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PRESENTATION

Operator

Good morning, my name is Lori and I will be your conference facilitator today. At this time I would like to welcome everyone to the Harsco first-quarter release conference call.

(Operator Instructions)

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I would now like to introduce Mr. Dave Martin, Director of Investor Relations. Mr. Martin, you may begin your call.

Dave Martin - *Harsco Corporation - Director of IR*

Thank you, Lori. Welcome to everyone joining us this morning. I'm Dave Martin, Director of Investor Relations for Harsco.

With me today is Nick Grasberger, our President and Chief Executive Officer, as well as Pete Minan, our Senior Vice President and Chief Financial Officer. This morning we will discuss our results for the first quarter of 2016 as well as our outlook. Then we will take your questions.

Before our presentation, however, let me take care of a few administrative items. First our Q1 earnings press release was issued this morning. A PDF file of this news release as well as a slide presentation for this call have been posted to the IR section of our website.

Secondly, this call is being recorded and webcast. A replay will be available on our website later today. Next, we will make statements this morning that are considered forward-looking.

These statements are based on our current knowledge and expectations and are subject to certain risks and uncertainties that may cause actual results to differ materially from these forward-looking statements. For a discussion of such risks and uncertainties, see the risk factors section in our most recent 10-K and 10-Q as well as in our other SEC filings. The Company undertakes no obligation to revise or update our forward-looking statements.

Lastly, on this call we would refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to US GAAP results is included in our earnings release issued again today as well as our slide presentation. With that being said, I will now turn the call to Nick for our prepared remarks.

Nick Grasberger - *Harsco Corporation - President and CEO*

Good morning, everyone, and thanks for joining us this morning. The first quarter developed as we expected, as we were able to offset market challenges by reducing costs and improving execution. We are maintaining our full-year guidance for earnings and cash flow.

Our outlook for the key end markets and our performance within those markets for the balance of the year also remains unchanged. Although steel and energy prices have stabilized and improved somewhat, demand has remained weak and we see little reason to expect a change in our revenues this year compared to our original guidance.

From an operational standpoint, we continue to be very pleased with the performance of our Metals and Minerals business in recent quarters. We are operating at a high level of discipline, focus, organizational alignment, and precision, and we are confident our capital allocation process will lead to higher margins and returns on capital as we have seen over the past year or so.

The first quarter was a case in point. M&M's adjusted operating income increased double digits versus Q1 of last year, and margins were up about 150 basis points.

Nonetheless, some of our customers' sites within Metals and Minerals remained financially stressed, and further site closures, such as a site idled in Spain during the first quarter, are certainly possible. Given how dynamic the situation is, we're watching our customers' sites across all geographies very closely.

In terms of growth, our unique footprint in China, India, and other developing markets is also yielding attractive opportunities essentially unavailable to our major competitors. Also, our product and service capabilities provide an opportunity to grow in other markets. So although current market conditions are very weak, we still believe that the medium-term to long-term outlook for M&M is quite attractive, and I applaud the team for maintaining their focus and executing.

In our Rail business, the Class I railroads in North America are reducing their capital spending plans for maintenance of equipment in part due to weak demand for steel and energy products. We are working hard to offset this impact through further penetration into the international markets where opportunities remain plentiful.

We are also focused on developing the initial vehicles for the Swiss national railway later this year. We expect to recognize revenue on the project once the machines are fully commissioned in 2017. Despite this delay, initial customer feedback concerning the quality of the vehicles is very positive, and we look forward to a long and profitable relationship with this important new customer in a new geography.

The pipeline for like opportunities remains strong, and we're targeting such contracts in the UK, Sweden, and Germany that should be awarded later this year.

In the Industrial segment, we are focused on developing and launching new products in IKG and Patterson-Kelley and reducing production costs in developing our downstream business in Air-X-Changers.

We are very encouraged by the customer response to our Hammco product line acquired a few years ago and targeted towards the downstream market. These products are growing at a strong double-digit rate this year in contrast to our legacy products oriented more towards the upstream sector.

Our capacity expansion in Tulsa will be a key point of competitive advantage for both product lines as markets recover.

The buzz around our new high security fencing product reached new highs after GrateGuard was recognized as the top new product for anti-terrorism and force protection at a leading international trade show. This follows from the large contract we won to provide high security fencing around the new Mexico City airport.

