THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

MSA - Q3 2013 Mine Safety Appliances Earnings Conference Call

EVENT DATE/TIME: OCTOBER 23, 2013 / 2:00PM GMT

CORPORATE PARTICIPANTS

Mark Deasy *MSA - Public Relations Director*

Bill Lambert *MSA - CEO, President*

Stacy McMahan *MSA - Senior VP & CFO*

William Lambert *MSA - CEO, President*

CONFERENCE CALL PARTICIPANTS

Richard Eastman *Robert W. Baird & Company, Inc. - Analyst*

PRESENTATION

Operator

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

Mark Deasy - *MSA - Public Relations Director*

Thank you, Vivian, and good morning everybody. And actually I want to welcome you to our third quarter earnings conference call for 2013. Joining us on the call this morning are Bill Lambert, President and Chief Executive Officer; Stacy McMahan, Senior Vice President and Chief Financial Officer; Ron Herring, President of MSA Europe; Nish Vartanian, our newly elected President of MSA North America who succeeds Joe Bigler in that role. I should mention that in September Joe was appointed to a newly created position at MSA, that of Vice President and Chief Customer Officer. A press release announcing their respective new roles for Nish and Joe was announced on September 4, and that release is available on our website.

And lastly we have with us Ken Krause, Executive Director of Global Finance. In addition to his financial management responsibilities, I'm please to let everyone know Ken will be taking on a much more active and more visible role in our investor relations efforts. In this capacity, he will, of course, be working closely with Stacy. So hopefully you'll have a chance to meet or speak with Ken soon. Our third quarter press release was issued this morning at 8.30 and it to is available on our website at www.MSAsafety.com. This morning Bill Lambert will provide his commentary on our quarter, Stacy will then review our financials, and then Bill will conclude with his closing comments. And after that, we'll open up the call for your questions.

Before we begin, I need 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 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 July 24, 2013. You are strongly urged to review all such filings for a more detailed discussion of such risks. Our SEC filings can be obtained at no charge at www.sec.gov, our own website, and, of course, a number of other commercial sites. That concludes our forward-looking statements, so at this point, I'll turn the call over to Bill Lambert for his comments. Bill?

Bill Lambert - *MSA - CEO, President*

Thank you very much, 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 our third quarter press release and have our financial figures with all comparisons corresponding to the equivalent period in 2012. I'm going to start by running through some of the highlights of our third quarter results and talking about the progress we are making on key strategic priorities. I also will share with you some views on the current business environment, and how it is likely to affect us as we move through Q4 before I turn it over to Stacy to run through the actual results. Then we'll open it up for your questions.

During our last investors call back in July, I indicated we had seen choppy but improving trends in order activity and business conditions during the latter half of the second quarter. Unfortunately, as we entered August and into September, we started to see sequestration-related delays, a lower level of large orders, customers requesting shipments to be delayed into future quarters, and a continued slowing trend throughout the mining regions of the world. These trends combined to have an adverse impact on our third quarter financial performance. As noted in our press release, third quarter sales were $278 million, down $9 million or 3% from a year ago.

Weakening foreign currencies decreased as reported second quarter 2013 sales by $6 million. So excluding the effective currency our sales were down 1% or $3 million, when compared to the third quarter of 2012, with growth and core products fully offset by a lower level of adjacent and peripheral product sales. The primary drivers of our sales performance are sequestration-related delays and its impact on fire service markets.

A lower amount of large orders shipped, which declined $5 million between the third quarter of 2012 and the third quarter of 2013, and continued weakening business conditions in mining-related markets across regions like Australia, Peru and Chile. In just a bit, Stacy will provide us with more insight into this financial performance, with a breakdown by end market, by product group and by geographic reporting segment. But before that, I want to provide some comments regarding our strategy to grow or business and to expand our operating margins.

So I'll begin with some comments about our core product focus, which, as many of you know, remains a key element of our long-term strategy. Once again, these product 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 our principal product, and lastly fall protection products. Sales from these five product groups comprise 70% of our total third quarter sales, and showed local currency revenue growth of 3% when compared to the same period of 2012.

Core sales, as a percent of our total sales, continued to grow as we provide emphasis on these five product lines. During the quarter, local currency portable gas detection product sales grew 9% and fixed gas and flame detection sales were up 7%. Our focus on the oil and gas market is showing benefit, and growth in our gas detection product lines is clearly evident. Fall protection sales increased 6% in the current quarter. Head protection sales were up 1% as industrial and mining related markets outside the US experienced slow downs. So, in other words, this quarter is principally about SCBA sales which declined during the quarter.

