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MSA - Q2 2016 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Good day and welcome to the MSA second-quarter earnings call. At this time all lines are in listen-only mode and the floor will be open for questions following the presentation. (Operator Instructions).

It is now my pleasure to introduce your host, Director of Corporate Communications, Mark Deasy. Please begin.

Mark Deasy - MSA Safety Inc. - Director of Corporate Communications

Thank you, Kelly, and good morning, everybody. I too would like to welcome you to our second-quarter earnings conference call for 2016. With us this morning are Bill Lambert, Chairman, President and Chief Executive Officer; Ken Krause, Vice President, Chief Financial Officer and Treasurer; Ron Herring, Senior Vice President and President of MSA International; and Nish Vartanian, Senior Vice President and President MSA Americas.

Our second-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-Q which was filed on May 2 of this year.

You are strongly urged to review all such filings for a more detailed discussion of such risks.

Our SEC filings can be attained at no charge at www.SEC.gov or our own website in the investor relations section. MSA undertakes no duty to publicly update any forward-looking statements made on this call except as required by law.

In addition, I need to note that 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 most directly comparable GAAP measures are likewise available in the investor relations section of the MSA website. You can find this information in the quarterly results section which is located under the financial information header.



That concludes our forward-looking statements so at this point it is my pleasure to turn the call over to our Chairman, President and Chief Executive Officer, Bill Lambert. Bill?

Bill Lambert - MSA Safety Inc. - Chairman, President and 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.

As you saw in our press release issued last night, we saw growth in revenue and earnings as well as strong improvement in margins. While economic headwinds in certain emerging market regions and lower oil prices continue to weigh on parts of the business, the strategic investments that we have made in R&D and acquisitions combined with our sharp focus on improving our cost structure drove solid performance in the second quarter.

Today I'm going to discuss several investments that we have made to capture share in attractive end markets and drive the improved profitability I just mentioned. I will start by giving everyone an update on our revolutionary G1 SCBA platform. Then I would like to tell you about another organic investment we are making, this one in the fixed gas and flame detection segment where we plan to launch new groundbreaking technology later this year. I will also provide an update on our progress with the integration of Latchways, our recent fall protection acquisition. After that, I will turn the call over to Ken for his financial review.

Looking at our press release, you can see that strong growth in SCBA sales and the addition of Latchways were the key drivers of our top-line results for the quarter, and through our efforts to control costs and improve efficiency we were able to leverage that 3% revenue growth into 21% improvement in net income. The restructuring program we executed in late 2015 along with a number of discretionary spending controls were the key drivers of our selling, general and administrative expense improving 140 basis points moving from 27% of sales in this period a year ago to 25.6% in this quarter.

When we began this cost reduction/ value creation program in third quarter of last year, we set a goal of achieving \$10 million of operating expense savings for the full year of 2016. I'm pleased to report that for the year-to-date through the second quarter, our SG&A expense is down 5% or \$8 million in constant currency and excluding Latchways. So we are very much on track to reach and very likely exceed our full-year savings goal.

Managing our cost structure to drive operating margin expansion remains a top priority as we move into the second half of 2016.

Shifting gears and looking at our revenue drivers for the quarter, our SCBA performance in both geographic segments was clearly a top performer. Our international segment SCBA sales increased 26% in constant currency primarily on large order shipments of industrial SCBA in Western Europe.

For our Americas segment, SCBA sales grew 18% in the quarter in constant currency reflecting continued strong momentum with our new G1 SCBA. I attribute much of the success of the G1 platform to the extensive voice of customer feedback that we solicited during the product development stage. With more than 50% of incoming orders in the quarter reflecting competitive conversions, it is clear that the G1's impressive technology and enhanced comfort continues to be well received in the marketplace.

We are building on that success by launching innovative technologies that leverage the G1's advanced technology platform such as a personal thermal imaging camera that can be integrated into the G1 central control module.

As I indicated on the April call, the integrated thermal imaging camera has been submitted for regulatory approval and is now available on a pre-order basis.

From a profitability standpoint, we are realizing benefits from our value engineering process. While the G1 SCBA margins are still below our corporate average, we have seen substantial improvements from a year ago and have even gained traction from the first quarter of this year in improving G1 margins. Ken will provide you with a bit more insight on this improvement in his comments.

In addition to the strong results we continue to see in the US fire service market, our broad SCBA product portfolio is also supporting exciting wins in global SCBA markets. As an example and as we announced in June, we were awarded a \$4 million contract to supply service and maintain 3600 AirGo eXXtreme SCBA for Fire and Rescue New South Wales in Australia.

