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MSA - Q4 2012 Mine Safety Appliances Earnings Conference Call

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PRESENTATION

Operator

Welcome to the MSA fourth quarter earnings conference call. My name is Ellen 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 this conference is being recorded.

I will now turn the call over to Mark Deasy. Mr. Deasy, you may begin.

Mark Deasy *- Mine Safety Appliances - Director, Corporate Communications*

Thank you, Ellen. And good morning, everybody. And I too would like to welcome you to our fourth quarter and year-end earnings conference call for 2012. I'm Mark Deasy, Corporate Communications Director, and with me this morning are Bill Lambert, President and Chief Executive Officer, Dennis Zeitler, our Senior Vice President and Chief Financial Officer, Joe Bigler, our president of MSA North America, Ron Herring, President of MSA International who is responsible for our business in Europe, Russia, the Middle East, India and North Africa and Kerry Bove, President of MSA International responsible for Latin America, Asia, Australia and sub-Saharan Africa.

Our fourth quarter 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 quarter and year-end results, and then Dennis will review our financials in more detail, and after Dennis' comments we will open up the call for your questions.

Before we begin I want to remind everybody 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 October 24, 2012. You are strongly urged to review such filings for a more detailed discussion of such risk. Our SEC filings can be obtained at no charge at www.sec.gov, our own website, and many other commercial sites.

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

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

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

To begin, I want to say at the outset I am pleased to report today's quarterly and full year results, which I believe demonstrate solid performance by the MSA team. While economic and business conditions were uneven throughout much of 2012, I am encouraged by the fact that our corporate strategy continues to gain traction around the world, as indicated by many of our key metrics for success.

For example, we continue to see improving performance in our five core product groups throughout emerging and developed markets, and I will provide more texture on that in a moment. Additionally, the results we continue to see from our new product development efforts , our ongoing focus and close million meant of manufacturing and operating costs, and continued success from general monitors in our overall fixed gas and flame detection business are likely encouraging to see. The focus and performance of the team across these key areas of our corporate strategy helped MSA recognize solid growth in revenues, record cash flow, and record profitability in 2012 while building a strong foundation for 2013.

While we continue to experience persistent, uneven economic uncertainty in global markets here at the start of 2013, I am feeling a growing sense of optimism and momentum building in the outlook for many of our markets. The growth MSA has seen in core product sales, combined with improved margin levels, further support my optimism for the business. I want to assure you that we remain committed to executing our strategic plan. The strategy continues to provide shareholders and customers with value, and our fourth quarter and full year financial results reflect the results of this commitment.

As you saw in our press release, our consolidated sales for the quarter were $294 million. On an as-reported basis, sales were down $10 million from a year ago. However, when analyzing these sales results , it is important to consider the divestiture of the North American ballistics products business and the impact of weakening foreign currencies on the year-over-year comparison.

The fourth quarter of 2011 included $16 million of ballistic protection product sales in our North American segments. These noncore ballistic vest and ballistic helmet businesses were divested late in 2011, and during the first half of 2012 respectively. Additionally, weakening foreign currencies decreased as-reported fourth quarter 2012 sales by $4 million. Therefore excluding the currency effects and the divested business impacts, our sales were up $10 million, representing an increase of 4% for the quarter.

The increase in local currency revenue in the fourth quarter was driven by the focus our team continues to place on driving demand for core MSA product lines, which, as you well know by now, is a key element of our long-term strategy. These core product lines include fixed gas and flame detection systems, portable gas detection instruments, industrial head protection products, supplied air respirators, and fall protection products.

Sales from those five core product lines comprise 68% of our fourth quarter sales, and had local currency revenue growth of 10% when compared to the fourth quarter of 2011. Sales across these same core product groups and emerging markets grew by 27% in the quarter. For the full year, local currency sales of our core products increased 10% overall, and 21% in emerging markets.

Our core product business accounted for 65% of total 2012 MSA sales. That's up from 60% in 2011 and up from 55% in 2009. We continue to see solid growth opportunities for these core product lines, and for this reason we remain focused on advancing this initiative around the world.

I am especially proud of the progress we are making in managing manufacturing costs and improving gross profits as a part of our operational excellence initiatives. Our excellence over the past four years to optimize our manufacturing footprint and improve our supply chain processes globally continue to yield major results. Overall, our focus on core products as well as our operational excellence initiatives contributed to the 480 basis point improvement in gross profit margin that we saw in the fourth quarter. The emphasis we are placing on improving our sales mix via a heightened focus on higher margin, more profitable core products, coupled with our ongoing focus on strategic pricing and managing manufacturing costs is clearly improving gross profit.

