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MSA - Q2 2013 Mine Safety Appliances Earnings Conference Call

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PRESENTATION

Operator

Welcome to the MSA second quarter earnings conference call. My name is Ellen, and I will be your operator for today's call. (Operator Instructions). I will now turn the call over to Mark Deasy, Director of Corporate Communications. Mr. Deasy, you may begin.

Mark Deasy - Mine Safety Appliances - Director of Corporate Communications

Thank you, Ellen, and good morning everybody. I too want to welcome you to our second quarter earnings conference call for 2013. With me this morning are Bill Lambert, President and Chief Executive Officer, Dennis Zeitler, Senior Vice President and Chief Financial Officer, Stacey McMahan, our Senior Vice President in Finance, and our three Geographics Segment Presidents, Joe Bigler, Ron Herring, and Kerry Bove. Our second quarter press release was issued this morning at 8.30, and it is available on the home page of MSA's home site, at www.msasafety.com

This morning, Bill will provide his commentary on our quarter, Dennis will then review our financials, and then Bill will conclude his formal remarks with some closing comments. After that, we will open up the call 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 the Private Securities Litigation Reform Act of 1995. Forward-looking statements including without limitation, all projections in anticipated levels of future performance involve risks, uncertainties, and other factors that may cause our actual results to differ materially than those discussed here. These risks, uncertainties, and other factors are detailed from time to time in our filings with the SEC including our most recent Form 10-Q which was filed on April 24th of this year.

You are strongly urged to review all such filings for a more detailed discussion of such risks. Our Sec filings can be obtain at no charge at www.sec.gov, our own website, and many other commercial websites. That concludes our Forward-looking statements. So at this point, I will now turn the call over to Bill Lambert for his comments. Bill.

Bill Lambert - Mine Safety Appliances - President, CEO

Thank you, Mark, and good morning, everyone. As always I want to begin by saying thank you for joining us today on this conference call and for your continued interest in MSA. Presumably, all of you have seen or second quarter press release and have our financial figures with all comparisons



corresponding to the equivalent period in 2012. I am going to start by running through some of the highlights of our second quarter earnings and talk about the progress we are making on some of our strategic priorities.

I will also share some views on the current business environment, and how it is likely to affect us through the remainder of the year before I turn it over to Dennis to run through the actual results. Then, we will open it up for your questions. In the second quarter, better than anticipated core revenue growth, coupled with solid performance in developed markets and continued gains in emerging markets led to record financial performance for MSA. Throughout the first half of the quarter, we saw some very choppy conditions and a somewhat uneven order pace, but by late May things had settled down, and we saw some strengthening to finish out the quarter.

As I look at where we are and what we have accomplished against our strategic priorities so far this year, I am encouraged by our second quarter financial results. Our ongoing focus and efforts aimed at gaining share and driving demand of core products in both developed and emerging markets, developing innovative new products, and controlling manufacturing and operating costs, all helped us recognize record second quarter continuing sales, operating income, and pro forma net income. As you saw in our press release, our consolidated sales for the quarter were \$300 million. On an as reported basis, sales were up \$5 million from a year ago or 2%.

However, the second quarter of 2012 included \$5 million of ballistic helmet sales in our North American segment. For those of you who are regular participants on our calls, you know we divested this non-core business in the second quarter of 2012. Additionally, weakening foreign currencies decreased as reported second quarter 2013 sales by \$3 million.

Excluding this currency effect and the divested business impact, our sales were up 4.5% when compared to the second quarter of 2012. As we look at where we are in relation to our longer term priorities, we are seeing the tangible benefits of our long-term growth strategy and the shift of our revenue mix towards our more profitable core product lines.

Dennis will provide more details of our financial performance with a breakdown by end market, bi-product group, and by geographic reporting segment in his comments. This morning, I want to discuss and provide some comments regarding our strategy to grow the business and expand our operating margins. Driving demand for core MSA product lines remains a key element of our long-term strategy.

As many of you know well by now, these lines include fixed gas and flame detection instrument systems, portable gas detection instruments, industrial head protection products, Supplied-Air Respirators where Self-Contained Breathing Apparatus, or SCBA is the principle product, and lastly fall protection products. Sales from these five core product lines comprised 72% of our total second quarter sales and showed local currency revenue growth of 11% when compared to the same period of 2012. I think that is an important point worth restating. That nearly three quarters of our business grew 11% year-over-year when stated in local currency terms.

Putting a little more texture to the story, the US Fire Service remains a challenging and competitive environment, but the results we are achieving in increasing breathing apparatus shipments were very encouraging in the second quarter. We spoke about this at length in our last investor's call. During the second quarter, SCBA revenue remained quite strong and our marketing efforts at this year's Fire Department Instructors Conference in Indianapolis or FDIC, created strong demand and interest from our distributors and our end users. At that show, we launched two new products, the MSA M7- XT air mask and a new Thermal Imaging Camera called the MSA Evolution 6,000.

The FDIC conference also marked for us the launch of a bold new marketing campaign built upon our commitment to understanding the unique needs of firefighters and our longstanding partnership with the Fire Service industry. To underscore that message, our theme for this new campaign is simple and to the point. When you go in, we go in with you.