New South Wales in Australia is the world's seventh largest fire department and we expect to recognize the full value of the contract in the second half of this year. Needless to say I am pleased that our equipment is helping safeguard the lives of firefighters around the world. The New South Wales contract represents yet another important competitive conversion for MSA.

While we see even more opportunities on the horizon in both the US and international markets, it is important to understand that the exceptional year-over-year SCBA growth rates that we have seen over the past few quarters will moderate as we move forward. If you remember, we made substantial progress in ramping up G1 SCBA production by the second quarter of 2015 and we were fully ramped up by the third quarter of last year.

While we expect the replacement cycle and market share capture to continue to support elevated sales volumes, I want to note that the year-over-year comparisons in the third quarter and beyond will undoubtedly become more difficult.

While the success of our organic investments in SCBA has been a key driver of our results over the past several quarters, we continue to focus on innovating around another area of MSA's core to position ourselves for the future.

In that spirit, I am excited to announce the development of our brand-new fixed gas and flame detection platform, the Ultima X5000 and GM S5000 gas monitors. As you probably know, a fixed gas and flame detection system, or FGFD system, protects assets and workers within a facility by sensing toxic or combustible gases in the air. The Ultima X5000 and S5000 gas monitors represent an R&D effort that has been four years in the making and they combine the very finest sensing technologies from both MSA and General Monitors, the California-based company that we acquired in 2010, leveraging a combined 150+ years of experience in this field.

While I won't get into a lot of technical detail today, I will tell you that this new platform is powered by differentiated technology that we believe provides greatly improved facility safety at lower costs of operations. At the heart of this differentiation, our MSA's best-in-class XCell sensors that are built to last longer than competitive sensors have improved reliability and have the patented ability to be tested and adjusted remotely. Best of all, this product line is equipped with Bluetooth technology that allows an installer to remotely configure the device making the installation process easier and safer.

These new products will protect MSA's leading market position in FGFD and help us capture a greater share as the oil and gas market recovers. From a timing standpoint, we expect to launch this new product globally in the fourth quarter of this year. The adoption process is a rigorous one in this market but we are excited about the future possibilities as the energy sector positions itself for reinvestment.

This new FGFD technology is yet another example of how our R&D investments are yielding innovative market-leading technologies. For the second quarter, sales of products developed and launched within the past five years reflected 34% of our total sales. While we are diligently focused on controlling general and administrative costs, we remain committed to investing in new product development and inorganic growth opportunities that will drive our business forward.

Thinking about another strategic investment within our core product portfolio, I would like to provide an update on our progress with the integration of Latchways. As I mentioned in our April investor's call, we immediately started executing on our integration plan following the acquisition. Harnessing the combined power of our organizations, we were able to achieve \$1 million of earnings accretion in the first quarter of this year or \$0.03 per diluted share and we continue to see solid returns in the second quarter.

Despite a currency translation headwind of 7%, Latchways second-quarter revenue of \$13 million reflects a 22% increase from the same period a year ago and on a fully loaded basis with incremental interest and purchase accounting, Latchways quarterly earnings were accretive to MSA by \$0.01 per diluted share.

As you may recall, we forecasted \$0.05 to \$0.10 of earnings per share accretion from Latchways for the full year of 2016. Despite the economic uncertainty surrounding the UK, we continue to expect to finish the year in that range. Incoming orders pipeline at Latchways remains healthy and we are gaining traction in the utilities, aircraft maintenance, construction and renewable energy markets. And from a geographic standpoint, Latchways provides MSA with a solid footprint in the European fall protection market.

Without a doubt this acquisition complements MSA's strengths and further broadens our fall protection portfolio. While there is still work to be done on the integration, I am very pleased with our progress so far year to date.

With that I would like to turn the call over to Ken for his financial review. Ken?

Ken Krause - MSA Safety Inc. - VP and CFO

Thanks, Bill, and good morning, everyone. I would like to take some time to walk you through our second-quarter financial results and to provide more insight into the drivers of our performance. Additional information will be available when we file our Form 10-Q with the Securities and Exchange Commission.

While we continue to see headwinds in certain markets, we had a strong quarter that was reflective of the ongoing focus we are placing on driving sales of core products, improving margins and free cash flow. To touch on a few highlights, we reported constant currency sales growth of 5% in the quarter driven by strategic investments we made in both the G1 SCBA and the Latchways acquisition.

