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HSC - Q2 2015 Harsco Corp Earnings Call

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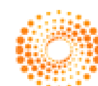

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PRESENTATION

Operator

Good morning. My name is Samuel, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation second-quarter release conference call.

(Operator Instructions)

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Please go ahead.

Dave Martin - *Harsco Corporation - Director of IR*

Thank you, Samuel.

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, and Pete Minan, our Senior Vice President and Chief Financial Officer. This morning, we will discuss our results for the second quarter, our outlook for the year, and update you on our key initiatives. Then we'll take your questions.

Before our presentation, however, let me take care of a few administrative items. First, our earnings release was issued this morning. A PDF file of the news release, as well as a slide presentation for this call, have been posted to our website. Secondly, this call is being recorded and webcast. A replay will be available on our website later this afternoon.

Next, we will make statements today 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 our risks and uncertainties, see the Risk Factors sections 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 any forward-looking statements.

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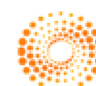

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Lastly, on the call we will refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to US GAAP results is included in our press release today, as well as in our slide presentation.

With that being said, I'll turn the call over to Nick Grasberger to begin our prepared remarks.

Nick Grasberger - *Harsco Corporation - President & CEO*

Thank you, Dave.

Good morning, everyone, and thanks for joining our call.

I was satisfied with our ability to deliver profit above our expectations in the second quarter. It's also important to note that there were no special items in the quarter. Lower SG&A costs across each business and in corporate offset the negative effects of reduced demand in M&M and Industrial due to weak steel and energy markets.

A revised outlook for the remainder of 2015 assumes these markets remain very weak and continue to obscure the operational improvements we've made in both M&M and Industrial. In addition, a handful of difficult contracts in South America continue to weigh on M&M. And therefore, we have reduced the midpoint of our operating income guidance for the full year by about 15%.

I'll offer just a few brief comments on each division. M&M continues to execute on the initiatives outlined over a year ago to transform the business into a leaner, more disciplined and data-driven organization, focused on boosting its return on capital. And now with the full corporate team actively engaged with the M&M team, I expect streamlined decision-making, the complete support of our organization, and full alignment around our strategic plan moving forward.

We expect to realize $35 million to $40 million of benefits by the end of next year through the simplification component of Project Orion, which is a bit higher than original projections. We're also beginning a program targeting additional reductions and cost of sales at our sites on a global basis, which is another outgrowth of our deep dive into site operations over the past several months.

Our triage teams are aggressively pursuing the best possible commercial outcomes on our underperforming contracts. We're also driving operational improvements at these sites. We expect over $10 million of annualized earnings improvement from the underperforming contracts that we've successfully addressed or finalized this year. And this figure should grow in 2016 as the remaining underperforming contracts are finalized.

Finally, the fundamental process changes in our bid and contract management function and the implementation of global operational standards are creating a more uniform business with stronger controls. Put simply, we are very excited about the upside opportunity in M&M when markets recover.

We've also reduced the outlook for our Industrial division, which is heavily exposed to the energy sector, as you know. Previously, we assumed a modest recovery in energy prices in the second half of this year, but that has clearly not happened. Nonetheless, our Industrial leadership team moved quickly and skillfully earlier in the year to mitigate the impact of lower demand. And we expect the year-over-year decline in earnings to be quite modest relative to the decline in revenue.

Moreover, we continue to feel confident in the impact of our operational initiatives and new product offerings we will have in 2016 and beyond. The operating leverage of our Industrial group has never been higher. And we look forward to generating significant earnings growth as markets recover.

The outlook for our Rail division is unchanged and certainly quite positive. We fully expect Rail to be a $500 million business with continued attractive margins and returns within a few years, based largely on existing backlog. And we are optimistic the backlog will continue to grow over the next year as additional long-term contracts are awarded. We are also excited about the pipeline and possible acquisitions we've identified. And our Rail leadership team is talented, disciplined and focused, and has proven its ability to execute at a high level.

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Overall, we remain steadfast in our focus on driving three key financial metrics and creating a more balanced portfolio of businesses. We expect to improve free cash flow and EBITDA minus CapEx margins this year, despite a $50 million negative effect on profit from market conditions, FX rates, and commodity prices. And ROIC would be about level with last year, if not for a higher tax rate.

In terms of portfolio balance, we have committed much more growth capital over the past year to Rail and Industrial than to M&M. And our acquisition focus remains fixed on our manufacturing businesses. At the same time, we have removed a great deal of risk from the M&M business through implementing tighter processes and controls, and addressing legacy risk items, such as poor contracts.

No one is more disappointed in Harsco's earnings and share price performance than I am. But I am confident we are building a better Company for the future.

I will now turn the call over to Pete.

Pete Minan - *Harsco Corporation - SVP & CFO*

Thanks, Nick.

Let me start on slide 4 of the presentation. Operating income in the second quarter of $36 million was above our guidance range of $30 million to $35 million, as performance in our Rail segment was better than anticipated. And also, corporate spending was slightly lower than we had forecasted. These positives offset the results in Metals, where the performance was impacted by lower steel output, or LSTs, in North America and Brazil. Weaker nickel demand and higher maintenance costs in certain locations as well. We were also impacted by the bankruptcy of a customer in South Africa.

Compared to the 2014 quarter, operating income declined as we expected, with each business unit reporting lower earnings compared with the prior-year quarter. These changes were only partially offset by lower costs at corporate from reduced consulting fees and other areas where we are focused on controlling our expenditures.

Revenues in the quarter also declined as expected, to $456 million. This represented a decrease of 15% year over year. This change resulted mainly from the impact of a stronger US dollar, site exits, and lower nickel-related sales within our Metals & Minerals segment. Revenues also fell in our Industrial business as a result of weaker demand for its products, which was mostly tied to trends in US energy spending. As a result, our operating margin was essentially unchanged at 8.6% compared with the prior period. Earnings per share was $0.08 in Q2, as compared to our guidance range of $0.06 to $0.12.

