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PRESENTATION

Operator

Good morning. My name is Roshay, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation second quarter earnings release conference call. (Operator Instructions).

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I would now like to introduce Mr. Dave Martin of Harsco Corporation. Mr. Martin, you may begin your call.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you, Roshay, and welcome to everyone joining us. 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 the results for the second quarter of 2017 and our outlook for the remainder of the year. We will then take your questions.

Before our presentation, however, let me take care of a few administrative items. First, note that Nick, Pete and I are in different locations today so please bear with us through any transition and/or communication challenges. Secondly, a PDF of our quarterly earnings release as well as the slide presentation for this call have been posted to the IR section of our website. Third, this call is being recorded and webcast. A replay will be available on our website later today.

Next, we will make statements today that are considered forward-looking within the meaning of the federal securities laws. 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 most recent 10-Q. The company undertakes no obligation to revise or update any forward-looking statements.

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

With that being said, I'll turn the call over to Nick.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Thank you, Dave. Good morning, everyone, and thanks for joining us. Second quarter results were quite respectable across our three segments, and we've again lifted the full year outlook for profit, cash flow and return on capital. The combination of support of markets and strong internal execution propelled the results in Q2, and we expect these trends to continue. Overall, most of our key financial metrics are expected to show meaningful improvement over last year. Specifically, we expect that ROIC should approach 10% this year, double the figure in 2014, while debt to EBITDA should end the year around 2x, down from over 3x just 18 months ago. Furthermore, the end markets for each of our segments remain well below peak levels of a few years ago so we expect profit growth to continue well beyond this year.

Metals & Minerals delivered another very strong quarter and exceeded its Q2 performance of last year, which had been M&M's best quarter in many years. The mix of our contracts continues to improve and we have recently signed attractive new contracts in growth markets such as Turkey, China, India and Egypt. We expect that our strong competitive position in these markets such as these will enable us to deliver growth well above the growth rate in the global steel industry and certainly above those of our competition. We also expect the redeployment of our capital from lower-margin, lower-growth markets into such opportunities will boost our return on capital beyond the current decade-high level. At the same time, the developments in acquisition of new technologies, coupled with on-site advancements in productivity, environmental solutions and safety, are further improving our value proposition to our global customer base.

The Industrial segment also produced its best quarter in some time, led by our Air-X-Changers business, which has seen a quicker recovery in demand than expected. AXC margins have already reached highs beyond those realized at the peak of energy market in 2014 due to benefits from consolidating our manufacturing facilities and reducing product costs. The improving competitive dynamics in the IKG grating business and the end market demand and new product gains in Patterson-Kelley also contributed to the strong results in the Industrial segment. In fact we believe we're capturing market share in each of the three Industrial businesses.

Earnings in our Rail segment were a bit ahead of expectations due largely to timing, although the outlook for the business is a bit weaker over the next six months than our previous view. Although Rail traffic is beginning to grow again, the capital spending of our major customers on maintenance of way equipment remains very weak. However, we did win a significant new contract in the U.K. in a product category called stone blowers, where we hold a technological edge on our competitors.

As we begin to look forward to 2018 and beyond, I'm very excited about the prospects of our Rail business due not only to a recovery in the end market but also to the benefits of several new initiatives aimed at growth and productivity under the new leadership team.

So before I turn the call over to Pete, I'd like to thank the roughly 10,000 employees at Harsco for their hard work and dedication both to our company and to our values. The shift in our culture towards our values has certainly played a meaningful role in the success of Harsco over the past several quarters.

So over to Pete.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Thanks, Nick, and good morning, everyone. So let me start with Slide 4 in the presentation materials. Reported operating income in the second quarter was $42 million, which exceeded our guidance range of $32 million to $38 million. This result reflects better performance in each of our business segments compared to our expectations a few months ago. Compared to our views at the beginning of the quarter, in Metals & Minerals, we benefited from higher service levels, more favorable mill services mix in North America, Brazil and Southern Europe, and in our Applied Products businesses, Reed Minerals had another strong quarter and we were aided by healthier metal yields at our nickel-related site in China. Meanwhile, operating result in Industrial were again helped by stronger demand for heat exchangers from our energy market customers. The Rail team also performed well and was able to pull forward some equipment and aftermarket sales from later in the year, which led to a better-than-anticipated quarter for this segment. Compared to 2016 [numbers] adjusted operating income increased 3%. You may recall that the second quarter of last year was a very strong quarter for Harsco, particularly in our Metals segment.

