

They're the primary competitor and we're a close number two to Draeger in Europe.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay and then, how much is left on the ballistic helmet order into Europe?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Stacy, Ken I look to you on that question.

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**Ken Krause** - *MSA Safety Incorporated - Executive Director - Global Finance and Assistant Treasurer*

Yes, you know our backlog Rick in the ballistic business is down a bit from where it was earlier and this year as we work it down. As you might recall, we really started to ship on that in the fourth quarter of last year and so, we've worked it down quite a bit.

You'll continue to see a little bit of business come out of that. And for the second half, but we definitely have made some really nice progress in the first half towards that backlog.



**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay, so it will wind down quickly here. Bill, let me ask you the kind of a generalized question. Obviously assuming and knowing that you don't give guidance.

But when I look at the core product lines, the six core product lines and as we look out to the end of 2015. Fixed gas and flame obviously even though the backlog is healthy, presumably in the second half, it will be down year-over-year because of the comps.

Portable gas is down for the year, but I'm curious when you look to the six core product lines and we're still kind of holding onto, are targeting mid single-digit growth rate. Aside from the SCBA, are there any other of the six core product lines that you know, you think have a positive finish to the year?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

I think that, when we look overall Rick and what we saw in the second quarter here. Our new firefighter helmet, the F1 XF is really strong and it's also winning competitive accounts.

We won a large competitive account in Australia in the second quarter and shipped on that product in that location and as well as in other markets in South East Asia and into China.

So I see some opportunity outside of SCBA, but that's clearly the largest. The G1 will clearly be the largest positive impact for us. Fall protection I think, fall protection is still relatively strong here in North America.

Our presence in South America is being impacted by that Brazil recession and so we've seen. It's been a little bit more challenging and that's why I think for the quarter you saw overall flat performance out of fall protection, but we're still pretty optimistic in that side.

In FGFD, even though the comps will be extremely hard for us, we do expect growth by year-end. I think we'll be looking back and seeing maybe low to possibly mid-single-digit growth in the FGFD space.

Our order book in that space is actually quite a bit stronger than what we had expected with everything else we're seeing in the oil and gas vertical.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

I see, okay. Very good. Thank you.

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**Operator**

Thank you. Our next question is coming from Rudy Hokanson.

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**Rudy Hokanson** - *Barrington Research Associates, Inc - Analyst*

I'm just wondering, could you please talk a little bit more about, how things are progressing in Europe with the restructuring and if you're on the time table that you had expected and what we should anticipate in terms of margins in Europe going through the rest of this year into early 2016?



**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Sure, Rudy. I'll provide some color on that and then I'll turn it over to Stacy for some commentary on the margin side of it. We very much remain on track with the European transformation that we've talked about in past quarters. The performance there is quite evident in what you're seeing, what we've reported.

We're planning go live events with our remaining European affiliates late in the second half there, eight more affiliates that will go live into the principal operating company model that we have there. Four in early October and four in early January, that will bring them into the principal operating company model.

They'll be operating under the SAP umbrella and as part of that, we'll be consolidating their warehouses into our single third party logistics provider out of Germany. So I think it's very much on schedule having the impact that we had hoped that it would have.

We have high exit taxes this year, but on a go forward basis, we should see that improved quite dramatically as we get into full year 2016 and can compare that with where we are for this year and last year.

There is more to the project including leveraging that SAP module to drive operational experience. We're looking at ways we might expand process excellence in that region across the region. The warehouse closure and the SAP implementation- they all reflect kind of the key steps to completion of our European transformation.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

And Rudy, I would say that, you know you saw an operating margin performance in the second quarter at about 12.5%. And you know that's a pretty solid, operating margin for the year to consider.

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**Rudy Hokanson** - *Barrington Research Associates, Inc - Analyst*

Okay, thank you.

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**Operator**

Thank you. Our next question is coming from Brian Rafn.

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**Brian Rafn** - *Morgan Dempsey Capital Management LLC - Analyst*

Bill, congratulations on being Chairman. Certainly well deserved. So that's. Let me ask from the standpoint of the G1.

You talked a little bit about pent-up demand. You talked a little bit about explosive demand. Could some of that be pent-up from the fact that there was some certification delays in 2014?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well sure, I think that's a bit of it. It's hard to quantify how much of that there is. So as we began to show the G1 SCBA in the spring of 2014, so clearly we believe there were number of fire departments that held off on their purchasing decisions as we worked our way through those certification issues throughout much of 2014.

**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Okay, when you look at the penetration of the G1. Is that primarily urban fire departments, you know pay roll or is that? Or you're seeing penetration also in some of the rural volunteer fire departments?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Well I think that historically, MSA has had a very strong market share position in the rural volunteer fire departments and one of our leading competitors has had a very strong hold in the urban areas in the big cities and as I indicated in my commentary.