Compared with our outlook, higher operating income was offset by taxes, Brand joint venture contributions, each of which negatively impacted EPS by $0.02 to $0.03. Compared with the prior-year quarter, EPS decreased $0.11. And the just-completed quarter included an equity loss contribution from our Brand JV of approximately $8 million. This figure translates to an EPS impact of roughly $0.06 after tax, and compares to a loss of $3 million in the prior-year quarter.

Regarding Brand, it's important to emphasize and highlight that we reported a seasonally weak period for this business during our Q2. And also that the Brand P&L impact to Harsco was again impacted by non-cash foreign exchange losses in the second quarter. These foreign exchange losses totaled $23 million for Brand in the quarter, and impacted our EPS by approximately $0.05. Also on Brand, the JV ended the relevant quarter with net date of $1.7 billion, which was essentially unchanged from the prior quarter.

Free cash flow for Harsco in the quarter was $10 million, which was better than we had forecasted internally, primarily due to the underspending of capital. Meanwhile, free cash flow declined $10 million versus the second quarter of 2014, as lower CapEx was offset by the change in cash earnings. And the fact that our prior-year quarter included additional cash proceeds from the sale of our infrastructure business. And lastly, return on invested capital improved to 6.8% from 6.1% in 2014.

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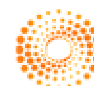

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I'm going to talk about the businesses; I'm moving to slide 5. In the second quarter, Metals & Minerals generated operating income of $19 million as compared to $24 million in the prior-year quarter. During the quarter, the organizational savings under Project Orion and lower bad debt costs were more than offset by foreign exchange impacts, site exits, and lower nickel prices and shipments.

Customer LSTs in the quarter declined 4% year over year in absolute terms. This change reflects the fact that we exited sites in the past year. And it also accounts for lower customer production in certain locations, such as North and South America, that impacted our Q2 results. Free cash flow year to date in Metals totaled $22 million, as compared to $5 million in the prior year, with this improvement attributable to both lower capital spending and working capital.

Let me move on to slide 6. Our Industrial business generated operating income of $14 million in Q2, as compared to $17 million in the second quarter of 2014. This change resulted from lower demand across the business, along with facility moving costs related to the new CenterPoint operation in Tulsa that totaled approximately $1 million in the quarter. As a result of these income and revenue changes, operating margins declined just over 100 basis points year over year.

In the face of meaningful headwinds, we continue to reduce our overhead structure within the Industrial businesses. These cost reduction initiatives to date offset a large portion of these headwinds in Q2. And we anticipate additional workforce changes will be completed in the coming months. Free cash flow year to date totaled $21 million versus $29 million in 2014. And this change is attributable to our capital expenditures for CenterPoint.

Lastly, our backlogs declined 8% sequentially during the quarter, as can be expected. It's important to note that these backlogs, which represent more than three months of segment revenues, are little changed versus the year-ago period, and will continue to support the business for the balance of the year.

Moving to slide 7. Operating income in Rail was $11 million, as compared to $14 million in the prior-year period. This result was ahead of internal plans as a result of better parts and service mix, and lower administrative costs. Compared with the 2014 quarter, however, income and margins fell due to a less favorable sales mix. Free cash flow in Rail totaled $14 million year to date versus $33 million last year. And this change is due to fewer customer advances on certain large contracts within our backlog. Our current Rail backlog, as you know, includes two sizable contracts with the Swiss national railroad, SBB.

We are very pleased with the progress of our Rail team against these contracts. And as expected, we are poised to begin delivering equipment and recognizing revenue under these contracts in the fourth quarter of this year. As in the past, we highlight the strength of our Rail business and our growth opportunities within the global maintenance of way market.

These opportunities remain unchanged. And the large equipment tenders that we referred to in the past remain outstanding. We continue to remain very encouraged by the opportunities, and confident in our ability to win some of these contracts in the forthcoming quarters.

Before I walk through the changes to our 2015 outlook on slide 8, let me again highlight that the majority of the guidance changes result from the external pressures on our businesses that we've discussed in the past. These pressures, as you know, are most pronounced within our Metals & Minerals business and our Industrial business.

At the time of our last conference call in May, we were encouraged that a number of indicators within the metal and energy markets suggested that the fundamentals may have bottomed and that maybe the worst was behind us. This improvement was short-lived, as evidenced by a significant fall in nickel and oil prices, and as the strengthening in scrap demand in steel production failed to materialize.

In Metals & Minerals, these factors have an incremental earnings impact in excess of $10 million versus our prior outlook. And when combined with other external challenges, such as a stronger US dollar, they are now expected to impact the business's earnings by more than $40 million as compared to 2014. Also in Metals, our updated outlook now incorporates additional site exit and contract termination costs in underperforming regions that we had not anticipated earlier. As well as additional maintenance and operating costs at a small number of underperforming sites in Latin America.

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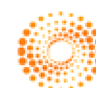

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In Industrial, we now anticipate that our cost-reduction initiatives within the business will not fully offset the impact from reduced energy-related demand for our heat exchanger and grading products in 2015. These gross impacts are now estimated at $10 million to $15 million versus $5 million to $10 million previously. Overall, we are pleased with how our businesses are managing through a difficult environment and executing upon key priorities and strategies. Although, as Nick mentioned and as you would expect, we are clearly disappointed with the changes to our guidance.

In Metals & Minerals, the transformation has clearly improved the business, but there is certainly much more work to do. The cross-challenges in Metals that I referred to earlier are limited to a small number of sites. And these have and will continue to get more attention in the forthcoming quarters. Also, as I mentioned in the past, we continue to explore other cost reduction initiatives and business levers in Metals & Minerals to create value. And I'll comment more on these in a few minutes.