Constant currency SG&A expense in the quarter is down 1% including Latchways and down 5% excluding Latchways. Our restructuring programs and continued focus on productivity and cost management has provided 140 basis points of operating margin leverage in the quarter and 230 basis points for the year-to-date period. This ongoing focus has helped drive a constant currency SG&A savings of \$8 million excluding Latchways for the first six months of 2016.

Our recent acquisition of Latchways was accretive to MSA earnings by \$0.04 per diluted share in the first half of 2016 on a fully loaded GAAP basis and we are on track to finish the year within our targeted accretion range of \$0.05 to \$0.10 per share. And net income in both the quarterly and first half prior-year comparison increased 21%.

Now let's take a closer look at the quarterly financial results.

Sales from continuing operations in the [second] quarter (corrected by company after the call) were \$296 million which includes \$13 million of Latchways related revenue. Revenue was up 3% on a reported basis and 5% on a constant currency basis reflecting a 2% foreign currency headwind. The foreign currency headwind in the year-over-year period was mainly driven by weaker currencies throughout emerging markets and notably in Latin America.

Looking closer at the year-over-year quarterly results comparison, core product sales increased by 10% on a constant currency basis or 4% excluding Latchways.

The G1 SCBA continues to be a key driver of the results with a competitive conversion rate of more than 50% and increased demand from the ongoing replacement cycle. Coupled with strong growth in international markets from shipments of other SCBA products in our portfolio, consolidated breathing apparatus sales increased 21% in constant currency. We also saw 14% growth in portable gas detection driven by a large order in the US from a utilities customer and continued strength across international markets. These improvements were partially offset by an 11% decline in FGFD revenue on the timing of shipments and a difficult prior-year comparison.

If you recall, we saw a 10% increase in FGFD in this quarter a year ago. Additionally we had a 5% decline in industrial head protection this quarter as lower employment levels in the energy market and a soft industrial sector continue to impact demand particularly in the US.

We continue to deal with sluggish conditions that are impacting revenue from products sold into energy and markets. As we have 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 estimate that total exposure level within these products reflects about 10% of consolidated revenue.

While we see some opportunity for a modest uptick in these products during the fall turnaround season, we have yet to see any meaningful change in incoming order patterns in this area.

Continuing to look at energy exposure, another 5% to 10% of our consolidated revenue primarily in the FGFD product line is more susceptible to a pullback in capital equipment spending. The FGFD business continues to be a mixed story, varying by geography. For example, we continue to have a healthy backlog of business in the Middle East where the cost of extraction is lower relative to other regions. However, project business has been weak in the Gulf Coast region of the US. And while FGFD invoicing was down in the quarter, our consolidated backlog is healthy which should provide support for the second half of the year.

Looking at the emerging market geographies of our business, revenue in those areas was down 1% on a constant currency basis. Our business in the Middle East was strong, growing 13% in the quarter offset by continued economic headwinds in key markets like Brazil. As a result, we have been diligently focused on taking cost out of our business and improving efficiencies to mitigate the impact of recessionary conditions in key areas. For example, in the year-to-date, constant currency revenue in Brazil is down 3% but we have been able to reduce SG&A expense in this region by 8%, reflecting our ongoing focus on executing restructuring and other cost reduction activities to respond to these challenging business conditions.

Our gross profit rate for this quarter was 45.9% improving 40 basis points from a year ago despite pricing pressures in certain geographies. While we continue to see some negative impact from a less favorable mix, our value engineering activities associated with the G1 SCBA are narrowing the margin gap to the corporate average. In the quarter, gross margins on breathing apparatus in the Americas segment, where the primary product is the G1, were up 460 basis points from a year ago as we shipped more G1 accessories and realized improvements in product costs associated with our ongoing initiatives aimed at improving margins.

Selling, general and administrative costs were \$76 million in the quarter decreasing \$2 million or 2% from a year ago on a reported basis and down 1% on a constant currency basis. Excluding SG&A related to Latchways, quarterly constant currency SG&A was down \$4 million or 5% and is down \$8 million or 5% in the year-to-date period.

As you can see, the restructuring steps we have taken to reduce operating costs, both through headcount reduction and implementing discretionary spending controls are proving effective in driving operating leverage. We are capturing the savings that we targeted when designing these cost reduction activities.

