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MSA - Q2 2012 Mine Safety Appliances Earnings Conference Call

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**John Cooper** *BB&T Capital Markets - Analyst*

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## PRESENTATION

### Operator

Welcome to the MSA second-quarter earnings conference call. My name is Christine and I will be your operator for today's conference. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note today's conference is being recorded. I will now turn the call over to Mark C. Deasy. You may begin.

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### Mark Deasy - Mine Safety Appliances Company - IR

Thank you, Christine and good morning, everybody. I too would like to welcome you to our second-quarter earnings conference call for 2012. With me on our call this morning are Bill Lambert, President and Chief Executive Officer; Dennis Zeitler, Senior Vice President and Chief Financial Officer; Joe Bigler, President of MSA North America; Ron Herring, President of MSA International who is responsible for Europe, Northern Africa, Russia, the Middle East and India; and lastly Kerry Bove, President of MSA International, who is responsible for our business in Asia, Australia, Sub-Saharan Africa and Latin America.

Our quarterly press release was issued this morning at 8.30 and we hope everybody has had an opportunity to review it. The release is available on the home page of our website at [www.msasafety.com](http://www.msasafety.com).

This morning, Bill Lambert will provide his commentary on the second-quarter performance and then Dennis will review our financials in more detail. After Dennis's comments, we will open the call up for your questions.

Before we begin, I want to remind everybody that the matters discussed on this call, excluding historical information, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 as amended and Section 21E of the Securities Exchange Act of 1934 as amended.

Forward-looking statements, including without limitation all projections and anticipated levels of future performance involve risks, uncertainties and other factors that may cause our actual results to differ materially from those discussed here. These risks, uncertainties and other factors are detailed from time to time in our filings with the Securities and Exchange Commission, including our most recent Form 10-Q, which was filed on April 25 of this year.



You are strongly urged to review all such filings for a more detailed discussion of such risks and uncertainties. Our SEC filings can be easily obtained at no charge at [www.SEC.gov](http://www.SEC.gov), our own website and a number of other commercial sites. That concludes our forward-looking statement, so at this point, I will turn the call over to Bill Lambert for his comments. Bill?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Thanks, Mark and good morning, everyone. Let me begin by saying thank you to all of you for joining us today on this conference call and for your continued interest in MSA. Presumably all of you have seen our second-quarter press release and have our financial figures with all comparisons corresponding to the equivalent period in 2011.

Our second-quarter results reflect continued demand and preference for the MSA brand around the globe and the focus that our team is placing on successfully executing our corporate strategy, which, as I have talked to you in the past about, our strategy is aimed at, one, growing MSA's core business in both developed and emerging growth markets around the world; two, focusing on developing, innovative, new products that help keep our customers safe in the workplace; and three, diligent management of our operating costs and improving business efficiency under initiatives like Project Magellan and our recently announced Europe 2.0, which is the next step we have taken in our European transformation focused on the integration of common processes across Europe, enabled by a common SAP platform.

When completed, Europe 2.0 will further simplify our business model there, result in sustainable efficiency gains and help us generate more robust financial performance with higher levels of customer satisfaction. Approximately 55% of MSA Europe is currently operating under SAP, so this is an expansion of that and this effort will over time get that percentage to 100%.

Our Q2 incoming order book of activity benefited from large orders during the second quarter and was up 8% compared to a year ago. However, the underlying base business was somewhat uneven during the second quarter. Additionally, a strengthening dollar and economic uncertainty throughout Europe and Asia are tempering our optimism as we head into the second half of 2012.

As you saw in our press release, our consolidated sales for the quarter were \$295 million. When you exclude the impact of weakening foreign currencies, sales actually increased 6% or \$16 million. The increase in sales volume across most of our core productlines, combined with our efforts to improve margins and expand MSA's presence in emerging markets, had a positive impact on our quarterly results.

The increase in local currency revenue in the second quarter was driven by the focus our team is placing on driving demand for our core productlines, which are Fixed Gas and Flame Detection instrument systems, Portable Gas Detection instruments, industrial Head Protection products, supplied air respirators and Fall Protection products.

Core products comprised 63% of total sales during the quarter and had local currency revenue growth of 10% when compared to the second quarter of 2011. I think what is especially encouraging is that sales across these same product groups in emerging growth markets grew by 18% year over year.

