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MSA - Q3 2012 Mine Safety Appliances Earnings Conference Call

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PRESENTATION

Operator

Welcome to the MSA third-quarter earnings conference call. My name is Kim, and I will 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 will now turn the call over to Mr. Mark Deasy. Mr. Deasy, you may begin.

Mark Deasy - Ketchum Public Relations - Corporate Communications Director

Thank you, Kim, and good morning, everybody. I, too, would like to welcome you to our third-quarter earnings conference call for 2012. As Kim said, I'm Mark Deasy, Corporate Communications Director. And with me on the 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 our business in Europe, Northern Africa, Russia, and the Middle East and India; and Kerry Bove, President of MSA International responsible for 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 homepage of MSA's website at www.msasafety.com.

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

But 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 SEC, including our most recent Form 10-Q, which was filed on July 25, 2012. You are strongly urged to review all such filings for a more detailed discussion of such risks and uncertainties. Our SEC filings can be obtained at no charge at www.sec.gov, our own website, and, of course, many other commercial sites.

That concludes our forward-looking statements. So at this point, I will turn the call over to Bill Lambert for his comments. Bill?



Bill Lambert - MSA - CEO & President

Thank you, Mark, and good morning, everyone. Let me 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 the comparisons corresponding to the equivalent period in 2011.

In our last investors conference call in July, I described our underlying order activity, and that economic uncertainty throughout Asia and Europe tempered my optimism as we headed into the second half of the year. Indeed, we have seen a slowdown in those markets, but North American and Latin American sales, adjusted for the military business we've exited, are showing good stability. Additionally, the General Monitors acquisition and our Fixed Gas and Flame Detection business is strong. I think our third-quarter operating results reflect many signs of solid execution of our corporate strategy by the team here at MSA, and I'll review them with you in my comments today.

In spite of the uncertain economic and global business conditions, I want to assure you that we remain committed to our corporate strategy of growing in our five core product lines in both developed and emerging geographies, investing in developing innovative new products and close management of manufacturing and operating costs to improve operating margins.

And we're seeing the results of our strategy execution. As you saw in our press release, our consolidated sales for the quarter were \$287 million. On an as-reported basis, sales were down \$12 million from a year ago; however, when analyzing our sales, it's important to consider the impact of weakening foreign currencies and the divestiture of our North American ballistic products business on the year-over-year comparison.

The third quarter of 2011 included \$11 million of ballistic product sales in our North American segment. Additionally, weakening foreign currencies decreased as-reported sales by \$16 million. So excluding the impact of weakening foreign currencies and the non-core North American ballistic helmet and ballistic vest businesses that we divested late last year and earlier this year, sales were up \$14 million or up 5% during the quarter.

The increase in local currency revenue in the third quarter was driven by the focus our team continues to place on driving demand for our core product lines, a key element of our long-term strategy. These lines include Fixed Gas and Flame Detection systems, portable gas detection instruments, industrial head protection products, supplied-air respirators, and fall protection products.

Our core products comprised 64%, or nearly 2-thirds, of our total third-quarter sales and had local currency revenue growth of 7% when compared to the third quarter of 2011. Sales across these same core product groups in our emerging growth markets grew by 18%.

It's important to realize that our strategy has us continuing to focus on shifting the mix of our product sales towards higher margin core products.

To give you a sense of this, over the past three years, our mix of core product sales has increased from 55% of our total business in 2009 to 64% in 2012. Even in the face of ongoing economic challenges, we continue to see growth opportunities for these core lines, and for this reason, we remain focused on advancing this initiative around the world.

The progress we're making in managing manufacturing costs and improving gross profits as a part of our operational excellence initiatives is also encouraging. Our efforts to optimize our manufacturing footprint and improve our supply chain processes globally continue to yield solid results. Overall, these and other initiatives helped contribute to the 220 basis point improvement in gross profit margins that we saw in the quarter.

What I think is noteworthy and reflective of the payoff from our efforts is the progress we are making in improving core product line gross margin levels. Gross margins of core products improved 140 basis points when compared to the third quarter of 2011, and they have improved 200 basis points through the first nine months of 2012 to just over 55%.

We have made solid progress in core product margins over the last several years, improving by almost 540 basis points when compared to 2009. Needless to say, I am proud of the accomplishments our team continues to make in this area and pleased to see the payoff from our efforts.