Our investment in R&D this quarter was \$11 million or 3.8% of sales. Introducing market-leading safety solutions within our core products is central to our mission and we continue to invest in innovations like the G1 SCBA and new FGFD platform that raise the bar for our customers. As you may have noticed, we have spent below our targeted R&D range of 4% to 4.5% of sales through the first half. While some of this decrease is due to the efficiency and productivity improvements, much of this is due to timing. We expect to see an uptick in R&D in the back half of this year to finish the year at the lower end of our targeted 4% to 4.5% of sales range.

Investing in R&D is and will remain a critical part of our strategy and with 34% of sales derived from products developed and launched over the past five years, it is clear that our R&D investments are driving our business forward.

GAAP operating margin was 16.2% in the second quarter, increasing 290 basis points from a year ago. Operating margin excluding restructuring and currency exchange gains in the quarter was 16.6% of sales reflecting a 270 basis point improvement from a year ago.

Quarterly operating income excluding restructuring and currency exchange gains increased by 23% on the 3% increase in sales. For the year-to-date, operating income excluding restructuring and currency exchange gains has increased 24% from a year ago on the 6% increase in sales.

These improvements in operating income reflect the ongoing focus the team continues to place on driving improved product margins and solid cost control.

Our effective tax rate for this quarter was 33.8%, down 80 basis points from a year ago due to the benefit of the R&D tax credit and reduced foreign entity losses in jurisdictions where we cannot take tax benefits. These were partially offset by a less favorable profitability mix. Due to the success of the G1 SCBA and headwinds in emerging markets, about 26% of our quarterly operating income was in the international segment versus 74% in the Americas and corporate. The Americas and corporate carry a much higher tax rate. This split is causing an unfavorable mix effect in our tax rate and we would expect this trend to continue into the second half of 2016.

We estimate that our full-year tax rate to be in the range of 34% to 35% excluding nonrecurring taxes associated with our European reorganization.

Net income was \$29 million in the quarter or \$0.77 per diluted share on a GAAP basis compared to \$0.63 per diluted share in the same period a year ago. Adjusted earnings were \$0.79 per diluted share in the quarter compared to \$0.67 per diluted share a year ago.

Quarterly free cash flow was \$21 million, increasing \$5 million from a year ago despite making an \$18 million payment in the quarter and \$38 million in payments in the first six months associated with the product liability settlement we discussed with you in early 2015. If you remember, payments on this settlement commenced in the third quarter of 2015 and it is now paid in full. Improvements in receivables and inventory were the key drivers of cash flow generation in the quarter. We also paid dividends of \$12 million in the quarter to shareholders.

In the first six months of 2016, free cash flow was \$4 million compared to a use of \$8 million in the same period of last year. When looking at the year-to-date comparison, it is important to note that we paid \$49 million in product liability settlements in the first six months of this year, largely related to the settlement that I just mentioned, compared to only \$3 million in the same period a year ago. Despite these payments, year-to-date free cash flow has increased on improvement in receivables and inventory and higher net income.

Our total debt balance was down \$24 million from the first quarter of this year, finishing the quarter at \$454 million. Our cash balance was \$103 million, resulting in net debt of \$351 million. Debt to EBITDA at quarter end was 2.3x or 1.8x on a net debt basis.

In summary, we continue to build on the momentum from the first quarter delivering solid revenue growth and double-digit net income improvement despite ongoing market challenges. While our backlog of business is healthy, we are not seeing an uptick in demand levels in the energy sector and business conditions across the industrial related markets suggest that the slower growth environment is here to stay, especially in the near-term.

Additionally, as in past years, we expect the third quarter to feel the impact of the traditional summer holiday season across Europe.

Heading into the second half of the year, our focus remains on making strategic investments that create long-term value for our shareholders, driving improvements in margin with a focus on our cost structure and improving free cash flow.

I will now turn the call back over to Bill for some concluding commentary.

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

Thank you, Ken. Looking at our top-line results and our earnings growth, it is clear that our quarterly results were driven by strategic investments that we have made over the past several years including the G1 SCBA, the Latchways acquisition, and internal restructuring programs. The returns on these investments are encouraging but we are facing a slower growth environment moving forward. We continue to see economic challenges in certain emerging markets and weakness in near-term energy related markets.

In light of these headwinds, we continue to control operating expenses and closely manage our cost structure to drive higher levels of profitability even in challenging times. While we are holding the line on SG&A expense, I want you to know we are committed to investing in both organic and inorganic growth opportunities and transformational initiatives that continue to enhance shareholder value for many years to come.



I want to thank you for your attention this morning and at this time Ron Herring and Nish Vartanian have 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 expectation for future sales and earnings.

Having said that, we will now open up the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Edward Marshall, Sidoti & Company.