We don't believe the decline is representative of a trend in the market, but rather specifically related to the US government sequestration and shutdown situation. As indicated in our press release, sequential quarter SCBA orders were down $9 million in North America, as federal government sequestration-related approval delays impacted our introduction of new SCBA products and caused delays in buying decisions by fire departments. As many of you know, we are in the process of developing two new SCBA that meet new NFPA performance standards for breathing apparatus. The new NFPA performance standard took effect in August, and NFPA compliance remains a critical decision factor for US fire departments.

Unfortunately, testing and certification of our new devices as NFPA compliant has been significantly delayed, first due to the federal government's budget sequestration, which went into effect on March 1, and then leading up to October 1, the absolute shutdown of activities at government test labs. The impact on the federal testing facilities and their respective resources and bandwidth has adversely affected MSA, and it has affected all SCBA suppliers to the US Fire Service. This adverse effect takes the form of delaying the introduction and availability of new products and delaying purchasing decisions by fire departments. We sorely felt that in the third quarter.

As a result of the government-related certification issues, the NFPA made a decision to issue a tentative interim amendment, or TIA, as it is known in NFPA parlance. Essentially, the temporary interim amendment allows manufacturers an extended window to continue shipping SCBA compliant to the old edition of the NFPA standard up until February 28 of next year. This decision was made because there were no SCBA on the market fully certified to the latest revision of the standard, and none were expected with the government shutdown looming. Unfortunately, and as you might expect, the market is well aware of the new SCBA coming which meet the new NFPA requirements, and the Fire Service realizes these delays are only a temporary situation. And so demand for the older style SCBA is waning as they await the new SCBA.

The approval-related delays due to sequestration, the whole NFPA TIA situation, all combined to have an adverse impact on our third quarter SCBA business in North America as we basically were unable to invoice or ship any breathing apparatus to the US Fire Service from August 31 to September 15. And worse, it is adversely impacting our ability to introduce new products, and it impacts decision making by fire departments.

There is no doubt the government sequestration and shutdown-related effects adversely contributed to we saw in the quarter. However there is good news, and that good news is that we believe these adverse impacts are, in fact, only temporary. We remain confident in the strength of the US Fire Service market and the increasing demand for SCBA, which we have forecasted. We've talked about that in previous calls, and we still believe the US Fire Service provides a great opportunity for future growth at MSA. Looking ahead, we are hopeful that recent congressional action will remedy the situation so government approval agencies and manufacturers like MSA can resume their important work for the US firefighter.

Turning attention now to our performance in emerging markets, this part of the world remains a keen focus for us and represents 30% of our total global business. For the quarter, our local currency sales and emerging markets were down 1%, as core product growth of 9% across Latin America and Southeast Asia was offset by softening business conditions in mining markets and a lower amount of large orders in the Middle East and China. We continue to invest in research and development and the results generated from this investment are providing us with some sense of encouragement. In fact, we have a number of new products that have recently been introduced or are expected to be launched in the fourth quarter of 2013.

Let me give you some insight into some of the activity we foresee on the new product front. First, in the gas detection area, MSA launched a new fixed gas and flame detection product in China, named the MSA PrimaX IR Pro, during the third quarter. Infrared detection is a popular method to use for combustible gas detection and infrared-enabled instruments comprise a major portion of the fixed gas and flame detection market in China. This market represents a significant part of the Chinese oil, gas and petrochemical market, and based upon initial feedback, the features of our new product have been very well received by end users.

At the recent National Safety Congress and Conference in Chicago, we showed our new Fas-Trac 3 Suspension System, designed for the industry-leading MSA V-Gard Hard Hat. Voice of customer testing has confirmed that this new suspension has been well received by customers providing the industry's highest level of user comfort. In addition, the Fas-Trac 3 provides an enhanced level of stability, which is important to our customers who wear their V-Gards in the most challenging conditions.

Additionally, I'm proud to announce that in the third quarter, we successfully launched in North America a new addition to the MSA V-Gard helmet family, the V-Gard GREEN. What is unique about the V-Gard GREEN is that it is made from high density polyethylene derived from sugar cane, a renewable resource. This product was developed by our engineering center in Brazil, and the latest version, which has been certified to ANSI standards, was also launched at the National Safety Congress. More and more of our customers are focused on sustainability and reducing their carbon footprint, and MSA is proud to be able to make an important industry-first contribution toward those sustainability goals with the introduction of the MSA V-Gard GREEN.

