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MSA - Q4 2018 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the 2018 4Q earnings webcast. (Operator Instructions). And it is now my pleasure to introduce today's host, Elyse Lorenzato, Director of Investor Relations. Please begin.

Elyse Lorenzato - *MSA Safety Incorporated - Director of IR*

Thank you, Kelly. Good morning, everyone, and welcome to MSA's Fourth Quarter and Year-end Earnings Call for 2018. With me here today are Nish Vartanian, President and CEO; and Ken Krause, Senior Vice President, CFO and Treasurer.

Our fourth quarter press release was issued last night and is available on the MSA website at www.msasafety.com.

Before we begin, I'd like to remind everyone that the matters discussed on this call, excluding historical information are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to all projections and anticipated levels of future performance. Forward-looking statements 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 in our filings with the Securities and Exchange Commission, including our most recent Form 10-K filed in February 2018.

MSA undertakes no duty to publicly update any forward-looking statements made on this call, except as required by law.

We've included certain non-GAAP financial measures as part of our discussion this morning. Reconciliations to the most directly comparable GAAP measures are available on our Investor Relations website at investors.msasafety.com.

With that, I'll turn the call over to our President and CEO, Nish Vartanian.

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Thank you, Elyse, and good morning, everyone. The MSA team delivered a strong fourth quarter, and as a result capped the most successful year in our company's history. Not only was fourth quarter revenue a record for us, we realized growth of 7% in constant currency and that's coming of a very strong comparison from 2017.

Adjusted earnings of $1.27 per share was down from $1.31 a year ago. And as you may recall, we had a record-breaking fourth quarter in 2017 in terms of revenue and earnings.

While we were able to generate mid-single digit growth in revenue, our earnings line reflects higher variable compensation that is directly tied to the stronger revenue and cash flow performance in the fourth quarter. Ken will cover that in more detail.

However, we view $1.27 of adjusted earnings per share as a very strong result for the quarter. And I'm proud that the team was able to generate 24% adjusted earnings growth and 13% revenue growth for the full year.

In 2018, our growth was nicely balanced between our fire service and industrial products. In fact, all core product groups posted mid-single to double-digit growth as a combination of new products, and market-focused programs continue to fuel our growth and leadership positions across our portfolio.

With the 3-year adjusted earnings CAGR of more than 20%, there has been a step change in our profitability profile. We've improved SG&A from 28% of revenue in 2015 to 24% of revenue in 2018. We acquired and integrated Latchways and Globe, and we've seen a strong industrial rebound driving organic revenue growth, all of which contributed to double-digit earnings growth that we've now seen for 3 consecutive years.

While Ken will provide more insight into the drivers of our quarterly and full-year results, I want to briefly highlight some of the other key successes in 2018.

Notably, our new product development engine and our progress in improving profitability in our International business segment. Let's first look at our R&D commitment, where we invested $53 million in 2018. I'm very pleased with the momentum of our new product development pipeline, for example, in 2018, we launched Safety io, our first subsidiary focused on wireless technology and cloud-based computing to enable a broad range of connected safety services, like live monitoring and fleet management.

On the PPE side, if you recall, at Investors Day last year, we discussed the robust NPD pipeline that we have planned for fall protection in 2018, which included launching 15 new products. I'm pleased to say, we did complete all those launches by year-end. We introduced a series of innovations under the V-Series product line, including a premium racing-style type harness that delivers exceptional comfort. And our first-to-market, leading edge, Personal Fall Limiter. The NPD pipeline and investments in sales and marketing resources in fall protection, collectively supported 15% growth for the quarter and 10% growth for the year.

We have several new exciting launches planned in the coming weeks that continue to build out the V-Series fall protection line.

In fire service, we recently launched our M1 SCBA for the international market. In fact, in the fourth quarter, we delivered our first M1 order to a customer in Europe. And we have received additional orders from customers in Spain and Taiwan. The common thread among all these launches is leveraging technology and innovation to provide solutions that make our customer's workplaces safer and more productive. And we continue to do this quite well in 2018. 38% of our overall revenue is from products developed and launched in the past 5 years.