To give you more texture on the Fire Service and SCBA sales in particular, consolidated SCBA sales to the Fire Service were up 9% in the quarter, led by North America where Fire Service SCBA sales increased 17% from a year ago. Our new marketing program, along with our ongoing efforts to develop leading edge products for the Fire Service market was very well-received and continues to reinforce our strong commitment to First Responders and the global Fire Service market. Emerging markets also a key initiative in our corporate strategy were clearly a source of strength for us in the quarter.

Our ongoing focus throughout the Fire Service, the construction, oil and gas, mining and other key industrial markets helped drive strong quarterly sales growth in key emerging markets like Brazil and Southeast Asia where local currency sales increased a very healthy 15% in both Brazil and Southeast Asia during the quarter. And in China, another emerging market focus area for us, local currency sales increased 19% in the year-over-year quarter. The results we are seeing in core products and in emerging markets throughout Latin America and Asia are certainly promising and reinforce my optimism as we head into the second half of 2013.

As I have noted in the past, we remain deeply committed to developing innovative new core products that enhance the MSA brand and more importantly, advance the level of worker safety in the industries we serve. In addition to our efforts to develop pioneering products for the Fire Service, we continue to develop a number of new and innovative core products for industrial markets. As an example, during the second quarter, we launched a new V-Gard head gear system.

This new global product provides iron face protection to workers who are not required to wear head protection, but need eye and face protection nonetheless. This product is very complimentary to the V-Gard helmet accessory system that we launch around the world just a year ago. I should note this morning that we also continue to see solid progress in our portable gas detection business, driven by demand for new products developed and introduced over the past five years. In fact, approximately 50% of our total portable gas detection sales for the second quarter came from new products launched within the last five years.

This is particularly encouraging when you consider that portable gas detection sales continue to be one of our fastest growing and most profitable areas with sales growing 20% when compared to the same period a year ago. This 20% growth has been fueled by the introduction of market leading products and sensors like the ALTAIR 4X and ALTAIR 5X, MSA's industry leading XCell gas sensor line, and our recently introduced GX-2, automated testing and calibration system. In a similar way, we continue to see strong results from our fixed gas and flame detection business.

The investment we made in this area a few years ago when we acquired General Monitors combined with our team's ongoing focus in developing new products, like the soon to be released Observer Eye Ultrasonic Gas Leak Detector continues to deliver robust returns. The Observer Eye is truly a unique and innovative technology that is generating a lot of market attention.

While we won't formally launch the Observer Eye detector until later this year, global, oil, gas and petro chemical customer who have participated with MSA as part of our product development process are excited about the Observer Eye's expanded area coverage, best in class background noise rejection, and a reduced total cost of ownership. And in key emerging markets like China, we continue to introduce innovative, low cost new products, like a new hard hat suspension system we call the PushKey, one touch suspension system. In addition to providing customers with a new suspension system option, we believe this product will provide MSA with greater access to an attractive segment of the head protection market in China.

Overall, the results we see from our R&D team continues to be encouraging and reinforce my conviction that innovation and the continuous flow of new product introductions are critical to success in the advanced safety markets that we serve. The progress we are making in managing manufacturing costs and improving gross profits as part of our operational excellence initiatives is also a strongly performing element of our strategy. Our efforts to optimize our manufacturing footprint and improve our global supply chain processes continue to yield solid results. These efforts combined with shifting our mix focus to our core product lines favorably impact the gross profit margin in the quarter which increased 250 basis points over the second quarter a year ago.

To give you an even longer term perspective of this, gross profit margins have expanded over 700 basis points since 2009 as we have improved our supply chains, improved our focus on the core, and developed and introduced innovative and strategically priced products for our markets. I also want to provide to you an update on our Europe 2.0 initiative, which as I have discussed with you before, is focused on integrating and aligning our SAP IT systems throughout Europe in order to one, simplify our business model there; two, increase visibility and transparency that drives efficiency; three, increase customer satisfaction through improved delivery and availability of products and services; and four, improve financial performance through better cost management and centralized sourcing.



In our last call, I informed you we had our first and very successful go live with the new system in Germany. In the second quarter, we had our second largest European affiliate in France go live, and I am pleased to tell you it has been our smoothest go live yet. Our two largest affiliates in Europe are now operating under the same system providing complete visibility of customer data and operational data, like product availability.

During the second half of the year, we will be working on MSA Italy and MSA Spain, and by the end of the year, we will have close to 70% of our European revenues under the new Europe 2.0 SAP operating system. As you know, MSA Europe's net profit margins are the lowest and most challenged in the MSA family, currently in the mid single digits.

Our goal is to see these net profit margins in the low double digits when our Europe 2.0 initiative is completed, and we believe we are on track to get there. Now, I would like to turn the call over to our CFO, Dennis Zeitler, who will provide greater insight into our first quarter financial performance. After Dennis finishes with his report, I will provide some closing comments, and then we will open up the call for your questions. Dennis.

Dennis Zeitler - Mine Safety Appliances - CFO

Thank you, Bill, and good morning. I will share with you my insight into our second quarter financial performance and additional information will be available later today when we file our Form 10-Q with the Securities and Exchange Commission. As Bill mentioned, continuing sales in the second quarter of 2013 were a record \$300 million, up \$5 million or 2% from the prior year.