We're seeing about 60% success rate in converting those competitive accounts and so many of those in fact like Baltimore County that I mentioned in there, a number of other that we have been successful with and those are urban paid firefighter departments.

And it's not historically been a stronghold for us and it represents good market share gain opportunities for us.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

That's excellent. What is - so how is, if you look at the G1 with all of its accessories on a standalone basis and I know I'm sure there is volume discounts and that type of thing. What does that suit run with all of the options, pricewise?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

With all the options, you're probably in that, I look to Nish for clarification but you're probably in that slightly north of \$5,000 a unit range.

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**Nish Vartanian** - MSA Safety Incorporated - President - MSA North America

Yes, that's very accurate. So typically, we see about \$5,000 per unit with the accessories included.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Okay and Bill, what would be the next horizon to the next set of standards. Is that about to 10-year to 15-year horizon? What's kind of the horizon for G1?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Well, the horizon for G1 is certainly in that 10-year to 15-year, but there will be updates to the standards that the NFPA provides in the way of performance requirements for firefighters and that next standard revision, hard to believe, but it's just around the corner in 2018.

So it's an every 5-year update, 2013 is when the last standard was approved, the last revision and we'll see that in 2018. Probably just slight tweaks to the standard. I don't know that there is any discussion right now at this moment of anything earth shaking.

So the G1 will have the ability to be updated at that time. We've built the product very flexibly with anticipation of updating of standards. It's the only SCBA in the market that is able to be upgraded at software, is able to be upgraded. So as standards change, we'll be able to really build on that platform that we've introduced.



**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Okay and when you look at Murrysville, Pennsylvania and you look at Berlin and I'm not going to ask you about backlog numbers or units or anything. What would be the size difference in capacity? Is Berlin 25% or half of what Murrysville could be in production?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Wow, that's a good question, Brian. I don't know off the top of my head. Murrysville is clearly our largest producing plant for SCBA.

I would probably put Berlin's capacity at maybe a third to a half of what we're able to produce out of Murrysville; it's in that range. Meaningful, but not at the size and complexity that Murrysville is.

And we have done a lot of over the last year to two years to really build up the production capability and capacity of Murrysville.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Yes, with your exceptional conversion rates. The fact that it's brand new state-of-the-art technology, what you know and I'm sure obviously you're booking the shipments is, you know huge, you're taking in a lot of orders.

As it delays to get that product delivered to those firefighters. Are they exceptionally long for a product that's just come out of the blocks or give us the sense as to how, what's the back log or do you have a queuing system, is that on allocation, by order size? How do you guys kind of mitigate that, when you have such a huge demand out of the blocks?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Well as we reported in the first quarter. We had \$82 million in backlog in global SCBA demand. We worked that down a little bit to \$77 million, but the incoming order pace is still extremely high.

So while we're at the highest production rates that we've ever been on SCBA here, our backlog is still fairly high. Our customers to this point in time have been very accommodating to how we can phase that in, if certain customers require their SCBA. Certainly, we go through a prioritization make sure to determine which one is shipped.

But the production rates where they are, I looked at Nish, for commentary on what we're typically looking at here from a delivery perspective.

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**Nish Vartanian** - MSA Safety Incorporated - President - MSA North America

Yes, today we're running about. We're quoting about a 3 month delivery on a G1. Keeping in mind, especially with the 60% conversion rate. When these departments are converting from Brand X to MSA. They're going through a training period.

So they need to train all the firefighters on the product. So the longer lead time on the product really isn't disruptive for what they're doing. So they're able to train their people and set a date.

We're working on some deals today that they're looking at a projected install date of January and February and are very comfortable with that because they need sometime in the front to prepare for that.



**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Well okay, that sounds good. I would assume, Bill well how many shifts are running in Murrysville.

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

We're running, we're running three shifts. That plant is running, they're running all the time.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Any CapEx expansion there or is Berlin the CapEx expansion?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

I think the CapEx expansion is relatively minor. You won't see anything significant from a balance sheet standpoint regarding CapEx associated with the G1. We're able to fit that into our normal \$30 million to \$40 million in total CapEx spend annually.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Okay, sounds good. Give me just a little visibility you've talked certainly with the G1 on the fire rescue. Any comments on verticals across the globe either in industrial or mining or some of your other vertical areas. You talked a little bit about oil and gas. How about industrial and mining?

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**Bill Lambert** - MSA Safety Incorporated - Chairman, President, CEO

Well I think mining it's generally known that mining is down globally that's not a surprise to anyone.

The oil and gas market, while here in North America is off quite significantly. Oil and gas market actually in the Middle East is quite strong and contributed to that 35% growth in sales that we saw out of our Middle East operation.