In addition to fueling the NPD pipeline, we're keeping a sharp focus on improving the profitability of our International segment. While we did see a decline in the quarter in international operating margin, due primarily to higher variable compensation cost and a very difficult prior year comparison. We made good strides in 2018 and are on track with our medium- and long-term financial goals in this region.

To give you a better sense of this, MSA International generated a full year operating margin of nearly 12%, representing a 90 basis point improvement over 2017.

One of the tailwinds behind this improvement was the 10% revenue growth for the full year, driven by our channels optimization program. Overall, our total number of channel partners decreased by 16% in 2018, leading to meaningful improvements in average revenue per channel partner. But more importantly, our progress on the channels front supports our ability to serve our customers with a more efficient go-to-market strategy.

To wrap up, the team executed very well in the fourth quarter and for all of 2018. While we typically see a backlog decline from the third quarter to the fourth quarter that was not the case this year. To the contrary, we saw consistent backlog levels compared to the third quarter to finish the year, which remain elevated when compared to both historical levels and 1 year ago. In a quarter where we invoiced more than $360 million, finishing with a higher level of backlog gives you some insight into the solid momentum we continue to see in our order book.

With that, I'll turn the call over to Ken for our financial review. Ken?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Thanks, Nish, and good morning, everyone. Before I begin the P&L review and discuss the quarter in more detail, I'd like to step back and provide a few key financial highlights. First, revenue growth was 13% for the full year or 8% in organic constant currency terms, when you exclude the impact of our acquisition a year or so ago. With record fourth quarter sales performance of $362 million supported by growth in all core products, we exceeded the high end of the mid-single digit expectation range we communicated at Investor Day 2018. Great to see this level of growth in our business and the continued elevated level of backlog that we are carrying into 2019.

Profitability at both the gross and operating line remains strong. Annual earnings growth was over 20% again in 2018, and adjusted operating margins improved 120 basis points versus 2017, as we continue our focus on improving productivity.

Free cash flow finished very strongly with quarterly free cash flow of over $60 million, more than doubling from the same quarter a year ago despite the strong revenue growth. The improvement is reflective of our ongoing focus on managing working capital.

For the year, we reduced working capital as a percentage of sales by 220 basis points, despite generating 13% revenue growth. As a result, 2018 marks our third consecutive year of exceeding our goal of 100% free cash flow conversion.

As you compare our full-year results to the long-term financial expectations we communicated at our last Investor Day, you can see that our 2018 results tracked ahead of many of the measures we discussed with you, like revenue growth and cash flow generation.

Now I'd like to walk you through our fourth quarter financial results.

Total revenue increased 7% in the quarter in constant currency, with growth in nearly all core products. We had a 2% FX headwind on revenue in the quarter. We had a 4% headwind in the International segment as a number of currencies most notably the Euro weakened versus the same quarter a year ago, and a 1% headwind in the Americas segment, due primarily, to weaker currencies in Latin America. We continue to see solid results in head protection, portable gas detection and fall protection in the quarter.

We've often talked about hard hats being a barometer for global economic conditions. With that in mind, it's encouraging to see revenue growth in this area in all of our operating regions to finish the year, and order activity has been healthy across these areas to start the new year.

We had a difficult comparison in FGFD in the quarter, and timing of large orders and international weighed on performance, which was down 1% globally in the quarter, but off 12% in the International segment. Our fixed gas and flame detection backlog is healthy. And recent order pace has been strong. Quarter-to-date orders were up to over 10% globally to start the new year, which provides some optimism heading into 2019.

In the fire service area of our business, we had double-digit growth in SCBA in this quarter, and we continue to see ongoing benefits from the U.S. replacement cycle and good performance in our International segment.

Gross profit came in at just under 45%, and was up 40 basis points in the quarter. It's good to see our leading market position supporting the improvement in margins, despite the inflationary pressures in raw materials.