Turning back to our outlook, we now expect 2015 operating income of $120 million to $135 million as a result of our updated expectations for Metals and Industrial. Our underlying forecast for our Rail business are essentially unchanged versus our prior guidance. Meanwhile, our EBITDA minus CapEx guidance, a very important metric for us, is maintained at $135 million to $150 million for the year, as we have reduced the capital spending plans across the Company. And it's important again to highlight that we still expect year-over-year improvement in this key financial metric.

Our capital budget for 2015 is now $135 million to $145 million, as compared with $165 million to $170 million previously. Most of this change is attributable to the Metals unit, although our spending plans have declined also in our other businesses. Next, our free cash flow forecast for the year is now $60 million to $80 million, which incorporates our latest working capital forecasts. And lastly, earnings per share is now expected to be between $0.41 and $0.55.

Now, this range now assumes a tax rate of 42% to 44%. And this is tax rate change is driven by the geographic distribution of our anticipated profits. Also note that the expected equity contributions from our Brand joint venture are unchanged at $4 million to $6 million for the year.

Before I turn to slide 9 and discuss our third quarter, let me comment on our financial position. As you know, we withdrew a bond offering in early June, given timing and market conditions. At that time, we simply found the financing options unattractive, as have a number of companies in recent months.

We continue to evaluate the options to refinance our $250 million of notes due in October. We are evaluating various alternatives, and are confident in our ability to complete the refinancing prior to maturity. At this point, we can't say much more about our efforts here, although I will highlight that we remain very comfortable with our financial position and flexibility.

At the end of the quarter, our net debt stood at $876 million. In addition, subsequent to the quarter end, we monetized a euro-denominated cross-currency interest rate swap agreement. And the cash proceeds from this transaction of approximately $75 million provide us additional liquidity and financial flexibility.

Now, regarding our third quarter, we expect operating income to be between $20 million and $25 million, and earnings per share of $0.05 to $0.09. In Metals & Minerals, operating income will decline versus the prior year, as cost reductions will be offset by lower LST, site exits, weaker nickel and scrap demand, and foreign exchange impact.

For Industrial, operating income is expected to decrease, given that reduced demand will offset lower SG&A costs. In Rail, earnings will decline meaningfully from a very strong third-quarter 2014, as a result of lower parts and service contributions and a weaker mix. And lastly on Brand, we are expected to record equity income of approximately $4 million in Q3.

Turning to Project Orion in slide 10. The major work streams of Project Orion continue to progress according to our expectations. And we are in the later stages of these initial steps to improve the capital returns in this business. Regarding our simplification efforts, 90% of the anticipated workforce changes have been completed.

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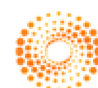

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We realized roughly $5 million of savings in the quarter. And we still expect $20 million of savings this year related to these workforce and operational improvements. Also, the run rate of the improvements to date now approximates $35 million, as compared to our year-end target of $35 million to $40 million. We are on track.

Regarding underperforming contracts for sites, we have finalized solutions at 56% of the original underperforming contracts, or UPCs, as of the end of the quarter. This means four were finalized since our last call in May. The financial performance at our finalized sites continues to improve, despite external market headwinds. And additional benefits will accrue as outcomes become effective.

Overall, we are very pleased with the efforts of our triage teams to date. And as we've discussed, addressing these underperforming contracts is difficult work, and involves prolonged discussions with our customers. Of the remaining 30 underperforming sites, 19 are in progress. And despite numerous challenges, our triage efforts are expected to accelerate in the coming months. We still anticipate addressing our remaining UPCs by early 2016.

Lastly, let me comment on the other improvement initiatives underway within Metals that I referred to earlier. To start, we are in the midst of a comprehensive review of our M&M costs. These efforts include an analysis of all cost-of-sale items, SG&A, and procurement expenditures. Our Metals cost of sales totaled nearly $1 billion. And we see further opportunities to reduce our operating costs, building on the success of Project Orion.

Key focus items for us include labor efficiency, productivity, equipment utilization and maintenance, fuel and tire costs, to name a few. In the coming months, we plan to identify a number of key operating priorities with each of our site-level operating and maintenance supervisors to achieve significant improvement. Also, we anticipate that these actions will be implemented starting in the fourth quarter of this year.

Now, at this point, it's too early to quantify the expected benefits and state when these savings may be realized. But we believe the value potential from these initial initiatives is meaningful at this point. Lastly, as we've stated before, we expect that these initiatives will offset a significant portion of the macroeconomic headwinds evident in the business today.

That concludes my prepared remarks. And at this point, we would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Jeff Hammond from KeyBanc Capital Markets.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Hey, good morning, guys.

Nick Grasberger - *Harsco Corporation - President & CEO*

Hi, Jeff.

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Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Hey, Pete, just on your last comment about additional things that can be done, I don't know if there is a better way to quantify or just talk about -- did you need to get Project Orion done first before really attacking this? Or is it just a function of the weaker environment? Just a little more color there?

Pete Minan - *Harsco Corporation - SVP & CFO*

I think it's more the former, Jeff. We have experienced and continue to experience success with Project Orion. We got a lot done, and we want to build on that by really, in essence, expanding the initiatives that we started with Project Orion into these other issues. So they're not entirely sequential; there is a fair amount of overlap. But it's really building on the successes that we got with Orion, which we expect to do with the broader project on cost of sales and remaining SG&A.