Our efforts to reduce debt and improve our liquidity position are yielding results. Free cash flow in Q1 was better than expected, and we've improved our outlook for financial leverage and liquidity at year end. It has been very encouraging to see how well our employees have responded to this and other key initiatives we have launched over the past year, and our focus on safety continues to result in record low numbers of recordable injuries and is increasingly recognized by our customers.

In short, I'm very pleased with how the organization is developing in terms of alignment around our values and strategy, as well as its ability to execute. I will now turn the call over to Pete.

Pete Minan - *Harsco Corporation - SVP and CFO*

Thanks, Nick, and good morning, everyone. I'm going to start on slide 4 of the materials.

Our reported operating income as adjusted for special items in the first quarter of $18 million was above our guidance range of $6 million to $11 million. As compared to our expectations for the quarter, results in our Metals and Minerals segment were better than anticipated, due mainly to positive performance within our European and North American regions as well as favorable weather and market conditions within our applied products business.

In Rail we benefited from the acceleration of certain equipment shipments that we had expected to occur in the second and third quarters. Corporate costs were lower mainly due to lower temporary labor and professional services costs and continued scrutiny of G&A.

Compared to the 2015 quarter, first it's worth highlighting that our Metals business realized an improvement in adjusted earnings and margins. We certainly did not see any benefits from the external environment in the quarter, and thus we believe this improvement is indicative of our progress to strengthen this business.

With that said, adjusted operating income for the quarter declined versus the prior year as anticipated. Lower profitability in Industrial and Rail, which as you recall included a large foreign exchange gain in the preceding year, offset the Metals impacts and lowered corporate costs.

Revenues in the quarter also declined as expected to $353 million, which represented a decrease of 22% year over year. Reduced demand for heat exchangers in Industrial accounted for the largest portion of this change. Revenues in Metals were impacted by site exits, lower steel production, foreign exchange rate changes, and weaker nickel demand.

Adjusted earnings per share was $0.03 in the first quarter, which was also favorable to our guidance given our operating performance. And compared with the prior-year quarter, EPS decreased $0.17.

The just completed quarter included equity income from our Brand Energy joint venture of approximately $3 million as compared with $4 million in the prior-year quarter. And as in the past both quarters included inter-company foreign exchange losses which negatively impacted our P&L.

Free cash flow was a deficit in the quarter, as is traditionally the case during the March quarter. A free cash outflow of $17 million compared to a $14 million outflow in the first quarter of 2015, as cash flow improvements in Metals and Minerals and at corporate were offset by free cash flow changes in Industrial and Rail. Compared to our internal plan for the first quarter, free cash flow was better than expected, primarily due to tighter controls over capital spending.

Also, as detailed in our earnings release, we recorded a few unusual items in the quarter. These items, which totaled $19 million or $0.16 per share for the quarter, included $3 million of costs incurred for the planned separation of Metals and Minerals, $5 million of severance costs in underperforming European site that was idled and which we are in the process of exiting, and a $7 million adjustment, net of tax, related to our Brand Energy joint venture.

As indicated in our press release as permitted under our contractual arrangement, we have decided to make our payments to our joint venture partner in kind as opposed to in cash for all of 2016. We see this as a prudent decision as we focus on reducing our debt, and as a result we will have diluted our joint venture interest by 3% to approximately 26% by the end of the year. This net charge is essentially to write off a proportionate amount of the book value.

Moving to slide 5, in the first quarter Metals and Minerals generated adjusted operating income of $12 million from $11 million in the prior-year quarter. During the quarter, improved performance at previously underperforming sites, workforce reductions, and other cost reductions were only partially offset by lower customer output, site exits, and commodity prices.

These other cost improvements are attributable to a variety of items, including maintenance and travel costs as well as professional fees. Also, the negative impact of net site exits, or contract churn as we call it, on operating income was approximately $3 million. This amount is mainly the result of the customer shutdown in Europe that we incurred in the second half of 2015.

Customer liquid steel tonnage, or LST, declined 18% year over year in absolute terms and 8% on a continuing site basis, which mirrored steel industry trends in the major regions where we operate during the quarter.

Importantly, free cash flow improved materially in Metals to $22 million compared to $6 million in the prior year. As we discussed in the past, we are increasingly focused on working capital trends in this business, and working capital was in fact the primary driver of the improvement in free cash flow. Additionally, lower capital spending helped in the quarter.

