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MSA - Q4 2015 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Good day ladies and gentlemen, and welcome to the MSA fourth-quarter earnings conference call. At this time, all phone lines have been placed in a listen-only mode and the floor will be open for questions following the presentation. It is now my pleasure to introduce your host, Mark Deasy. Please begin.

Mark Deasy - MSA Safety Incorporated - Director of Corporate Communications

Thank you, Joe, and good morning everybody. And I too would like to welcome you to our fourth-quarter earnings conference call for 2015. I am the Director of Corporate Communications and joining me on the call this morning are Bill Lambert, Chairman, President, and Chief Executive Officer; Ken Krause, Vice President, Chief Financial Officer and Treasurer; and Ron Herring, Senior Vice President and President MSA International.

Our fourth-quarter press release was issued last night and it is available on our website at www.MSASafety.com.

Before we begin, I need to remind everybody 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 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 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. You can find this information in our quarterly results section, which is located under the Financial Information header. That concludes our forward-looking statements.

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



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

Thank you, Mark, and good morning everyone. As always, I want to begin by saying thank you for joining us this morning and for your continued interest in MSA. I also want to thank the employees of MSA who continue to manage through challenging business conditions. I'm pleased to report that due to their efforts, we had a strong finish to the year.

Consolidated local currency sales increased 8% in the fourth quarter, and increased 4% excluding Latchways, the UK-based fall protection company that we acquired October 21 of last year. This strong finish to the year helped us recognize 8% local currency growth for the full year, or 7% excluding Latchways. This 8% local currency growth was at the high end of the mid-single-digit sales growth range that we have been discussing with you throughout the year. Much of this was due to great success in the fire service, which I will detail in just a minute.

Overall, I believe we executed well despite the external headwinds that are impacting our business, most notably the strong US dollar, the weak economic conditions in emerging markets like China and Brazil, and of course depressed oil prices that continue to adversely impact employment levels and investment levels in the oil and gas industry, which ultimately adversely impacts demand for some of our core product like hardhats and portable gas detection instruments.

While Ken is going to discuss our outlook on these areas during his commentary, I'd like to focus today on a few key themes of the quarter.

First, I want to provide an update on our performance in the fire service and in particular the continued success we are seeing with our new G1 self-contained breathing apparatus. Then I'd like to highlight progress made on key strategic initiatives in the fourth quarter, programs that are designed to position MSA for future growth and improved long-term profitability. These include our recently announced cost reduction program, our fourth-quarter acquisition of Latchways, and our Europe 2.0 transformation project. After that, I'll turn the call over to Ken for a financial review.

Looking at our financials, the G1 SCBA was a clear standout success for us in the quarter and really for the entire year. And that's exactly what we envisioned when we first began gathering customer feedback that identified for us the features and attributes firefighters wanted in a breakthrough and world-class SCBA. And that's what the G1 SCBA represents. It really is a revolutionary product that is allowing us to gain market share in an unprecedented fashion throughout the year. We continued to build momentum in manufacturing and the fourth quarter was our strongest quarter yet in terms of G1 units shipped.

The dedication of the team at our Murrysville plant here in Pittsburgh was instrumental in reducing our backlog throughout the year. What began as an \$80 million backlog in early 2015 changed to a \$68 million backlog at the end of the third quarter and then \$45 million at the end of the year.

The production throughput we saw in the fourth quarter drove North American SCBA sales up by an unprecedented 130%. Consolidated SCBA sales increased 57% from a year ago, driven by the outstanding performance in North America. Needless to say, this product continues to hit the mark with our customers in the fire service and has been a catalyst for capturing market share in this sector. In fact, more than 50% of all incoming orders we took in 2015 were competitive conversions. In the fourth quarter, MSA SCBA shipments reflected over 50% market share of all NFPA compliant SCBAs shipped to the fire service as reported by the International Safety Equipment Association who tracks these statistics. These metrics are a real testament to the G1's revolutionary design, its acceptance in the market and the advanced technology it brings to firefighters, all of which has set the G1 apart from competitive offerings.

Overall, we continue to see a steady incoming order pace for the G1, and we expect the replacement cycle opportunity for SCBA, which we've talked to you about before, to continue through 2016 and into 2017. That said, I think it's important to note that the year-over-year comparisons will become more challenging to beat each successive quarter, particularly as we move into the second half of this year.

If you recall, we entered 2015 with an elevated SCBA backlog due to the delay in government approvals for the G1 back in 2014. Throughout last year, we ramped up production and we worked that backlog down to \$45 million, which is relatively in line with historical levels. While we are planning for continued growth in incoming orders this year, we don't have the benefit of entering 2016 with the backlog we had to start 2015.

Our SCBA growth in 2016 will come from continued success with competitive conversions at major municipal fire departments, the retention of existing MSA accounts looking to upgrade their equipment and their capabilities, and success with opportunities outside the US in places like the Middle East, Latin America and Australia, just to name a few, where we are seeing strong G1 interest.

While we achieved unprecedented success in the US fire service in 2015, I know it will come as a surprise to no one on this call when we will say conditions were quite challenging in some of our other key end markets, most notably the oil and gas industry. As we've explained in the past, sales of portable gas detection instruments and industrial hardhats have been adversely impacted by decreasing employment levels in the energy market, primarily those activities related to turnarounds and maintenance outages.

If you remember, refining margins and consequently refining utilization rates were extremely strong during 2015.