Nick Grasberger - *Harsco Corporation - President & CEO*

And I would add, that has really been facilitated by having a global operational organization that really has been able to understand, as they have worked with each region, where the opportunities lie across those regions. It is the next logical step here, after having taken out the cost above the site, that now we are looking much more closely at the operational performance at each site and where the opportunities lie.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. And then can you quantify -- it sounds like you didn't have any charges this quarter, but it seems like there's, in the back-half guidance, some one-time exit costs, and then some short-term maintenance issues. So where to quantify that? And when we are all done with the exits, how much of a headwind goes away into 2016?

Pete Minan - *Harsco Corporation - SVP & CFO*

In the quarter, if you just focus on the exits for now -- and it's a little bit of a mixed bag here. Because it's not only just the year-on-year exits, but it's also some additional costs we are incurring in exiting contracts, or sites that have been cited for exits, particularly in South America. But the net impact on revenues from contract exits in the quarter is about $13 million. And the net churn at the operating income level is just under $4 million. When you extrapolate that out for the full year, we're talking about revenue impact of, say, $58 million or so, and a net churn impact of negative $7 million.

So the impact that we are experiencing during the quarter, though, is affected by some additional, really, closing costs that we probably underestimated a bit when we identified actually one or two specific sites -- one in South Africa and one in South America. We're incurring more costs than we had planned. We still expect to and are on track to exit the site completely by the end of this year, so that should go away completely for next year.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, but the $7 million -- is that profits associated with this $58 million of revenues exited? Or is there a portion of that, that's one-time cost?

Pete Minan - *Harsco Corporation - SVP & CFO*

It's a year-on-year impact of the contracts that are exited and are in process of being exited.

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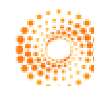

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Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. And then can you quickly quantify the FX impact by business?

Pete Minan - *Harsco Corporation - SVP & CFO*

Yes. Year-on-year impact for FX is about $10 million for Metals, which is the vast majority of the impact. There is some minor impact in Industrial and in the Rail business, but it's not consequential. That is at the OI level. The impact on the revenue level is about $160 million year on year.

Dave Martin - *Harsco Corporation - Director of IR*

Jeff, were you asking about the second quarter specifically or the full year?

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Yes, second quarter.

Dave Martin - *Harsco Corporation - Director of IR*

Oh, sorry.

Pete Minan - *Harsco Corporation - SVP & CFO*

I will give you those details. It's $45 million of revenue in the second quarter. $43 million-plus of that was in Metals. And then at the OI level, it was $2.2 million, and all of that was at Metals.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, thanks, guys.

Pete Minan - *Harsco Corporation - SVP & CFO*

Okay.

Operator

Next question from the line of Scott Graham from Jefferies.

Scott Graham - *Jefferies & Company - Analyst*

Good morning.

Nick Grasberger - *Harsco Corporation - President & CEO*

Hi, Scott.

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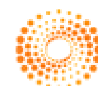

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Scott Graham - *Jefferies & Company - Analyst*

As I look at the adjusted operating income bridge on slide 5 for M&M, I'm seeing a much different picture with the 5.4 up than we saw last quarter, which was 4.1 down. Is that all project Orion and improved operating improvements?

Pete Minan - *Harsco Corporation - SVP & CFO*

It's probably best if I just walk you through it, if I could, Scott. The Project Orion benefits that we experienced during the quarter were about $5 million. That is where the bulk of that is in. There is also the favorable comp on bad debt expense that is also included in that figure. But if you are just focusing on the Project Orion benefits from the simplification efforts, it's $4 million to $5 million.

Scott Graham - *Jefferies & Company - Analyst*

Got you. If we look at this, the nickel and applied products hit, I'm sure that's a lot worse than what you'd thought. If you were to look at this from a, let's say, a nickel versus applied products -- because I know that you are more in control of applied -- what is the split there on the 5.8 between nickel versus the applied?

Pete Minan - *Harsco Corporation - SVP & CFO*

Scott, it's 100% nickel-related sites. Nickel prices are down roughly 30% year over year in the quarter. Our volumes were down the same percentage. So that entire $6 million is nickel.

Scott Graham - *Jefferies & Company - Analyst*

On a go-forward basis, obviously you don't want to hedge now at the low, but is this something where we could mitigate this? Because this is such an uncontrollable for you guys. What is the plan there?

Pete Minan - *Harsco Corporation - SVP & CFO*

We obviously have considered -- now is not the right time, as you said. But we have considered whether or not we could find ways to hedge our exposure here. It's a little bit more complicated than it would appear. It's not just price; there's demand and volume issues. Plus the accounting -- as you can imagine, the accounting for this is very difficult to achieve, the financial accounting benefits. You end up having some unfavorable volatility in the earnings, even if you were able to hedge it economically. But that being said, we do continue to evaluate whether there are ways to deal with this, Scott.

Scott Graham - *Jefferies & Company - Analyst*

Okay. And here is my last one on M&M, and then I will get back in the queue. The net contract churn key -- is that the cost to exit?

Pete Minan - *Harsco Corporation - SVP & CFO*

It's a combination of factors. It's mostly the year-on-year comparison of operating income from exited contracts. In the current year, though, it does include an element of increased cost to exit for a couple of sites.

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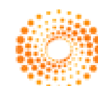

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Scott Graham - *Jefferies & Company - Analyst*

Okay. Because that went up versus last quarter. Does that mean that you're -- not that we're cutting into the meat here, I don't mean it that way. But in some ways, is that a good thing, that your -- the bar, as it goes higher, actually shows that you are more focused on the ROIC? There's a, I think, relationship there, yes?

Pete Minan - *Harsco Corporation - SVP & CFO*

There is a relationship, although I think this is -- the increase that we are talking about is probably just additional cost from an underestimation, frankly, of what it would take to get out. It shows that we are getting out of the egregious contracts. That's consistent with the objectives of Project Orion. We continue to do that. In that sense, it's a fair statement, Scott. But the impact this quarter and for the full year has an impact of just additional costs to exit at a couple of sites.