While the percent of total sales in core products have improved from 55% of sales in 2009 to 65% of sales in 2012, I am pleased to report that over that same four-year period, our gross margin levels of core products have improved by 460 basis points. And for the year just completed, gross margin of core products improved 170 basis points. While we still have more to accomplish in this regard, I do view this as solid evidence of progress, and I am proud of the accomplishments our team continues to make in this area.

Shifting gears, and now looking at our expense management, our SG&A expenses were high in the quarter. While we did see higher selling and administrative expenses on the higher level of sales and profitability, higher legal expenses associated with our ongoing insurance receivable collection efforts and lower pension income, which Dennis and I noted on our third quarter call also had an impact . Therefore, our as-reported operating margin for the quarter was 11.7%, a 130 basis point improvement over the same period a year ago. Dennis will provide more detail on operating margins and our fourth quarter SG&A expenses in his comments.

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 $11 million, increasing 17% from the same period of a year ago. For the full year, R&D was up 4.2%. This investment allowed us to design, develop and launch several new core products throughout 2012, including an innovative escape respirator to protect oil and gas workers from the rigorous elements of the Caspian Sea, where temperatures of minus 30 degrees Celsius are comment. MSA shipped this breakthrough order, totaling $6.5 million, in the fourth quarter of 2012.

Before I move on, another great example of an MSA innovation that I want to mention is the industry's first green hard hat. I don't mean the color. We'll have a press release coming out later today about this product, but we believe it is the first safety product produced from nearly 100% renewable resources. The V-Gard Green is an extension of our market leading V-Gard line of hard hats. But it is special because the helmet shell is manufactured from high density polyethylene sourced entirely from sugar cane. Using sugar cane as the source, we are actually reducing the overall carbon footprint associated with the entire life cycle of this particular product. So now workers have the option of using a hard hat that not only helps to protect their head, but protects the environment as well.

I continue to be encouraged by the performance of the new product development team as we have innovative new core products that drive higher levels of sales and profitability.

Let me give you a sense of the impact new product introductions are having on our business. When you factor in these launches with our strategic pricing efforts and lower manufacturing costs in our combined gas detection product lines -- that's fixed gas and flame detection and portable gas detection instruments -- sales increased 11% for the year while gross margins improved by over 200 basis points from a year ago. In similar fashion our new product introduction efforts in fall protection have increased margins 400 basis points from a year ago in that product line.

While it is true competition and the markets we serve is fierce, our new product development efforts, our strategic pricing efforts, and our operational excellence initiatives to lower costs are helping us to grow sales, improve profitability and improve our position in the markets we serve. Twenty-five percent of our consolidated sales in 2012 were from products introduced in the last five years. And that's an improving trend we intend to continue.

As I have highlighted on previous calls, cash flow is another key area of focus for the management team. Our cash flow from operations in 2012 was $150 million, compared to $85 million in 2011. This was a record for MSA. We have used this cash to continue to invest in the business, to increase our dividend, and to pay down our debt. Including the special dividend paid in December, we paid shareholders a record $51 million in dividends during 2012. Once again, Dennis will be providing more details on cash flow in his commentary. But I think it is important to point out that this was a record year for MSA and our shareholders on many fronts.

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 MSA North America.

Sales in our north American segment were down 9%, primarily to the divestiture of the ballistic helmet and ballistic vest business that I noted earlier. Excluding these in the year-over-year comparison, sales increased 1% on improving strength in industrial markets. Industrial market sales represented 69% of our full year North American business up from 64% of the business in 2011. For the quarter, industrial sales increased 5% on the strength of portable gas detection and fixed gas and flame detection product sales. To get a bit more granular, our North American sales of fixed and portable gas detection products increased 9% for the quarter, while full year sales of these product lines increased 13% in North America.

As I have discussed with you on previous calls, the North American fire service segment bottomed out in 2011, but began to rebound slightly in 2012. Full year North American fire service sales increased a modest 1%. Fourth quarter sales declined 4% from the prior year, but we don't see that as a trend. We continue to believe North American fire service markets' worst days are behind us, and we are positioning ourselves for solid growth opportunities late this year and into 2014 and 2015.

We continue to make solid progress and expanding gross profit margins in North America. Overall, gross profit margins improved 670 basis points in North America on a greatly improved mix, with less military product sales, coupled with improvements in pricing and lower manufacturing costs.

Now turning our attention to Europe. It is accurate to say the ongoing economic uncertainty and the government austerity measures continue to provide headwinds across many parts of our pan-European business. But I was pleased for the quarter, MSA Europe local currency sales were up 11%, with local currency industrial market sales up 28%. This is far in excess of what we think is sustainable for Europe, but I see this as a solid evidence that our strategy to strengthen industrial distribution activities across Europe and to grow our business in the growth regions of east Europe, Russia, and the Caspian Sea and down to the Middle East is yielding solid results. For the year local currency sales for MSA Europe have increased 8%, as we further expand our channel of distribution and increase our presence across industrial markets in Europe.