The downstream oil and gas market has been enjoying lower crude input costs, historically high crack margins, increased demand for gasoline, all coupled with improvements in risk-based inspection programs in their facilities. This has resulted in refiners deferring all but the most critical turnarounds and keeping units running at high utilization rates.

The industry reports the extremely high utilization rates seen in 2015 have not been seen in the refine -- since the refining boom of the early 1980s. Industry experts further predict that deferring of maintenance spending will likely come to an end in 2016 due to thinning crack margins and the need to align sulfur content in gasoline to new EPA regulations. We expect that increased turnaround activity to drive some welcome growth in our sales of portable gas detection instruments and head protection for 2016. But as you know, market dynamics have been choppy at best and require a cautious outlook in this area.

In response to the slower growth environment, we announced a cost reduction initiative on our October call. During the fourth quarter, we completed a number of key activities associated with the program which was focused on reducing headcount throughout our segments and implementing discretionary cost controls.

The steps we've completed to date are expected to result in \$10 million of operating cost savings in 2016. While this initial phase of the program is now complete, we continue to look at opportunities for further cost reduction and efficiency improvements as we foresee continued headwinds in the key industrial markets and emerging markets that we serve. Along with many other global industrials, we are operating in a challenging environment, and we are taking these steps to ensure that MSA is well-positioned to continue executing on our growth strategy and making progress toward our long-term financial targets.

Despite the macro factors I just mentioned, we continue to capitalize on opportunities for growth in attractive markets, attractive markets like global fall protection. This is the largest segment of the global sophisticated safety products market which is estimated at \$1.5 billion to \$2 billion in size.

Our fourth-quarter acquisition of Latchways, a UK-based leader in highly engineered fall arrest systems, immediately doubled MSA's market share in fall protection. This step now positions us as a global leader in the market and provides a solid foundation on which we can build and execute our growth strategy.

Since closing the transaction in late October, Latchways revenue has been tracking in line with our expectations. We've also seen a solid incoming order pace with opportunities in end markets that were not previously strong MSA strongholds, including utilities, wind energy, and aircraft maintenance.

In addition to complementing MSA from an end market standpoint, the combination of these two great companies is also strengthening and broadening our product offering and geographic footprint. We are on track with our integration plan and have taken steps to ensure that we are positioned to achieve our target revenue and our target cost synergies. We still expect to be accretive in 2016, the first full year of ownership, and Ken will review some of our other assumptions with you in his commentary.



As we have noted previously, this transaction represents a key step in the execution of our corporate strategy by expanding our investment in one of the fastest-growing segments of the global safety market. Overall, I am pleased with the progress we are making in leveraging MSA and Latchways' unique strengths, and I am very excited about the wide range of innovative and market-leading fall protection solutions that MSA now provide to our customers around the world.

Switching gears and thinking about another project that is positioning MSA for long-term success, let me give you an update on where we stand with regard to our Europe 2.0 initiative. As most of you know, Europe 2.0 is our transformational initiative focused on moving away from a fragmented structure of individually managed affiliates to a Pan-European organization enabled by a single IT platform under SAP ECC 6. Last year, we took the benefits of this project a step further by implementing a Principal Operating Company model in Switzerland. The model is designed to drive optimal performance by aligning certain strategic planning and decision-making functions into one location, which reinforces the standardized business processes that are such a key part of Europe 2.0. This model also allows us to drive maximum after-tax value on this investment.

As you might remember from our last call, we announced we had successfully integrated four European affiliates into the Principal Operating Company model in October, and we told you that we would bring four more affiliates into the model just after the first of the year. I'm pleased to report that's exactly what we have done.

Our affiliates in the Netherlands, Belgium, Poland and the Czech Republic are now part of the Principal Operating Company model in Europe. This means we successfully implemented SAP in these locations and we went live without any major business disruptions.

Further, we consolidated our warehouses at these locations to our central warehouse outside of Berlin. And with that, our warehouse consolidation efforts are now complete. What this means is that we have gone from 10 warehouses in Western Europe at the start of this initiative to one warehouse by January 2016. The new warehouse structure helps us to reduce overall inventory held throughout the region, reduces our management costs and, most importantly, better enables us to serve our customers with improved on-time delivery performance. This consolidation was not an easy task, and I am proud of our entire team in Europe and their tireless efforts to complete this extensive project on schedule and without any business disruptions.

As we have noted previously, streamlining our European organization in this way and exiting certain jurisdictions can trigger one-time exit tax charges. Along those lines, we are expecting to incur about \$3 million to \$5 million in exit taxes in the first quarter of 2016 which are associated with our January go-live events. This amount will be reflected in the provision for income taxes line on the income statement.

With eight new affiliates now part of the POC model and our Pan-European management team in place in Switzerland, I foresee MSA Europe to be a key value contributor over the next several years. Along with improved growth and operating margin expansion at the segment level, we are expecting to generate a 200 to 300 basis point improvement in our consolidated effective tax rate over the next year or two as a result of implementing the POC model.

Lastly, I want to take a moment to publicly welcomed Ken Krause to MSA's executive leadership team. As we announced in December, MSA's Board of Directors elected Ken as our new Chief Financial Officer. From controllership and audit services to financial planning and analysis portfolio management, Investor Relations, treasury and tax planning, over the past 10 years, Ken has accumulated significant experience across virtually every area of finance and accounting at MSA. Additionally, he knows our operations and the challenges and opportunities that we face extremely well. I know I speak for our entire Board of Directors and my executive leadership team when I say that we are pleased to have Ken as our new Chief Financial Officer, and I look forward to the value, insight, and perspectives that he's going to bring to this role.