However, excluding unfavorable currency effects of \$3 million and \$5 million of divested ballistic helmet sales, revenue increased \$13 million or 4.5%. Incoming orders this quarter grew 8% over the first quarter and 7% over a year ago. I will comment on four different ways we look at our sales performance by end markets, bi-product group, by geographic reporting segment, and by emerging markets. By end markets, our growth was led by our industrial business with local currency revenue growth of 7% and now represents 72% of sales.

Global fire service sales were up 3%, and were 25% of the total. Military sales were 3% of sales, down from 6% last year on a divestiture of the US ballistic helmet business. When we consider our sales bi-product, our five core product groups delivered growth of 11% on a local currency basis, also making up 72% of total sales.

All five core product groups increased, led by portable instruments, up 20%, fixed gas and flame detection instruments up 14%, fall protection up 12%, breathing apparatus up 8%, and head protection up 3%. Several large fixed gas and flame detection and SCBA orders were shipped during the quarter. The remaining 28% of sales were down 14% half from the divested business and the remainder across most of our non-core product groups as we execute the first element of our corporate strategy to focus on core products, our fastest growing and more profitable product groups.

Moving to our reported segment sales performance. In North America, sales in the second quarter were up 5% and up 8% excluding the divested ballistic helmet business and the impact of a slightly stronger Mexico peso. When looking at North American end markets local currency sales to the fire service grew 11% and sales to industrial customers increased 9%.

Sales to US military were \$1 million in the second quarter. Bi-product group, our five core product groups represented 81% of sales in North America, and were up 14%. Fixed gas and flame detection products led the growth at 21% with several large orders shipped during the quarter, followed by portable instruments at 19%, and SCBA sales at 12%. Head protection and fall protection each grew 4%.

All other non-core product groups were down a total of 25% due primarily to the decrease in military sales. Moving on to our international segment, we reported sales were down 2%, but local currency sales grew 4% with strong growth in Brazil, Southeast Asia, and China, offset by lower sales in the developed markets of Japan and Australia. When looking at international end markets, local currency industrial sales were up 5%, and comprised 81% of total sales.

Fire service local currency sales were down 4% on lower sales of Thermal Imaging Cameras compared to last year. Military sales were \$2 million in the quarter. Bi-product group, sales of core products were up 8% for the quarter and grew to 57% of total sales.

Fall protection sales were up 32% followed by portable instruments growing at 26%, and fixed gas and flame detection instruments up 17%, SCBA sales declined 2% due to a large order that was invoiced in the second quarter of last year, and head protection sales fell 1%. All other product groups were down 1%. Finally, our European segments reported sales were down 1% and down 2% in local currency terms.

Europe's local currency sales to industrial customers represented 56% of total sales and grew 2%, driven by our distribution strategy in Western Europe. Fire service sales declined 5% and military sales were down 12%. Core product sales grew 7% this quarter and comprised 68% of total sales. Head protection was up 18% from a small base, portable instruments up 14%, SCBA up 10% and fixed gas and flame detection sales were flat. All other product groups were down 17%.

We end our look at sales growth with the focus on emerging markets. Our corporate strategy includes growing sales in emerging markets where we see strong opportunities for profitable, long-term revenue growth. We have emerging markets in each geographic reporting segment.

Our emerging market sales grew 5% in the second quarter, led by 12% growth in our more profitable core product groups. Emerging market sales represented 30% of total sales in the quarter, up from 29% a year ago. Our gross profit rate for this quarter was 44.3% an improvement of 250 basis points over last year.

Our double digit core product sales growth drove this significant improvement and was supplemented by our continued focus on cost and price. Reported selling general and administrative costs were up 4% this quarter compared to last year driven by an increase in selling and marketing costs as we continue to invest in resources focused on driving core product sales around the world.

Our investment in research and development this quarter was \$11.4 million, up \$1.1 million over last year as we continue to invest in a significant pipeline of new products to be introduced over the next 24 months.

There was a \$1 million foreign currency loss this quarter as well as over \$2 million in restructuring expense in Australia in response to continued challenging business conditions and in Europe, as part of our ongoing Europe 2.0 plan. The resulting operating income has sent these one-time items was a record \$41 million and 13.5% of sales, compared to \$35 million and 11.8% of sales last year a 170 basis point improvement year-over-year.

We continue to make solid progress towards our goal of a 15% operating margin by 2015. Our consolidated tax rate this quarter was 30%, down 200 basis points from last year and at our expected rate for the remainder of the year. The bottom line is reported second quarter net income of \$24 million or a \$0.65 per basic share compared to \$0.76 last year.

However, add since the \$8 million of asset sales in the second quarter of last year and \$3 million of restructures and FX expense this quarter, net income was a record \$26 million and increased 20% over last year with pro forma earnings per share of \$0.71. Our cash position of \$82 million is up \$5 million from the prior quarter and has composed mostly of cash outside of the United States. Our total debt at the end of the quarter was \$300 million, up \$14 million from the prior quarter.