To continue offsetting rising input costs, we implemented a price increase in both the Americas and international segments in January, and we've tightened our special price request process globally.

SG&A expense was $85 million in the quarter or 23.4% of sales compared to $76 million or 22% of sales a year ago. The SG&A increase in the quarter was primarily driven by higher levels of variable incentive compensation, up about $6 million in the quarter associated with stronger financial performance in the quarter, notably, organic revenue growth and improvements in working capital.

Organic revenues were up 7% over the record fourth quarter a year ago, and working capital was down over 200 basis points from a year ago, driven by strong improvements in the fourth quarter.

As I've said before, we continue to evaluate cost reduction and productivity improvement programs for our business in light of the inflationary environment that we expect to continue into 2019.

Along those lines, we expect to make progress on our International segment footprint rationalization project in the first quarter of 2019. While these actions may drive noncash restructuring charges associated with the write-off of cumulative currency translation, we expect these actions to drive a more efficient business model, and the steps are similar to those we took to reduce our footprint and improve our efficiency in other areas of the International segment, most recently in Japan.

GAAP operating income was $42 million or 11.7% of sales in the quarter, which includes the $20 million of other operating expense related to increasing our cumulative trauma product liability reserve. The increase is mostly related to incurred but not reported or IBNR claims.

As we've indicated in our filings for some time, we perform a robust review of our IBNR reserve on an ongoing basis. The IBNR is realized on the set of facts and circumstances that we review with our actuaries and external counsel.

As part of that review, we reflected changes in underlying assumptions in our model and recognize a charge of approximately $20 million in the fourth quarter. Including the increase to the reserve, our total product lability reserve is $187 million at year-end, which is just about equal to our insurance-related assets of $186 million. Those assets consist of receivables, notes and short-term investments.

While the timing of cash flows for product liability and insurance receivable can and do vary from quarter-to-quarter, we've been very successful in establishing cash flow streams that have allowed us to fund these liabilities without a material impact on our capital allocation priorities.

Excluding foreign currency, restructuring, strategic transaction cost and the product liability expense I just mentioned, adjusted operating margin was 18%, down 40 basis points from a year ago on the higher variable compensation I mentioned a moment ago, and a less favorable product mix, primarily in the International segment.

And looking closer at the segments, adjusted operating margins showed nice improvement in the Americas in the quarter, up 90 basis points. The improvement reflects our ability to leverage pricing programs across the segment. If you recall, we moved earlier in the year in 2018 on a mid-year price increase in the Americas, and this has had a positive impact in the segment.

Much of the margin pressure in the quarter in International came out of our Middle East region, on the less favorable product mix associated with the lower level of fixed gas and flame detection revenues in the region. We continue to see really good traction in Europe, as we leverage 9% growth in the very healthy double-digit earnings growth. Our GAAP effective tax rate was about 35% for the quarter, which includes discrete charges related to the adjustments associated with tax reform and exit taxes.

On an adjusted normalized basis, our quarterly effective tax rate was just under 20%, and our full-year effective tax rate was 21.8%, down nearly 500 basis points in 2018, due primarily, to tax reform in the U.S.

In addition to driving the lower effective rate, U.S. Tax Reform has also provided us with the ability to repatriate foreign cash. For the year, we repatriated $96 million of cash from our foreign subsidiaries, achieving our goal of repatriating $75 million to $100 million in 2018.

GAAP net income was $25 million in the quarter. Quarterly adjusted earnings were $50 million or $1.27 per share. The higher revenue, gross profit and effective tax rate improvements were offset by the increase in SG&A in the quarter. But as Nish mentioned, we did expect a difficult comparison this quarter.

For the full year adjusted earnings were $175 million or $4.50 per share, increasing 24% on the 13% increase in revenue. Double-digit adjusted earnings growth for the third consecutive years is a reflection of the team's focus on growth while also managing the cost structure.