So, with that, let me turn it over to Ken for him to speak to you about our fourth-quarter and year-end financial results. Ken?

Ken Krause - MSA Safety Incorporated - VP, CFO, Treasurer

Thanks, Bill, and good morning everyone. Let me first start by saying that I'm honored to join MSA's executive leadership team as Chief Financial Officer. I look forward to working with the entire team at MSA to drive earnings and cash flow growth as we bring new and innovative products to the markets we serve around the world.

Today, I'd like to take some time to walk you through our fourth-quarter financial results and to provide more insight into the drivers of performance. Additional information will be available when we file our Form 10-K with the Securities and Exchange Commission.

We had a strong finish to a very challenging year. Despite some of the macro headwinds we faced throughout the year, we were able to generate strong topline local currency growth and took solid steps to position ourselves for long-term value creation.

Let's start today's review by recapping a few of the highlights of our full-year 2015 performance. First, full-year revenue from the core area of our business increased 11% in local currency, or 10% excluding Latchways on strong performance in fire service markets. Our past R&D investments are yielding solid returns with sales from products developed and launched over the past five years comprising nearly 40% of our consolidated sales.

We efficiently deployed capital to acquire Latchways, a strategic investment that immediately doubled our market share in fall protection while expanding our geographic footprint and broadening our end market coverage. We executed a cost reduction program in the second half of the year and maintained a close watch on discretionary spending, driving 130 basis points of operating leverage on selling, general and administrative expenses for the full year, excluding transaction costs related to the Latchways acquisition. I assure you we will continue to keep a sharp focus on reducing our cost structure while investing in key long-term value creating programs and initiatives.

To ensure sufficient capital was available to invest in these programs, we executed a new global revolver in December that provides access to \$575 million of committed capital. Additionally, during January, we took advantage of low long-term interest rates and issued an \$80 million note at a fixed interest rate of 3.4% through 2031.

And as part of our balanced approach to capital allocation, we continued to increase our dividend just as we have done for nearly 50 years. During 2015, we returned \$1.27 per share to shareholders, reflecting a 3% increase over 2014. As we drive improvements in earnings and cash flow, we will continue to return capital to shareholders while investing in programs aimed at driving long-term value creation.

Now, let's dig a little deeper into the quarterly financials. Sales from continuing operations in the fourth quarter were \$313 million, which includes \$10 million of Latchways sales. Excluding Latchways' results, sales were down 3% on a reported basis and up 4% on a local currency basis in the quarter.

As you know, we've seen significant headwinds this year related to weaker foreign currencies. As Bill mentioned, for the full year, the FX translation headwind was 8% on revenue and 2% on earnings, in line with the range we communicated to you on our past earnings calls. Looking forward to 2016, we continue to expect some pressure from FX translation but anticipate a reprieve from the significant pullback we saw during 2015.

Looking closer at the year-over-year quarterly results comparison, core product sales increased by 12% on a local currency basis, or 8% excluding Latchways. Results continue to be driven by strong sales of the G1 SCBA. Global SCBA revenue was up 57% on North American SCBA sales that more than doubled, driving that strong sales vitality metric I mentioned a few minutes ago. These improvements were partially offset by portable gas detection down 6%, and industrial head protection down 10%, as lower employment levels in the energy market continue to impact demand for these products, particularly in North America.

Looking at FGFD, if you remember, on the last call, we indicated that we faced a challenging comparison in this area for the fourth quarter as this period of 2014 saw an unusually high volume of large project shipments that drove nearly 25% growth in that period. Given this tough comparison in the overall market conditions, we saw an 11% decline in FGFD sales in the quarter.

In light of the headwinds in the oil and gas industry that we've seen since the beginning of the year, let me provide a quick update on the outlook for our products that are more exposed to this market. As we've communicated on past calls, a significant portion of our portable gas detection and industrial head protection sales are correlated to employment levels in the oil and gas industry. We continue to estimate the total exposure levels within these products reflects between 10% and 15% of consolidated revenue. We saw pullback throughout the year in this area. Echoing Bill's comments, we expect that deferred maintenance turnaround activity could provide a source of modest growth in 2016, but we remain cautious on this given the volatility of the market.

Continuing to look at energy exposure, another 5% to 10% of our consolidated revenue, primarily in the FGD product line, is more susceptible to a pullback in capital equipment spending. Although FGD was growing in the high single digits through the first half, we saw it we can in the second half on a very challenging prior-year comparison, finishing the year at 2% decline in local currency.

Overall, the FGD the business held up well despite a very challenging year. We continue to see solid performance from investments we have made in markets outside of North America across the Middle East, Latin America, Mexico, and Eastern Europe where full-year local currency revenue from these products improved over 20%. These results were offset by weakness in the US and Canada, where full-year revenues were down 8%, notably within the Gulf Coast region and in the energy markets throughout Western Canada.

Across the energy sector, 2015 was a very challenging year, but I am pleased with how we performed in the FGD business. In addition to solid performance on larger projects outside of North America, business derived from our installed base held up well. As we have discussed on a number of occasions, this business has a considerable recurring revenue stream, and that, combined with the solid project business in international and European markets, helped to offset weakness in North America. While we could see a slowdown in this area in 2016, order activity remains ahead of expectations to start the new year, and the pipeline of new projects remains healthy outside of North America. Additionally, our strong installed base and healthy recurring revenue stream is expected to help continue to provide a nice cushion against the downturn in project oriented business.