We are also getting very positive reviews from European firefighters for our recently introduced F-1 XS fire helmet. This innovative European-style firefighter helmet helps to integrate several technologies that European and global firefighters, until this time, have had to do either without or jerry-rig their own solutions. Features like incredible comfort, stability and protection, combined with integrated lighting, eye and face protection, and integrated communications capability position this product well for success in the fourth quarter 2013. These are just a few of the many core products that we continue to develop and have launched over the past several months, and as I look to the future, I see an exciting pipeline of new products which will be introducing over the coming quarters, including the new SCBA, which I mentioned early on.

In this call, I also want to provide 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 will drive efficiency; three, improve customer satisfaction through improved delivery and availability of products and services; and four, improve financial performance through better cost management and centralized shared services. We continue to make progress in this important initiative, and we are on track to continue to drive improved performance.

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 property margins in the low double-digits when our Europe 2.0 Initiative is completed by the end of 2015, and we believe we are on track to get there. In early July our MSA France operations went live on SAP, joining MSA Germany, who went live in April of this year. Our on-time delivery to customers is the highest it's ever been from these two entities. By the end of the year, MSA Spain and MSA Italy will also be under the new SAP operating environment. When that occurs, more than 70% of sales and transactions in Western Europe will be under the new operating environment.

Now, I would like to turn the call over to our new CFO, Stacy McMahan, to provide an overview of our third quarter financial performance. Stacy was named our CFO in September and is now responsible for all finance activities at MSA, and we are delighted she is here. After Stacy finishes with her report, I'll provide some closing comments, and then we will open up the call for your questions. Stacy?

Stacy McMahan - *MSA - Senior VP & CFO*

Thank you, Bill. Good morning. I am pleased to share further insight into our third quarter financial performance. 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 third quarter of 2013 were $278 million, down $9 million or 3% from the prior year. Excluding unfavorable currency effects of $6 million, driven by weakness in the Brazilian real, Australian dollar and South African rand, revenues increased $3 million or 1%.

I will comment on four ways we look at our sales performance by end markets, by product group, by geographic reporting segment and then by emerging markets. First by end markets, global industrial market, local currency sales were flat versus a year ago and represented 71% of our total business in the quarter. Global fire service sales, representing 25% of our total business, increased 3%. And finally, sales to the military market represented 4% of quarterly sales, down from 5% last year on a lower level of gas mask sales in the United States, and ballistic product sales in Europe.

When we consider our sales by product, our five core product groups delivered growth of 3% on a local currency basis and represented 70% of total sales. The core growth was led by portable instruments up 9%, fixed gas and flame detection instruments up 7%, fall protection up 6%, and head protection up 1%. Breathing apparatus was down 2% from the prior year on lower large order activity and the aforementioned regulatory delays in the quarter. The remaining 30% of sales were down 10%, primarily from a lower level of military business throughout all of our segments, as well as lower mining-related product sales in international markets.

Moving to our reported segment sales performance, in North America sales in the third quarter were up 1% from the prior year to $135 million. When looking at North American end markets, local currency sales to industrial customers grew 3% and fire service sales increased 2%. Sales to the US military were $1 million in the third quarter, down $3 million on a lower level of gas mask sales.

By product group, our five core product groups represented 81% of sales in North America and were up 5%. Portable instruments led the growth at 10%, followed by fixed gas and flame detection products at 8%, head protection sales at 7%, and breathing apparatus at 1%. Fall protection sales decreased 2%. All other non-core product groups were down a total of 15%, driven again predominantly by the lower level of gas mask sales.

Moving on to our international segment, reported sales were down 10% to $76 million with local currency sales down 1%. When looking at international end markets, local currency industrial segment sales were flat and comprised 79% of total sales for the quarter. Fire service local currency sales increased 2% on strength in Brazil and were 19% of total sales in the quarter. Military sales made up the remaining 2% of international sales and decreased 27% from the prior year.

By product group, sales of international core products were up 6% for the quarter and were 56% of total sales. Fixed gas and flame detection instrument sales were up 44%, followed by portable instruments growing at 27%, and fall protection up 22%. Breathing apparatus sales declined

4%, due to a decrease in large order activity in the quarter, and head protection sales fell 7%. All other product groups were down 8%, primarily related to a lower level of peripheral and adjacent product sales to the mining market.