As we have stated previously, driving demand for core product groups into global growth markets is a critical element of our long-term corporate strategy and we remain focused on executing this initiative around the world.

Another critical element of our strategy that contributed to our quarterly performance was the continued progress we are making in managing manufacturing costs and improving gross profits as part of our operational excellence initiatives. Our multiyear efforts to optimize our manufacturing footprint and to improve our supply chain processes globally are yielding solid results.

Overall, the focus on these initiatives helped contribute to a 140 basis point improvement in gross profit margins that we saw in the quarter. What continues to be encouraging is the progress we are making in improving core product margin levels. Gross margins of core products improved 180 basis points when compared to the second quarter of 2011 and have improved 250 basis points through six months this year.

Operating margin was 11.8% for the quarter, an improvement of 30 basis points over the same period a year ago. As always, Dennis will provide more detail about this progress in his comments.

As we have mentioned to you in the past, we remain committed to developing innovative new core products that enhance the MSA brand and advance the level of worker safety in the industries that we serve. Quarterly research and development expense was \$10 million, increasing 10% from the same period of a year ago. We continue to invest in developing innovative new core products like the portable and Fixed Gas and Flame Detection instruments that I have mentioned to you on previous calls.

To give you a sense of the impact these new product introductions and our strategic pricing efforts are having, gross margins in our combined Gas Detection productlines, that is Fixed Gas and Flame Detection and Portable Gas Detection instruments, are up 280 basis points year to date on sales growth of 17% year to date.

While we continue to see increased competition in the markets that we serve, our new product development efforts are helping to improve profitability and improve our position in the marketplace. We remain committed to investing in R&D and we think we have a pretty exciting pipeline of new core products that emphasize innovation and durability while lowering costs of operations for our customers and improving profitability for our shareholders.

As I look out over the next 3 to 12 months, products scheduled to be launched include the new Galaxy GX2 instrument management system. This is an automated instrument calibration system designed to provide customers with the lowest cost of ownership and advanced safety management capabilities.

We will also be introducing additional value-adding accessories for our V-Gard branded industrial helmet line; a range of Fall Protection products designed to meet the unique requirements of key international markets; eight brand-new MSA developed gas detection sensors that nicely expand the capabilities of our already successful ALTAIR 4X and ALTAIR 5X portable instrument line; several new supplied air escape devices targeted for the global oil and gas market; a brand-new thermal imaging camera platform designed to meet the new NFPA 1801 standard; a new structural firefighting helmet platform designed for international markets; additional cross-branded MSA and General Monitors Fixed Gas and Flame Detection products; and lastly, a new Self-Contained Breathing Apparatus product designed to meet the requirements of the anticipated revision to the NFPA 1981 standard, which is due to be released at the end of this year.

Needless to say, we are very excited about this lineup of new product offerings. We have been working very hard to better understand the unmet needs of customers in our key vertical markets and our core product segments and to execute exciting designs that meet those unmet needs.

Cash flow is another important area of focus for us and it was strong in the quarter. Operating cash flow for the first six months of 2012 was \$65 million compared to \$19 million in the first half of 2011. We have used this cash to continue to invest in the business, increase our dividend and to pay down \$40 million of our debt. Once again, Dennis will be providing more details on cash flow in his commentary.

Now I would like to turn your attention to the results in each of our geographic segments and I will start first with North America. In our industrial North American markets, sales grew 12% over the same quarter of a year ago on strong performance across core MSA productlines. To give you just a bit more insight into this performance, sales of Gas Detection products increased \$11 million and the sale of industrial Head Protection products increased \$2 million.

Along with a solid sales growth in core product groups, our profitability in North America also improved with gross profit margins on core products increasing 340 basis points due to the combined effects of strategic pricing and lower costs of recently introduced products.

In the North American military market, sales declined \$4 million on lower sales of ballistic helmets and vests. As we announced during the first-quarter conference call, we had previously signed a nonbinding letter of intent to sell our North American ballistic helmet business. I am pleased to report that we completed the transaction to divest of this non-core business in June. This follows the divestiture of our non-core ballistic vest business during the fourth quarter of 2011.



In the North American fire service market, although municipalities continue to deal with lower funding levels and municipal budget pressures, quarterly revenue in these markets were up 2% from a year ago.