Edward Marshall - Sidoti & Co. - Analyst

Good morning, everyone. So I wanted to talk about the margin because it was impressive in the quarter and I thought the majority of the cost cuts were in Europe and when I look at the operating margin that you provided for both the Americas and international, I guess the international is up a little bit on a year-over-year basis but Americas was up much stronger. Should I assume that and interpret the mix more driven by mix or is there some cost actions leaked into that as well? Maybe you can help me parse that out.

Ken Krause - MSA Safety Inc. - VP and CFO

Sure, Ed. That is a good question. When we look at the gross margin line what I talked about in my prepared comments was the benefits we are seeing on the SCBA area. Mix certainly still continues to be a headwind for us across our product portfolio with declines in FGD and industrial head protection but the work that we have executed around the G1 and the value engineering efforts is certainly paying off in addition to some of the accessories.

We have talked at times about how we go to market with our G1 and how we accessorize that product. Those accessories are certainly enhancing our profitability profile a bit there. So there are two components really, it is the cost take-out on the G1 and some of the value engineering work but then also what we are seeing is just benefits from the accessories. So that is really driving it.

From a segment perspective which I think is the other part of your question, what we are doing on the SG&A front is really global. We are looking at our cost structure in all of our regions whether it be here in the US or in Latin America or in Ron Herring's segment of the business and international sector. So we are certainly doing a lot of continued focus on cost control and cost take-out just around the world.

Edward Marshall - Sidoti & Co. - Analyst

Got it. You gave some color along the accretion of Latchways and I know it is a sequential slowdown in EPS contribution. I am wondering if there is any seasonality in that business that we should be aware of? And you kind of touched on it and I will ask, did currency have some impact there too?

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

I will answer the seasonality question and ask Ken to comment on the translation effect. There is seasonality in the sense that there are large orders in that business, engineered projects, engineered products for the fall protection market that Latchways serves is a little bit lumpy. I wouldn't necessarily say that it is seasonal per se but in the aircraft maintenance side of the business, it just gets a little bit lumpy. So our expectations as I



think I indicated in my comments are still very favorable for the full-year results on Latchways. I would not think that what we saw in Q2 is an indicator of any kind of weakness or slowness in that market going forward.

Ken Krause - MSA Safety Inc. - VP and CFO

And then from an FX and translation perspective, Bill had commented in his comments around the [29%](corrected by company after the call) constant currency growth but it was [22%](corrected by company after the call) on an as reported basis. 7% headwind there; that is an area we are all familiar with the Brexit issue and what the Pound is doing and so certainly we do see a bit of a headwind from an FX perspective on our UK-based business.

Edward Marshall - Sidoti & Co. - Analyst

And just a one-off. Should we expect any pickup from the Olympics in your Brazil business?

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

I don't think so, Ed. As they ramped up and as they knew that the Olympics were coming to Rio over the past years, those orders kind of came in over that time period. I would not expect anything -- we don't see anything very significant here in the second quarter or third quarter specifically attributable to the Olympics.

Edward Marshall - Sidoti & Co. - Analyst

Got it. Thanks, guys. Appreciate it.

Operator

Walter Liptak, Seaport Global.

Walter Liptak - Seaport Global Securities - Analyst

Thanks. Good morning, guys. Wanted to ask about the fixed gasoline detection when we look at the trends in the first half of the year, it looks like you decelerated in the second quarter but when we look at some of the macro numbers out there on energy, the price of oil, rig counts, it looks like things are bottoming. And I wonder how that factors into your thinking and comments which sounded kind of conservative or cautious on the second half?

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

Well, I think they are cautious in general in the energy related markets that we go after with FGFD but I think a lot of what we see in FGFD similar to my last comment on Latchways project business, it can be lumpy. And in fact what we saw in the second quarter weakness down about 11%, we don't expect that kind of weakness as we look out over the next three months or even six months. We are cautious on energy related markets, there is no question about it. But our feeling is similar to yours and others who I think feel like this market has perhaps bottomed or is getting close to the bottom and that we now start to hear commentary and talk about the major energy producers especially on the E&P side of the business looking to reinvest.

So as we look outward into 2017 and 2018, we see some ability to improve and in 2018 certainly. But we are cautious about that, we've been through these cycles before but I would not expect the third quarter and fourth quarter to be, to show marked decreases. Ken?