Our SG&A expenses were high during the quarter, and they were up \$3 million from a year ago. Most of this increase was one-time expense, and the remainder was a decrease in pension income. Therefore, our as-reported operating margin for the quarter was 10.7%, a 20 basis points decline over the same period year ago. Dennis in his comments will provide more detail on the operating margins and on those Q3 SG&A expenses.

As we've noted 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 4% from the same period of a year ago. This investment allowed us to design, develop, and launch several new products that I'd like to review with you.

MSA is excited to report on the recent launch of four new products, all of which fall within MSA's core product family. You will recall that a key pillar of MSA's corporate strategy is to focus on our core product lines because products in that core family create a differential level of value creation for our customers and for our shareholders.

The MSA GALAXY GX2 Automated Test System was launched on October 4 and brings powerful but simple-to-use automated calibration and digital record-keeping capability to MSA's portable instrument customers. It is a complementary product to our tremendously successful ALTAIR 4X and ALTAIR 5X portable gas detection instruments. The customer only has to place their MSA portable gas detection instrument into the GX2 docking station and the calibration process begins automatically without having to touch a single button. The speed of the system greatly reduces the time and the amount of calibration gas required to do the test, which results in an easily demonstrated cost of ownership benefit for our customers. And the data management system onboard the GX2 provides powerful but easy-to-use record-keeping capability. The graphical user interface can be viewed in 18 different languages, making this product a truly global offering that is in alignment with the world market opportunity, especially for the oil, gas, and petrochemical markets that we serve.

Also for the global oil and gas market, the SUPREMATouch Fire and Gas controller is the latest addition to MSA's Fixed Gas and Flame Detection product line. This new system builds on our earlier generation SUPREMA controller with major improvements that offer greater ease of use, more flexibility for the customer, and enhanced processing power.

I'm also pleased to announce the launch of MSA's complete family of V-Gard frames and visors. As you can tell from the product's name, this line of eye and face protection is designed to be integrated with MSA's iconic V-Gard family of hard hats. Not only does this family of frames and visors integrate beautifully with the V-Gard helmet, the line also includes several innovative features that solve previously unmet customer needs.

One example, which was designed in response to a customer voice need, is a feature called debris control. Debris control provides a tight seal between the face shield frame and the V-Gard helmet that prevents falling dirt, debris, and moisture from leaking into the inside of the face shield.

Our voice of customer work in the construction market has verified that this feature will make life a little easier and safer for the millions of workers worldwide who depend on our hard hats and face shields for protection. And because the helmet and face shields are tested as a complete system against recognized global performance standards, customers can be assured that the specified protection is there when they need it most.

Finally, I'm pleased to report on the launch of the MSA Workman 50 ft Self-Retracting Lanyard, or SRL as it's called in the industry. This product is one more example of MSA's expansion in our fall protection product line. This new platform product will replace heavier and more expensive products in MSA's line. SRLs are used extensively in the construction industry to improve a worker's safety at height. The new MSA Workman 50-foot SRL provides industry-leading durability while integrating radiofrequency ID technology that allows for simplified product tracking and maintenance record keeping. This new self-retracting lanyard from MSA provides the right combination of size, weight, and price point to make it a very attractive choice for customers in the construction segment.

Let me give you a sense of the impact that these new product introductions are having on our business. When you factor in these launches with our strategic pricing efforts and our lower manufacturing costs, sales, for example, in our combined gas detection product lines, that is Fixed Gas and Flame Detection and portable gas detection instruments, these sales are up 11% through nine months, and gross margins are up 240 basis points from a year ago. While our efforts in fall protection have increased margins 700 basis points from a year ago.



While it's true we continue to see increased competition in the markets we serve, our new product development efforts, our strategic pricing efforts, and our operational excellence initiatives to lower costs are helping us improve profitability and improve our position in the verticals that we serve. Needless to say, having a pipeline of fresh, new, innovative products is key to our future, and we remain committed to investing in product development and innovation.

Cash flow is another important area of focus for us. Cash flow from operations for the first nine months of 2012 was \$89 million compared to \$38 million for the same period in 2011. We've used this cash to continue to invest in the business, increase our dividend, and to pay down \$38 million of debt. Once again, Dennis will be providing more details on cash flow during his comments.

But before I turn the call over to Dennis, I would like to briefly review the results for each of our geographic reporting segments. I'll start with North America.