Free cash flow was $62 million in the quarter compared to $29 million a year ago. The current quarter includes $11 million of net outflows from product lability compared to a prior year that reflected net outflows of $26 million.

Underlying cash flow generation was strong with working capital finishing the year at 23.8% of revenue, improving 220 basis points from the end of the third quarter, despite the strong demand we saw throughout our portfolio in the fourth quarter.

I'm very pleased to see cash conversion exceed 100% in a year where we had double-digit revenue growth. The team did an outstanding job managing working capital this year, and we've made great strides from a few years ago when we used to regularly trend at a rate of 70% to 80% for cash flow conversion.

The strong operating cash flow enabled us to pay down $108 million of debt in 2018, and fund $57 million in dividends to our shareholders, while continuing to invest in our business. And we remain well positioned to execute on our strategic growth programs that create value.

Debt-to-EBITDA is 1.3x at the end of the year compared to 2x at year-end 2017. We were able to reduce our debt while bringing on $40 million of EBITDA in 2018. About 1/3 of that profitability growth was from the Globe acquisition, while the remainder reflects growth and leverage in our organic business. We finished the year with total bank debt of approximately $360 million with an average interest rate of 3.5%.

We remain very well positioned to continue to execute our strategy and to invest in our business. I'm pleased with the 7% revenue growth we saw in the quarter, the gross profit improvements and strong free cash flow. Order activity and backlog remain very healthy throughout the fourth quarter and to start 2019, and that positions us well for the new year.

With that, I'll turn the call back over to Nish for some concluding commentary. Nish?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Thanks, Ken. Once again I'm pleased with the strong performance in the quarter. We had 7% revenue growth, gross profit expansion of 40 basis points and earnings held up well on a difficult comparison from last year. We also generated more than 100% free cash flow conversion for the quarter and for the year, despite the strong top line performance. This was simply great work by the team, and I believe MSA remains well positioned to continue driving growth and margin expansion in 2019.

Thank you for your attention this morning. At this time, Steve Blanco, President of MSA Americas; and Bob Leenen, President of MSA International have joined Ken and I in the room, and will be glad to take any questions you may have.

Please remember that MSA does not give guidance. Having said that, we will now open up the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) All right. And our first question we have is from Stanley Elliott from Stifel.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

Guys could you all talk about the improvements that you made on the working capital side, especially with what I would have thought would've been higher in kind of freight transportation cost, material cost et cetera? And then secondly along those lines, is it fair to assume that we'll see free cash flow conversion ahead of 100% again in 2019?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Hi, Stanley, it's Ken. I'll take that question. As I had indicated in the prepared commentary, the team did a tremendous job at driving improvements in working capital in the fourth quarter. And what was really great to see was not only the inventory improvements that we saw, we saw really nice performance in inventory, despite seeing some of those things you just referred to. But the other thing we saw was a really strong improvement in receivables. Despite seeing the uptick in revenue, the focus on receivables, both our current receivables as well as some of our older receivables, really paid off in the U.S. in the Americas. But also over in our International segment, we saw really good performance under Bob Leenen's leadership there. As we move forward, we still remain committed to driving free cash flow improvements and continuing to hold that conversion at or above 100%. Often times, it's a challenge when you are in a growth cycle like we've seen in the last year. But it's been really good to see, despite seeing all that growth come on us being able to leverage improvements in working capital. So our focus remains the same, Stanley. We remain committed to driving 100% free cash flow conversion as we move forward.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