Moving to slide 6, our Industrial businesses generated operating income of $6 million in the first quarter as compared with $17 million in the first quarter of 2015. As was the case in the preceding quarters, this change in earnings resulted mainly from lower customer demand for heat exchangers. Also as you may recall, we had a gain on an asset sale of approximately $3.5 million in the prior-year quarter which was not repeated this year.

Despite a nearly 40% decrease in revenues in the first quarter, we were able to maintain margins just above 10% because of aggressive cost reduction efforts.

Also in Industrial it is worth highlighting the positive trends and developments within our boiler and grating businesses. Patterson-Kelley is performing very well, and we continue to experience growth as a result of our systems control technology and new product introductions as well as favorable market conditions. Meanwhile, our IKG grating franchise recently entered the security fencing market as we previously announced, and we are very optimistic about this product given the business we have won to date and the other opportunities that have been identified.

Let's go to slide 7. Operating income in Rail was $5 million compared with $22 million in the prior-year period, which included a foreign exchange gain of $11 million. Additionally the quarter was impacted by lower spare parts sales and a weaker mix versus the prior year.

Meanwhile Rail had a free cash outflow of $27 million in Q1, primarily as a result of a buildup in inventories and fewer customer advances compared to the prior quarter. The change in free cash flow compared with the prior year was attributable to these advances that were not repeated and also cash earnings. We continue to expect that Rail free cash flow will improve meaningfully in 2016 partially due to advances anticipated later in the year.

Regarding our growth priorities in Rail, we continue to actively pursue a number of international equipment tenders and we hope to win some of these during the year. Also we continue to execute against our SBB contracts.

As Nick mentioned, the quality and uniqueness of these machines that we are developing for SBB are truly impressive. Some of the machines have already been delivered, and we've worked through much of the software and electronics challenges that we mentioned on the previous call.

Also, discussions are ongoing to finalize all design changes with our customer presently. We still do not have final resolution of all the open matters at this point, and accordingly we do not expect any meaningful margin on the initial contract in 2017.

Moving to slide 8. Slide 8 includes our key outlook items, which are unchanged for the year. Adjusted operating income and earnings per share are still expected to be between $80 million and $100 million, and $0.13 and $0.33 per share respectively.

Free cash flow of $50 million to $70 million is anticipated for the year, including capital investments of $95 million to $105 million. This outlook reflects that the timing benefits realized in the first quarter will reverse as well as the continued customer and market risks within all of our business units.

These uncertainties include among other things the potential that one or more metals customers could idle a mill. We're pleased overall with our portfolio of Metals and Minerals sites, although this remains a risk in a limited number of situations. Also in Industrial and Rail, as is generally typical at this time of year, our order books have yet to be filled for the balance of the year.

In recent months, as you know, the steel and energy markets have experienced a recovery of varying degrees. We are certainly hopeful that these trends prove sustainable and will continue, although at this point again we have maintained our underlying market assumptions for the year. In this context, we remain focused on our cash generation and reducing debt.

Before I turn to the second-quarter guidance, let me comment on our financial position. At the end of the first quarter we had net debt of approximately $820 million and liquidity of $220 million, both of which were essentially unchanged from the year end despite seasonal factors that negatively impact our cash flow in the March quarter.

As communicated previously, mindful of the uncertainty in our end markets, we're targeting net debt reduction of $75 million to $100 million during the year through a number of different initiatives designed to improve free cash flow or otherwise generate cash. In this vein, we eliminated our dividend, as we previously discussed, and now have decided to suspend our cash payment to our Brand joint venture partner for the rest of the year. So the majority of our free cash flow will be used to reduce debt.

Additionally, we have other levers, which include various idle or underutilized assets which can be monetized to generate cash and strengthen our balance sheet. The cross currency interest rate swap that we monetized during the quarter for roughly $17 million is another good example, and we continue to evaluate other alternatives.

So let me move to slide 9. Regarding our second-quarter outlook, we expect operating income to be between $22 million and $27 million, as compared to $36 million in the second quarter of 2015. This year-over-year change is expected to be mainly driven by our Industrial businesses followed by the Rail segment.

As was the case in the first quarter, Industrial earnings will be impacted by lower demand for heat exchangers. In Rail the current quarter will be impacted by the movement of some sales into the first quarter, and in total lower equipment sales and mix are likely to lead to lower profitability compared with the 2015 quarter.