Sales in our North American segment were down 6%, due primarily to the lower level of ballistic helmet and ballistic vest business that I noted earlier. Excluding these in the year-over-year comparison, sales increased 1% on strength in the Fire Service market.

As I've discussed with you on previous calls, the North American Fire Service segment bottomed out in 2011 and has been on a slight rebound this year. We had a very solid third quarter in the North American Fire Service market as we shipped several large supplied-air respirators orders. Overall, North American Fire Service sales were up \$7 million or 22% year over year during the third quarter. Year-to-date, sales to the US Fire Service are up 5%. This is quite a bit stronger than some of the dire predictions some have been making regarding the state of the US Fire Service and it's a testament to the strength of the MSA brand and the strength of our distribution channels in this market segment.

We continue to make solid progress in gross profit margins in North America. Overall, gross profit margins improved 650 basis points in North America on a greatly improved mix, \$11 million fewer military sales, all coupled with improvements in pricing and lower manufacturing costs.

Now turning our attention to Europe, it's accurate that the ongoing economic uncertainty and government austerity measures continue to provide headwinds across many parts of our pan-European business. But I was pleased that for the quarter local currency sales were up 6% with local currency industrial market sales up 16%. I believe this is solid evidence of our continuing success in advancing industrial distribution activities across Europe. Year-to-date, local currency sales in Europe have increased 7% from 2011 on strength in the industrial market as we expand our channels of distribution and increase our presence across Europe.

As is commonly recognized, business and economic conditions remain challenging for much of Europe. In this highly uncertain environment, a key focus of ours continues to be lowering our overall cost of doing business in Western Europe, and the results we are seeing there are encouraging.

MSA Europe is a tale of two regions -- Western Europe, where we see great austerity, and Eastern Europe, Russia and down into the Middle East, where we see growth. While we continue to invest in the emerging markets that are included in our European segment, markets like Eastern Europe, Russia, and the Middle East, we are controlling our operating costs across Western Europe.

For the quarter, our local currency operating costs throughout Western Europe were down 11% from the same quarter of a year ago. Year-to-date, local currency sales in Western Europe are flat from a year ago, which I take as a win in such a difficult environment. That performance, combined with a 21% year-to-date growth in the emerging growth part of MSA Europe, has led to a solid turnaround in profitability. As you saw in our results, MSA Europe net income was up 10% in the third quarter, and it is up 77% year-to-date.

Lastly, I'm 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're putting forth in this segment are very much reflected in the positive results. Growing our business in international emerging markets, as I noted earlier, is and will continue to be a key element of our corporate strategy.

Local currency sales improved a dramatic 27% in Latin America with local currency core product group revenues increasing 35% during the quarter due to strong demand for industrial head protection products and in part to large orders like the SCBA Chilean National Council of Firefighters order.



During the quarter, we shipped \$2 million of SCBA on this order. And as you may recall, we shipped \$3 million in the second quarter to the Chilean Fire Service.

While the results and Latin America are encouraging for MSA International, economic and business conditions in Asia and Australia temper my overall optimism as we head into the final stretch of 2012. For the third quarter, local currency sales across the Asia-Pacific region increased 11%, but we're definitely seeing a slowdown. Local currency sales in China increased only 3% versus a year ago, and incoming order activity has continued to slow across Southeast Asia and Australia.

In light of the slowdowns, we've implemented restrictions on discretionary spending and have initiated other cost controls to help mitigate the impact on our business in these geographies where we're seeing a slowdown. We believe the slowdown will only be temporary, and we remain committed to the region and expect it to be a source of long-term profitable growth for MSA.

So what's in store for the rest of 2012 and even into 2013? The revenue, earnings, and cash flow improvements that we have reported over the past several quarters, I believe, demonstrate success in how our global team is effectively implementing our corporate strategy. We remain committed to staying this course, in spite of what I foresee as somewhat choppy waters for the balance of 2012 and likely into 2013.

We continue to closely monitor uncertain economic conditions, especially in Western Europe and throughout Asia, but agility is the key. And I assure you that we remain focused on those areas of our business where we are seeing stability and seeing growth opportunities. This agility will help us to accelerate growth, increase market share and ensure the Company's long-term success.

And while the economic uncertainty may be tempering some of my usual optimism going into the fourth quarter, it does not affect our determination. I believe MSA's business strength and position in the marketplace affords us many opportunities for continued profitable growth. I continue to believe our strategy is appropriate for us, and there is much evidence that it is working. It is most certainly providing us with sustainable competitive advantages that we will 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?