We did see a significant increase in accounts receivable at the end of the quarter, as June was a strong invoicing month. We invested \$9 million in capitalized items, and we paid over \$11 million in dividends. In summary, our second quarter continuing sales, our operating income, and our pro forma net income are all records for MSA. This performance gives you continued confidence in our corporate strategy to grow sales, improve financial performance, and enhance shareholder value. I will now return the microphone to Bill.

Bill Lambert - *Mine Safety Appliances - President, CEO*

Thank you, Dennis. As I look back at the quarter we just completed, I am pleased by our success on many fronts and in executing many of our strategic initiatives. As we move forward into the second half of 2013, we will continue to execute the same strategies that have transformed MSA into a company that has proven itself capable of delivering profitable growth even through challenging economic cycles.

I am maintaining a conservative macro outlook while remaining confident in our ability to deliver solid operating margin expansion just as we have talked to you about in the past. We will maintain our investments in innovation and the high growth markets around the world to continue

to drive growth and improve our market share position. To sustain this performance, the key will be to maintain our focus on driving demand of core products throughout our markets and geographies, driving down manufacturing and operating costs, all while continuing our investment in and introduction of new and innovative safety technologies.

This strategy continues to yield strong results and positions MSA to create value for our stakeholders even in times of uncertainty. In closing, our quarterly results reflect strong profitable growth. However, we still see a significant amount of uncertainty in the markets.

Order activity remains uneven and trends are more choppy than I would prefer. While we are keeping a close eye on economic and business conditions, I assure you that we remain focused on our strategy and are investing in those areas of our business where we see good opportunities for growth. Thank you for your attention this morning.

At this time, Joe Bigler, Kerry Bove, Ron Herring, Dennis Zeitler, Stacy McMahan, and I will be happy to take any questions you might have. Please remember that MSA does not give what is referred to as guidance, and that precludes most discussion related to our expectations for future sales and future earnings. Having said that, we will now open the call up to your questions.

QUESTIONS AND ANSWERS

Operator

Thank you (Operator Instructions). Our first question comes from Edward Marshall with Sidoti & Company. Please go ahead.

Edward Marshall - Sidoti & Company - Analyst

Morning, guys.

Bill Lambert - Mine Safety Appliances - President, CEO

Good morning, Ed.

Edward Marshall - Sidoti & Company - Analyst

Good continued work on the operating margin. I wanted to see if I can get maybe some of the puts and takes - - let us say on sequential basis because I know there were some executive compensation that was running through there, maybe higher than normal, and then the legal costs from the insurance, I wanted to dig into the line a little bit further, if we could.

Bill Lambert - Mine Safety Appliances - President, CEO

Yes, the stock compensation expense in this quarter was about \$1.8 million. Is it 1.8 or 2.8?

Dennis Zeitler - Mine Safety Appliances - CFO

\$2.8 million.



Bill Lambert - *Mine Safety Appliances - President, CEO*

\$2.8 million. It will be \$1.8 million less the next two quarters. 2.8 absolute number this quarter. It will be \$1 million each of the next two quarters.

Edward Marshall - *Sidoti & Company - Analyst*

Okay.

Bill Lambert - *Mine Safety Appliances - President, CEO*

And the first quarter would have been --

Dennis Zeitler - *Mine Safety Appliances - CFO*

A little North of \$5 million. So it is about \$2.4 million lower in the second quarter versus the first quarter.

Edward Marshall - *Sidoti & Company - Analyst*

On the legal?

Bill Lambert - *Mine Safety Appliances - President, CEO*

The legal expense really has not changed much from quarter-to-quarter. It is still running a little over \$2 million.

Edward Marshall - *Sidoti & Company - Analyst*

And that is supposed to end this year?

Bill Lambert - *Mine Safety Appliances - President, CEO*

That will still run into next year. Hopefully it will be less next year, but that is a really tough number to guess.

Edward Marshall - *Sidoti & Company - Analyst*

So if I look at the --

Dennis Zeitler - *Mine Safety Appliances - CFO*

I think it is safe to say that our second quarter SG&A rates are about where we would expect them to be for the balance of the year.

Edward Marshall - *Sidoti & Company - Analyst*

Right.



Bill Lambert - *Mine Safety Appliances - President, CEO*

SG&A really should not be going up the rest of the year because of the stock comp and because of the benefits from the restructuring charges we took. We will see some benefits from that in the third and fourth quarters.

Dennis Zeitler - *Mine Safety Appliances - CFO*

But we did see a \$2 million in increase in selling expense due to higher sales. We had about -- yes, \$2 million of additional selling expense associated with higher commissions and the better sales that we had in our core product areas.

Edward Marshall - *Sidoti & Company - Analyst*

If I just think about this intuitively, your 13.5% which is ahead of your 13% goal this year 15% by 2015. I have asked before, I am probably not going to make the same mistake again. You are ahead of the game here it seems, and you have got some costs rolling off into next year into even the back half of this year. Can you comment around that or just leave it alone?

Bill Lambert - *Mine Safety Appliances - President, CEO*

We probably leave it alone, Ed. Yes, this is a good quarter, but we are saying 13% for the full year. So we had to make up for being below our target in the first quarter. So we have to continue to be well above 13% in order to finish this year at 13%.

Edward Marshall - *Sidoti & Company - Analyst*

Yes it, looks like this would be the run rate for the remainder of the year, this 13.5% or so.