Shifting gears, let's take a look at our results in emerging markets, which continue to be a mixed story. These areas declined by 4% in the quarter as weaker performance in China and Brazil, along with lower large orders in Mexico, was only partially offset by strong results in the Middle East and parts of Latin America. For the year, emerging market sales were up 3% in total, or 7% when you exclude China and Brazil.

Looking forward, we continue to see strong growth opportunities across parts of Latin America, the Middle East, and Mexico. However, we are facing weaker business conditions in China and the Brazilian recession continues to present challenges. All told, we expect these conditions to persist into 2016 in China and Brazil, impacting our overall growth in emerging markets.

In light of the challenging growth environment that Bill discussed and we continue to face, cost controls and restructuring activities aimed at streamlining our business model continue to be a focus for us. As we discussed in October on the third-quarter call, we completed a significant cost reduction program in the fourth quarter, and have entered 2016 closely monitoring spending levels. I'll share more details with you on that in just a moment.

Our gross profit rate for the third quarter was 42.8%. Excluding amortization related to the recent acquisition, gross profit was 43.3%, decreasing 170 basis points. While a less favorable product mix had an impact on margins, indirect costs, primarily related to warranty expenses, decreased gross profit by 120 basis points.

Here at MSA, we pride ourselves in providing a customer experience like no other. And part of that experience means ensuring that our products are of the highest quality for every customer on every order. In the case of this quarter, the promise to our customers put some pressure on gross profit in the form of warranty expense. However, it is that same promise that keeps our customers coming back time after time, demonstrating their loyalty to MSA and supporting the strong local currency sales growth that we recognized this year despite the challenging environment.

Selling, general, and administrative costs were \$84 million in the quarter, increasing \$6 million from a year ago on a reported basis. Excluding Latchways transaction and integration costs, which were just under \$7 million in the quarter, SG&A was \$77 million, or 24.5% of total sales, compared to 24.9% of sales a year ago. As I mentioned earlier, for the year, SG&A, excluding transaction costs, provided 130 basis points of operating leverage, reflecting the cost control initiatives that we have executed throughout the second half the year. Good performance as we continue to execute on a number of initiatives aimed at driving operating costs lower.

Our investment in research and development this quarter was \$12 million, or 3.9% of sales, as we continue to innovate around the G1 platform and other areas of the core like gas detection. Our sales vitality results, that is the percentage of consolidated sales derived from products developed and launched within the past five years, continue to gain momentum, finishing at 38% for the year compared to 27% in 2014, driven by investments we have made and results we are seeing in SCBA and fire helmets.



Operating margin in the fourth quarter was 12.2% of sales, or 14.9% on an adjusted basis excluding Latchways' transaction, integration, and amortization associated with the acquisition. For the year, operating margin was 12.1% of sales, or 12.9% on an adjusted basis excluding Latchways' transaction, integration and amortization costs, improving 20 basis points from last year.

Thinking about how we can make strides towards our long-term targets and manage through these challenging conditions, let me give you some detail on the initiatives we executed in the fourth quarter. On the October call, we announced a comprehensive cost reduction program aimed at driving \$10 million of operating cost savings in 2016. We finished that program in the fourth quarter and executed restructuring activities across all three of our reporting segments, including taking steps to right-size several emerging market geographies and other areas impacted by the weaker conditions in key end markets. As part of this program, we have reduced global headcount by approximately 220 employees as we have made tough decisions on where to invest and where to reduce expenditures. While we've made significant progress on this program and fully expect to get the \$10 million of cost savings we planned for, we are actively evaluating additional cost reduction opportunities that could be acted upon should economic conditions weaken further.

Our effective tax rate this quarter was 29%, down from 31.7% a year ago, due to benefits from the US research and development and manufacturing credits, as well as lower cash repatriation as we optimize our global cash position while taking advantage of offshore cash to invest in the acquisition of Latchways. Our full-year effective tax rate, excluding European exit taxes, was 33.1%, right in line with the range we indicated on the October call.

Net income from continuing operations was \$21 million in the quarter, or \$0.55 per diluted share. Adjusted earnings were \$0.84 per diluted share in the quarter, down 10% from our record fourth quarter a year ago. The Latchways transaction was dilutive to quarterly earnings by \$5 million, or \$0.13 per diluted share, all of which is attributable to nonrecurring transaction costs. Excluding nonrecurring transaction and integration costs, the acquisition had no impact on MSA's earnings.

On that note, let's discuss some of the financial expectations for Latchways. From a performance standpoint, Latchways' post-acquisition sales of \$10 million increased over 10% in local currency from the same period a year ago, and finished the year in line with our internal plans.

Looking forward, the incoming order book is healthy. As we indicated on the last call, we expect accretion in the first full year of ownership and returns in excess of our weighted average cost of capital by year three. After refining our purchase accounting assumptions, we continue to model accretion in the range of \$0.05 to \$0.10 per share for the full year of 2016 on a GAAP basis, driven by a combination of cost synergies and recovery in the base business. We have a growing confidence in our ability to achieve this accretion in 2016. We are executing well on realizing our cost synergies and the base business continues to recover, as demonstrated by the strong local currency revenue growth I just mentioned.