Now I'll walk through the segment details in a bit, but let me just highlight that the operating margin in Metals & Minerals was an impressive 12.4% in the quarter, and our Industrial margin was a similar percentage and exceeded 10% for the first time in 3 quarters. Revenues in the second quarter were $395 million, which represented an increase of 7% year-over-year. Most of this positive change can be attributed to higher demand for heat exchangers within Industrial and higher equipment sales in our Rail segment.

Harsco's reported diluted earnings per share was $0.22 in the second quarter versus our previous guidance range of between $0.14 and $0.19 per share. There are no unusual items in the quarter, and this earnings per share figure compares with a GAAP loss of $0.35 per share and adjusted earnings per share of $0.15 in the second quarter of 2016.

Free cash flow for Harsco in the second quarter was $30 million, which was higher than we forecasted internally, primarily due to better cash earnings and less capital expenditures. Also, free cash flow increased $11 million versus the second quarter of 2016. This year-on-year change is mainly attributable to the Rail segment and lower inventory levels compared with last year.

Let's move to Slide 5. In the second quarter, Metals & Minerals generated operating income of $32 million. This result represented an increase of about $1 million on a revenue increase of approximately $6 million compared with the prior year quarter. During the quarter, higher steel production and services and increased commodities prices led to the year-over-year improvement in operating earnings. These positives offset higher SG&A and other costs, as shown in the operating income bridge in the slide presentation. There are a number of items embedded within this summary, although the major items driving the year-over-year change included: higher professional fees, travel expenses and some site exit costs in the quarter.

As you know our major site pruning actions were completed a while ago. However, as we continue to monitor our portfolio, there will be naturally some contracts and sites that we exit in the future for various reasons, most notably for those not meeting our economic targets and expectations. The net operating impact of new and exited sites was minimal in the quarter. Customer volumes or LSTs increased 6% year-over-year in absolute terms. And on a continuing site basis, LSTs increased 4%, which was consistent with our expectation for the second quarter.

Lastly on Metals, free cash flow for the first half of 2017 totaled $42 million. This figure compares with $61 million in the comparable period of 2016 and the year-over-year change can be attributed to higher capital spending and the catch-up working capital benefits that were realized in 2016, which, as expected, did not repeat in 2017.

So turning to Industrial on Slide 6. Revenues increased 11% and operating income increased 25% as a result of increased demand for air-cooled heat exchangers from our energy customers. And as I referenced earlier, the operating margin in the quarter was 12.4% compared with 11% in the prior year quarter. The SG&A and other items shown on the bridge on Slide 6 mainly represent commissions or sales costs and some additional medical expenses, which we've mentioned in the past. Overall, the outlook for this business continues to strengthen as a result of improved fundamentals and increased capital spending in the U.S. energy market.

Our second quarter bookings remained robust, and for the entire segment, bookings were comparable to the first quarter levels. Compared to the prior year quarter, bookings increased roughly 60% and our segment backlogs at quarter-end rose 14% sequentially and roughly 36% year-over-year. The order and backlog trends within Air-X-Changers, which is our most upstream-exposed business, were even more positive. Here, bookings in the quarter rose nearly 200% year-over-year from your cyclical lows in 2016, and our backlogs increased 24% sequentially.

Now on slide 7. In Rail, revenues increased 24% due to higher machine sales, while adjusted operating income was essentially unchanged. Our operating income and the resulting margin were impacted by lower contributions from parts and services, additional costs and a less favorable mix. The additional expenses included selling-related costs as well as some severance costs as the new leadership team of Rail took actions to improve efficiency and strength in this business.

Now for our outlook on Slide 8. Here, I'd highlight the key changes. First, our operating income guidance has increased to a range of $125 million to $140 million. Our previous guidance for operating income was $115 million and $130 million. Likewise, our forecasted EPS is now $0.55 to $0.69 per share as compared to $0.47 to $0.61 per share previously. Our anticipated net capital expenditures are unchanged for the year, and as a result, our free cash flow outlook has increased to a range of $80 million to $95 million.