Meanwhile, operating income in Metals is expected to be consistent with or slightly below the prior year due to lower customer output, site exits, and commodities demand. And corporate costs are anticipated to be similar to the prior-year quarter.

Lastly, we expect to report an equity loss of between $1 million to $2 million related to our Brand joint venture in the second quarter given the seasonal factors in their relevant quarter. Although I'd note that our expectation for the joint venture's income is also unchanged for the whole year.

That concludes our prepared remarks, and at this point we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jeff Hammond, KeyBanc Capital Markets.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Hi, good morning. Just on the debt pay down, I think before you were talking $30 million to $50 million, now you're saying $75 million to $100 million. Any other moving pieces in there besides the change from the Brand knockout and the swap?

Pete Minan - *Harsco Corporation - SVP and CFO*

Those are the two biggest pieces, Jeff, but we've also undertaken some internal initiatives to improve our working capital in all the businesses, and are starting to see the benefits of that. So really what the rest of the year and that change in number is attributable largely to this initiative and seeing the full realization of those benefits, both within working capital and outside of working capital the remainder of the year.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

How is the bias within that $95 million to $105 million of CapEx?

Pete Minan - *Harsco Corporation - SVP and CFO*

We are probably on a net basis, taking into consideration some of these initiatives, down to the lower end of that.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, good. Can you -- I guess two questions on Metals. One, can you just talk -- have you seen any real impact nearer term from this more constructive steel pricing environment? And two, just as you look at site risks can you just walk through any assessments you've done to target what the potential risk could be from these additional site closures?

Nick Grasberger - *Harsco Corporation - President and CEO*

I'll take that, Jeff. First of all, in terms of impact of lower steel prices, we really haven't seen much lift in production at our customers' sites. Even though prices are firmed, and that of course is reducing the risk of further site closures, the LST was still down on a like basis I think 8% in the first quarter.

We expect it to be down about 3% for the full year. So certainly improving over the course of the year, but that has been implicit in our guidance.

So no, we haven't. We have seen nickel prices pop a little, and that is providing some bit of tailwind, but they are quite low and mostly consistent with our forecast. With respect to high risk sites, we are spending an awful lot of time analyzing the sites from that perspective and understanding what options we may have to mitigate those risks.

If you look at the sum of the sites that we view as high risk, they would account for less than 10% of our earnings. So while we are of course quite concerned about those sites, I think it is fair to say there wouldn't be a material impact on our sales and profits going forward if they were all to close, and we certainly don't expect that.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, thanks. I'll get back in queue.

Operator

Bhupender Bohra of Jefferies.

Bhupender Bohra - *Jefferies & Co. - Analyst*

Good morning. Just a question on your Industrial business here, could you talk about -- I know you spoke about the heat exchanger business being weak right now. If you can give some color on the Hammco acquisition which you made a few years ago, and you were trying to -- you talked about how that has been a positive, a real [flight] within Industrials. Just give us some color on that?

Nick Grasberger - *Harsco Corporation - President and CEO*

Sure. So the Hammco acquisition has far exceeded the expectations that we had when we bought the business. As you know, it's oriented more towards the downstream segment of the market, which has held up quite well.

And in particular, given our capacity expansion at our facility in Tulsa and moving the Hammco products into that facility, we now have the ability to produce much larger quantities of Hammco coolers, which is what the customer is looking for. We believe we are taking market share in the downstream sector of the market with Hammco, and we expect revenues in Hammco to grow 30% to 50% this year.

Bhupender Bohra - *Jefferies & Co. - Analyst*

Great. Just a follow up on the Rail business. We saw the margin decline pretty steep here year over year because of the high equipment mix. How should we think about margins as we go through the quarters for the rest of the year?

Pete Minan - *Harsco Corporation - SVP and CFO*

This is Pete. The margins that we're going to see are pretty much going to be slightly down for the rest of the year compared to the prior year basically attributable to the mix, but should improve in the latter quarters from what the first quarter experienced.

Bhupender Bohra - *Jefferies & Co. - Analyst*

Was there any one-time items where the margins were suppressed in the first quarter? You were saying we should see sequential improvement in the margins as we go through the quarters.

Pete Minan - *Harsco Corporation - SVP and CFO*

That is true, and in fact you'll recall this quarter last year we had some pretty good margin part kits aftermarket sales that affected the comp as well.

Bhupender Bohra - *Jefferies & Co. - Analyst*

Right. And the margin in this particular quarter was ex the $11 million gain last year, right? Is that true?