Perfect. And then you guys mentioned pricing actions both internationally and domestically in January. Is it fair to assume that, that's enough to kind of cover the cost of maintain a pause just sort of the price cost balance going forward? And then maybe what are you seeing on the inflation side on the material side? And then I guess, lastly the ability to look at additional pricing actions down the road if need be?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Hey, Stanley, this is Nish. Yes, so we do have the price increase going into effect, that went into effect January this year. And we believe, we can continue to offset anything we're seeing from a material cost standpoint. The team has done a fantastic job from a pricing standpoint and in finding opportunities for price increases. And then as important also on special pricing requests, we've really tightened up some of the requirements, and are doing a nice job with reports and monitoring our special pricing discounts and getting more sophisticated in how we manage that side of the business. So as we mentioned in 2018, we thought we can offset any inflation we saw in the material cost, which we did a nice job of. And we believe, we can do the same here in '19, in fact if we see additional inflation during the year '19, we certainly would have some sort of price adjustment mid-year just as we did in North America, we had that mid-year price increase to offset things. So we're very focused on that. And we're pretty confident we're able to execute that.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

Perfect. And the last for me. Can you guys talk about what you seen in the M&A environment? You've done a nice job of Globe acquisition, the General Monitors, Latchways. It's an interesting component to the story. What are you seeing out in the marketplace? Is it still something that you have an appetite for, just any color there would be great?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Sure do. Yes, we are very active and we have a really good pipeline in place, Stanley. Realistically, valuations are fairly high. And as you know, we've got a good track record of buying value with General Monitors, Latchways and Globe all were accretive in the first year. We'd like to have a high degree of certainty about generating the right level of returns for our shareholders, but I'd certainly like to get one. It was somewhat disappointing, we didn't get an acquisition in 2018 and we're very focused on that for '19. But no, we're not going to chase price, Stanley. We want to make the right move, and make the right type of acquisition, so we can drive that shareholder value.

Operator

All right. And our next question we have is from Richard Eastman from Baird.

Richard Charles Eastman - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Could we just kind of spend just a second or 2 on the European operating margin at kind of performance in the fourth quarter? And I want to just kind of trend line that into a full year discussion. But just from a standpoint of the quarter, was currency -- did currency have much of an impact on the Op margin in Europe? And maybe you could just kind of parse out what the expectation for -- of just -- just for International incremental might be for '19?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

So why don't I take first and then Ken and Bob, if you guys want to chime in with some color. Rick, the headwind for International really wasn't Europe in the fourth quarter, it was the Middle East, where a year ago, fourth quarter fixed gas flame detection shipments were extremely high. This year that business was soft due to 2 factors. Number one, it's natural cycle of the business, the projects were down this year versus last year and that's a natural cycle that we'll see in that space. And then secondly, one of our largest customers put a pause on purchases as they transition to the S5000 transmitter, which is great news. It's great news to see one of our biggest customers in the world transition to that new product. The good news is, as part of that elevated backlog that we have going into the first quarter, we have today, significant orders for S5000s for that customer and into the Middle East, and the project pipeline continues to build. So we're fairly optimistic that, that weakness we saw in the Middle East, will rebound here in '19, and specifically, with the fixed gas and flame detection business. Bob, you want to add some color?

Bob Willem Leenen - *MSA Safety Incorporated - VP & President of MSA International*

Yes, thanks, Nish. Yes, that's correct. We actually see a lot of activity in the market, very good pipeline of opportunities. And in Q4, actually, in the Middle East, our backlog activity versus the year before increased 60%. So it's very encouraging to see that. We had a bit of a slow period in 2018, but we structurally believe in the potential for the Middle East market. And back to the European question, I'll leave the FX one to you Ken.

Europe showed in 2018, and also in Q4, very solid, substantial profitability improvement. It was a really good first step. We also know this since it's a longer-term journey we're on with Europe, and we're looking at all pieces. We've grown the revenue significantly, which is of course, wind in our sales on the profitability as well. There is significant effort behind price increases. Part of what we did in Q4 is deploy a large amount of product group training to our commercial organization to help us with delivering the price increase in 2019. And just the productivity culture that Ken referred to is something, which is also front and center in Europe. We have some bigger ticket items we're looking at, we're analyzing, which are a little bit more longer term on the footprint of shared services, manufacturing, et cetera. But also short-term opportunities for productivity that we're actioning, and we continue to identify more. And finally, our channels optimization is the foundation behind all of this. The example of an affiliate we're closing is a good example of what we're able to do with the channels optimization, where in a range of countries, we believe, we can grow faster and be more profitable with less internal footprint and more use of channel partners. So I think we're in the right track in here.