Now turning our attention to Europe, ongoing economic uncertainty and governmental austerity measures continue to provide headwinds across much of our Pan-European business, but I was pleased that for the quarter local currency sales were up 1%. Year to date, local currency sales in Europe are up 8% from 2011 as we expand our channels of distribution for our products and increase our presence there.

As is commonly recognized, business and economic conditions remain very challenging across much of Europe. In a highly uncertain environment with forecasted declining GDP growth rate for much of Western Europe in 2012, a key focus of ours continues to be lowering our overall cost of doing business in this region. And the results we are seeing there are encouraging.

While we continue to invest in the emerging markets that are included in our European segment, markets like Russia, the Middle East and Eastern Europe, we are controlling our operating costs across Western Europe. For the quarter, local currency operating costs throughout Western Europe are down 4% from the same quarter a year ago.

I am pleased to report solid results in our international segment, which includes the geographies of Asia, sub-Saharan Africa, Australia and Latin America. Our focus on emerging markets and the efforts we are putting forth in this segment are very much related to the positive results. Growing our business in international emerging growth markets, as I noted earlier, is and will continue to be a key element of our corporate strategy.

We continue to grow our business in areas like Latin America where local currency core product group revenues increased 37% during the quarter due to strong demand for industrial Head Protection products and in part to a \$3 million SCBA order to the Chilean National Council of Firefighters. Our team remains highly committed to advancing our strategy. While the results in international regions are encouraging, economic and business conditions in parts of Asia and in Australia do somewhat temper our optimism going into the second half of 2012.

In taking a look at what is ahead and our focus for the next six months, the revenue, earnings and cash flow improvements we have reported over the past several quarters I believe demonstrate success in how our global team is effectively implementing our corporate strategy. We must remain committed to staying this course and we will. While we continue to closely monitor uncertain economic conditions, especially in Europe and in parts of Asia, I assure you that we remain focused on those areas of our business that will help us to accelerate growth, increase marketshare and ensure the Company's long-term success.

While we are seeing stability and some signs of strength in the US industrial market and continued strength in many of the emerging growth markets we are in around the world, we do expect uncertain economic conditions to remain in much of Southern and Western Europe for the remainder of 2012, as well as in parts of Asia and Australia.

And while this economic uncertainty is tempering some of my optimism going into the second half of 2012, it does not affect our determination. I believe MSA's business strength and our position in the marketplace affords us many opportunities for continued profitable growth. I continue to believe our strategy is appropriate. It is working and it is most certainly providing us with sustainable competitive advantages that we intend to continue to leverage in the months and years ahead for the long-term benefit of shareholders.

Now I would like to turn the conference call over to Dennis Zeitler, our CFO, who will provide you with more insight into our quarterly financial results. Dennis?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

Thanks, Bill. Good morning. I would like to give you some further insight into our second-quarter performance and comment on the balance sheet and cash flow statements. Additional information will be available later today when we file our Form 10-Q with the Securities and Exchange Commission.



As Bill mentioned, sales in the second quarter of 2012 were a record \$295 million, only a slight increase over the second quarter of 2011, but still a record second quarter. In local currencies, our sales actually increased 6% over last year, but currency translation decreased this quarter's sales by over \$16 million.

In US dollars, North American sales were up 6%. International sales were flat and European sales were down 10%. By markets, the fire service was up 9%, military was down 26% and our industrial business, which was 69% of our total sales, was flat compared to last year. However, in local currency terms, our industrial sales were actually up 6%.

Our North American segment sales in the second quarter were up 6% compared to 2011 comprised of a 2% increase in the fire service, a 34% decrease in military sales, and a 12% increase in industrial sales, which was 69% of our total North American sales.

In our industrial business, Head Protection was up 10%, Portable Gas Detection up 14%, and Fixed Gas and Flame Detection was up 30% with a strong contribution from General Monitors. In North America, our sales of ballistic helmets and ballistic body armor decreased to \$5 million this quarter compared to \$10 million in 2011 and will be zero in future quarters as we have exited both of those businesses.

Our reported international segment sales were flat this quarter in US dollars, but were up 10% in local currency terms. Fire service was up 54% as we continued to deliver on our order for the Chilean fire service. Military was down 28% as we have exited the body armor business and industrial sales, which were 81% of our international sales, were down 6% in US dollar terms, but actually up 4% in local currencies. In local currencies, our sales in Latin America and Africa are up 23%, but our sales in Asia and Australia are down 7% from last year.