Dennis Zeitler - MSA - SVP & CFO

Thank you, Bill. Good morning and I would like to give you some further insight into our third-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, reported sales in the third quarter of 2012 were \$287 million, which is \$12 million less than the same quarter last year. However, if we adjust for the changes in currency values over the past 12 months and the two ballistic protection businesses that we have divested, our sales are actually up \$14 million or 5%.

North American sales were down 7% with all of that decrease related to the divested ballistic businesses.

European sales are down 6% in dollar terms, but up 6% in local currency. And international sales were up 2% in dollars, but up 12% in local currencies.

By markets, the global Fire Service was up 13% in dollars, but up 18% in local currency. Military was down 50% due to the divested ballistic businesses. And our industrial business, which was 70% of our total sales, was down 4% compared to last year. However, in local currency terms, our global industrial sales are actually up 2%.

Our North American segment sales in the third quarter were down 7% compared to 2011 comprised of a 22% increase in the Fire Service, a 76% decrease in military sales, and a 6% decrease in industrial sales, which was 68% of our total North American sales.



In our North American industrial business, Head Protection and Portable Gas Detection were each up 6%, but Fixed Gas and Flame Detection was down 6% due to the timing of some large orders. In North America our sales of ballistic helmets and ballistic body armor decreased \$11 million this quarter as we have exited both of those businesses. When we exclude those divested sales, local currency sales in North America were up 1%.

Our reported international segment sales were up 2% this quarter in US dollars, but were up 12% in local currencies. Fire Service was up 48% as we continued to deliver on our order for the Chilean Fire Service, and industrial sales, which were 80% of our international sales, were down 5% in US dollar terms but actually up 5% in local currencies. In local currencies, our sales of Latin America and Africa are up 22%, but our sales in Asia and Australia are down 1% from last year.

In Europe our reported sales were down 6% in US dollars, but up 6% in local currencies. European Fire Service sales decreased 15%. Military was down 26%. And industrial sales, comprising 61% of our total European sales, were up 4% in US dollars and up 16% in local currency terms. This quarter continues to reflect our shift toward the use of distributors in Europe and their ability to reach more of their industrial customers with our products.

In the face of very challenging business conditions in Western Europe, for the first nine months of this year, our industrial sales and local currencies are up 7%, and our net income in Europe is up 77% over last year. We are making real progress in our efforts to improve the financial performance of our business in Europe.

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 \$35 million was an increase of 19%, and our US military sales of \$3 million was a decrease of 76%. And then when we look at all of our other globally-diversified sales, which have risen to 87% of our total sales this quarter, these sales were down 3% in US dollars but up 4% in local currencies.

Our gross profit rate for this quarter was 43%, up 220 basis points from last year. Our global efforts to reduce manufacturing costs, the increased production volume in our factories, our emphasis on our five core product groups and 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 million compared to last year. There are several items that I would like to address so that you have a better understanding of certain expenses that fall under administrative costs.

First, we spent roughly \$2 million this quarter on due diligence for two separate projects that were one-time expenses. We also spent an additional \$1 million pursuing our legal actions against our insurance carriers. This is not a one-time expense as such, but will certainly go away someday.

And lastly, the income from our over-funded pension plan was \$2 million less this quarter than last year due to the unusually low discount rates that are used in that computation.

Those three items total \$5 million, which is 1.7% of sales for the quarter and the equivalent \$0.09 of earnings-per-share.

Our investment in new product developments this quarter was \$10 million. That is up \$400,000 from last year, and there were no restructuring charges this quarter. We did record a non-cash foreign currency loss due to intercompany transactions of \$600,000.

The resulting operating income, excluding those foreign currency losses, is \$31 million, a decrease of 6% over the third quarter of 2011. That is an operating margin of just under 11% of sales this quarter and 20 basis points less than last year. But when I try to understand if we are making real progress and expanding our operating income as a percent of sales, I do go back to that \$5 million of special administrative costs this quarter and realize that our operating income as a percent of sales actually increased 150 basis points over the comparable 2011 number.

Economic conditions in 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.



Our consolidated tax rate this quarter was 28%, down from 34% last year, due mostly to a one-time tax benefit we recognized this quarter and the increasing amount of profit we earned outside the United States. If the R&D tax credit is renewed later this year, that would reduce our effective tax rate for the full year by roughly another 1%.