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

So Rick, you'd have I believe the question on currency and the incremental margin profile, is that correct on the European business?

Richard Charles Eastman - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Yes, just I ramble there a little bit. But my question really was around currencies impact on the fourth quarter? And then just maybe just broaden it on, just the incremental margin you might expect in '19 from International and from the Americas?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Yes, so looking at currency, first, Rick. When we look at currency, as I said in the some of the prepared comments, the Euro was certainly a headwind there. I think it was about 5% headwind on revenue in the quarter. And it's a consistent headwind on the earnings coming out of that segment, maybe slightly smaller coming out of the European segments in terms of the earnings being translated back to the U.S. dollar. Overall, the incrementals are relatively healthy though. It's hard to see the incrementals when you just look at the year-over-year comp, because it was a challenging comp. But oftentimes what I'll do is, I'll look at the sequential quarter incremental margin profile. And what was really nice to see was the sequential quarter in the International segment, the incremental margins coming in at 24%. And so that was really good to see. Year-over-year is a tough comp, as you know last year in the fourth quarter, we did almost 15% in the International segment. But we continued to see each and every quarter improvement this year. And so as we head into 2019, we still think we're positioned well to drive across the business 30% incremental margin profile on our business. And so it's going to come from different sources. But generally, the targets that we provided a year or so ago at in the Investor Day, I think are very much intact.

Richard Charles Eastman - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And just one last question, on the head protection business, just very strong all year. And I'm curious, is that -- do you view that as kind of a cyclical, maybe leading indicator in your business? Or were there some distribution gains? Was pricing a factor there? I just -- really tremendous performance out of head production throughout the year let alone the fourth quarter. I'm just curious, how that business is kind of set up as well heading into '19?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Yes, you know it was really strong, Rick, from a diversified basis. All regions did really well in head protection. We saw near double-digit growth with every single region, which is really healthy. We had very strong share in the Americas, and then geographically as you go around the world, some areas, we have better market share than others. So we think we have some market share gains that we've had and in some International segments. So the business has held up quite well. And that is somewhat a leading indicator we look at with the industrial business. Remember, we kind of look at our business in 3 different segments, you have the industrial, quick-turn products being a head production, fall protection, portable gas detection, and even air purifying respirators are near in that adjacent area. And then the fire service, typically doesn't follow that track. We expect that this replacement cycle for breathing apparatus will continue on for several more years. And even if there's a little economic downturn that business should holdup pretty well. And FGFD tends to be that late cycle business that comes in a little later and holds up well. If you go back to the 2015 industrial recession, that's where you see hard hats dropped, they contracted some, portable gas detection contracted, but the self-contained breathing apparatus business for fire service that progressed quite nicely. So if we have a short downturn here, we might see a similar type profile, as you go forward. But we haven't seen that downturn yet, so we're optimistic about the business.

Operator

(Operator Instructions) All right. And we do have another question. This question is from Larry De Maria from William Blair.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

First clarification. You just discussed tax rate expectations for '19, and also the magnitude of the price increase, maybe on average portfolio?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Sure. I'll take the tax question, first, Larry. I think we're positioned well to continue to see a very favorable tax rate here at MSA. I think that 23% to 24%-ish kind of range is probably the range we'd like to be in. As we go through the first quarter, there's a number of things we're analyzing, and we'll provide a more specific guidance around that for the year as we get into the first quarter. But something in that range is probably not out of the realm of reason at this point. From a pricing perspective, I'll talk a little bit about that, but also I'll turn it over to Nish. I think the pricing has been very strong. And so as we look at our business, we've been, as Nish has indicated earlier in the call, we were very active at introducing an off-cycle price increase in the Americas. We've continued to follow that on here earlier this year. And so we're certainly positioned very strong for pricing as we head into 2019, to more than offset some of the direct cost inflation that we're seeing in the business.