MSA Europe remains a tale of two regions -- Western Europe, where we see austerity and slow growth and Eastern Europe, Russia, the Caspian Sea region and down into the Middle East where we see significant growth opportunities. The $6.5 million special SCBA escape respirator for an oil and gas consortium in Kazakhstan I mentioned earlier is a great example of us winning business in these emerging market growth regions. We saw improvement in revenues during the quarter in western Europe, where local currency sales increased 6% for the quarter and increased 2% for the full year. This is great performance by our teams in western Europe, in an economic zone where significant challenges remain. Recognizing the challenges, we understand we must continue to exercise cost discipline across much of the western European region as we look for those pockets of growth opportunity and improved profitability.

And that is exactly what we are doing there. Local currency operating costs for western Europe are down 9% for the year and down 13% in the quarter. At the same time, we are continuing to make investments in the emerging markets across Russia, Eastern Europe, and the Middle East where sales grew 28% in the quarter and were up 23% for the full year.

While the environment remains challenging across Europe, the progress we are making toward improving profitability across our entire European segment is encouraging. For instance, MSA Europe as-reported net income was up 74% in the fourth quarter and up 76% for the full year. The cost control we maintain across western Europe, coupled with the growth we are seeing in areas like Russia and the Caspian Sea region, are providing solid returns for our shareholders. This was the eighth consecutive quarter where we reported increasing net income in MSA Europe over the prior year result.

The last segment I would like to cover is our business across the international segment, which includes the geographies of Asia, sub-Saharan Africa, Australia and Latin America. Our ongoing focus of markets, and the efforts we are putting forth in this segment, have shown solid results throughout 2012. For the quarter, local currency sales improved 13% in Latin America, with local currency core product group revenues increasing 36% due to strong demand for industrial head protection products and in part to large orders, such as our SCBA contract with the Chilean National Council of Firefighters. During the quarter we shipped $2 million of SCBA on this order. As you may recall, we shipped $7 million earlier in the year to the Chilean fire service.

For the year, local currency sales across Latin America were up 18% with core product sales improving 28%. While the results in Latin America are very encouraging for MSA International, economic and business conditions in Asia and the ongoing disruptions in the mining markets across sub-Saharan Africa temper my overall optimism as we head into 2013. For the fourth quarter, local currency sales across the Asia Pacific region increased a modest 4%, with 3% growth seen in China, and 11% growth in southeast Asia.

Candidly, incoming order activity throughout the Asia Pacific region in the third and fourth quarters of 2012 was a bit slower than expected. Much of this had to do with slowdowns in China's industrial output and the ripple affect seen in the Australian and southeast Asian mining markets in response to China's slowdown. Although we have implemented some restrictions on discretionary spending and initiated other cost controls to help us navigate these conditions in Asia, we believe they are only temporary and we remain committed to this growth region. I expect it to be a source of long-term profitable growth for MSA.

So what is in store for 2013? The revenue, earnings and cash flow improvements we have reported over the past several quarters I believe demonstrate the traction that we are gaining when it comes to implementing our corporate strategy. We remain committed to staying this course, focused on our core profitable product lines and focused on emerging market growth opportunities, in spite of what I characterize as uncertain, but somewhat improving business conditions at the beginning of 2013. We continue to closely monitor economic conditions, especially in western Europe and throughout Asia, while ongoing disruptions in the mining markets across sub-Saharan Africa are raising some concern.

But I think agility is the key, and I assure you that we remain focused on those areas of our business where we are seeing stability and we have good growth opportunities. This agility will enable us to profitably grow, increase market share, and ensure the Company's long-term success.

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

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Thanks, Bill. Good morning.

I would like to give you some further insight into our fourth quarter performance and comment on the balance sheet and cash flow statements. Additional information will be available next week when we file our form 10-K with the Securities and Exchange Commission.

As Bill mentioned, sales in the fourth quarter of 2012 were $294 million , a decrease of 3% compared to the fourth quarter of 2011. However, in the fourth quarter of the prior year, we had $16 million of ballistic sales in North America, businesses that we have since sold. This had a 6% impact on our global sales in this quarter, and the stronger dollar had another 1% impact. The result is that our comparable sales grew 4% versus the reported 3% decrease.

Using the same basis for comparison purposes, North American and International segment sales were flat this quarter, and our European sales were up 11%. By markets, the fire service is down 4%, military is down 52% as we have exited most of this business, and our core industrial business, which was nearly 70% of our business was up 7%.