In Europe, our reported sales were down 10% in US dollars, but up 1% in local currency terms. European fire service sales increased 2%, military was down 13% and industrial sales, comprising 54% of our total European sales, were down 16% in US dollars and down 6% in local currency terms.

The impact of the economic issues in Europe, along with the falling value of the euro, have certainly impacted our business there. We did have a very good start to this year in Europe and it is worth noting that, in local currency terms, sales in the second quarter were equal to sales in the first quarter. However, the prior-year comparisons were quite different. And our European net income has more than doubled over the past six months compared to last year.

The other view of our sales performance is to separate the two portions of our business that historically have been the most volatile -- the US fire service and the US military -- from everything else. Our US fire service sales of \$32 million was an increase of 7% and our US military sales of \$7 million was a decrease of 45%. Then when we look at all of our other globally diversified sales, which has risen to 87% of our total sales this quarter, these sales were up 1% in US dollars and up 8% in local currencies.

Our gross profit rate for this quarter was 42%, up 140 basis points from last year. Our global efforts to reduce manufacturing costs, the increased production volume in our factories, more effective pricing all contributed to this gross profit improvement. It is our ongoing expectation that we will continue to improve our gross profit margin by higher volumes, continued cost discipline, increasing focus on our core product groups and value-based pricing.

Selling, marketing and administrative costs in this quarter were up 3% in US dollar terms, but up 7% in local currencies due to wage inflation and increased local currency sales. There were no restructuring charges in this quarter. We did record a non-cash foreign currency gain due to intercompany transactions of roughly \$1 million. Our investment in new product development this quarter was \$10 million, up \$1 million from last year. We continue to invest in exciting new products that will be coming into the market in 2012 such as our all new Galaxy GX2 instrument management system, more of our V-Gard branded hardhat accessories, more of our best-in-class XCell sensors and cross-branded MSA and General Monitors Fixed Gas and Flame Detection products.

The resulting operating income, excluding those foreign currency gains, is \$35 million, an increase of 3% over the second quarter of 2011. That is an operating margin of just under 12% of sales this quarter and an increase of 30 basis points over our comparable performance in the second quarter of 2011. We are doing better than last year, but not as well as we did in the first quarter of this year. Issues in Europe, Asia and Australia

have negatively impacted our profitability this quarter while North America, Latin America, Africa and General Monitors are performing better than our expectations.

This quarter did have an unusual amount of other income as we sold another parcel of land near our corporate offices and sold the North American ballistic helmet business. These two transactions generated a total of \$17 million of cash, \$8 million of other income and \$5 million of net income.

Our consolidated tax rate this quarter was 32%, down 180 basis points from last year due mostly to the relative increase in our taxable income outside of the United States. If the R&D tax credit is renewed later this year, that would reduce our effective tax rate by roughly another 1%.

The bottom line is record quarterly net income of \$28 million, or \$0.76 per basic share, compared to \$0.53 last year, an increase of 43%. On a pro forma basis, excluding the non-cash currency gain and the one-time income items, which together total \$6 million, our net income would be \$22 million, which is \$0.59 per share and 7% above the comparable 2011 calculation even though our reported sales did not increase. In local currencies, our pro forma net income is up a respectable 14% on a 6% increase in sales.

As for the cash flow statement, we had another good quarter as we generated \$32 million from operations and another \$17 million from asset divestitures. Our cash position is up \$8 million composed almost entirely of cash outside the United States. Our total debt at the end of the quarter was just over \$300 million, down \$19 million in three months and down \$40 million so far this year. We spent \$10 million in capital improvements this quarter and paid \$10 million in dividends. As you know, it is our plan over the next several years to continue to significantly reduce our outstanding debt.

Those are my comments. At this point, Bill, Joe Bigler, Ron Herring, Kerry Bove and I will be more than glad to answer whatever questions you may have. Please remember that MSA does not give what is referred to as guidance and that precludes most discussions related to our expectations for future sales and earnings. Having said that, we will now open the call to your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Richard Eastman, Robert W. Baird.

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

Yes, good morning. Dennis, could you just repeat your local currency growth rates for fire service and military? I am not sure if --.

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

On a global basis, the fire service increased 14% this quarter and the military was down 22%.