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

That's correct. And so the pricing effect as of January, we're looking for 1.5% to 2% net effect on that pricing that we had. It varies in different parts of the world. So for instance in Brazil, we didn't have a very aggressive price increase, but for most of the Americas and other parts of the world we did. You know, and then again, you're going to be lapping. So we had the price increase for the U.S. and Canadian markets in July of last year. So we'll get the additional benefit of that in the first half of this year on top of the increase they just put in place. So, we're very focused on that. And we're not opposed to doing an off-cycle price increase once again if we do continue to see inflation in the channel.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Got you, that's very helpful. And the 1.5% to 2% net is that net of materials, or that's just a net price increase after the nominal rate that you get back from discounting?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Net price increase.

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

So we would see a net realization.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Got you. Now in terms of the International footprint rationalization, I think like we're doing a lot more on efficiencies, shared service, things like this. Is there any appetite to do anything or maybe there is going on right now more structural rationalization, maybe closing facilities and things like this at this point?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Yes, we are. We're certainly looking at that, Larry. We're taken a hard look at shared services model for Europe. That's where we've driven a lot of efficiencies in North America and South America. And so we're taking a hard look at that opportunity. So that's longer-term, this is a 4- or 5-year journey that we'll be on with the International segment. There are some things that we were able to do short term and realize some benefits in 2018, we think that will continue in '19. But we're also looking at some more structural type activities that probably take place over the next 12 to 18 months. That will sustain that profit improvement as we go forward. And that's certainly one area we're taking a hard look at.

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Something that we have said consistently, Larry, is that we have opportunities up and down the P&L. And so we have manufacturing opportunities, we continue to look at sourcing opportunities, but we also have SG&A opportunities that we're very much actioning. And so there's a tremendous amount of opportunities. It's good to see margins in International go from sub-10 just 2 short years ago to now just about 12% in a really short period of time. But we also continue to see more and more opportunities ahead of us to continue to improve that margin and the underlying profitability.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Okay, thank you. And then last question for me. Obviously, backlog seems healthy, you mentioned sequentially, I guess, flattish. When you think about '19, is the market being driven more by upgrades and replacement, or is it driven by the economic growth in projects? And how broad-based we expect that strength to flow through your various business lines?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Yes, I don't think it's necessarily upgrades. I think it's a normal business flow. We're seeing some really good gains across our product portfolio especially with the new product launches that we've had. So we think we're gaining a little bit share wise, the organic growth of 8% supports that thought. And really the new products have done a nice job in strengthening our position in many of the markets, whether it's the 5000 series transmitter, what we've done with fall protection, with the 15 products we've launched. You know what's really interesting is that some people talk of the slowdown as they went into the fourth quarter. Our fall protection business built, we had some real strength in the fourth quarter. And I think that was on the back of the new product launches that we had and that will continue into the first quarter of this year. So we're pretty optimistic about our position in the market and what we can do going forward.

Operator

All right, and it looks like our final question is from Edward Marshall from Sidoti & Company.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

So you just mentioned that there are levers -- several levers for margin sourcing, manufacturing even mix, I guess. Could you just talk about maybe what the biggest swing factor could be in margin? Which of these might have the biggest impact for MSA?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

Sure, Ed. What we've consistently said is we are not dependent upon on one specific factor. We've got factors that avail themselves to us across the P&L. But the thing that's really nice to see and the work that Bob is leading in International is around our channels optimization and our ability to access the customer in a much more efficient manner than we historically had. So it's really good to see the progress we're making there. But as we go forward, we're looking at all of those opportunities across the P&L to continue to build on this incremental margin profile that we're seeing at around 24% here in the fourth quarter versus the third quarter. And so we continue to look at that. I'll turn it over to Bob, if you want to add any color there as well.