Our North American segment sales in the fourth quarter were down 9% compared to 2011, due to the 84% decrease in military sales mentioned earlier, a 4% decrease in the fire service, and a 5% increase in the 71% of our business presented by our broadly defined industrial sales. In our core product groups, portable gas detection was up 15%. Fixed gas and flame detection was up 6%. And both head protection and fall protection was up 5%.

Our international segment sales were down 3% compared to last year, and flat when you include the weakness in a number of foreign currencies. And in local currency terms, the fire service was up 19%, military was down 12% on a very small base, and industrial sales, which are 79% of our international sales, were down 4% in local currencies and down 7% in U.S. dollars.

Although we saw 13% growth in Latin America and 4% across Asia, our South Africa business was off 12% due to the recent labor disruptions there, and our Australian business was down 20% as a result of decreased demand from China for Australian coal and a large respirator sale in 2011 that did not repeat in 2012. In Europe our local currency sales were up 11% this quarter, and in US dollars, they were up 9%. Without the currency impact, our European fire service sales decreased 14%, military was up 26%, and industrial sales were up 28% over the same quarter in 2011. About half of this $11 million increase in industrial sales was an order for supplied-air respiratory products for the oil fields in Kazakhstan, and remainder we attribute to our increasing use of industrial distributors.

Our gross profit rate for this quarter was 44.3%, up 480 basis points from 39.5% last year. Our global efforts to reduce manufacturing costs, increase production volume in our factories, more effective pricing, and focus on our more profitable core products all contributed to this gross profit improvement. It is our expectation we will continue to improve our gross margin performance in 2013 by higher volumes, cost discipline, product mix, and value-based pricing.

Selling and administrative costs in the fourth quarter were up $6 million compared to last year, and up $3 million compared to the third quarter of 2012. Over half of this amount is related to less pension income and more insurance litigation costs as I mentioned last quarter, and the remainder is selling and commission expense on the increasing level of local currency sales for the year.

The $2.8 million of restructuring expense in this quarter was driven by staff reductions in North America and Europe as we re-aligned our resources to focus on our core product groups and to drive sales in the industrial and fire service markets. The resulting operating, income excluding those restructuring charges and currency expense, is $35 million, an increase of 10% over the fourth quarter of 2011. That is 12% of sales in the fourth quarter, and an average of 12% for the full year. That is 140 basis points higher than the full year of 2011, and our plan for 2013 is for our operating income as a percent of sales to again increase significantly.

Our consolidated tax rate this quarter was 36% due to a couple of tax adjustments in the quarter, one of which affected the full year and the other was a one-time adjustment in South Africa. For the full year the tax rate was 32%. In the first quarter of 2013, we will account for the $1 million R&D tax credit from 2012, and we will be accounting each quarter this year for the 2013 R&D tax credit. Therefore our effective tax rate for 2013 will be closer to 30%.

The bottom line is reported net income of $19.5 million, or $0.53 per basic share, compared to $0.46 last year. Pro forma income for the quarter was $21.8 million or $0.59 per share based on $35 million of operating income and average tax rate of 32%. For the full year we had record earnings of $91 million, $2.45 a share and 30% higher than the prior year.

As for the cash flow statement, we also had a record year. Our cash and short-term investments increased $28 million over the year, and now stand at $88 million composed almost entirely of cash outside the United States. Our total debt at the end of 2012 was $279 million, down $63 million during the year. Although local currency sales were up $38 million in 2012, we actually reduced working capital by $17 million with positive cash flow from payables, receivables, and inventory.

Our net spend for capital equipment purposes during 2012 was only $12 million due to significant asset dispositions, and we paid $51 million in dividends, including a special dividend in late December. In summary, our net cash flow for the year was $138 million, which was over 150% of our net income.

Those are my comments. At this point, Bill, Joe Bigler, Ron Herring, Kerry Bove, and I will be 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

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

Edward Marshall - *Sidoti - Analyst*

Good morning.

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

Hi, Good morning, Ed.

Edward Marshall - *Sidoti - Analyst*

It's good to hear an industrial company saying momentum is building and looking at kind of the cost structure of the business and to have the strength of the quarter you had, even with the higher SG&A and even R&D expense. That's my first line of questioning. I know you mentioned the $2.8 million in restructuring. I don't know you quantity the legal expense. Hopefully we can do that, quantify the increase in legal expense in the quarter, and then maybe touch on what is going on with the R&D.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

The legal expense was $1.5 million greater than the fourth quarter of last year. The pension income was $2 million less than the fourth quarter last year.

Edward Marshall - *Sidoti - Analyst*

What was the after share impact on the legal expense?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

It would be about $0.03.

Edward Marshall - *Sidoti - Analyst*

$0.03, okay. And the R&D, I know you touched a bit about what is going on there -- is this a new run rate, or is this something extraordinary going on in the fourth quarter here?