Finally our European segments reported sales were down 1% to $67 million and down 4% in local currency terms. By end market, Europe's local currency sales related to fire service were up 6% and comprised 34% of total sales on improvements in fire helmet sales. Military sales declined by 15%, representing 11% of total sales, while sales to industrial customers decreased 8% and represented 55% of total sales.

By product, Europe's core product sales decreased 4% this quarter, and comprised 64% of total sales. Decreases in breathing apparatus, portable instruments, fixed gas and flame detection products and fall protection were offset by an increase in head protection of 8%. All other product groups were down 6%, driven by a lower level of Military shipments in the Middle East and India region.

We end our look at sales performance with our 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 market in each geographic reporting segment. Total emerging market local currency sales were down 1% from the prior year related to a 9% decline in adjacent product sales. Emerging markets were inconsistent in the quarter with strong core product growth in Brazil and Southeast Asia but partially offset by a lower amount of large orders, defined as orders in excess of $1 million, and by weaker conditions in mining markets in areas like Chile and Peru.

Our gross profit rate for this quarter was 42.5%, a decrease of 20 basis points from last year. However, product sales gross margin performance improved 120 basis points when compared to the third quarter a year ago, 80 basis points of which was driven by lower costs and improved pricing, with 40 basis points being driven by an improved core product sales mix. These improvements were offset by volume variances in our factories and cost incurred for one product recall with a higher return rate than historically experienced.

I think it is very important to step back and look at our progress in this area over the longer term. From a year-to-date perspective, gross profit margin is 43.7%, improving 110 basis points over the same nine-month period in 2012. And when compared to 2009 when we embarked on this new strategy, gross profit margins have improved over 600 basis points as we continue to drive favorable mix of core products, recognize improvements in pricing and lower manufacturing costs.

Reported selling general and administrative costs were down 10%, or $8 million this quarter, compared to last year on lower stock compensation expense, product liability related expense, legal expenses and lower selling and marketing and bonus costs on the reduced sales volume. Our investment in research and development this quarter was $12.3 million, up $2.2 million over last year, as we continue to invest in a significant pipeline of new products to be introduced over the next 6 to 12 months.

There was a $2 million foreign currency transaction loss this quarter, as well as $2 million in restructuring expense related primarily to our ongoing Europe 2.0 plan. The resulting operating income, absent these one time items, was $33 million and 12% of sales, compared to $31 million and 11% of sales last year, a 100 basis point improvement year-over-year. Our consolidated tax rate this quarter was 29.6%. The year-to-date effective tax rate is just over 29%, versus 30.4% through the first nine months of 2012 primarily related to the research and development tax credit that was enacted earlier this year.

The bottom line is reported third quarter net income of $20 million or $0.52 per basic share, consistent with the prior year. Excluding $3 million of restructuring and FX expense recorded this quarter, as well as a $1 million gain from property sold, net income was $22 million, resulting in pro forma earnings per share of $0.57 per basic share. Increasing 8% on the 1% decline in revenue versus the equivalently adjusted third quarter 2012 results. Free cash flow was $34 million, approximately 170% of net income. Cash at the end of the quarter was $96 million, up $14 million from the prior quarter, and composed largely of cash outside the United States. Our total debt at the end of the quarter was $289 million, down $11 million from the second quarter.

In summary our third quarter performance was impacted by lower sales volumes in an uneven business climate. However, we continue to see improvement in year-over-year operating margins, driven by an improved mix, operational excellence in our factories, and control over expenses. Ongoing execution of our strategy, with a keen focus on these areas, has and will continue to improve financial performance and enhance long-term shareholder value. I will now return the microphone to Bill.

Bill Lambert - *MSA - CEO, President*

Thank you Stacy. As we move forward into the final quarter 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 disappointed in our Q3 results but I am not discouraged. The sequestration and government shutdown related delays are only temporary hurdles as we stay committed to our growth strategy. In light of the ongoing economic uncertainty in some parts of the world, we continue to closely manage hiring and discretionary spending. We have put restrictions on discretionary spending but remain committed to obtaining our investments in innovation and the high-growth markets around the world to continue to drive top-line growth and improve our market share position.

While we all realize there will be short-term fluctuations, our strategy has created shareholder value over the past four years, and we expect it to continue to do so over the long-term. The strategy has yielded very strong results over the past several years, and I am confident that it positions MSA to create value for our stake holders, even in times of uncertainty.