Quarterly free cash flow was \$34 million, or 165% of net income, compared to \$47 million a year ago, driven by an improvement in inventory that was partially offset by lower net income and a higher level of product liability settlements. For the full year, free cash flow was \$19 million, or 27% of net income, as the launch of the G1 SCBA and the associated manufacturing ramp up drove weaker results in working capital. Additionally, we paid \$33 million for the year in connection with the product liability settlement that we discussed with you earlier this year. Excluding the product liability activity, free cash flow conversion approximated 75% of net income for the year. Driving improvements in working capital is a key priority moving forward, and we expect this effort to contribute to improvements in free cash flow this year.

Our total debt balance was \$467 million at the end of the year and our cash balance was \$106 million, resulting in net debt of \$361 million. We finished the year with a debt to EBITDA ratio of just under 2.5 times, or 1.9 times on a net debt basis, in line with the targets we discussed with you on our last call.

Since closing the acquisition in late October, we've made substantial progress in securing access to additional capital while also taking the opportunity to lock in very attractive long-term rates. In December, we refinanced our global revolving credit facilities into one new facility, increasing our available revolver capacity to \$575 million from \$300 million. Then, in January, we refinanced \$80 million of that new revolver debt into a fixed 15-year facility with a coupon of 3.4%. These changes to our capital structure have positioned us to continue to maintain our balanced approach to capital allocation.



As we think about 2016, we expect to continue to see a slower growth environment, and that will most certainly require us to continue to diligently manage our cost structure. All told, we are planning for mid-single-digit revenue growth in local currency for 2016.

From a free cash flow perspective, we expect to see improvements in working capital next year as we start to drive down the higher level of working capital we saw in 2015 on the strong revenue growth in SCBA. The investments we made this year in new product development, fall protection with the acquisition of Latchways, and our efforts to reduce costs and restructure our business should help us manage through challenging conditions that we face in key end markets and geographies in 2016. We continue to focus on using our enhanced capital structure to strategically deploy capital, helping us maintain our balanced approach to capital allocation while investing in new product development and other key initiatives that will continue to lay the foundation for profitable growth in 2016 and beyond.

That concludes my financial review. I will now turn the call back over to Bill for final remarks.

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

Thank you Ken. As we close the book on 2015, I am proud of how the MSA organization executed in this challenging environment. We achieved our mid-single-digit local currency sales growth goal, we took steps to invest in growth opportunities and deploy capital on a very strategic acquisition, and we made restructuring investments to streamline our operations and reduce our operating expenses going forward.

Moving into 2016, we continue to look at how we might further optimize our geographic footprint and our cost structure to drive higher operating margins in what is shaping up to be a slower growth environment. Despite the headwinds that we face, we are going to continue to use our strong capital structure to make focused investments that will drive progress against the pillars of our corporate strategy and position MSA strategically and financially for long-term value creation.

Thank you for your attention and your interest in MSA this morning. At this time, Ron Herring has joined Ken and me and we will be happy to take any questions that you may have. Please remember that MSA does not give guidance and that precludes most discussion related to our expectations for future sales and earnings. Having said that, we will now open the call to your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. The floor is now open for questions. (Operator Instructions). Edward Marshall, Sidoti.

Edward Marshall - Sidoti & Company - Analyst

Good morning gentlemen. So, I wanted to ask a little bit about the guidance, and I just want to talk about the tax rate because I know there's a lot of movements there with the Swiss benefits probably kicking in in 2016 and R&D tax credit, and I'm assuming there are some changes with Latchways. So can you give us an indication as to what you expect for the tax rate for 2016?

Ken Krause - MSA Safety Incorporated - VP, CFO, Treasurer

Sure, Ed. When we look at the tax rate, as you very well know, our global footprint really -- our global footprint really has an impact on our tax rate, really where we make money. And so when we look at for example 2015's performance at 33% for a full year, excluding exit taxes, a big part of the profitability that we recognized in 2015 was driven by the strong North American and US-based results.



So as we think about next year and going forward, we certainly are planning for continued improvements in profitability in North America but also continued improvements in profitability across our European segment as well under our POC. However, when we think about our tax rate, a lot of it is going to be driven by the composition of those profits around the world.

So I'm a little reluctant to give forward-looking guidance that shows that we would recognize a significant improvement year-over-year because there's just so much uncertainty in our end markets that's driving the profile of profitability at this point.

Edward Marshall - *Sidoti & Company - Analyst*

Fair enough. When you look at kind of the fire services, and I guess I kind of wanted to get your thoughts on the cycle because I guess the typical change -- when there's a typical change of the NFPA standards, there's a one-year lag that's kind of digested by your customer base. Then sales start to pick up. We are seeing a little bit different cycle this time, especially with the delays that you originally faced.

I kind of want to get a sense as to what you think, from the market, how the share gains are playing into it in this awkward ramp, and more importantly, how you think ancillary add-ons that you've been working on like thermal imaging integration, how that plays into kind of the cycle as well.

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

Sure. I can take a stab at that. I think that you need to take a look back at that replacement cycle. And if we go back to 10 to 15 years ago, there was roughly \$3 billion of firefighter grants that were pumped into the market from 2002 to 2006. And of that, about 30% to 50% was used to purchase SCBA. And when you fast-forward to the present day, most of that, those units, are reaching their end of useful life and are coming out of service. So, I think it's reasonable to assume we take some of those big numbers, we take pricing impact and the changes of NFPA standards over the time period, and we make some certain assumptions on what the replacement cycle replacement rate might be. So if you factor that all down, maybe it's a \$1.2 billion to \$1.5 billion opportunity, we think, in purchases over the past year, but really looking forward over this year and over the next two to three years perhaps. So \$1.2 billion to \$1.5 billion in total opportunity. And so that's why we think it so critical then to introduce these new technologies that are in the G1 SCBA and to advance those technologies even further into a system concept, as you indicate, by integrating TIC as we showed at last year's FDIC show, and we will be further developing in 2016. We think those are all great opportunities for us to take share, continue to take share this year, and to excite the market with some of these new integrated technologies that the G1 enables us to have.