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

Ed, this is Bill. I don't see that as the new run rate. There were extraordinary expenses in the fourth quarter of last year . So it was quite a bit heavier than normal, but I know we have mentioned this in the past, but going forward, looking at a high 3%, up to 4.5% of sales as a run rate for R&D is about right.

Edward Marshall - *Sidoti - Analyst*

Okay. Also I forgot to mention, Dennis, or ask, the tax adjustment in the quarter, what was the per share impact, or what was the number, the absolute number?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

The absolute number is $1.4 million.

Edward Marshall - *Sidoti - Analyst*

$1.4 million.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

$1 million of it was an adjustment in the fourth quarter that should have been spread across the full year if we had caught it earlier. The $400,000 was a one time that will not repeat.

Edward Marshall - *Sidoti - Analyst*

I see. But the full impact to the fourth quarter was $1.4 million?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Right, $1.4 million in the quarter.

Edward Marshall - *Sidoti - Analyst*

So $400,000 in the quarter -- I see what you are saying.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Of the $1 million, only $250,000 of the $1 million should have hit in the quarter. It gets a little confusing.

Edward Marshall - *Sidoti - Analyst*

No, I understand. I wanted to touch base on the green hard hat, if I will. Sugar cane versus say an ethylene product, is there any cost-savings to you that would hit either in the pricing structure or anything we can comment on sourcing and then ultimately to customer pricing that would ultimately affect the margin in one way or the other?

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

Yes, I think -- I won't comment on the cost side of things. It does provide us some opportunities from a pricing perspective for those customers who are concerned about and have ongoing activities in sustainability where they are looking to be able to earn credits, carbon credits for their sustainability initiatives. So we do see that there is opportunity for us there.

But I wouldn't say that it would be so material that you would actually see it, Ed, in our financial results. We think it is an innovation. We are glad to be a part of it. We are already marketing and selling the product in Brazil, in Latin America, and we are expanding that to global markets around the world.

Edward Marshall - *Sidoti - Analyst*

It is fair to characterize this is an example of something you guys have been doing to improve not only your sourcing, but also improve the price of products, etcetera through pricing innovation?

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

That's right, yes.

Edward Marshall - *Sidoti - Analyst*

And then finally, you had some 2015 targets out there for operating margin. I think it was at 15% by 2015. They are obviously trending much faster than that. Can you update us on maybe your plans or your thoughts surrounding that 15%? It obviously seems much more achievable here.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

At this point, like I said, we did better than 12% in 2012. We are significantly improving in 2013 and I certainly think we are on -- we will be able to make our 15%, but we are not changing that target at this point.

Edward Marshall - *Sidoti - Analyst*

Would you be surprised if you hit that earlier?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Probably not.

Edward Marshall - *Sidoti - Analyst*

Dennis, you usually break down the sales, and I know the structures change, but North America fire service, and North American military which I know is so minimal now and everything else.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

I can give you that, Ed, but are you right. I took it out because we have so little military sales left. North American fire service in the quarter was $36 million.

Edward Marshall - *Sidoti - Analyst*

And North American military I'm assuming was $2 million or $3 million?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

You got it, $3 million.

Edward Marshall - *Sidoti - Analyst*

Okay, perfect. Thanks, guys.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

You're welcome.

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

Thanks, Ed.

Operator

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

Richard Eastman - *RW Baird - Analyst*

Good morning.

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

Good morning.

Richard Eastman - *RW Baird - Analyst*

Nice quarter.

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

Thanks.

Richard Eastman - *RW Baird - Analyst*

Could I just ask, Dennis -- on the gross margin I know you gave a couple explanations here, volume pricing, focus on the core products. When I look at the gross margin sequentially from Q3 to Q4, there is almost 100% conversion on the sales increase from Q3, Q4. Is that just a really generous mix or how do we get to the sequential conversion right there?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

You characterized it pretty well. The self-contained or the supplied-air respiratory business we had in the fourth quarter was a very good rate.

Richard Eastman - *RW Baird - Analyst*

So that is a mix issue. And then maybe, Bill, how do you -- when you look at the core products, and I think for the year, you commented it is about 65% of sales for the five core product groups, when you think about that 65% of sales, those products into 2013, I know you don't give guidance, but is the expectation for those core product groups to grow at a similar rate? Again, maybe a double-digit rate or 10% or -- because you are putting so much focus on that. Can you at least maybe characterize your growth expectation for those key core products?

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

Ed, it is -- I mean Rick, excuse me. It is the heart and soul of our strategy here is to focus in on these core products and grow those sales and also to focus in on the emerging markets. And so when you look at our percent of sales, percent of emerging market sales which are core product lines, that's growing at a much higher rate -- up north of 20% per year growth rates. So over time that 65% -- actually I think it was 69% in the quarter -- over time we expect core product sales to become a greater and greater percentage of our overall consolidated sales.