Bill Lambert - *Mine Safety Appliances - President, CEO*

That is the arithmetic you would need to get to 13% for the full year, you are right.

Edward Marshall - *Sidoti & Company - Analyst*

The industrial pick up that we saw in North America. I might have missed it. I don't know if you clarified, but was there a large order that ran through because this is the highest that we have seen that number for some time, by a significant amount? Was this broad based across the board North America pick up?

Bill Lambert - *Mine Safety Appliances - President, CEO*

I think it was broad based, Ed. There was not anything particular large single orders in the industrial segment for MSA North America. That 9% growth, I think Dennis mentioned we had 9% growth in our core industrial for North America, and there was nothing -- I am looking at Joe Bigler, but there is nothing that I can remember as being one-off big orders. Maybe in the fixed gas and flame detection area we had some fairly significant orders, but that business by its very definition is a little bumpy.



Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

You are absolutely right. From an industrial standpoint in North America, it is pretty broad based. Whether you look at light manufacturing, heavy manufacturing, if you look at the energy market, the automobile industry, we saw some positive signs throughout the whole quarter, pretty fairly broad based that really helped to drive the second quarter sales for North America from an industrial prospective.

Edward Marshall - *Sidoti & Company - Analyst*

Nothing to mention as far as construction yet? I didn't hear you mention that.

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

Certainly, housing has picked up to some extent, but we really do not benefit much from the housing market, but we are starting to see some slight positive effects on the industrial construction and the commercial and construction side. So I would say it certainly improved in the second quarter versus the first quarter, and that was certainly a small contributor to our industrial pick up in the second quarter overall.

Edward Marshall - *Sidoti & Company - Analyst*

I guess on the SCBA, there is a new standard as we are all aware. How do you see that business kind of playing out through the remainder of the year? It continues to march higher, and you would assume we would see a slowdown in front of the new standard, but that hasn't happened.

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

I think it is worth spending some time on this new standard and the impact it might have on SCBA. The government sequestration has impacted the two government agencies that need to approve new product. So none of the SCBA manufacturers have approval to that new standard which was to take effect in August, next month. So what has happened is that because of some of those delays and that sequestration, there is a process in place right now that will actually delay the implementation of that new standard to the end of February of next year. So it is about a 6-month delay.

So what does that mean then to overall SCBA sales? It enables all of the manufacturers, including MSA, to continue to sell their current product line, which, you know, we view as probably a neutral thing, maybe good to neutral. Anybody that was holding off for the new standard or for the new products now knows that while they are going have to wait another six months, and do they really want to do that. We saw some good, strong buying during the second quarter based on the FDIC show, based on the introduction of some of the new products that we had.

So we think that the SCBA market is a little bit stronger than what we had planned going into the year, but that is probably a good thing, and it is in line with our expectation that a lot of the SCBA that are in the market right now are approaching that useful life period of ten years or so, and in the big heavy AFG years of 2003 and 2004 and 2005. you have a lot of breathing apparatuses that are now approaching the end of life and need to be replaced. So we are seeing some of that play out in the North America/the US SCBA market for sure. What will the impact being on delaying the new standard? We do not know for sure, but we do not see it as a negative thing. If anything, it is probably neutral to perhaps slightly positive.

Edward Marshall - *Sidoti & Company - Analyst*

And the new mask that you're rolling out in relation to the delay on the standard?



Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

Well, we are continuing on your track to roll that product out late this year to be introducing it late this year, but obviously it is all dependent on getting these government approvals. There is two government agencies that need to approve the product, and they are without question impacted by some of the sequestration that has gone on. So we will -- we may be delayed by that impact. It is really hard for us to tell. We have no visibility into these approval agencies.

Edward Marshall - *Sidoti & Company - Analyst*

And so there would be no -- even if you were delayed, you would not be able to kind of estimate how long that delay would be, I assume?

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

That is right, Ed, I really don't. It would be measured in months. It would not be measured in quarters.

Edward Marshall - *Sidoti & Company - Analyst*

So more of a delay than a full postponement or something like that?

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

Yes.

Edward Marshall - *Sidoti & Company - Analyst*

Okay. Thanks, guys.

Bill Lambert - *Mine Safety Appliances - President, CEO*

You are welcome, Ed.

Operator

The next question comes from Richard Eastman with Robert W. Baird. Please go ahead.

Richard Eastman - *Robert W. Baird - Analyst*

Yes, thank you. Could I just ask about international? We saw a nice uptick in some of the international markets and you rattled off a couple of them, China, Brazil, Southeast Asia. Could you just talk maybe a bit about the drivers in those markets? Is it industrial, and also maybe sustainability there?

Bill Lambert - *Mine Safety Appliances - President, CEO*

Sure. In the Brazil market -- the Brazilian market for us has been quite a bit about share gains and our penetration into markets like the oil and gas market and other industrial markets. The rate of growth that we are seeing and have seen in Brazil, far out paces GDP growth in that country.



So a lot of that growth then is coming from us penetrating new markets and taking share. Same thing with Southeast Asia quite honestly. China had an uptick in demand.