Edward Marshall - *Sidoti & Company - Analyst*

I'm assuming your goal is 100% share? I'm kidding. What is the goal for share gains and where do you think you sit right now after kind of almost one year of production?

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

I don't think I'll indicate what our share gains are, but it's certainly to improve our position. As I indicated in our comments, roughly, we are seeing roughly 50% of all of our incoming orders for SCBA as competitive conversions. We are really happy about that, and the data that is supplied by the ISEA shows that in fact we had in the fourth quarter over 50% market share of units sold as reported by ISEA. So we are really happy with that and let's just trying to keep that going.

Edward Marshall - *Sidoti & Company - Analyst*

Could you remind me what your North American share was in 2014 for those product lines?



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

I don't have that, but if I were to guess, it would probably be just around 30%. That's a fair estimate.

Edward Marshall - Sidoti & Company - Analyst

Good. Thanks guys, appreciate it.

Operator

Rob Mason, Robert W. Baird.

Rob Mason - Robert W. Baird & Company, Inc. - Analyst

Good morning. Bill, you mentioned that your target is mid-single-digit local currency growth this year. So Latchways obviously contributes maybe 3, 3.5 points of that, so modest, very modestly positive expectations around organic growth. If you had to handicap how that weights out by geography, your three geographic buckets, how does that modest organic growth look between North America, Europe and the international piece? And I'm thinking does the G1 SCBA, I know we have still tough comps that we'll be dealing with in the second half, but is that really what pushes -- does North America lead here compliments of the SCBA?

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

I think it does, Rob. The way we look at the market, North America right now is our strongest market, unquestionably. We are seeing nice growth in certain international markets like the Middle East, like Spanish-speaking Latin America, but those growth areas are being offset by areas like China and Brazil where the markets are much softer right now, Brazil actually in a very significant recession.

So, when you look at it in totality, North America is really the area of the business that has some growth opportunities right now, certainly with the G1 SCBA, as we've talked about.

But also as we expect and as my comments reflected, we think that, in the energy sector, the turnaround activity will increase this year. It has been at historically low levels for the last couple of years, and we are getting indications that that should be an improvement. And that helps us in the hardhat area, in portable gas detection instruments area, those product lines that are related to employment levels.

Rob Mason - Robert W. Baird & Company, Inc. - Analyst

Okay. Because if you look at your fourth-quarter North America product line growth, obviously SCBA did well, but the other categories degraded. I know comparisons played into that. But did you sense that demand in some of these other maybe broader industrial categories eroded on you in the fourth quarter, or was this fourth-quarter channel inventory adjustments and you haven't necessarily seen that carry into the first quarter? But maybe just some more color on how the fourth quarter played out more broadly to the extent it's oil and gas related, sure, but broader industrial as well perspective?

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

Yes, I think that, broadly, industrials eroded a bit in the fourth quarter last year. I think there's probably consensus on that among other industrial CEOs as well. But there are certain segments of the market that did improve or that did show some strength. Aircraft construction, those employment levels were improving in the fourth quarter and we saw some increased activity there. Utilities seeing some increased activities there.



But broadly, I would say and agree with you that the industrial segment decreased. The comps were a little bit tough, so you have to kind of pull that away. North America had some very tough comps in fixed gas and flame detection orders and shipments in the fourth quarter of 2015 versus 2014. So pulling that aside, we saw it erode a little bit. I wouldn't say that it eroded perhaps as dramatically as the as-reported results might indicate because of the large order and large shipment affect.

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

Just to add onto that, I would agree. Just starting the year and some of the order activity in some of our industrial-based businesses, it is certainly challenging. But I had commented in my remarks, Rob, was the FGFD business continues to do quite well to start the year. So, it's really a mixed bag so to speak. We continue to see some challenges in the portable gas and the head protection side. FGFD is performing well though.

Rob Mason - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And Ken, just a clarification on the gross margin commentary. You mentioned gross margin without amortization. But just to be clear, you did not pull amortization out in your adjusted EPS number, did you? Or is that excluding --

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

No, you're right. No, we did not. You're exactly right. And so we kept the amortization in our adjusted number, what we reported out, just to show the impact on the gross profit figure. I know I think, in your early report from this morning, you had talked a bit about that, so we thought we would help the investment community with that.

Rob Mason - *Robert W. Baird & Company, Inc. - Analyst*

Was there any inventory step up revaluation impact on gross profit from Latchways (multiple speakers)

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

That's right. Yes, Rob. Part of that 50 basis points or so is the step up in the inventory and the related amortization. It's a small component of that, smaller component of it, but there is a piece of that.

Rob Mason - *Robert W. Baird & Company, Inc. - Analyst*

And then the warranty impact, I'm sorry, I just didn't catch the number that you provided.

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

Our indirect -- so in the quarter, I want to say we talked about 120 basis points of headwind from indirect charges, you know, warranty, freight, those sort of things, just responding to the customers' needs.

Rob Mason - *Robert W. Baird & Company, Inc. - Analyst*

Would you consider those one-time items then, just unique to the fourth quarter? Is that something that carries forward to service those?