Ken Krause - MSA Safety Inc. - VP and CFO

The only thing I would add there, Bill, is the price of oil, it is interesting when you think about the different products we have in our portfolio. FGFD I would say very much lags the price of oil. It is a long tail project oriented business, takes quite a while for these things to come through. In fact some of the business you see coming out now was projects from a year or so ago. So some of that takes a while to work its way through the system.

You see it more, respond more quickly though in the head protection and the portable gas area which is tied more to the employment levels. And so it is important to think about when we think about the energy prices that you see, the FGFD business certainly will lag that, you will see more of a response in some of those more employment related products.

Walter Liptak - Seaport Global Securities - Analyst

Okay, great. Thank you for that color. I wonder if you have a view on the turnaround season for this fall. Are you hearing about more projects or is that going to be something in and out here like 2017?

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

That is a very good question, a very tough question to answer. I think that there could be a modest uptick in the fall, we think there could be. The good news is we are coming off of a very low base in 2015. Gasoline inventories are very high. Further good news, the crack spreads have dropped significantly especially over the last few weeks, the last few months. And we are hearing that there are quite a few projects related to refineries going off-line for the upgrades required by the EPA on sulfur content and fuels.

So there is a lot of good news to suggest that there will be more projects in the fall. But we actually thought that would happen in the spring and it didn't happen to the degree that we thought in the spring and utilization rates, refinery utilization rates remain very high, upwards of 90%, maybe 90+%.

So I think it is cautious right now and I would expect at some point in time the turnaround season will need to -- almost have to come back in a strong fashion because so many turnaround activities and upgrades have been put off, delayed, pushed out in time. But we are a bit cautious on it. I will ask Nish if he would like to provide some more color in that area.

Nish Vartanian - MSA Safety Inc. - SVP and President, MSA Americas

I think you painted a pretty good picture of that, Bill. That is kind of what we see. We track the number of turnarounds coming into the fall and they don't look like they are going to be significantly higher than a year ago but we continue to monitor that and there could be a number of unplanned outages and some of those unplanned outages could provide some nice opportunity for us going forward.

Walter Liptak - Seaport Global Securities - Analyst

Okay, great. And I would like to ask about the SG&A reduction programs which obviously are very impressive and showed up in your results. And the question is have you learned anything going through this process of reducing SG&A about productivity levels? And I guess what I'm trying to get at is there more that you will be able to do beyond this current program and when does the current program come to an end?



Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

I will begin the commentary and then ask Ken to provide some color on that as well. I think there is certainly a lot that we have learned going through these restructuring efforts. It forces you to learn, it forces you to become more efficient, it forces you to look for best practices across the organization, to share those best practices.

So there is a lot that we have learned, a lot of ideas. Our workforce has been incredibly engaged in this process and coming forth with ideas and even further ideas to improve our cost structure going forward. So is there more? We are constantly looking at that and as we look back at the improvements we have made in productivity and efficiency this year, we look to say what else might we be able to do as we look to the future and 2017 as we put our planning together for 2017? So we are constantly looking at that, Walt.

I think we have become a stronger, leaner organization through the efforts that we have taken over the last year and I would expect that this cost consciousness that we see now, this value creation mentality that you see across MSA will just continue to gain momentum.

Walter Liptak - Seaport Global Securities - Analyst

Okay, that is great. Just as a follow-on to that, the SG&A, does some of it come back after let's say international markets improve or energy markets improve or are these structural changes that have happened where the SG&A does not come back?

Ken Krause - MSA Safety Inc. - VP and CFO

It is a mixed story there. When we look at the segment take out, there certainly -- if you do see growth coming back in these markets, you certainly would see a slight uptick in some of the spending but we are committed to maintaining the leverage, Walt. So when you look at the leverage over the revenue line, leverage over the SG&A line, we are committed to keeping the leverage and so we are smart about it and we are very diligent about it and taking a very proactive and a diligent approach to just managing the cost structure.

I will say that we are not deferring investment, we are making investment around the world. We are making investment in our organization and we will continue to make the investments that we have made over time.

Walter Liptak - Seaport Global Securities - Analyst

Okay, sounds great. Thank you.

Operator

Stanley Elliott, Stifel.

Stanley Elliott - Stifel Nicolaus - Analyst

Good morning. Thank you for taking my question. Bill, a quick question for you. The tone of the call, you mentioned challenging markets a number of times and I do think that is fair. Could you help us though, did conditions decelerate through the quarter or are we looking at relatively stable levels kind of at this level and just some of the macroeconomic headwinds that are fairly well-known in the marketplace?