Thank you for your attention this morning. At this time, Nish Vartanian, Ron Herring, Stacy McMahan and I will be happy to take any questions you may have. Kerry Bove, who normally joins us on this call, is traveling in China and is unable to do so. 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 earnings.

QUESTIONS AND ANSWERS

Operator

(Operator instructions)

And our first question comes from Richard Eastman. Richard, please go ahead.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Yes, good morning. Could you maybe speak to, in Europe, when we look at the industrial piece of the business, you did comment that Russian Industrial was lower, but is there any sense here that we maybe hit the wall a little bit in terms of distribution gains in Europe and now industrial in Europe is starting to reflect current market conditions there?

William Lambert - *MSA - CEO, President*

Rick, I think I would characterize it slightly differently, and I would say that in our reported European sales we also include, as you noted, Russia, but also the Middle East. And what we have seen really, in the wall as you called it, is more, I think, related to a slow down in Russia and slow down in the Middle East, and some of the large orders that we have there being delayed into future quarters. On the distribution front for western Europe, we have made some good gains in the past, but I still see some improving conditions there and I still think we have a little bit of runway ahead of us, especially in western Europe. We are seeing improving conditions in southern Europe, in France and Italy in particular. So I think our European performance is probably more reflective of -- is more reflective of what we have seen happen in the Middle East and in Russia than it is for Europe as a whole.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

And Mid East, again, that is large orders and that's on fixed gas and flame side primarily?

William Lambert - *MSA - CEO, President*

It's a combination, Rick, of both fixed gas and flame detection and some SCBA orders, supplied air respirator orders.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

I see, okay. And then just maybe a somewhat similar question. On the international side, where were the surprises there? Mining has been weak and perhaps maybe the step down in 3Q, which you know Cat mentioned today, is a bit of a surprise. But also, on fire service, I guess you had a known tough comp there and you still grew the business in international. But where were the surprises on the industrial piece of international to end up with kind of a flat number there?

William Lambert - *MSA - CEO, President*

I think that mining has been -- has had a lot of headwinds for the majority of this year. MSA Australia continued to weaken during the quarter, and in previous quarters we've had Latin America, Brazil, Chile, Peru as being able to offset that, and a lot of those came from markets outside of the mining market. So for instance in Chile, we have talked in past calls about our success with breathing apparatus to the national fire brigades of Chile, and we just didn't have some of those big offsets. So the decline and the weakness and mining markets just became more apparent and probably looks more -- shows itself more as a [preservation] in this past quarter than the steady decline that we've seen in mining for the past year.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Is industrial in international maybe overweighted toward the non-core kind of ancillary product lines?

William Lambert - *MSA - CEO, President*

When compared to the rest of MSA, I think that is a fair assessment. As we have set up distribution around the world and many of the areas of the world where safety is less sophisticated, so to speak, our tendency was, and the market demanded, that we provide lower levels of safety equipment which are really not in our core. And so what we have been trying to do since this new strategy is to move, shift that international group towards more of the core areas of our business, and to find that part of the business which is really core-driven and adjacent-product driven. The peripherals were definitely weaning ourselves off of.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay, and then just one last one and I'll get out of the line here. Just on the SG&A then, I got Stacy's, and Stacy, your commentary on why the substantial decline in SG&A sequentially. Would it be the expectation that SG&A kind of holds at this level through the end of the year now?

Stacy McMahan - *MSA - Senior VP & CFO*

It is some what variable regarding our sales performance, for instance, in terms of how we accrue bonuses, compensation-related accruals and control expenses related to the sales performance. But essentially, I think the answer is yes. We can expect that if everything remains the same.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

And the warranty cost, how does it decline when the recall cost actually went up?

Stacy McMahan - *MSA - Senior VP & CFO*

The warranty cost went up, Rick. They actually went up as a result of the recall. A very effective recall, actually, which is a good thing. But it was registered in warranty cost increase.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

I see, okay. Thank you much.

William Lambert - *MSA - CEO, President*

Okay Rick.

Operator

(Operator instructions)

And I'm not showing any further questions at this time.

Mark Deasy - *MSA - Public Relations Director*

Okay Vivian. Well, thank you. Since we have no more questions that will conclude today's call. If you missed a portion of the conference, a replay will be available on our website for the next 30 days, as will a transcript. So on behalf of our entire team here, I want to thank you again for joining us, and we look forward to talking with you again soon. Have a great day.

Operator

Thank you ladies and gentlemen. This concludes today's conference. Thank you for participating.