There are a number of moving parts within our outlook, including variables and assumptions for each business unit. Our segment outlook details are included in the appendix to the presentation, but let me call out some highlights. First, we've raised our operating income guidance for the Metals & Minerals segment. This change reflects improved performance in North America and Europe, higher expectations for our applied products businesses, some new contracts and foreign exchange rate changes. We've also increased our outlook for the Industrial business as a result of the added demand for air-cooled heat exchangers, which we mentioned earlier. We now expect that Air-X-Changers revenues will grow nearly 40% in 2017. And thirdly, these positive trends offset our modestly lowered expectations for the Rail segment to reflect a more cautious outlook on equipment spending and parts purchases in North America. As we discussed last quarter, Rail traffic trends in North America are positive and encouraging, however, spending habits among our key regional customers remain weak and there continues to be excess inventory of maintenance of way equipment within the supply chain. And as a result, we don't expect this market to begin recovering until 2018.

So now moving to slide 9. Regarding our third quarter outlook, we now expect operating income to be between $30 million and $37 million as compared to an operating income of $29 million in the third quarter of 2016. Operating income in Metals is expected to increase slightly versus the 2016 quarter, mainly due to higher steel production and service levels as well as additional contributions from nonnickel-related applied products. Industrial operating income is forecasted to increase due to improved demand for heat exchangers and commercial boilers and water heaters as well as a more favorable product mix. Meanwhile, Rail income is forecasted to decrease due to lower equipment sales and contract services contributions and a less favorable product sales mix overall. And corporate costs are anticipated to be slightly above prior year levels.

So that concludes our prepared remarks. And at this point, we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Rob Brown with Lake Street Capital.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Can you give some further color on your heat exchanger trends? I know that they were doing well, but sort of where are you at in terms of kind of the cycle? How much, I guess, margin expansion can you see there? Maybe a longer-term goal and sort of how that plays out?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Well, the revenues in Air-X-Changers are still about half of what they were at the peak in 2014. So we think there's still some ways to go before we get back to the next cyclical peak. In terms of margins, as we noted, both Pete and I noted that the margins have been, I'll say, even a bit surprisingly strong, we're already at the peak margins even though revenues are half of what they were at the peak. So many of the investments that we've made are clearly beginning to pay off in better operating leverage. And so I certainly would anticipate that the margin will continuing to go north as we move towards the peak of the next cycle. I'd hesitate to make any predictions, but certainly a few points would be a reasonable assumption.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, great. That's good color. And then, maybe the Rail business, could you give us a sense of maybe the weakening you expect, is it more of a flattening or is it more of a down situation? Just some kind of directional color there would be good.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Yes, I think it's -- the weakness is kind of at the margin, it's not a significant change from what we had been expecting. We have done well the first few quarters of the year to exceed our internal expectations, but if we just simply look at the backlog now and where we see the trends in after market, we're just being a bit cautious on the second half of the year. But it's not at all what I deem a significant change.

Operator

Your next question is from the line of Jeff Hammond with KeyBanc Capital Markets.

James Albert Picariello - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is James Picariello. Just since we're on the Industrial topic, for Air-X-Changers, you mentioned revenue up 40% for the full year, that's your expectation. But what are you seeing in orders, given recent oil price volatility? In terms of how we should start thinking about next year because, clearly, this year is very strong.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Yes, well, we've not yet begun to really model out 2018. Although, I suspect -- we expect that if oil remains in the $50 range, that we'll continue to see growth in 2018. I'd be surprised, although pleasantly of course, if the growth rate in '18 matched that of '17. But we certainly would expect further top line and certainly profit growth in Air-X-Changers in '18.

James Albert Picariello - *KeyBanc Capital Markets Inc., Research Division - Associate*

So you really saw no deceleration in bookings growth for the quarter?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

No we haven't. We have not.