Bill Lambert - MSA Safety Inc. - Chairman, President and CEO

I think it is more related to the macroeconomic events and markets that are fairly well-known. When you look at mining, I am not sure mining can get much worse on a global basis and so that affects our Latin America region quite significantly, our South Africa region, our Australian area. And



so it forces us to shift our focus to other markets that are quite strong like the fire service that we have talked about, utilities, aircraft maintenance, that sort of thing.

The oil and gas sector, we have talked about for quite a few quarters ever since you saw the peak in mid-2014 two years ago and the declines we saw dramatically in the back half of 2014. We have talked about how that impacts our portable gas detection instruments, our head protection products, the declines in employment that we have seen there. So that has been I think well communicated.

And as I indicated in the last answer to the question, I think, we think that has either bottomed or is bottoming and shouldn't get much worse in that area. We in fact see some opportunity for improvement as I indicated as we see energy companies looking to now position themselves for reinvestment as the cycle starts to improve maybe late 2017 and into 2018. And that is what we are positioning ourselves for, that new platform product that I talked about in the FGFD space. I mean that is all about positioning ourselves for this energy sector and as it returns especially on the upstream and downstream sides of the business that we can take a product in there with great new technologies and great new features that are plug and play to the hundreds of thousands of transmitters that MSA has already installed out there and General Monitors has already installed out there and really refresh that area of the business.

So I don't think it will get too much worse on the FGFD side, the oil and gas, petrochemical side, there are some bright spots that we look to. We have shifted our focus where we can in those parts of the business, those parts of the markets that are growing as I said.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Perfect. And kind of switching gears to the balance sheet, inventory is down basically 15% on flat sales and you have added acquisition since that time. It is all of this SCBA coming out or is MSA getting more efficient at turning to the inventory?

Ken Krause - *MSA Safety Inc. - VP and CFO*

I think it is both of those points, Stanley. It is Ken here. When we look at what we talked about last year, late last year, finishing out the year we talked about hitting our stride with the G1 and working down that backlog and certainly we have. We have certainly hit our stride on the manufacturing side and the operations side and so the inventory level has responded very nicely.

Then also just on a general productivity and managing that side of our business, the operations side of inventory side, we are implementing a number of new procedures, ongoing focus on inventory management, ongoing reporting and close management of that I think is certainly yielding some solid results as well. So a little bit of process improvement and also a little bit of just ramping up the full production capacity.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Perfect. Then last for me, a lot of discussions about free cash flow conversion improving. It sounds like that is still on track but I wanted to confirm that.

Secondly, just to clarify, did I hear that the \$48 million cash that is the final settlement that you paid meaning all else being equal that we would pick up pretty close to that amount in next year just from a comparison standpoint as it relates to free cash flow? Thank you.

Ken Krause - *MSA Safety Inc. - VP and CFO*

So Stanley, last year about this time we announced a \$70 million to \$75 million settlement and so that was paid out commencing in the third quarter of last year through the second quarter of this year. We made our final payment this year. So that will provide a bit of a reprieve as we head into the second half not having to do that.

But as you all very well know, we deal with the uncertainties of product liability each and every day and so we are managing through that very uncertain complex environment. But you are right with respect to this specific settlement, we will see a reprieve in the second half.

Stanley Elliott - *Stifel Nicolaus - Analyst*

And then to actually carry forward all else being equal assuming no additional claims what have you that free cash flow theoretically should improve by close to that amount in 2017?

Ken Krause - *MSA Safety Inc. - VP and CFO*

Yes, assuming no other issues you are exactly right. I mean that will go away.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Perfect. Thank you.

Operator

Richard Eastman, Robert W Baird.

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

Good morning, all. Bill or perhaps Nish and Ron, maybe could just touch on the portable gas business had a very good quarter, comp was easy but it gets actually easier. But I am curious, the 5% growth in North America and the 31% growth in international, can you just lay a little color on those on the portable gas product line in the quarter and the performance there?

Bill Lambert - *MSA Safety Inc. - Chairman, President and CEO*

Sure, let me give a high-level view and I will turn it over to those two guys to provide a little more color.

Portable gas detection is one of our highest gross margin areas of the business so we have invested heavily in that over the last five years and we have seen some great gains in the marketplace with those product lines and new products that we have introduced. But it has been impacted greatly by the employment declines in the oil and gas sector, no question about it and the lack of turnaround activity.

So as I indicated in an earlier comment, we have had to shift our focus and our geographic focus and impact on portable gas detection. And so we are seeing some of the benefits of that. So, Nish, why don't you talk about some of the benefits that we saw in portal gas detection and other markets other than oil and gas and Ron, maybe from a geographic perspective.