The bottom line is quarterly net income of \$19 million, or \$0.52 per basic share compared to \$0.54 last year, a decrease of 4%. On a pro forma basis, excluding the restructuring charges that we had last year and the \$5 million of special administrative costs this year, our local currency net income this quarter is up 15% and up 37% for the first nine months of this year.

As for the cash flow statement, we had another good quarter as we generated \$24 million from operations and increased our cash position to \$74 million. Our cash is composed almost entirely of cash outside the United States. Our total debt at the end of the quarter was just over \$300 million, down \$38 million so far this year. We spent \$7 million on 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, and 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.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Edward Marshall, Sidoti & Company.

Edward Marshall - Sidoti & Company - Analyst

So I'd like to dive a little into the SG&A if I could. First, you mentioned the \$2 million and the \$1 million charge for the due diligence and the legal fees. Those I understand. I wanted to talk more about the pension and the discount rate, which I get. But is that new to this quarter? Is your pension year in line with your calendar year for reporting purposes, or should we have seen those calls in prior quarters? Can you help me out with that?

Dennis Zeitler - MSA - SVP & CFO

You're exactly right, Ed. It would have been each quarter this year compared to the prior year. It's just that it's more obvious this quarter when nothing else changed bit these three items.

Edward Marshall - Sidoti & Company - Analyst

Okay. You mentioned a tax benefit in the quarter. What was that tax benefit?

Dennis Zeitler - MSA - SVP & CFO

We had a parcel of land here in our Cranberry Woods Office Park that we donated to the local township and got a tax benefit.

Edward Marshall - *Sidoti & Company - Analyst*

What was the number?

Dennis Zeitler - *MSA - SVP & CFO*

Roughly \$1 million.

Edward Marshall - *Sidoti & Company - Analyst*

\$1 million. Okay. So if I could turn to the oil and gas business and maybe you can talk about this domestically and internationally. And I think, Bill, you mentioned that Fixed Gas and Flame Detection in North America was down about 6% due to timing. Can you maybe -- I think they are related. Can you talk about that as this relates to the domestic oil and gas business?

Bill Lambert - *MSA - CEO & President*

Sure, we did mention that. I think it was Dennis mentioned that in his commentary. But that's really just the timing of orders and shipments, some large orders that we have in the shipments that we see.

Overall in the oil and gas market in particular, and even petrochemical market, we're seeing very strong performance, very strong incoming orders for that part of our business and those products that sell into those markets. We have not seen really a weakening there, even though the global economic conditions tend to be weakening around it.

What we are starting to see are some of the new projects which are being discussed for late 2013 or into 2014. We're starting to hear that those might be tempered or might be pushed back a little bit, delayed somewhat. But nothing that's really -- nothing that we see or foresee as being imminent to affect our business.

We have been very successful on large projects in the Middle East and in Asia and even here in North America this year for our Fixed Gas and Flame Detection business. So it's one part of our business that we feel has been and we continue to feel very strongly about.

Edward Marshall - *Sidoti & Company - Analyst*

And then finally if I could, can you talk more about some of the sales catalogs that are potentially coming down the road, and I'm referring to maybe construction housing is on the mend, nonresidential construction is coming back a little bit. Talk about maybe some of those trends you are starting to see in that line and then, of course, the Fire Services, which I think you had some good prepared remarks about?

Bill Lambert - *MSA - CEO & President*

Right. Construction first. Over the last few years, we've really been revamping our fall protection product line and also doing a lot to augment our head protection line. So I mention adding face shields and other accessories that mount to our hard hat, all in anticipation that this construction market would, in fact, resurge. And it was good to hear some of the early reports that we are hearing, that construction is coming back.

So I think we are getting our product line in shape nicely for a resurgence in that vertical. And so what we've done with our hard hats, what we've done with the accessories that attach to hard hats, eye and face protection-type products that attach to the hard hat, as well as the complete fall protection line, I think positions us much more strongly for that particular segment.



In the Fire Service, we've talked about it in past calls a number of times, and I think throughout 2011 it was our sense that the US Fire Service market would reach its bottom in 2011. And I really believe that it has.