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

So 14%, that is the LC number and down 22% is the LC number?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

Right, correct.



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

Okay, okay. And then also I had a question for Bill. One of the new product areas that you mentioned was teed up here for introduction, these eight new gas detection sensors. Is that benefiting the gross margin on your portable and fixed instruments or are those products, those sensors being sold to third parties?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Those sensors are benefiting our portable instrument line. They are not yet benefiting our Fixed Gas and Flame Detection productline. That is an effort that we will likely see in years to come. But right now, those were designed specifically for low power consumption, increased durability, lower cost of manufacture, lower cost to total cost of ownership for customers for the portable instrument productline only.

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

And we sell those -- we do not sell those to third parties at all. These are totally proprietary to MSA in our portable instrument line.

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

Okay, okay. So that is -- again, you had sourced those before, correct?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

That is right, Rick. We did source those before. We always manufactured a small number of those, a certain percentage of those, but we also sourced them and we have moved entirely away from external sourcing to internal sourcing.

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

Okay. And then I think a somewhat related question, but when you were talking about the gross margin, Bill, on the core products being up 180 bps year to date, I assume when you say core products, that is on the 63% of sales that you defined as core products. Is that right?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

That is exactly correct.

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

Okay, I understand. So some real benefits are pretty visible there from the value engineering side of the story?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

That's right.

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

And then, Dennis, just one question. I think you grouped these together, but the two other income items -- the sale of the land and the gain on the ACH sale -- are those both, those combined, to be \$8 million and in the P&L, those are both in that other income line?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

Yes, those are both in the other income line. So there is another income line of, what, \$8.259 million?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Yes.

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

Most of that is those two transactions. We always -- there is some interesting (inaudible) and a few other things, but most of that is those two transactions.

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

Okay. And then that again combines to be \$5 million net income?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

Exactly.

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

Okay, perfect. Thank you.

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**Operator**

(Operator Instructions). Walt Liptak, Barrington Research.

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**Walt Liptak** - *Barrington Research - Analyst*

Hi, thanks. Good morning, guys. I wanted to ask one first about the gross margin improvement, which looked nice. You called out volume and pricing. I wonder if there is a way that you can quantify and talk about either of those.

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

We hope to be able to do that next quarter. We have our new pricing director here. Actually one year ago today, we hired him July 25 of last year. And he is working on that report for the second quarter, but it is not ready yet. But I am hoping that by third quarter, we will have a nice report that shows gross margin improvement is attributed to price, to cost, to product mix.



**Walt Liptak** - *Barrington Research - Analyst*

Okay, all right, got it. All right, then if I can switch gears and just ask about -- the Europe -- you mentioned the industrial part in local currencies declining. Can you talk about just what you saw during the quarter? Is it kind of consistently down or are you seeing the trend improve? Obviously, we are all focused on what is happening in Europe and any color that you could provide would be helpful.

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

When we take a look, if I were to compare what was reported in Dennis's comments where Dennis reported our European industrial core part of the business down about 6% in local currencies, what that does not reflect is the incoming order book that we saw out of Europe during that same time period. So we actually saw nice sales growth in Europe in our incoming order book. So we were pleased by that. Most of that is coming out of Eastern Europe and into Russia in the oil and gas regions, supporting the oil and gas region.

So we are seeing -- we are seeing I would say more difficult conditions in the established regions of Western and Southern Europe. There is no question about that. We are offsetting quite a bit of that through our industrial distribution strategy. But just as we have reported here, if in local currency sales we feel if we can just hold ground, even move sideways in Western and Southern Europe, I think that is a bit of a win. And I see that happening with our industrial distribution strategy success that we are having over there in those areas.

And then we are looking to Eastern Europe and into Russia, the Caspian Sea region or even down into the more Middle East area for real growth markets. And that is exactly what we are seeing and we are seeing nice improvement in those regions of the world to offset some of that, which is in Western and Southern Europe, clearly those areas have headwinds.

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**Walt Liptak** - *Barrington Research - Analyst*

Okay. So it sounds like this down 6% for industrial core local currency is -- it's not getting -- it is not getting worse as we get into the third quarter. Maybe it is getting better.

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

It is very early in the third quarter. So I would hesitate to comment on just exactly what we will see in the third quarter, Walt. But there are some -- there are some successes that we hope and that we anticipate will offset some of the declines that we are seeing in the more established parts of Europe.