Nish Vartanian - *MSA Safety Inc. - SVP and President, MSA Americas*

Yes, Rick, as I think Ken mentioned earlier, we realized a nice sized order out of a major utility here in the US and that is really what drove the growth in our sales here in the second quarter for the Americas. So we are not seeing a general rebound in our base business when it comes to portable instruments but what we do see is our market share is still very strong. We continue to do well with our product line, with the XCell sensors so we are very confident that our share is in real strong position. So when we do see that uptick come back with the plant turnarounds in the oil and gas industry, we do expect the Americas to come back quite strong. So we feel we are well-positioned.

Hopefully there will be some other nice size orders in markets outside of oil and gas where we can continue to find some opportunity and we continue to hunt those down.

Ron Herring - *MSA Safety Inc. - SVP and President, MSA International*

This is Ron. As we look at the portable gas detection in international, the two real big plays there would be in Europe. Some of that was timing, moving from some orders going from the first quarter to the second quarter which it helps to explain the really large increase in the second quarter. But a lot of that is our focus on the sales organization because it is a growth opportunity for us we have with the new product development efforts that we have had. We have some real key advantages that we can promote across Europe, the European region.

And then for the Middle East, it really is a lot of market share gain. The Middle East hasn't seen the downturn of employment that you have seen in the Gulf Coast and so the opportunity there still exists for us to be able to gain share and with the innovations that we have in the portable gas detection products, we have been able to see a pretty nice level of success there.

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

Okay. Maybe just the same type of question and color if you will on fall protection. The fall protection market seems to be much stronger in Europe maybe for reasons that aren't that obvious given their employment levels. But then here in the US that business has kind of failed to pick up as well. So I am curious about the differential between MSA's core fall protection business in the US and Latchways growth rate of 20%. Is that end market exposure or have we done some things with the channel there or how do we get our arms around what the real growth rate is in fall protection?

Bill Lambert - *MSA Safety Inc. - Chairman, President and CEO*

The fall protection market is more end market related, Rick. Our efforts here in North America where we had strength in the construction segment and within the oil and gas segment, those have been under a lot of pressure and haven't done as well. And so we see that mid to -- let's say 8% decline in sales in the Americas there in fall protection.

Latchways however is focused on different end market segments as I indicated. They are focused on utilities and aircraft maintenance, renewable energy markets and that is where they have seen some very strong uptick in demand in both the UK and North Europe. And they have continued to strengthen their market position there.

What we are trying to do as well is to bring some of that strength in those end markets to the North American market. We had success in Australia, we are gaining some strength in Latin America with that product line. So it is really this matter of how do you deal with the oil and gas downturn, construction industry that hasn't rebounded quite as strongly as we might like to see it and how do we shift that market focus to areas that are investing and do have opportunities?

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

Okay. Maybe just last question, when I look at the gross margin, very impressive in the quarter, probably bumped a little bit by the portable gas growth rate of that product line. But in the second half as we move forward, I mean some of the structural changes you made there, some of the improvements on operating side maybe we lose the driver of portable gas in that contribution. But how confident are you that we can maintain the gross margin in the second half north of 45%?

Ken Krause - MSA Safety Inc. - VP and CFO

We haven't been above 45% for a few quarters as you very well know, Rick. And so I am reluctant to say that I have a high level of confidence that we can maintain that into the second half. What I can tell you is that we are doing a lot of good work in the VAVE work and the G1 is a great example of that and so we are making some good progress, some good strides. But it is definitely -- I am reluctant to provide a high level of confidence or tell you that we are going to stay above that.

In my prepared comments I talked about pricing pressures. I mean it is a competitive environment, it is a very dynamic environment and not only here in the US but abroad and so there's pricing pressures certainly are real but we are trying to -- we are certainly managing through them quite nicely here into the second quarter.

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

Okay, I understand. Very good and very nice quarter.

Operator

(Operator Instructions). Okay, and while we are waiting to see if have any last minute people coming in, I will turn it back to you, Mark, for any closing comments.

Mark Deasy - MSA Safety Inc. - Director of Corporate Communications

Thank you, Kelly, and seeing that we do have no more questions, that will conclude today's call. I just want to remind everybody that if you missed a portion of the call, an audio replay and transcript will be unavailable on our website for the next 90 days.

On behalf of our entire team here, I want to thank you again for joining us this morning and we look forward to talking with you again soon. Have a great day. Goodbye.

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