They had a slow first quarter due to some holiday schedules and the way certain things fell on the Chinese calendar, but second quarter was very strong almost 20% growth we saw in China, and again, that also is very broad based in the oil and gas market, construction market, and industrial markets that we see over there, but some of the offsets in international because we did not see that upside everywhere. Some of the offsets were Australia, Australia continues to suffer, the mining industry in Australia, the mining industry in South Africa, both under a lot of stress right now. The mining industry in Chile and Peru also under stress right now. So those were some of the negatives against some of the great positives that we are seeing broadly in China, Southeast Asia, and Brazil.

Richard Eastman - *Robert W. Baird - Analyst*

Is there enough strength in some of these, I guess the emerging markets that you incorporate into international. Is there enough strength in these markets to continue to see growth local currency growth accelerate in international?

Bill Lambert - *Mine Safety Appliances - President, CEO*

I think unquestionably.

Richard Eastman - *Robert W. Baird - Analyst*

Yes, okay, from the second quarter level. And then also in Europe, could you just dissect -- At one point you were willing to dissect Eastern Europe from Western Europe. Is all of the growth coming out of distribution gains in Western Europe? Did Eastern Europe show any growth?

Bill Lambert - *Mine Safety Appliances - President, CEO*

Give me a second there, Rick, to take a look. When I look at Eastern Europe's performance overall, it was just about flat, up about 1%. Actually, the strength that we are seeing in Europe quite remarkably is in the countries that you hear the most negative news about in the news.

When you read the newspaper, and you hear about France and Italy and Spain, and even Germany perhaps, we actually saw some nice solid gains in that part of our business and where we are year-to-date in that part of our business. The UK, Northern Europe is where we have seen -- that part of the business has been off versus previous years, and then as we look over further East into Poland, Hungary, and even into Russia, Kasikstan, that possessor of the business is up, but not where we expected it to be although we are starting to see some of these large orders look like they are going to break free. Ron Herring, I know you are on the line. Ron, do you want to add anything to that?

Ron Herring - *Mine Safety Appliances - President, MSA International WEZ/MEZ*

Sure, Bill. Talking about that, for Central Europe, for example, where we are moving from -- one of the strategies we have is moving from government to private, and we see a transition moving from there, pretty significant. For example, last year I think about 52% of our Central European sales were from the private sector, and we're tracking at around 55% right now year-to-date, and that is mostly from growth going through industrial distribution, adding industrial distribution and share gain in those areas.

Bill Lambert - *Mine Safety Appliances - President, CEO*

Ron, maybe also comment on Middle East, Ron because we have seen some weakness in the Middle East and that is part of MSA as a reporting segment.



Ron Herring - *Mine Safety Appliances - President, MSA International WEZ/MEZ*

Yes, what we are seeing really in some of the large orders, we are hoping the fall are being delayed, and I think a lot of that has to do with some of the unrest that you see there, but we continue to monitor that very closely and are adjusting strategy so that we are going after the industrial segment and looking at industrial distribution there. But overall the Middle East is one of those troubling area that we are not performing at the level that we had originally planned for the year.

Richard Eastman - *Robert W. Baird - Analyst*

Okay, very good. And then there was a comment made I think before orders in the quarter being up about 8%. Was that comment specific to the five core product groups?

Bill Lambert - *Mine Safety Appliances - President, CEO*

That is overall comment, overall consolidated sales.

Richard Eastman - *Robert W. Baird - Analyst*

Okay. I am sorry, one last thing. Any sense for any anticipated restructuring the second half? Is there a number that you might be able to share?

Bill Lambert - *Mine Safety Appliances - President, CEO*

It would be a relatively small number if we have some more restructuring in Europe, but it would be small, I would think.

Richard Eastman - *Robert W. Baird - Analyst*

We are done in Australia then?

Bill Lambert - *Mine Safety Appliances - President, CEO*

Hopefully.

Richard Eastman - *Robert W. Baird - Analyst*

Okay. All right, thank you very much. Very nice quarter.

Bill Lambert - *Mine Safety Appliances - President, CEO*

Thanks, Rick.

Operator

(Operator Instructions). The next question comes from Walt Liptak with Global Hunter Securities. Please go ahead.



Walt Liptak - *Global Hunter Securities - Analyst*

Hello, thanks, good morning, guys.

Bill Lambert - *Mine Safety Appliances - President, CEO*

Hello, Walt.

Walt Liptak - *Global Hunter Securities - Analyst*

So I wanted to ask about the Europe 2.0 and you outlined four points. I wanted to focus on the fourth one, the financial performance and see if we could get a little bit more detail about what do you think that should do to kind of the net margins for Europe, and the time frame for that?

Bill Lambert - *Mine Safety Appliances - President, CEO*

That was in my commentary. So I will address it briefly, then I will look to Dennis to add some color to it. Our Europe 2.0 initiative has the four legs of the stool that we talk about or the four goals, I should say, that we are trying to achieve there, and the last element there is the improved financial performance so there is better cost management and centralized sourcing and purchasing that would able to go on there as well as consolidation of warehouses and that sort of thing.

Right now, as we look at net profit margins for MSA Europe, we are in the low to mid single digits. It is our goal here by the time we are done with Europe 2.0, that our net profit margins would be in the low double digits. So up in that 10%, 11%, 12% range, Walt. How long does it take us to get there?