James Albert Picariello - *KeyBanc Capital Markets Inc., Research Division - Associate*

And then, there was a recent -- because you mentioned share gain throughout all three Industrial businesses. There was an acquisition, a recent acquisition, Chart acquired Hudson products, which I think is a competitor to Air-X-Changers. How do you see that market shaping up with that consolidation?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Well, the acquirer has a relatively small business that competes with us, although they're not one of the top competitors. So we simply look at their acquisition of Hudson as probably a supportive move for the competitive situation in the industry. So it's not really a concern to us. I wouldn't say and as we've discussed in the past, Hudson's products compete with us in a part of our business but not in, I'll call it, the heart of our range. Not in the upstream segment where we are growing fast now and developing a lot of profit growth.

James Albert Picariello - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay. And then just one last one for me. Clearly, the Metal's backdrop is -- continues to improve and is strong. But on the applied side, you mentioned that as one of the drivers to your improved outlook. So I'm just wondering, what do you see as a near-term opportunity within applied And then also longer term, how are you thinking about internal investment versus maybe some bolt-on M&A to grow and broaden that business?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Well, we expect the trends in applied products that we've seen in the first two quarters to continue. They have been above our expectations, not yet reflective of much investment that we've made. As we turn to 2018, we certainly will be increasing our investment in applied products both internally and, hopefully as you point out, through some acquisitions. It remains an opportunity that is quite compelling for us, where from a competitive standpoint and a market demand standpoint, there's just a lot of white space for Harsco to continue to expand. So we're quite confident that when we do invest, we'll get good returns on those investments. But the performance thus far and really for the rest of the year, we expect to reflect more internal execution and end market dynamics than were the result of any investment.

Operator

Your next question is from line of Rob Norfleet with Alembic Global Advisors.

Robert F. Norfleet - *Alembic Global Advisors - MD and Senior Analyst*

Just quickly, you'd mentioned, obviously, some of the M&M's recent contract wins that you got in Turkey and China, Egypt, etc.. Can you kind of walk us through what your typical investment into these sites is? On average, I know you -- each one is going to be somewhat different, but I mean, historically, that was a really high and you guys were bringing that down. Can you kind of give us some color on that? And then secondly, I know Pete had mentioned that there was still some underperforming contracts or contracts were likely to exit. Can you just give us an idea of where we are in terms of the number of contracts that are either in a loss or unprofitable position at this point?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Sure. So in general, to address the first part of your question, the capital that we invest in new contracts tends to be between 50% and 100% of the annual revenues. So if we are signing contracts with annualized revenue of, say, $50 million, you'd expect us to spend both initially and over the life of that contract between $25 million and $50 million of capital, and the target returns would be north of 18% on that capital. And of course, that depends, to some degree, on the risk profile as well of both the geography, the customer and, specifically the site that we're serving. But as a minimum degree, the return target is 18%.

In terms of under-performing contracts, as we've indicated before, that figure was as high as 65 to 70 underperforming contracts, defined as those which did not achieve our return targets. That number now is in the kind of mid-single digits. So I think it's six or seven right now that are underperforming. That's not to say they're losing money, in fact, they are profitable. It's just a question of their returns are less than we'd expect. So -- but the process is the same. When a contract is underperforming, there is a good bit of attention applied to it, not only by the regional leadership team where that contract resides but also the central and global operations team tends to get more involved. So we think it's a good process. It's certainly worked in the past. You've seen the increase in our margins. And a big part of that increase in margins is due to improving the mix of contracts. And we think that will continue, maybe not at the pace as it has the past couple of years but we do expect further margin lift for a better contract mix.

Robert F. Norfleet - *Alembic Global Advisors - MD and Senior Analyst*

Great. And just my second question just involves -- when you guys discuss your outlook, especially for Q3, I know the perception or the outlook for M&M is very favorable. You did cite that you expected lower nickel price kind of volume mix in the quarter. I guess, I just wanted to kind of understand that in context of nickel prices, as we've seen nickel move up over 15% in the last 30 to 40 days. Are you kind of saying that you expect that lift in nickel to subside? Or is there something else I'm not reading into that?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Yes, so Pete, would you like to take that?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes, sure. Absolutely, we did expect there to be some decline in commodity pricing, but it's really a combination of commodity price in yield. So when we talk about the expectations for the second half of the year, it is -- reflective certainly of the nickel price, which had been coming down precipitously, but as -- in the last couple of weeks actually, it started to move back up. But it's also reflective of the yield that we get out of the site from extracting it from the metallics slag. So it's a combination of those factors. But in the case of Metals, we're still going to be up in the second half compared to prior year because the volumes are going to be up, and we're also going to see the full benefit of some of the cost of sales initiatives. So the outlook for second half still should be positive. It's just, sequentially, it'll be down from what we experienced in the first half, really, because of the commodity pricing and then the seasonality of the production in those steel mill customers.