Scott Graham - *Jefferies & Company - Analyst*

Was the 3.7 million higher than you thought it would be, Pete?

Pete Minan - *Harsco Corporation - SVP & CFO*

Yes. It was probably $1 million or so higher than we thought.

Scott Graham - *Jefferies & Company - Analyst*

Very good, thanks.

Operator

(Operator Instructions)

Your next question comes from the line of Rich Glass from Deutsche Bank.

Rich Glass - *Deutsche Bank - Analyst*

Hi, guys.

Nick Grasberger - *Harsco Corporation - President & CEO*

Hi, Rich.

Rich Glass - *Deutsche Bank - Analyst*

Can you guys give us a little insight into how you do your forecasting? It seems to be you have been congenitally too optimistic on some of the pricing and some of the macro, particularly, commodity-related pricing side of things. And this beaten lower thing has gotten old. I would think you guys would be conservative as hell, quite honestly, at this point. And it's more than a little frustrating to have to go through this Chinese water torture we are living through here. So maybe you can help us understand how you do that?

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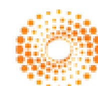

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Pete Minan - *Harsco Corporation - SVP & CFO*

Yes, it's obviously frustrating for everybody involved, Rich, but the forecasting process -- and really, let's focus on Metals here. That's what we are talking about. It's done at the site level. We have 170 sites. That's where it starts. It's getting an understanding of what the volumes will be at those particular sites. But as you know from the industry, there is not a whole lot of future visibility in terms of volumes, even by the customers at the site. But it starts there.

As far as the macroeconomic factors, let's just go backwards to where we were in this conference call in the first quarter, where we said that we were starting to see some indications that things were bottoming out. Well, nickel price was over $6, and was creeping upwards. Steel production seemed to be leveling out in North America and South America. We had foreign exchange, the dollar was starting to weaken, and we had oil that was selling around $60 a barrel. We felt pretty confident there. I think we clearly -- we don't think we were being overly optimistic there. We thought we were just reacting to the market conditions as we saw them. Unfortunately, as I said earlier, those perceptions were short-lived.

Nick Grasberger - *Harsco Corporation - President & CEO*

The other variable here, Rich, of course, is the whole triage process in underperforming contracts. We make assumptions on what the outcome of those negotiations will be with the customer, and whether we will exit or stay the course. Of course, we don't control the timing of that. And also, sometimes we will exit as opposed to continue. And there are costs associated with exiting that are difficult to forecast. I think that volatility or that high variance to forecast is going to come down over time as we navigate through all these underperforming contracts. That has been a real wild card for us and, frankly, difficult to forecast.

Rich Glass - *Deutsche Bank - Analyst*

Okay. I mean, maybe my question revolves around how much of a haircut you give the site-level forecast. It seems that a lot of the problems with the Metals & Minerals performance is that it was decentralized, that there were no best practices, that there were no standard operating procedures, that there was no central purchasing, that there was a very large degree of ownership at the local level. So how conservative -- how much of a haircut do you give them? And how can you have much faith in that number that they are sending to you?

Nick Grasberger - *Harsco Corporation - President & CEO*

Look, as Pete mentioned, we are extraordinarily frustrated about this ourselves. We have a new CFO in the business; we're looking for a new head of the business. As you know, the corporate team is leaning in much more actively -- Pete himself into the forecasting process, with our new CFO in that business, who we know well from our past. So this is clearly top on our agenda with the business right now, and there is a lot of resource being applied to it.

Rich Glass - *Deutsche Bank - Analyst*

Okay. Moving on from there, what is the number on the full-year cost to exit for that business? How big is that number? It sounds like it's pretty sizable.

Pete Minan - *Harsco Corporation - SVP & CFO*

In terms of exit costs?

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Rich Glass - *Deutsche Bank - Analyst*

Exit costs from the Metals & Minerals. Because you're moving out a fair amount of sites, it sounds like, between the beginning of this year and the beginning of next year.

Pete Minan - *Harsco Corporation - SVP & CFO*

Right. The vast majority of the costs that we anticipated from exiting sites from Project Orion and triage efforts were taken last year. There was almost $90 million worth of charges that were taken, were largely related to exit costs. We don't expect anything in the neighborhood of that, anywhere close to that this year, Rich. The exit costs we are talking about is where we identified a contract site for exit and we anticipated exiting within, say, six months, it may have taken nine months or a little longer than that. And the actual cost incurred in the intervening period may have been more. So when I was referring to exit costs being greater than expected earlier in this call, that's what I was referring to. We're not expecting --

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Rich Glass - *Deutsche Bank - Analyst*

What I'm trying to get at is, what comes back next year? What do you not incur next year because you did this year?

Nick Grasberger - *Harsco Corporation - President & CEO*

You certainly have loss-making contracts that are going away. I made a comment earlier that, of the sites we exited or addressed that were underperforming, we expect to have $10 million of incremental earnings from that set of contracts this year. And that number will grow significantly next year as we exit more contracts that are underperforming, and in many cases, loss-making. So there are three or four contracts in particular in South America that are loss-making we expect will either exit or not have losses next year.

Rich Glass - *Deutsche Bank - Analyst*

And are you talking to people about new business in the Metals & Minerals?

Nick Grasberger - *Harsco Corporation - President & CEO*

We are. We have a pipeline of new opportunities as well. But honestly, we're focused on renewing the best contracts and resolving the worst contracts. This is not about growth. You have seen our CapEx numbers come down. The CapEx that we are spending is mostly on renewals and on maintenance, not on new opportunities. That is different in India and China. Obviously we are very focused on growth in those markets, and we've announced some sizable new growth-oriented projects in India and China over the past year. And that is our focus.