We are probably midstream right now. So I would imagine we have probably another two years before we see those kinds of kinds of results assuming of course that top line growth continues along the path that we are projecting it to be, and we are getting some good signs in that regard from what we are doing there. I would think we are midstream and probably another two years as we get into 2015. We will track this. You will see this.

This will not be a step change. It will be somewhat linear, quarter by quarter, year by year. Dennis, anything that you would like to add?

Dennis Zeitler - *Mine Safety Appliances - CFO*

Walt, there is two pieces to Europe 2.0. One is to improve the efficiency of the operation of the business. So you will see operating profits. The operating margin as a percent of sales increase gradually as it has been increasing and improving. There will also be some tax efficiency involved. As Bill said, it will be linear.

You have to be able to follow the improvement in Europe, maybe not every quarter, but year by year until we get into the range that Bill mentioned 11% to 12% net profit in our total European segment.

Walt Liptak - *Global Hunter Securities - Analyst*

Okay, that sounds great. Is Europe 2.0 the final leg in this cost reduction and productivity for Europe or is there still some program of consolidation or whatever behind it?

Dennis Zeitler - *Mine Safety Appliances - CFO*

It is certainly the most of it, the majority of it, Walt. The only thing that would remain is as our presents grows in Eastern Europe and into Russia and these higher growth market segments those segments begin to take on more mass, more meat, and they need to be on the same kind of operating systems as though in Western and Central Europe do. But those are multi year efforts, and we will be phasing those in over time. So when we talk about Europe 2.0 and the fairly significant European transformation that we have been involved with over the past few years most of that will be behind us over the next two years.

Walt Liptak - *Global Hunter Securities - Analyst*

Okay, thanks very much.

Operator

The next question comes from Dick Ryan with Dougherty. Please go ahead.

Dick Ryan - *Dougherty - Analyst*

Thank you. Dennis, on the R&D and maybe a broader comment on operating expenses. You have significant products coming out over the next couple of years. What do we do for R&D, and then your comment about OpEx staying in this range. Are you talking absolute or percentage-wise?

Dennis Zeitler - *Mine Safety Appliances - CFO*

I am talking absolute for the next two quarters.

Dick Ryan - *Dougherty - Analyst*

Okay.

Dennis Zeitler - *Mine Safety Appliances - CFO*

As far as R&D goes, we do have a lot of efforts going on right now. We have some great new products that are coming out. I would not expect our R&D expense to increase over the next two quarters either, but that is a guess right now. All these approval fees and all of that gets into that R&D number, and they are not inexpensive. So when we are allowed to get our approvals, et cetera, I just don't know.

Dick Ryan - *Dougherty - Analyst*

Okay. Bill, on market share, you have talked about gaining share in some of these markets, but do you have a more global commentary about what you are able to achieve on market share? Is it coming through new products, pricing, and maybe what is the outlook for pricing over the next six months or so?

Bill Lambert - *Mine Safety Appliances - President, CEO*

Let me first say that on market share, most of the market share data that we have is secondary research, some primary and some secondary research that we conduct ourselves. So when we look at market share gains, it is not validated by outside sources with one exception, and that is within the

US. In the US, we have got a pretty good handle on what our market share position is in some of our core product line areas, that is number one. Number two, I think the reason for market share gain is multifaceted. One, certainly product innovation is element of that.

Secondly, I think its sales coverage, and the efforts that we have put into customer satisfaction and customer loyalty and driving the behavior of this organization to be more customer responsive and to be a better partner with our distributors. We have taken that globally, Dick, and some of those programs and processes and work procedures are now employed by our organization around the world, and we are seeing the kinds of impacts that we would hope to see from that.

I don't think it is related to pricing. We are not the least expensive brand out there by a wide margin. In many cases, we are a price leader, but the quality of our product, the durability of our product, the support and service we provide is among the best in the industry, and that is how we are gaining market share.

Dick Ryan - *Dougherty - Analyst*

Okay. You talked about the order patterns strengthening late may. Is that kind of continuing with the early look into the September quarter?

Bill Lambert - *Mine Safety Appliances - President, CEO*

That is a good try, Dick.

Dick Ryan - *Dougherty - Analyst*

I can try.

Bill Lambert - *Mine Safety Appliances - President, CEO*

We try to hold off on providing some of those Forward-looking statements. So I am just going to pass on that one.

Dick Ryan - *Dougherty - Analyst*

Thanks, guys. Good quarter.

Bill Lambert - *Mine Safety Appliances - President, CEO*

You are welcome, Dick.

Operator

The next question is a follow-up from Richard Eastman from Robert W. Baird. Please go ahead.

Richard Eastman - *Robert W. Baird - Analyst*

Bill or maybe Dennis, the core product mix in the quarter, first the ancillary products or other should we think about that as kind of normalizing now around this 72% or call it 75% of sales. Is that steady state going forward now with the ACH divestiture out? So we can build kind of a growth rate around core products versus ancillary products?



Dennis Zeitler - *Mine Safety Appliances - CFO*

Rick, I think that you will probably see the rate of change decreasing, but over time you will continue to see that number inch upward as more and more of our product is in the core area of our business, and as we give less attention and those peripheral products that are in our product line.