That's the game plan. And we are seeing that trend continue because where we are seeing growth in the emerging markets, more and more of that is in the core product line areas. You combine that with North America with less sales in the adjacent product lines or the periphery product lines or the divestiture of products, noncore products like the ballistic protection business, you see increasing trends in the North American fire service. You combine all of that together, and we see every expectation to see improving, increasing core product sales for MSA as we move forward.

Richard Eastman - *RW Baird - Analyst*

Okay. All right. If I think of maybe a secular growth rate for high end personal protection as being a 5% or 6% number these core products do grow faster and these ancillary products grow slower, that's how we get to the 5%, 6% number?

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

You are exactly right. Let me give you a little more color in the five core product groups, because one of them is self-contained breathing apparatus. And we have this standard in North America and the new products come out in August. We can't sell the old product before August. The new product comes out in the second quarter. The SCBA business in North America isn't going to grow as much as the other core product groups.

But you are absolutely right. The other four product groups will grow nicely. SCBA is sort of an unknown and then what we call adjacent product groups will grow much slower.

Richard Eastman - *RW Baird - Analyst*

And Bill you had made the mention, I think kind of post-third quarter that some of the fixed gas -- I think the comment was more on the fixed gas and flame side. You had seen globally some orders pushed for 2013 toward the back portion of 2013 versus the front half, despite the fact the fourth quarter would be good, and it appears to be. Is that commentary still accurate, because you also have a tough first half in gas detection as well. Does that business get off to a slower start in 2013?

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

Has it gotten off to a slower start? We are only into our sixth or seventh week here of the year. I would not characterize it as a slow start versus our expectations for the year. I would say it is slower than last year because last year came out of the gates so strongly. We don't have concern for the fixed gas and flame detection part of the business, but on a comparative basis it is relatively slower than last year. But last year it was so strong out of the gates. But I don't see any concern. We are not seeing orders that we had expected to flow in the first quarter of this year or being delayed a second, and a third, and a fourth time. We are not seeing that.

Richard Eastman - *RW Baird - Analyst*

And then just the last question for Dennis -- the pension gain you were able to apply to SG&A for the full year of calendar 2012, what was that number, and what does it look like for 2013?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

At this point, 2013 is practically 0. I think it is $1 million we budgeted for 2013 and for the full year we had -- one second here, get to the right line -- we had $5 million for the full year and going down to $1 million next year.

Richard Eastman - *RW Baird - Analyst*

Next year, okay. Great, thank you again. Very nice quarter.

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

Thanks, Rick.

Operator

The next question comes from Brian Rafn with Morgan Dempsey Capital Management. Please go ahead.

Brian Rafn - *Morgan Dempsey - Analyst*

Good morning, guys.

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

Good morning, Brian.

Brian Rafn - *Morgan Dempsey - Analyst*

Bill, talk a little bit about -- you've got your new fire service, new SCBA standard that you talked about August. How do you see those standards and product rolling out, and who are some of the early adopters ? I imagine some of the larger Class A urban fire departments, how do you see that product launching into 2013 and then into 2014?

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

With the new standard that has been issued by the NFPA -- we get asked this question quite often, which is how big of an impact do we think that is going to be? We don't expect to see a strong impact in 2013 due to that new standard.

I think this is going to be a year broken in two halves. The first half of the year will be fairly strong. You will see some fire departments that understand the standard is coming, and they just simply want to buy, perhaps even pre-buy the equipment that they are very familiar with right now. After August, manufacturers have to stop selling the old units. So for the first half of the year, maybe leaking into the third quarter we will see accelerated sales as fire departments buy up the older version. That's typically what we see.

Then from August through the balance of the year, there is probably going to be a lot of window shopping and tire kicking, if I can describe it as such, during that portion of the year . Fire departments are going to want to understand the standard differently, understand what is the difference of the breathing apparatus, understand how manufacturers are responding to that new standard with all new platform products like the kind of SCBA product we will be introducing in the back half of this year. We will have ample opportunity, then, to put that product into field trials and get them more accustomed to what the changes are, what the new platform is and the new developments.

So I don't see it having -- we don't see it having a major negative impact or a major positive impact for us this year, that being the new standard by NFPA. I think we will probably end up having, and what we are seeing is a fairly healthy first half of the year, into the third quarter, but late in the third quarter and into the fourth quarter, we will probably see a lot of window shopping and tire kicking.

Brian Rafn - *Morgan Dempsey - Analyst*

Okay. Your sense without exposing some of your strengths, 2013, the new standards, do you see new technology for the new fire apparatus to be revolutionary, or is it more of an incremental iteration upgrade?