Rich Glass - *Deutsche Bank - Analyst*

Right. So there are growth opportunities, though, in this business once we --

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Nick Grasberger - *Harsco Corporation - President & CEO*

No question.

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Rich Glass - *Deutsche Bank - Analyst*

-- Turn the corner, which seems to be a pretty slow process.

Nick Grasberger - *Harsco Corporation - President & CEO*

Well, it's that, and it's also the applied products business that we talk about. We feel that shining a light on that business globally, which really has not been done before -- as you know, that is not a capital-intensive business and we have good technology there -- we think that is the other opportunity in M&M.

Rich Glass - *Deutsche Bank - Analyst*

Okay. Switching to the Rail business, can you talk about the negatives on the spare parts and contract services? It seems like these were two businesses that you guys had a lot of white space in, because you hadn't pursued in the past. And that there should be a lot of upside in spare parts in contract services, as you move to capturing more of the aftermarket, was what I thought the plan was here.

Nick Grasberger - *Harsco Corporation - President & CEO*

Yes, no question. I think you have to distinguish between aftermarket and contract services. Aftermarket is where the real opportunity is. But the reality is, as we grow that business, it's lumpy. As you compare quarter to quarter or sequentially or year over year, you're going to have product mix affects from equipment versus aftermarket. So while we've tripled the size of the aftermarket business over the last couple of years, it's not linear quarter to quarter. It remains a bit lumpy and a bit opportunistic. That is part of the building out the new business model, to make it more systematic and more predictable.

Rich Glass - *Deutsche Bank - Analyst*

Purchases in the aftermarket for Rail are as lumpy as in the original equipment end of things? Or worse?

Nick Grasberger - *Harsco Corporation - President & CEO*

Well, I think the backlog in equipment is more consistent and more predictable in terms of how that's going to turn into revenue and profit. The aftermarket business tends not to have much of a backlog, and it tends to be more difficult to predict quarter to quarter because it remains, to some degree, opportunistic.

Rich Glass - *Deutsche Bank - Analyst*

I see. And what is the number for aftermarket? You've said you tripled it.

Nick Grasberger - *Harsco Corporation - President & CEO*

It's about $90 million of annual revenue, with margins that are 2X the margins on equipment.

Rich Glass - *Deutsche Bank - Analyst*

And where is the potential for that business, if we were looking out three to five years? How big can that be?

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Nick Grasberger - *Harsco Corporation - President & CEO*

We are actually under-represented in aftermarket relative to equipment. So we have a very small percentage of the market in aftermarket, so the potential is sizable.

Rich Glass - *Deutsche Bank - Analyst*

Okay. Does your guidance include an accrual for incentive comp for this year?

Nick Grasberger - *Harsco Corporation - President & CEO*

Yes.

Rich Glass - *Deutsche Bank - Analyst*

And how does that compare year over year?

Nick Grasberger - *Harsco Corporation - President & CEO*

It's down.

Rich Glass - *Deutsche Bank - Analyst*

A lot? A little? I mean, as a shareholder, it's a little hard to understand with targets that are only moving one direction, unfortunately, why much of anything is deserved above a base salary. That is supposed to be incentive comp, meaning you make your incentives and level of performance, and then you get paid.

Nick Grasberger - *Harsco Corporation - President & CEO*

Well, that is certainly true. Our comp program for executives is very much aligned with pay for performance. We have a high percentage of our compensation that varies with performance. So that accrual, as you might imagine, has come down throughout the year as we've reduced our earnings outlook.

Rich Glass - *Deutsche Bank - Analyst*

Okay. And is that accrued into corporate costs, or where does that get lumped?

Nick Grasberger - *Harsco Corporation - President & CEO*

Well, the corporate accrual for the executives is at corporate, but the business units have the accrual for their incentive comp.

Rich Glass - *Deutsche Bank - Analyst*

Okay. So can you explain to me why corporate costs, being flattish -- you guys didn't give exact numbers that I saw -- but why is that a good thing? It seems like your revenues are down 15%, you guys should be burning the furniture over there, quite honestly. And I don't know what the

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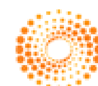

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opportunities are, but you would think with a business that's been constantly shrinking, that the overhead structure needs to shrink relatively as well.

Pete Minan - *Harsco Corporation - SVP & CFO*

So corporate costs are down a little bit year on year, Rich, and we are looking at opportunities to obviously reduce that further, naturally. It's combined with the efforts that I referred to on my call earlier.

Rich Glass - *Deutsche Bank - Analyst*

All right, thanks, guys. Good luck.

Operator

Next question from the line of Rob Norfeet from Atlantic Global Advisor.

Rob Norfleet - *Atlantic Global Advisors - Analyst*

Good morning, guys.

Pete Minan - *Harsco Corporation - SVP & CFO*

Hey, Rob.

Rob Norfleet - *Atlantic Global Advisors - Analyst*

Just a couple of quick questions. This might have been answered, but can you give us a little bit of an update on Brand? Clearly net energy markets are challenged -- we knew that on a daily basis. But I'm referring more to the legacy Harsco Infrastructure business. We've obviously had gotten a couple of glimpses that European non-res demand had at least stabilized a little bit. Maybe you could just discuss how you're seeing that business trend? And then secondly on that, any update on, just from you all's perspective, timing of the monetization of that asset -- whether you still think it's a 2017 event, or whether it could potentially be a 2016 event?

Nick Grasberger - *Harsco Corporation - President & CEO*

The outlook has not changed for Brand's EBITDA and cash flow over the past several months. As we've indicated before, given their exposure to energy, albeit mostly downstream, we expect their EBITDA to be down 5% to 10% year over year. That has not changed. But you are right to point out the legacy Harsco business, which is relatively larger outside North America than the Brand business, is doing well. They have seen a better performance, say, in Europe from the legacy Harsco businesses since the transaction than the North American business.