And so far this year we have seen a little bit of a rebound there. And I think, as we indicated, as Dennis indicated, our US Fire Service sales year-to-date are up something like 5% to 7% -- I'm trying to remember what Dennis indicated in his commentary, but year-to-date our sales are up in the US Fire Service --

Dennis Zeitler - MSA - SVP & CFO

22%.

Bill Lambert - MSA - CEO & President

Well, the third quarter was up really strong on shipments of some large orders.

So we see a new NFPA standard coming out that really takes effect late this year. We think that's going to begin to influence the market by the middle of 2013. And as we've commented to you in the past, we've got a new product portfolio that we'll be introducing in the second half of next year to address that NFPA -- that new NFPA standard.

Edward Marshall - Sidoti & Company - Analyst

Does it surprise you at all, I mean, it surprises me a little bit that the supply chain doesn't seem to have prepared for the NFPA standard that's coming out later this year and into next. I would have thought we would have seen a decline in shipments in preparation for that. But it doesn't appear that is showing up in your numbers.

Bill Lambert - MSA - CEO & President

Well, a part of that, as I indicated, I think is a credit to the strength of the MSA brand within the US Fire Service. It's a credit to our distribution channel partners and their strength in the marketplace and our product offering. I think we've got very solid product offering. We have gained market share. We know that from the statistics that get issued in the U.S. Fire Service market. So I think all of those things have worked to our favor. And you're right. We haven't seen maybe the putting off or delaying of purchase decisions in the Fire Service, but rather we're actually seeing some moderate strength.

Edward Marshall - Sidoti & Company - Analyst

Does it give you any cause that the standard may not necessarily be as big of a driver as you thought it was? What's the intel on the street basically saying to you?

Bill Lambert - MSA - CEO & President

Well, I'll look to Joe Bigler. Joe, you probably have a better sense of that than I do on --.



Joe Bigler - MSA - VP & President, North America

Yes, I think any time a NFPA standard comes out, it is a key driver. I think what you'll see, as Bill mentioned, this year a little bit of a surprise that we saw an uptick in demand, but it's been primarily a market share gain for us combined with a slight uptick in demand. I think what you'll see next year, as the new standard comes into play in December, manufacturers will have to stop selling old units as of August 1.

So I think the first half of the year will probably be -- people will try to understand the standard, but wait for the manufactures to have product, which is going through the approval process now by most manufacturers. So we would expect the first half of the year to be somewhat slow. And in the second half of the year, as people get familiar with the standard and manufacturers have products out there, that things will pick up in the second half of the year, and really 2014 and 2015 with people very familiar with the standard and some new product offerings, I would expect the Fire Service to be a pretty good growth market for manufacturers overall, particularly ourselves.

Edward Marshall - Sidoti & Company - Analyst

Thanks, Joe. Thanks, everyone.

Bill Lambert - MSA - CEO & President

You're welcome, Ed.

Operator

Richard Eastman, Robert W. Baird.

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

Just a quick question for Dennis. There was a reference to some product liability expenses in the quarter. I think it was North American net income commentary. Is that measurable and did that hit the SG&A line, or did that just flush into a reserve account?

Dennis Zeitler - MSA - SVP & CFO

The reference was to the legal costs of the litigation we have with our insurance carriers, and that was a \$3 million expense in the third quarter.

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

Okay.

Dennis Zeitler - MSA - SVP & CFO

And that expense will be significant for probably another couple of years, a year and a half years, two years we're probably going to be spending that kind of money.

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

Okay. But what flushed through the -- did that flush through the SG&A?



Dennis Zeitler - MSA - SVP & CFO

Yes and administrative costs.

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

It was \$3 million or \$1 million?

Dennis Zeitler - MSA - SVP & CFO

It is a \$1 million increase over what it was the third quarter of last year, but it's a \$3 million total.

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

Total number. Okay, I understand.

And then there was just a question -- when you look at Europe and you look at your industrial growth there, I think in LC you mentioned it was 16%. Do you have a sense of what maybe your same store sales are there versus the step-up that you get from increasing the distribution side of that?

Bill Lambert - MSA - CEO & President

Rick, I don't have a good sense of that. I would think that a lot of that growth in industrial business is coming from our expanded distribution channels are being able to cover more customers, more geographies, reach markets and reach customers that we have not been able to reach before.

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

Expanding the distribution, are you doing that into both western and eastern Europe, or is the sales model in Eastern Europe still more of a direct?