Industrially, I think Europe is a bit stronger than most people expect it to be and so we're pleased by what we see happening industrially there and Mexico from an oil and gas standpoint, from a construction perspective, infrastructure spend standpoint. There is still a lot of optimism in Mexico right now.

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**Brian Rafn** - Morgan Dempsey Capital Management LLC - Analyst

Okay and then one question, Stacy your CapEx budget for 2015 and then maybe any thoughts on debt deleveraging. Are you on pace, based on maturity or are you accelerating any of that?

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**Stacy McMahan** - MSA Safety Incorporated - Senior Vice President and CFO

So Brian our capital expenditure budget is roughly depreciation every year. So it really is not in the cash outflow

we have net of depreciation. We have, we're sitting at a very comfortable debt level right now. We'll continue to pay it down as we have excess cash to do so, but it's a very comfortable leverage level for us.

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**Brian Rafn** - *Morgan Dempsey Capital Management LLC - Analyst*

Sounds good. Thanks guys.

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**Operator**

Ladies and gentlemen. Our last question is coming from Richard Eastman.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Just wanted to come back to you real quickly. Stacy, what are you doing, what adjustments are you making to get this 12.5%? Is that an EBIT number?

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

The op -- are you talking about the..?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

I think.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Yes for Europe. I'm sorry.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

It's an operating margin number.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay, all right. So that's operating profit. And then also from a cash flow perspective, could you maybe give us a sense of what a target and either cash from ops or a free cash flow number would be for the year?

I mean, we had a decent second quarter, but we had a kind of lousy first quarter from a cash perspective. What's a budgeted free cash flow number or at least a cash from ops number, could you give us that?

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Our cash conversion rate is around 70% and we don't actually specifically target a free cash flow number, we look at conversion rate.

So that's a more relevant discussion for us and its ebbs and flows by quarter, Rick. So in the first quarter we saw a tremendous investment in getting ready for the G1 and we had working capital that swings. You have accruals and prepaids that swing quarter-by-quarter.

So we really look at a longer term view and look at our cash conversion cycle. Ken, you can add a comment.

**Ken Krause** - *MSA Safety Incorporated - Executive Director - Global Finance and Assistant Treasurer*

The only one thing, Rick I would point out. As we disclosed at the end of last year. As we reached the settlement for about \$70 million on the insurance side and so we're going to start funding that in the second half here over a four quarter period commencing in the third quarter. So you'll see a little bit of cash going out for that activity.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

Okay, all right and then just a last question for Bill. You know this 3M purchase of Capital Safety. I think kind of involves 3M into a pretty strong number one position in fall protection and then you've got Miller at Honeywell, pretty strong number two.

And then, it falls off really rapidly to who the number three player is, probably you guys. But I'm just curious when you look at that transaction.

Does that change the competitive dynamics here, is there still an opportunity to grow your market share in fall protection and is that still a primary focus on the core product side for you?

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Well it is part of your core focus. There is no doubt about that, Rick. I think it's important to realize that about 40% of the global fall protection market is cornered by those top two participations, 3M's Capital Safety and Honeywell's Miller.

Below that, the global fall protection market is highly fragmented and we see plenty of opportunity to compete and to take share as we look at the global fall protection market.

It is the largest and the fastest growing market segment within the safety industry, the safety industry in which we compete and it's a great long term play, we believe. And clearly by their actions with Capital Safety I think 3M shares those thoughts as well and they've indicated that.

I don't think the industry is consolidated by any means and we're still committed to realizing growth from this area.

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**Richard Eastman** - *Robert W. Baird & Co - Analyst*

And is there an opportunity to get your fall protection EBITDA margins up to Capital Safety's? I mean those are pretty significant EBITDA margins.

I don't know, if compliments the private equity perhaps, but nonetheless, that was a pretty astounding number in terms of profitability, so? All right, well, thank you so much. Appreciated it.

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**Bill Lambert** - *MSA Safety Incorporated - Chairman, President, CEO*

Okay, thanks, Rick.

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**Stacy McMahan** - *MSA Safety Incorporated - Senior Vice President and CFO*

Thanks, Rick.

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**Operator**

Thank you. I'd to turn it back to Ken Krause for any closing or final remarks.

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**Ken Krause** - *MSA Safety Incorporated - Executive Director - Global Finance and Assistant Treasurer*

Thank you, Joe. Seeing that we have no more questions that concludes this mornings' call. If you missed a portion of the conference, an audio replay will be available in our website for the next 90 days as will the transcript of the call.

On behalf of our entire team here, I want to thank you again for joining us and your continued interest in MSA and we look forward to talking with you again. Have a good day. Good bye.

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**Operator**

Ladies and gentlemen, this does conclude today's teleconference. You may now disconnect.

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