Richard Eastman - *Robert W. Baird - Analyst*

I would think on a year-over-year basis in the second half then, we would start to see a more normalized gross margin given the sales mix? Is that a fair statement?

Dennis Zeitler - *Mine Safety Appliances - CFO*

I think that is a fair statement.

Richard Eastman - *Robert W. Baird - Analyst*

And ancillary product is down 13%. You did mention half of that is the ACH divested business. Is the other half of that decline? Is that where the mining weakness is showing up? Is that maybe the biggest single biggest piece?

Bill Lambert - *Mine Safety Appliances - President, CEO*

That is probably the second biggest piece or maybe as big as the ACH business, but we also had a big drop-off in gas masks for the military, too by several millions dollars. There is three things going on there. But you are right. You continue to see the mining difficulty in Chile and Peru and Columbia, Australia, and some of it in South Africa.

Richard Eastman - *Robert W. Baird - Analyst*

Okay. Maybe a question for Joe. I just wanted to follow up for a minute on North American SCBA.

Bill, you gave a really good, kind of detailed commentary around the push on the standard change, but we are curious. As we track through the second quarter there was a general feeling that there might be some pre-buy of the old product or the non-compliant product because just because there was familiarity with that product, we kind of pick that up in the marketplace, and I am curious now with the standards pushed. Do you feel like the order pattern or demand pattern may still fall off in September? Or is there any indication of what that quarter-to-quarter order and sales pattern could look like for North American SCBA?

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

Boy, that is a challenging question. I would say in the second quarter we did see a slight bump in some departments in some of our distributors picking up on what we call our current unit, the unit that doesn't meet the new standard. So that was a contributor in the second quarter to some extent.

I really think as Bill mentioned, the third and fourth quarter, depending upon what happens with this extension that would allow us to sell the current unit as well as the new approved unit, whenever the government approves that, it is a challenge to call what the order pattern is going to look like. It really could be a good third and fourth quarter. It could be slower than what we expect. It really is a toss up. I think the manufacturers will know a lot more come the very end of August, beginning of September because we will know, should know by the end of August as to whether

or not we can continue to sell the existing unit until the end of February, and we will have a lot better understanding as to when manufacturers will receive approval on the new unit, and can really move forward on the new unit.

Richard Eastman - *Robert W. Baird - Analyst*

Because looking at the sequestration impact and the push on the standard and the order pattern or sales pattern, you look at -- I am sure you do -- but the SAFR grants and the fire grants, the number is down in absolute terms and the funds granted against that lower number have been really slow as well.

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

Yes, they have.

Richard Eastman - *Robert W. Baird - Analyst*

That is part of the sequester impact and this issue?

Joe Bigler - *Mine Safety Appliances - VP, President, MSA North America*

It is to some extent. Some of the funding -- the funding for the AFG program is about \$320 million. When you look at the real absolute numbers, most of the 2012 money has all been given out. The 2013 grants, hopefully, are going to start sometime at the end of this year and will go into next year.

The funding there is about \$ 320 million for AFG both what we gave out this year which is basically all depleted and the new grants that will be forthcoming. In fact, the Senate just approved approximately the same amount tentatively for 2014. So there has been some effect the sequestering, but for the most part AFG money has held firm at about \$320 million. I will say that the demand in the fire service is there. It is coming. For all of the reasons that we have talked. Bill has mentioned the new standard units being old from 9/11. So it does seem to be a focus of a lot of North America fire departments that they are taking a look at their SCBA. It is just the timing of that demand. However the next 12-18 months is a real question.

Richard Eastman - *Robert W. Baird - Analyst*

Understand. Last question. Dennis, can you just talk to the free cash flow? Again, year-to-date, you did address the receivables, but I am curious. Do you expect a significant improvement in the free cash flow in the second half of the year?

Dennis Zeitler - *Mine Safety Appliances - CFO*

Absolutely, just like we had last year, Eric. Second half of the year and now that we are at a peak for receivables. We had a strong invoicing month in June. Once you get to the end of the year, the last couple of weeks of December don't get a lot of invoicing. So receivables will be down. Our insurance receivable will probably not be increasing much. Inventories that have been built up for shipment will be down. Yes, I think it will look a lot like last year's pattern where we were weak towards the middle of the year and finished the year with a very strong free cash flow.

Richard Eastman - *Robert W. Baird - Analyst*

Okay. All right, thank you again for the follow-ups.



Operator

We have no further questions at this time. I would like to turn the call back over to Mark Deasy for closing remarks.

Mark Deasy - Mine Safety Appliances - Director of Corporate Communications

Okay, thank you, Ellen and given that we do not have any more questions, that will conclude this morning's call. I just want to remind everybody if you missed a portion of the conference an audio replay will be available on our website for the next 30 days, as will a transcript of the call. On behalf of Bill, Dennis, Stacey, Joe, Ron and Kerry, Again I want to thank you for joining us this morning. We look forward to talking with you soon. Hope everybody has a great day. Take care.

Operator

Thank you, Mark. Ladies and gentlemen, this concludes the MSA second quarter earnings conference call. Thank you for participating. You may now disconnect.

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