Bill Lambert - MSA - CEO & President

No, it is an indirect model as well. So in Europe, it is a mix, more so than it is here in the US as I think we've talked about in the past. In the US, our sales are 100% indirect, 100% through distributors.

In Europe it's a mix that is shifting more toward distribution. In fact, I would say that overall in Western Europe we are probably somewhere around 60% to 70% indirect through distribution, 30% would be direct to government agencies, primarily, and in Eastern Europe it's probably closer to 50-50.

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

Okay.

Bill Lambert - MSA - CEO & President

But also increasing. Industrial distribution or our management of channels in Eastern Europe and into Russia and into the Middle East is also increasing distribution. That is one of the initiatives that we have going on there, and we've had some success with.

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

And let me ask you, when I translate that down to Europe at the net income line, again some commentary that gross margin was down in Europe, and I presume that's a function of more distribution. And also, is there any pricing pressure there?

Bill Lambert - MSA - CEO & President

There is pricing pressure in Europe. That is unquestionable, especially in Western Europe. And you're right that some of that gross margin reduction in Europe or overall for Europe is also a result of that industrial distribution.

Now, what goes along with that is that we have been reducing expenses over there as well. So we've been working to reduce our selling and marketing expenses in Europe as we then increase our channels of distribution. So it's a trade-off, and it's a transition that needs to be worked through. But we've done it here in North America. We've done it in other parts of the world, and we're in the process of doing it in Europe.

So the bottom line, net income, as Dennis indicated, you see it in the net income line for MSA Europe where net income is up 77% versus nine months, a year ago.

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

I guess what I'm trying to see is some of your efforts in Europe being massed by the sales environment as it exists today. Because, again, I look at Europe net income, and I adjust for what would appear to be FX impact. And we're still looking at a net income that's around maybe 3% of sales. And are we in a position where, look, our cost efforts and our mix is being offset temporarily with sales and pricing that net income should rebound fairly quickly when the sales environment stabilizes? Because it's not that apparent in the net income number that you report in LC in Europe.

Bill Lambert - MSA - CEO & President

Right. Well, I think that the answer to your question, the short answer is yes. Right now, Western Europe is an area where we've got a lot of headwinds. The economy there has a lot of headwinds. But we're seeing good solid growth in that emerging growth part of Europe as we like to sometimes refer to it. And that's Eastern Europe, that's Russia, the Caspian sea region and down into the Middle East where we saw 22% growth. And so we combine all of that together.

If we return to a point where Western Europe actually begins to see some moderate signs of growth and not as significant and severe austerity programs that they are currently in, I think that's going to come to the bottom line. It's going to flow to the bottom line very, very nicely for that part of MSA.

And remember, our year-to-date net income is closer to 5% for MSA Europe. It was 3% in the third quarter, but it's closer to 5% year-to-date. And that's up from about 2.5% year-to-date a year ago.

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

Okay. And then just one last question. On international, from a sales perspective, is this -- the turmoil that we've seen really escalate in some of the South African mine marketplace, and we've seen that escalate August into September, is that disruptive in any way to my safety?

Bill Lambert - MSA - CEO & President

Yes, it is. Sure. When the mines go on strike, they don't -- in many cases, our workers who also unionize in that area will support those minors who are on strike. And so it disrupts our shipments to those mines. There's no need to ship product to those mines. And so it absolutely affects our business over there.

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

You wouldn't want to take a swipe at a revenue number, would you?

Bill Lambert - MSA - CEO & President

I will look to Dennis on that one.

Dennis Zeitler - MSA - SVP & CFO

Our South African business is about \$75 million, \$80 million a year of business. So you're talking something around \$20 million a quarter. So a couple of million books, \$2 million in the fourth quarter.

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

All right. That puts it into context. Thank you, again.

Bill Lambert - MSA - CEO & President

Okay, Rick.

Operator

(Operator Instructions). And at this time, I show no questions. I'll turn the call back to Mr. Deasy..

Mark Deasy - Ketchum Public Relations - Corporate Communications Director

Okay. Thank you, Kim. Well, given the fact that we do not have any more questions, that will conclude today's call. I want to thank everybody for joining us, and keep in mind, if you missed a portion of this morning's conference, an audio replay will be available on our website for the next 30 days, as well a written transcript.

So on behalf of Bill, Dennis, Joe, Ron, and Kerry, we thank you again, and we look forward to talking with you again soon and hope everybody has a great day. Goodbye.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.



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