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**Walt Liptak** - *Barrington Research - Analyst*

Okay. And then I wonder -- you mentioned the industrial distribution strategy. I wondered if you could talk at all -- I think last quarter, we thought maybe there was a little bit of an inventory build. Is that still happening? Are you still adding distributors or did you add more distributors during the quarter?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

We did add more distributors during the quarter, but these are not huge numbers and I know that a number of analysts had asked questions regarding filling the pipeline, industrial distribution. And I think we played that down in our commentary because you just don't see that happening over there.

So did we continue to add distributors? Yes. In Europe, I think so far this year -- Dennis, help me with the numbers. Is it 80 distributors that we have added?

**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

No, we were about 280 distributors at the end of the first quarter and our expectation is to add about 10 per quarter. I don't have an exact number. Ron might know the exact number for the second quarter, but our target is to get to about 400 total. So we still have a couple of years to go in this distribution process.

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Right. I think in total through six months, if I remember correctly, we have added about 80 distributors in our strategy. So the 10 months that you are talking about, 10 per month. Ron, you are on the line. If you would like to provide Walt with any more input there.

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**Ron Herring** - *Mine Safety Appliances Company - President, MSA International*

Yes, Bill, I think that is directionally correct. We have also taken distributors out at that same time, but I think the net number is someplace in that 80 distributor range.

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**Walt Liptak** - *Barrington Research - Analyst*

Okay. And then if I could just switch again to the fire service being up 14%. Is that largely due to the new products or are you starting to see or you think you're starting to see better demand trends out of some of the municipal customers?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

I think principally that is due to some of the success we are having in the international markets. I mentioned a \$3 million shipment in the second quarter to the Chilean National Fire Brigades and we are seeing our local currency sales in the fire service internationally up 59% in the second quarter. And a lot of that has to do with the success we saw in Chile.

But even in Europe, we have seen nice improvement there selling fire helmets. That is primarily fire brigades in Europe where local currency sales were up 14% in the quarter. And even in North America, we have talked on this call a number of times about North America and I think in our last call, we talked about or I talked about how we felt the North American fire service market had really bottomed. I didn't see it getting all that much worse even though municipalities have tight budgets. And in fact, I think when we look at our second-quarter results in the fire service for North America, sales were up 7%.

So I see some strength. It is not coming from a whole lot of new products in North America, Walt, to answer your question kind of directly. I think that business conditions are just not getting any worse in North America just as we had thought they would not and we are having success outside of North America.

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**Walt Liptak** - *Barrington Research - Analyst*

Okay, good. Okay, thanks very much.

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**Operator**

Holden Lewis, BB&T Capital Markets.

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**John Cooper** - *BB&T Capital Markets - Analyst*

Good morning. This is John Cooper on for Holden. Just a quick question looking at gross margin. I know it's a good 140 basis points improvement annually. But if we look at some of the puts and takes versus the very good 43.3% gross margin you did in Q1, what are some of the puts and takes there that saw the gross margin drop down to [41.8%]? Because it looks like sequentially sales are roughly in the same level. I believe there was a \$2 million delta to the negative side that hurt gross margin in Q1 and you still put up a really good number. So what are some of the differences to look at between those two?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Well, John, I think there are three things that -- I would put it into three buckets. Well, first of all, let me say that Q1 was a great quarter. We had a lot of things going our way in the first quarter, so the 43.3% that you mentioned in the first quarter, that was terrific performance. Maybe just slightly above what I think is something we can consistently do, but not by much.

But when I look at the difference then, the delta between Q1 and Q2, I look at it and I put them into three buckets. About a third of it was related to some large Fixed Gas and Flame Detection orders that we shipped during the quarter and those were some large orders, tightly competitively bid and so we took a little bit of that there.

The second impact had to do with a large gas mask order for New York City that we shipped providing them with the best protection for the police officers there and also that Chilean fire service order that I talked about. We had a \$3 million order there that was tightly competitively bid. So a couple of large orders there in that bucket. And then the third area is more internally focused where we took some charges for some tooling, asset write-offs and so that is about the third bucket. And then they are all about in the same range from one another.