Bob Willem Leenen - *MSA Safety Incorporated - VP & President of MSA International*

Yes, I think, some of these bigger ticket items, shared services or the manufacturing footprint. And I think there's larger analysis that we're undertaking right now. And we're also, especially, in Europe have work council process that we need to go through. So we really can't talk much about that right now. We have to kind of follow those process first. I'm sure in due course we'll provide more color on that.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Got it. And I think from past discussions, the channel optimization was significant characteristic between the difference, between what you've seen in North America versus what international was doing. I'm curious maybe if you could talk baseball terms for a second, maybe if you can talk about what inning you think you are in the channel optimization, go-to-market strategy with the international segment?

Nishan J. Vartanian - *MSA Safety Incorporated - President, CEO & Director*

Yes, we're early in that. I mean, certainly third inning. We're very much on the front-end. The team has really done a nice job there under some leadership. The person leading that effort, he was the person when I was the Director of Sales for North America, he was the channels manager, who really developed our model in North America. And Dave is now leading the European and International team, when it comes to channels. And he has done a really nice job with that team, and working our way into some channels of distribution we just didn't have relationships with. So we're building those relationships. We're seeing some nice progress with our position within those distributors. And we're building that position. So we're in the early stages of that. And we think that we can really gain some leverage if we execute effectively over the next several years.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Got it. And the product liability reserve. I just had a few questions on that. I'm curious to talk about maybe the pace that you've seen here, is this kind of been consistent with what you would anticipate? And also what might be drive -- what drives the, I know, there was about 1,500 lawsuits in the end of September. So is it new lawsuits that drives the P&L impact? Or is it kind of closer decisions in the existing lawsuits that would necessarily drive that increase in the reserve for the P&L?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

So to address your first question, we feel that the product liability exposures are very well managed. We continue to manage them, we continue to deploy a multifaceted approach to addressing product liability and we feel like we're positioned very well to continue to manage our exposures on that front. Albeit, it is a very uncertain area and it's an area that can change quite quickly. And so we continue to keep a really close watch on that area. What was a really good for us to see in 2018 was all of this success we had on the insurance front, securing cash flow streams to help manage the liability exposure and to mitigate the impact on our cash flow performance. And when we look at the overall claims experience, we feel like again, we're positioned well. Claims are certainly one of a number of things that we continue look at, the number of claims coming in, the average settlement values, and a number of different things that we continue to weigh as we look at this liability. But in summary, we feel like we're positioned, it's a very uncertain area, but we're positioned well, and we've continued to manage this area quite nicely over the last several years.

Edward James Marshall - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Got it. And the treatment of increases from here, would it be consistent with the way you've treated it? And would this be -- I mean, now that the insurance receivables essentially is exhausted with the current reserve. How do you think about -- how do we think about kind of the -- is that, I guess that's the cash used from MSA at this point. Or are there additional insurance receivables out there in lawsuits that you're kind of pursuing?

Kenneth D. Krause - *MSA Safety Incorporated - Senior VP, CFO, Treasurer & Principal Accounting Officer*

So when we look at the treatment, it's the change in the IBNR was purely a noncash impact for MSA. It was a change in estimate. And we accounted for it as such. We adjusted it out of our current earnings. It is a noncash charge, and it's entirely related to legacy products that we manufactured and sold decades ago. And so it's not part of our current operations. We feel like that we're positioned well as I said earlier, to continue to manage through this uncertainty. We still do look at our insurance profile and our insurance coverage. And we still do identify opportunities to pursue additional coverages. But as we've disclosed the substantial portion of our insurance assets have been secured and we've disclosed that at such in our public filings.

Operator

All right. And it looks like we have no further question. So I will turn it back to you, Elyse for final comments.

Elyse Lorenzato - *MSA Safety Incorporated - Director of IR*

Thank you, Kelly. Seeing that we have no more questions, that will conclude today's call. If you missed a portion of the call, an audio replay and a transcript will be available on our Investor Relations website for the next 90 days. On behalf of our entire team here, I want to thank you again for joining us this morning, and we look forward to talking with you again soon.