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

I don't think that carries forward. I think there were some unique situations. I don't think it makes sense to parse it apart here on this call. But there were some unique situations. I don't see that necessarily as a go-forward to that rate. We are always striving to improve our quality, reduce our warranty costs and expenses. And we had some one-off costs there in the fourth quarter that I would not expect to see going forward.

Rob Mason - Robert W. Baird & Company, Inc. - Analyst

Okay, very good. Thank you.

Operator

Rudy Hokanson, Barrington Research.

Rudy Hokanson - Barrington Research Associates, Inc. - Analyst

Good morning. A couple of questions, one on Europe. I know -- excuse me -- you're down to one warehouse. But are there other things that are still being implemented in terms of the integration into the 2.0?

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

Into 2.0, we have ongoing initiatives certainly, Rudy. But I would say that, into the POC model, we have another affiliate that will come into the POC model in 2016. And we continue to realign our resources over there to fit under the POC model and to best serve that market, those markets.

Rudy Hokanson - Barrington Research Associates, Inc. - Analyst

Okay. Is there anything that could delay adaption of the G1 in Europe in terms of any regulation or governmental issues as you had waiting for approval in the US, or could the G1 start selling just based on market demand in Europe?

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

A couple of thoughts on that. First, the G1 is approved for use and sale in Europe, so we are very actively marketing that product to fire departments over there and showing them the advantages and the new technologies that we have been showing here to the North American market.

But the big difference in Europe is you did not have, after the 2001/2002 time period, you did not have in Europe this large influx of federal funding for replacement of SCBA or to outfit firefighters with new equipment. So, there is no replacement cycle per se as there is here in North America.

So what we have done is introduce the G1 SCBA with the European approvals, necessary approvals. We've put together configurations that we think serve that market exceptionally well, and we are going out there and trying to sell it against a leading competitor who also has a very strong hold in Europe. So it's a tougher battle. It doesn't have quite the same stimulus behind it from a replacement perspective that the North American market does, but it is getting some attention, and we certainly hope to have success.

Having said all of that about Europe, we are seeing some opportunity and great success, as I indicated in my comments, for the G1 in the Middle East, in Australia, and in Spanish-speaking Latin America. And we have had success there with the G1 and we expect to continue to have some good success.



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

Thank you. And then on Latchways, you made the comment that the \$10 million that you recognized in revenue after it was closed in October in the fourth quarter was up 10% year-over-year. Is there something happening on a macro basis? You did mention that fall protection is probably the fastest growing market globally, or is Latchways? Does it have some new products that you are now getting the benefit from given the timing of your acquisition? Can we look at 10% as perhaps a run rate for 2000 -- realizing you don't give forecasts, but I mean, is Latchways positioned to get that kind of growth in its first year with you?

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

As you said, Rudy, we don't give guidance. I won't comment on the question of whether or not we should expect to see 10% growth in 2016 from Latchways. Having said that, I will tell you that Latchways has a strong presence in the utilities market, in the wind energy market, in the aircraft production and aircraft maintenance market segments. And those segments is where Latchways showed some very strong growth in the two months that we owned them in 2015. We see some continued good, strong opportunities as we then layer in MSA's distribution channels and channel partners. And additionally, Latchways does have a new product line that they have introduced and we fully expect to see the benefit of that in 2016.

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

Okay, thank you. Those are my questions.

Operator

Walter Liptak, Seaport Global.

Walter Liptak - *Seaport Global Securities - Analyst*

Thanks. Good morning guys. I wanted to ask about the G1 SCBA and production levels. You did a nice job working down the backlog. Is there a level that you would like to get it to still? And was production in the fourth quarter higher than normal as you go through this catch up? If we can just get some color on what you think the production levels will look like in 2016.

And then I also wanted to ask about profitability. I think you said on other calls that the operating profits were lower for the SCBA. I wonder if you've got improvement programs to get those margins up and are you there yet in terms of where you want to see the margins?

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

Sure. I think that, as I indicated in my comments, our backlog in SCBA is down to around \$45 million, which is not untypical for us in the SCBA product line. So, we are down to about where we normally have a run rate of backlog of orders on SCBA.

The fourth quarter was strong for us, so that was an uncharacteristically strong fourth-quarter performance for us. And I would expect to see -- I mean, it all depends on incoming order rates and our conversion successes in the market, but I would expect us to now be at kind of a stabilized rate in SCBA production going forward.

And what was the other part of your question?



Walter Liptak - *Seaport Global Securities - Analyst*

Margin improvement (multiple speakers)

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

Margin improvement (multiple speakers) SCBA.

Walter Liptak - *Seaport Global Securities - Analyst*

Yes, just on profitability margins.

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

Right. As we commented on earlier calls throughout the year, we saw some increased expense as we brought the G1 up to speed, ramped it up. We went to heroic efforts in some areas to work that backlog down and that caused us to have increased costs.

In the fourth quarter, we started to see some benefit of getting to more normalized rates in production, and we actually did see nice cost reduction programs have an impact and effect. So I would expect to see those SCBA margins improving and getting closer to the overall corporate average for gross margins in 2016.

Walter Liptak - *Seaport Global Securities - Analyst*

Okay. Thanks for that color. I wanted to ask too about working capital. You kind of called out the investment that you had to make in 2015. What kind of cash inflow can you get from working capital accounts in 2016? Where would you like to see working capital as a percentage of net income or as a percentage of sales by the end of the year?