In terms of the monetization, it's just difficult to say. Obviously that is a decision that will be taken along with our partner. With the downturn in the energy markets, I think it's fair to assume that the exit has been pushed out a bit. But we are still targeting a hold period that is a good bit less than what you would typically associate with a private equity-owned business.

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Rob Norfleet - *Atlantic Global Advisors - Analyst*

Okay, that's fair, thanks. And then just lastly, a question to Pete. You obviously talked about some additional cost saving actions at M&M on the cost of goods sold, the COGS, line. I know you gave some variables as to how that could happen, and I know you're not going to get overly specific. But without cutting into the bone, what type of savings could we potentially realize? Is this a 3% to 5% savings? Is it potentially 5% to 10%? I'm just trying to get some idea of the cost of that opportunity there.

Pete Minan - *Harsco Corporation - SVP & CFO*

I think we've got to be looking at a magnitude of 5%, to be truthful here. Tens of millions of dollars, is what we are targeting. But like I said, we haven't quantified it. We are not in the point where we can really crystallize that yet. But that's where we're trying to target.

Rob Norfleet - *Atlantic Global Advisors - Analyst*

Okay, great. That's all for me, thanks.

Operator

Next question from the line of Scott Graham from Jefferies.

Scott Graham - *Jefferies & Company - Analyst*

Hey, good morning. I just wanted a couple of follow-ups here. Nick, at the outset, I think you mentioned that the renegotiated contracts to date, that you will get a $10 million operating income benefit from that. I was just wondering, over what period are you looking for, for that?

Nick Grasberger - *Harsco Corporation - President & CEO*

To be clear, what that is, is that's the universe of underperforming contracts that have been finalized. So either they have been renegotiated or we have exited them, or in some cases, there have been significant operational improvements as part of the triage effort. That universe of contracts, if you look at the expected gross profits from those contract for a full-year 2015 versus a full-year 2014, that is about $10 million of positive incremental gross profit. If you then extrapolate into 2016 and make assumptions around -- within that same universe of contracts that is growing -- because we are exiting, we're addressing more of those underperforming contracts -- that $10 million should grow significantly in 2016. We have not yet quantified that. But if you look at the trend and you look at where some of the loss-making contracts are in the process of being exited, you start to feel pretty good about the impact that could have in 2016.

Scott Graham - *Jefferies & Company - Analyst*

With you. Your assumption for second-half steel production in North America and Europe?

Pete Minan - *Harsco Corporation - SVP & CFO*

The steel production in Europe second half, moderate to flat -- moderate increase to flat in Europe. Across North America and South America, it's declining. It's after the full year, we are assuming our LSTs are down 5.5%. So year to date, we are down 4% or so. You can extrapolate our assumptions from the second half. It's basically pointing to no improvement.

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Nick Grasberger - *Harsco Corporation - President & CEO*

One thing we should probably highlight as well is the geographic diversity of the performance in M&M. Europe, China, India, Middle East have all been performing quite well and according to their plan, largely. The challenge has been North America, mostly due to LST and nickel price. And South America, where it's a combination of bad contracts, poor execution on our part in terms of maintenance spending, and in some cases, also a weakening customer base. So we really can't paint the entire M&M portfolio with the same brush. There are very different levels of performance across the regions. That's why we are extraordinarily focused on South America right now. There's not a lot we can do about nickel price in the short term, and its impact on North America. But we feel that we are focused in the right places -- the European business. And again, we are very encouraged by China and India. We've put an awful lot of money in those two countries over the past two years, and they are performing well.

Scott Graham - *Jefferies & Company - Analyst*

Right. But the gist of my question, Nick, was that, I'm looking at the US and Europe toting up to close to 70% of your sales. And you are expecting flat, maybe up slightly, in North America, but you're expecting -- I'm sorry, in Europe, but you are expecting down in North America. Is that what I'm hearing you say?

Nick Grasberger - *Harsco Corporation - President & CEO*

That's right.

Scott Graham - *Jefferies & Company - Analyst*

Okay, all right, very good. Last question is on Brand, the guidance for the full year versus where we are now. Why are we -- that was a pretty big hit we took in the second quarter, on the negative side. So you are expecting some pretty good equity income out of the third and fourth quarter. A, am I calculating this wrong? I don't think I am, but maybe. B, why would we expect that?

Pete Minan - *Harsco Corporation - SVP & CFO*

Well, largely because of the fact that there was a large foreign exchange non-cash loss in Q2, which of course, impacts us significantly. That was $23 million. There is a plan to have that go the opposite direction in the next quarter. So we'll be benefiting from it. Year to year, we're going to still get the $4 million to $6 million that we are anticipating, even though we had a loss this quarter.

Scott Graham - *Jefferies & Company - Analyst*

You are saying that's going to be reversed this quarter, as in 3Q?

Pete Minan - *Harsco Corporation - SVP & CFO*

Yes, that's the plan.

Scott Graham - *Jefferies & Company - Analyst*

Or the second half?

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Pete Minan - *Harsco Corporation - SVP & CFO*

Second half.

Dave Martin - *Harsco Corporation - Director of IR*

Scott, the other thing to consider is just the seasonality of their business.

Scott Graham - *Jefferies & Company - Analyst*

Yes, okay. Got you. That's all I had. Thanks.

Nick Grasberger - *Harsco Corporation - President & CEO*

Thank you.

Operator

Next question is from the line of David Sachs from Hockey Capital.