Operator

And your next question from the line of Bhupender Bohra with Jefferies.

Bhupender Singh Bohra - *Jefferies LLC, Research Division - Equity Analyst*

And, Pete, a question for you on the Rail side. You did actually cite in your release about some timing benefit in the second quarter, can you size that, like, in terms of revenue and operating income?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

In operating income, the affect is about $1 million to $2 million, and the revenue will be equivalent normal margins.

Bhupender Singh Bohra - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And also on the Metals & Minerals side, we did actually see pretty strong margins here, 20 bps higher from last year. If I remember correctly, last second quarter '16, I think you had likes some better weather driving Minerals' volumes. Could you give us some bigger buckets, like -- I think you did cite, like, good LSTs in the quarter, which was about, like, 4%, I believe? If you can give us some color on what actually drove the margins despite last year being a peak margin?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes, I can answer that Nick. So it's a combination of certainly LST you mentioned, Bhupender. So LST is up year-on-year, that had an impact. Also, commodity pricing, not just nickel but chrome and [ferrous] scrap also had an impact year-on-year, which had obviously, very meaningful impact on the margin, as you would appreciate. Then as I mentioned, the cost of sales initiatives which we put in place -- started to put in place routinely last year, we're pretty much manifesting pretty substantially this quarter. Reed is the business you're referring to, last year, we had a lot of weather-related growth in Q2 2016. We had that to some degree, to a lesser degree but still some degree this year. So it's a combination of all those factored roughly equally that comprise the margin lift this quarter, Bhupender.

Bhupender Singh Bohra - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And lastly, for Nick. When you think about your -- the Minerals business, I think you answered a question here about your strategy to grow a little bit on the lower CapEx side, a lower CapEx intensity over the period like -- what should we think about, like, what's in your Minerals business where you can expand on, in terms of growth opportunities, in organic or inorganic?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Well, we actually have a rather broad portfolio of products, many of which have simply not had the sales and marketing support behind to realize their potential. So it's, in the shorter term, less an issue of adding new products than adding some resources to those product categories to grow them. And as I mentioned, I think that most of that opportunity is going to be realized in 2018 and beyond. What we're seeing this year are the dynamics that Pete referred to. But we certainly are very much open to acquiring in that space, whether it's geographies or products. Although, as I said, I think the primary focus will be making internal investments to the front end of those categories.

Operator

(Operator Instructions) And we do have a follow-up question from Jeff Hammond with KeyBanc Capital Markets.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

So you mentioned the U.K. Rail win. Can you talk about the timing and size of that contract that you won?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Yes. So that's a long lead time project we'd expect to begin recognizing revenue in 2019 on that. It's -- I think it's about 10 machines. I think we are reluctant, based on the customer request, not to disclose the size. But it is a healthy double-digit millions figure.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. And then you also mentioned that you believe you're gaining some share within Patterson-Kelley within the commercial boilers segment. Can you talk about -- I mean, it seems as though the industry demand has been pretty choppy thus far through the first half. What are you guys seeing from your vantage point? And what gives you the confidence that you could sustain the share gain?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Yes. Well, the end market demand has actually been fairly supportive in our segments. But the growth that we're seeing is really more the result of new products. Technology that we've developed that we are now applying to other products in the range and replacing on our products that are part of the installed base. So it's really a mix between end market demand and benefits from new technology that we've introduced.

Operator

(Operator Instructions) And there are no other questions at this time. Back to you Dave for closing remarks.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you, operator, and to those that listened to the call this morning. A replay of this call will be available later today through August 17, and the replay details are included on our earnings release. Also, if you have any follow-up questions, please contact me. My contact details are at the top of the earnings release. And lastly, we appreciate your interest in Harsco, and have a great day.

Operator

This concludes today's conference call. You may now disconnect at this time.