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

Probably more on the incremental side, I would expect. That driven by the standard is definitely incremental because we are coming out with a new platform. I would like to say our incremental is probably more than I would expect out of competitive improvements in the product, more of a step change. I would not necessarily call it revolutionary at this point in time.

Brian Rafn - *Morgan Dempsey - Analyst*

Yes, okay. As you look at and talked about the first half of the year and some of the departments buying up, pre-buying some of the older legacy equipment, is there a discounting in that you are coming up to the August window, and departments may be looking for discounts? Or how does that pricing go as you kind of come up to the new standard?

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

If I were to look at historical practice here as a guide, I would expect no significant discounting as we come up to that date.

Brian Rafn - *Morgan Dempsey - Analyst*

And then if you look at the new platform equipment, do you get any price inflation capacity at all with the new 2013 equipment?

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

Yes, I believe we do.

Brian Rafn - *Morgan Dempsey - Analyst*

Talk a little bit about you mentioned a little bit, China, sub-Saharan Africa -- when you look at some of the safety equipment, specifically for mining and that, are you seeing in a broader industrial and the emerging markets when you talk about core products, are you seeing safety standards being driven by statutory regulation, or is it always following some episodic disaster?

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

I don't think it is limited to South Africa and China. What we typically see happening, what we saw happen in the US over many decades, is it tends to be more episodic. Something horrible happens, workers lose their lives and standards change. Regulations get beefed up quite a bit.

I think just in general it tends to be episodic. The advantage I think, though, that emerging markets have is they can look to western Europe and they can look to the US as having standards that are very well developed and are very severe and they can adopt those kind of standards. That's what we have seen China do. That's what we have seen happen in South Africa as well. So some of the developed markets of the world have the most rigorous standards, product performance standards, and regulations, and you see the emerging markets then adopt some of those.

Brian Rafn - *Morgan Dempsey - Analyst*

How would you characterize the regulatory -- from the standpoint of policing some of these standards in the developing world? Obviously the developed world, if you violate that, OSHA or whatever, there are some penalties. How do you see the actual follow-up policing in the developing world?

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

There is great opportunity for continued improvement.

Brian Rafn - *Morgan Dempsey - Analyst*

Fair enough. Fair enough. Anything from the standpoint of inflation, feed stocks, plastics, metals, kind of commodity inflation, what do you see going into 2013?

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

Dennis, any commentary there?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

We've got no indication of significant cost increases as we develop our costs for the year.

Brian Rafn - *Morgan Dempsey - Analyst*

Okay, okay. When you look at going into 2013, are there any products , and you are focused on your core mix, the 69%. How much pricing inflation might there be, Bill, if your expectations are such that you are being a little more optimistic? Or is sales rev still a function of unit volume growth?

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

Well, I think that when you look -- I am not sure if you are looking for a specific number from me -- but when you look at the 480-basis point improvement in fourth quarter margins, as Dennis indicated in his commentary earlier, a big portion of that is because of mix. We have a nicely improved product mix in that margin.

But also a nice contributor there is lower costs that we are seeing, improved operational effectiveness in the factories and all of the activities we have going on there that would affect cost. And the third element is the strategic pricing. It is a lesser percent. It is a lesser impact at this point in time. But because our strategic pricing efforts are focused really on some of the new products coming out the door, and how are we properly positioning those, this is something we will see begin to have a greater impact over time. I don't know if you want a particular number, or Dennis maybe you can put a finer point on it --

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Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

The good news is that it's not one thing that we are depending on to improve those gross profit rates. We are not adding any significant capacity to any factory. So all the incremental volume that goes through those factories have no fixed costs related to it. So our costs are under control.

As Bill mentioned, we do expect to have some pricing power gain. The product mix is definitely a factor. It could be a third each, if you wanted to pick something.

Brian Rafn - *Morgan Dempsey - Analyst*

That's fair. What are your plans, as you (inaudible) look across the footprint of the Company, what might be your head count hiring? If Bill's comments are optimistic and things play out and you start getting some growth, how are you on the hiring side, given the property plan equipment somewhat fixed?

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

That's a good question. I know when we went through the budgets for the year we saw numbers on total headcount. Actually at this point in time we have hiring freezes across most of our business.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Not in international.

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

In international areas we are growing.

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

The emerging market area, the growth areas, we continue to hire.

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

North America head count is basically neutral because we did restructuring in the fourth quarter that was mentioned, actually reduced head count. We will replace those skills and capabilities here in 2013, so the headcount in North America remains fairly neutral.

Brian Rafn - *Morgan Dempsey - Analyst*

On that North American head count -- given the President's comment last night about a $9 minimum wage, how material is that to your business, or is minimum wage really at $9 not really applicable?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Only the finance people are paid the minimum wage.