Pete Minan - *Harsco Corporation - SVP and CFO*

Yes, that's correct.

Bhupender Bohra - *Jefferies & Co. - Analyst*

Okay, got it. I'll be in the line, thanks.

Operator

Jeff Hammond, KeyBanc Capital Markets.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Just a couple quick follow ups here. Just on Air-X-Changers, can you just talk about where you think we are in the bottoming process, what you're seeing in terms of backlog and orders filling towards the back half, and how that informs any view into 2017?

Nick Grasberger - *Harsco Corporation - President and CEO*

I think that we are still very much at the bottom. You've seen the rig count continue to decline. The rig count is now at an all-time low since they've been tracking that metric here in North America.

And as we look into our Qs three and four, we're not yet where we'd like to be with our order book, to be honest. We are maintaining our view for the full year in Air-X-Changers, but there is risk.

There's just not a lot of activity in the upstream and midstream sectors of the market. So we would expect there to be a healthy rebound in 2017. I think that it is really all going to come down to that rig count beginning to move up again, and it certainly has not done that.

Pete Minan - *Harsco Corporation - SVP and CFO*

Jeff, this is Pete. We also told you on the last call that there was some inventory in the channel. Even when the confidence is locked in in terms of the oil price and manifests in additional rig count, there may be a little bit of a lag before we start seeing that in our order book as well.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Just on Rail, your comment on 2017. So basically this SBB revenue uplift in 2017 we should count on low no margins. Is that the right way to look at it?

Pete Minan - *Harsco Corporation - SVP and CFO*

That's correct.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Last one on Metals, can you give the revenue impact from exited contracts in the quarter?

Pete Minan - *Harsco Corporation - SVP and CFO*

For the quarter the revenue impact was $24 million.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, helpful. Thanks.

Operator

Rob Norfleet, Alembic Global Advisors.

Rob Norfleet - *Alembic Global Advisors - Analyst*

Good morning. Just a quick question. Could you give us progress or an update on obviously the various stages of Orion? Just what the run rate that we are recognizing for cost savings?

And then maybe if you could just touch on any additional cost savings initiatives that you have under way, or if there's anything really left that we can still do to improve the cost structure, especially on the SG&A line.

Nick Grasberger - *Harsco Corporation - President and CEO*

The total savings from Orion were about $60 million. About two-thirds of that would be headcount related, the other one-third benefits from triage efforts and so forth.

Internally we view Orion as largely finished. We've had three waves of significant cost reduction, the process changes that we've made are now embedded in the business, including the triage process.

So Orion as we laid it out two years ago on this call is largely complete. But of course given that the changes were so dramatic in terms of process and structure, they of course remain part of the business.

In terms of additional cost reduction, we're focused very heavily on reducing our cost of sales through lower maintenance spend, more effective utilization of the equipment, and driving a number of metrics to show consistent performance in operational areas across the site.

We have not quantified those. We are driving it very hard. We have a global head of operations who is leading that as well as other initiatives. It is not an amount that's let's say included in our guidance, but we continue to push very hard to reduce the cost of sales in M&M.

In terms of SG&A, we certainly continue to push on SG&A. Part of the reason why the M&M results in Q1 were better than our projection was SG&A. So I think we will hopefully continue to see favorable variances relative to our plan for the year in SG&A.

Rob Norfleet - *Alembic Global Advisors - Analyst*

Okay, great. And my last question is I know liquidity at this point is certainly ample relevant to debt covenants et cetera, but at this juncture are you all contemplating any asset sales in an effort to raise cash? I know obviously there are some attractive businesses within industrial that you likely could fetch a good price for. I want to understand your thought process behind that.

Nick Grasberger - *Harsco Corporation - President and CEO*

The asset sales that we're focused on are largely within M&M. We have a number of idle assets and even perhaps some real estate that we are looking at, but really nothing of size and certainly not a business unit.

Operator

(Operator Instructions)

We have no further questions at this time. I will turn the call back to the presenters.

Dave Martin - *Harsco Corporation - Director of IR*

Thank you, Lori, and to those that participated in this call this morning. A replay of the call will be available later today through May 18, and the replay details are included in our earlier earnings press release.

Lastly, if you have any follow-up questions please contact me, and my contact details are included at the top of today's release. Thank you for your interest in Harsco and have a great day.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.