David Sachs - *Hockey Capital - Analyst*

Hi. I want to depart a little bit from the quantitative aspect of the call and talk qualitatively, if you can. At the KeyBanc conference, Nick, you talked about the portfolio and the composition of the portfolio, and your thoughts on how the portfolio might evolve. If you might share that again with this audience, in terms of where your head is at, in terms of the businesses that you own, the opportunity sets for those businesses? And look at the over-cycle earnings potential of the Company, as opposed to focusing on one or two poor quarters this year? Thanks.

Nick Grasberger - *Harsco Corporation - President & CEO*

Thanks for the question, David. As we have indicated at KeyBanc, that conference and elsewhere, we are, as you would expect us to do, looking at the portfolio quite actively and what fits and what doesn't and why. And what the issues are that arise from that question, and the answer to it. And honestly, everything is on the table right now. As we have been fairly clear, the focus over the past 15 months has been on transforming and turning around the Metals business. And on investing in growth in Industrial and Rail. We feel that is exactly what we have been doing the past 15 months.

We also laid out 15 months ago what we thought we could achieve financially over three years, from that focus. And honestly, we have not backed off of those targets. The components of getting from here to there have changed a bit. But the focus remains very much on growing Industrial and Rail, and continuing to execute the initiatives in M&M. Which is largely around dealing with risk items, improving controls, before we grow again. And of course, the frustrating thing has been that, in my view, the very good progress we have made against that in M&M has really been hidden by very poor markets and continued poor performance in a handful of contracts, mostly in South America.

But there is no question, David, to the core of your question. We are very focused on the portfolio. And of course, the Board is very actively engaged in those discussions with us. And we recognize that this portfolio is not optimal.

Dave Martin - *Harsco Corporation - Director of IR*

Samuel, any --

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Operator

Next question from the line of Jeff Hammond from KeyBanc Capital Markets.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Hey, guys, just a couple quick follow-ups. On the earlier question, I think you talked about $10 million improvement from these exited contracts and that improvement from there. Is that separate and distinct from Project Orion? And what is the incremental savings into 2016 on Project Orion?

Nick Grasberger - *Harsco Corporation - President & CEO*

Let's think back to the various components of Orion. There is what we call the simplification, or the cost-out initiative, both at the site and above the site. Then there was the change in the bidding contract management function to a very centralized, much more quantitative function, with better controls. And then the third one was this triage component of addressing underperforming contracts. So the $10 million that I mentioned is really from the triage activities. And that's distinct from the $35 million to $40 million that we expect to realize from cost-out in that first component. So it is incremental.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. And then what's the incremental savings from Orion? Because you're going to get, what, $15 million to $20 million this year, and then you'll get the balance in 2016?

Nick Grasberger - *Harsco Corporation - President & CEO*

Yes, another $10 million or so next year.

Dave Martin - *Harsco Corporation - Director of IR*

Yes, it should be $21 million this year, right?

Nick Grasberger - *Harsco Corporation - President & CEO*

Plus the incremental benefits from exiting poor contracts. Obviously you have to keep in mind there are some offsets to that. There have been exits of contracts that were profitable. They may have had poor returns, but they were profitable. So you really need to look at, again, over time, what is happening with return on capital, and also EBITDA minus CapEx margins. If you just simply look at EBITDA or earnings, there is an offset because those contracts that are underperforming, but still profitable. And as you likely know, there have also been some contracts that we liked that were profitable that we didn't want to exit, that have either been lost, or upon renewal, the terms weakened -- still good contracts, but not to the extent that they were. So there are a lot of moving parts.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. And then the South America issues. As you were going through the portfolio and the contracts and everything -- and there has been a multi-year discussion on better maintenance practices -- how did that get missed?

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Nick Grasberger - *Harsco Corporation - President & CEO*

If you go back to the origin of many of those contracts, we were the first mover in South America for mill services, right? There was a very aggressive push to very quickly penetrate that market. And not surprisingly, when that is your approach, you're going to make some mistakes. And there were poorly written contracts. We built out some teams that were not up to the job, honestly. We're replacing an awful lot of people there, both at the sites and also the people that run the business above the sites.

So it's been frustratingly sticky, I'll say, to improve the operations. But we are confident in the new people that we brought in. We're confident in the new leadership there. But again, these things take time. We have talked about this Harsco Way of operational standards that we're rolling out globally. And the first geography of focus is South America. So we have a disproportionate amount of resource being applied to fixing these issues in South America.

Pete Minan - *Harsco Corporation - SVP & CFO*

I just want to re-emphasize that we are talking about a handful of sites here. We have 20-plus sites in Brazil, for example, and the ones that we are talking about that are causing some concerns are the underperformers -- there's two or three -- four of them. It's not a pervasive issue across the country or even the region. It's really isolated to those underperforming sites that we knew were trouble to start with.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Right, okay. And then as you consider the financing, how are you thinking about the dividend -- same or differently?

Nick Grasberger - *Harsco Corporation - President & CEO*

I think we remain committed to the dividend, Jeff. We really don't have concerns about our ability to execute the refinancing in the fall. So our liquidity position is strong, and will be strengthened further as a result of the refinancing. This $75 million of proceeds from unwinding the swap also, of course, helps that. We continue to believe we have adequate liquidity and visibility to cash flow going forward to maintain the dividend.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, great, thanks, guys.

Dave Martin - *Harsco Corporation - Director of IR*

Thanks, Jeff.

Operator

There are no further questions at this time.

Dave Martin - *Harsco Corporation - Director of IR*

Thank you, Samuel, and those that participated in the call today. We appreciate your interest in Harsco. A replay of this call will be available later today through August 19, and the replay details are included in our press release this morning. Lastly, if anyone has any follow-up questions, please call me. And we look forward to speaking with you in the future. Thanks.

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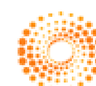

Operator

And this concludes today's conference call. Thank you for your participation. You may now disconnect.

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