If you take out each of those, that takes us into that 140 basis point range just for those three. Each of those about a third each. So I don't see anything going on that makes me overall worried in looking to the future quarters and I think that our gross margin improvement, while 140 basis point improvement is great year over year, I think we can do a little bit better than that. Dennis, any further comment?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

No, I think Bill hit all the major items. We had a little bit of extra warranty expense this year or this quarter compared to the first quarter. Our production variances weren't quite as good this quarter as the first quarter. I think we tried to say that first quarter just went very smoothly, didn't have any big orders, didn't have anything unusually good, but it had absolutely nothing bad. And this quarter, we had a few little bad things.

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**John Cooper** - *BB&T Capital Markets - Analyst*

Right, so taking all that into account is something like a high 42% is somewhat of a consistent level barring some abnormal larger orders or some other noise I guess?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

I can't disagree with that.

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**John Cooper** - *BB&T Capital Markets - Analyst*

Okay, okay. And then I guess just secondly just a little bit different here, looking at Europe, you had talked about some flattish kind of demand in that type of stuff kind of being offset by some of your distribution. And I guess is the way to look at that, even if we do get some flattish demand

in that region and some declining, given the steps that you are taking with your restructuring efforts, with the SAP efforts and all these other items, should we still be looking at that region as something that improves profitability even if sales do remain flat?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

That is exactly our game plan.

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**John Cooper** - *BB&T Capital Markets - Analyst*

Right, okay. All right, thank you.

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**Operator**

Dick Ryan, Dougherty.

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**Dick Ryan** - *Dougherty & Co. - Analyst*

Thank you. So you have given good color on Europe. Can you talk about what you might be seeing in the order book? You have also mentioned Asia, Australia, kind of tempered view there. Can you kind of give us a sense what you are seeing there as Q3 has started?

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**Bill Lambert** - *Mine Safety Appliances Company - President & CEO*

Sure. I will give some commentary and color and then I will ask Kerry Bove to chime in on that as well. In China, and China is the largest part of Asia for us in China, but also I will include Japan, we saw orders in the second quarter weaken quite a bit. So far in the third quarter, we have seen that come back nicely. So we did see a slowdown in parts of Asia, and the two most important parts for us really are China and Japan.

Australia, we saw some weakening in Australia we think due to, primarily due to some new taxes the government put in place, which has really impacted the coal industry or the mining industry, I should say, in general for Australia. I don't see Australia making strong improvements or rebounding. I do see some strengthening -- we are seeing some strengthening coming out of Asia and I will now include in addition to Japan and China, Southeast Asia. We are seeing some strengthening in our order book out of those areas. Kerry, is there anything you would like to add on that?

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**Kerry Bove** - *Mine Safety Appliances Company - President, MSA International*

Yes, the only thing I might add from an economic standpoint that allows you to remain a little bit more optimistic in China is that we have not seen the employment rates at all slip and there is the pending or expected RMB4 trillion stimulus from China. Though it is yet to be defined, we believe that it will keep the economy stronger in the second half.

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**Dick Ryan** - *Dougherty & Co. - Analyst*

Great. Dennis, I didn't have anything on the restructuring side, but is there anything going on in Europe that you might anticipate any restructuring going forward there?



**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

At this point, we do not anticipate any restructuring charges in Europe the remainder of this year.

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**Dick Ryan** - *Dougherty & Co. - Analyst*

Okay. And is there any additional land sales, any other acreage up there that can be sold or has that completed the landholding?

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**Dennis Zeitler** - *Mine Safety Appliances Company - SVP & CFO*

No, we still have one parcel to be sold. Right now, it may get sold in the fourth quarter, it may not.

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**Dick Ryan** - *Dougherty & Co. - Analyst*

Great, thank you.

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**Operator**

At this time, there are no additional questions. Please go ahead with any final remarks.

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**Mark Deasy** - *Mine Safety Appliances Company - IR*

Okay, thank you, Christine. Well, seeing that we have no more questions, that will conclude today's call. I want to thank everybody for joining us this morning. If you missed a portion of this morning's conference, I want to remind everybody that an audio replay will be available on our website for the next 30 days. So on behalf of Bill, Dennis, Joe, Ron and Kerry, thank you for your interest and participation. We look forward to talking with you again soon. I hope everybody has a great day.

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**Operator**

Thank you for participating in the MSA second-quarter earnings conference call. This concludes the conference for today. You may all disconnect at this time.

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