Ken Krause - *MSA Safety Incorporated - VP, CFO, Treasurer*

That's a great question. When we look at working capital and we look at free cash flow, over the long term, we've been in that roughly 80% conversion. I'll say we are not happy with that level of conversion. And what we are trying to target for is upwards of 100% conversion. So those are what we are looking at. Those are some of our targets, and some of the goals that we are executing towards as we enter 2016 and move forward.

Walter Liptak - *Seaport Global Securities - Analyst*

Okay, great. And the last one, on your oil and gas exposure, I'm hoping I can get a little bit more of a clear picture on how downstream turnarounds impact some of the personal protection devices, the helmets and the other personal devices. Do you need to see a pickup in turnarounds or is this a replacement cycle that the products are on?

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

No, we really need to see a pickup in the turnaround activity, the number of planned and unplanned outages that take place in downstream energy markets. And how it impacts MSA's business is that it's all related to employment levels. So as thousands of workers would descend upon a refinery, that's more hardhats, that's more portable instruments that get utilized, that's more fall protection that will get utilized in that activity.



And as I indicated in my comments earlier, 2015, we saw the lowest turnaround activity in at least the last eight to 10 years, and we haven't seen utilization rates within refineries at these levels in the past 30 years. So, we expect that 2016 will see increased turnaround activity and we are watching that very, very closely.

Walter Liptak - *Seaport Global Securities - Analyst*

Okay. That sounds like your data points are pointing to perhaps a pickup in the spring. Is that correct?

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

I think that it's not just our data, but it's some of the industry statistics that get reported would show that there would be an increase in the spring. And the fact that you have to look at both planned outages and unplanned outages. And the unplanned outages are also at historically low levels. So you can -- let's presume that the unplanned outages stay about where they are, the planned outages are absolutely scheduled to be at higher levels this year than they were for last year or for 2014.

Walter Liptak - *Seaport Global Securities - Analyst*

Okay. Thank you.

Operator

Brian Rafn, Morgan Dempsey.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Good morning Bill. Give me -- you did a great job certainly with some of your granular analysis on the SCBA. Can you give a sense as to what kind of forward runway you have for that, the new self-contained breathing apparatus, meaning what is the next NFPA guidelines? Is that about a 10-year horizon or eight-year horizon? How long would that product cycle go?

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

The NFPA standards, performance standards, for SCBA get revised every five years, so the next revision I think is set for 2018, so another couple of years before there is another revision to the performance standards for SCBA.

I don't know. I'm not in the right position to say what kind of changes they are looking at for the SCBA, but I can tell you that we have certainly designed the G1 SCBA to be very flexible in what it can do and how it could be upgraded, and how it could be integrated with other equipment like thermal imaging cameras, like radios and comm systems. And so I think the runway for the G1 is quite long. We see the G1 being around at least another 15 years, if not longer, in the market in one shape or another.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. That's good. I appreciate the color there. Give me a sense. Those add-on thermal imaging, the radios and that, are those selective? Those aren't mandatory. Those are like modules that you can add, fire departments can add those or not, given their cost constraints on budget?



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

That's exactly right.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. What -- relative, what are you seeing in the adoption? You guys have had a fabulous certainly competitive conversion. Maybe between the urban larger budget departments versus some of the rural volunteers relative to these G1s?

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

We've always had a strong position in the rural volunteer fire departments, which far outnumber the number of firefighters that are paid firefighters. But what the G1 has enabled us to do is really target municipal fire departments, paid fire departments, where we have not had historically a stronghold. And so we're going after both of them right now.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. So you don't see any sticker shock or whatever on the volunteer rural guys, budget-wise?

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

I would say that it's our experience that the value created by the G1 is enabling a lot of adoption by these municipal fire departments as well as the rural or volunteer fire departments, and I would also say that municipal budgets seem to be relatively healthy right now.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay, all right. And you've done a fabulous job certainly on new product introductions over the last three to five years. When you look at areas of the business that are softer, certainly the oil and gas -- the gas detectors, the flame detectors, that type of thing, how does that impact new product launches in areas where you might have sales erosion, where you don't have a lot of free cash flow being generated?

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

We try to look through the cycle, and our decisions on new product developments are not really impacted by where we are in the business cycle or economic cycle right now.

So, we have a portfolio of NPD activity that's ongoing, and you will continue to see MSA introducing new products even in some of those areas of the business that right now might be down on a comparative basis versus a year ago. But you will continue to see us introducing new products that have an impact and effect, and look for when the cycle turns around.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. And then finally, on your Europe 2.0, how many total affiliates will inevitably be on that platform? I think you mentioned you had eight. You're adding a ninth. How many total towards that finish?

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

That's a good question. I want to say close to 14.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. All right. All right guys. Thanks so much, appreciate it.

Operator

Thank you. Ladies and gentlemen, this concludes the question-and-answer session of today's call. I would like to turn it back to Mark Deasy for any closing or final remarks.

Mark Deasy - *MSA Safety Incorporated - Director of Corporate Communications*

Thank you Joe. I just would like to remind everybody that, if you missed a portion of this morning's conference, an audio replay will be available on our website for the next 90 days as will a transcript of the call. So on behalf of our entire team here, I do want to thank everybody for joining us this morning, and we look forward to talking with you again soon. Have a great day. Good-bye.

Operator

Ladies and gentlemen, on behalf of MSA, we would like to thank you for your participation. You may now disconnect and have a wonderful day.

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