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

Most of our labor is more skilled and is above that $9 minimum wage, so I don't think that has -- we don't foresee that as being a major impact to us.

Brian Rafn - *Morgan Dempsey - Analyst*

And then just one more, you guys divested, and this is for my clarification, the domestic US Army or US military ballistic helmet. Did you retain the ballistic helmet manufacture internationally?

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

Yes, we did.

Brian Rafn - *Morgan Dempsey - Analyst*

That would be NATO, SWAT, that type of thing, police?

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

I'm sorry, say that again, Brian.

Brian Rafn - *Morgan Dempsey - Analyst*

Bill, would that be NATO or foreign police departments, who would be your end market?

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

It is foreign police and military organizations that are looking for that kind of helmet. For instance , in France in the Maghreb of north Africa, we produce those riot control helmets, police helmets, and some military helmets for those forces.

Brian Rafn - *Morgan Dempsey - Analyst*

Okay. Superb job, guys, thanks.

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

Thank you.

Operator

The next question comes from John Cooper with BB&T Capital Markets. Please go ahead.

John Cooper - *BBT Capital Markets - Analyst*

Thank you, good morning.

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

Hi, John.

John Cooper - *BBT Capital Markets - Analyst*

Just a quick little question here talking about the European distribution channel buildout. Just want to get a sense now where you guys are at in terms of the volumes getting through that channel. It has been a nice driver of softening the impact in Europe and being able to go through this channel. What is kind of the longevity that you guys think in terms of being able to mitigate any weakness that is going on over there?

And then I guess secondly, more importantly -- now that you have the volumes in, how are you guys starting to address the cost structure now, and what is that time frame look like and progress there?

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

Well, let me -- you asked a number of questions there. Let me try to address those if I can remember all of them.

The number of distribution channel partners and outlets that we added in Europe -- across Europe, and that would be for the entire organization -- was over 150 last year. Adding new distributors and culling out the subperformers is an ongoing process. I would expect us to see this continual refresh.

Now are we approaching a point where that slows down in western Europe? Absolutely. So it now becomes a matter of really managing those channel partners and assuring they are hitting the sales goals and growth goals we have in mind for them. But we do, on an ongoing basis, we will pull out, cull out the performers that aren't hitting our goals, or the channel partners not hitting our goals, and we will add new channel partners to that mix.

As we look though east from western Europe, as we look into Eastern Europe, as we look into Russia, the Caspian Sea region and down into the Middle East, there is still plenty of opportunity to add distribution channel partners which also impacts our overall MSA Europe business. We are very much in the early stages there of what we can actually do and how we can add to our distribution channel mix.

So I would say there still continues to be opportunity. It is a high growth region. We've got more work to do in that regard. What was the back half of his question?

Dennis Zeitler - *Mine Safety Appliances - SVP, CFO*

Cost reduction.

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

Oh, the cost reductions in Europe.

Well, we have seen, as you know, John, we have had as a focus of ours the efforts to reduce cost, to restructure in western Europe, our operations primarily in western Europe. We have done a lot of that already, and we have taken those as charges in the past.

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What I see happening for us going forward there is this next phase of our European transformation, what we have called in previous calls, what we referred to on previous calls as Europe 2.0 . That is very much technology and process focused. It is that next critical phase for us in the European transformation effort.

What we are doing in that initiative is trying to achieve what we call these five pillars of transformation. One, grow the business. Two, focus on the customer. Three, reduce costs through some improved efficiency and reduced organizational complexity. And lastly, to improve our levels of employee engagement across western Europe.

That's an initiative, so it has primarily an IT initiative to it. It is a multimillion-dollar investment that we have made. Half of that will cover investment in SAP, fully aligning best practices across our pan-European operation. The rest of that million-dollar investment, multimillion-dollar investment is people expense. I think we have indicated on previous calls that that was around $10 million. Half on the IT cost, half in people restructuring costs as we simplify the organization.

So that's all under Europe 2.0. We are well into it. We are showing some good progress with it, all the while managing the business, growing our sales over there, and improving profitability. Does that answer your question, John?

John Cooper - *BBT Capital Markets - Analyst*

Yes, no, That's great. Appreciate the color. Thank you.

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

You are welcome, John.

Operator

We have no further questions at this time. I will turn the call back over to Mark Deasy foreclosing remarks.

Mark Deasy - *Mine Safety Appliances - Director, Corporate Communications*

Okay, thank you, Ellen. Given that we have nobody in the queue, that will conclude today's call. I want to thank everybody again for joining us and for your interest. And as a reminder, if you missed a portion of this morning's conference, an audio replay will be available on our website for the next 30 days. You can find that on the homepage of our website. On behalf of Bill, Dennis, Joe, Ron and Kerry, we look forward to talking with you again soon, and hope everybody has a great day.

Operator

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