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PRESENTATION
Operator
Good day, ladies and gentlemen, and welcome to the MSA Third Quarter Earnings Call. At this time, all lines are in a listen-only mode, and the floor will be open for questions following the presentation. (Operator Instructions) It is now my pleasure to introduce your host, Director of Corporate Communications, Mark Deasy. Please begin.

Mark Deasy  MSA Safety Inc. - Director of Corporate Communications
Thank you, Annette, and good morning, everybody. I, too, would like to welcome you to our third quarter earnings conference call for 2016. With us this morning are Bill Lambert, our Chairman, President, and Chief Executive Officer; Ken Krause, Vice President, Chief Financial Officer and Treasurer; and Ron Herring, Senior Vice President and President MSA International.

Our third quarter press release was issued last night, and it is available on our website at www.msasafety.com. Before we begin, I need to remind everybody that the matters discussed on this call, excluding historical information, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements 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 SEC including our most recent Form 10-Q, which was filed on August 9 of this year. You are strongly urged to review all such filings for a more detailed discussion of such risks. Our SEC filings can be obtained at no charge at www.sec.gov or on our own website in the Investor Relations section. MSA undertakes no duty to publicly update any forward-looking statements made on this call except as required by law.

In addition, I need to note that we have included certain non-GAAP financial measures as part of our discussion today. These non-GAAP financial measures should not be considered replacements for GAAP results. The reconciliations to the most directly comparable GAAP measures are, likewise, available in the Investor Relations section of the MSA website. You can find this information in the Quarterly Results section, which is located under the Financial Information header.

That concludes our forward-looking statement, so at this point it’s my pleasure to turn the call over to Bill Lambert. Bill?
Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Thank you, Mark, and good morning, everyone. As always, I want to begin by saying thank you for joining us this morning and for your continued interest in MSA.

As you saw in our press release that was issued last night, we drove double-digit earnings expansion despite moderated top-line growth as we continued to navigate a slow-growth environment and faced a difficult quarterly comparison for our self-contained breathing apparatus business in the Americas.

While it’s true the challenging underlying conditions still persist in certain key end markets and geographies, we did see some bright spots for the quarter. This included strong shipments in fixed gas and flame detection systems, or FGFD, growth in portable gas detection products, and continued momentum in fall protection driven by Latchways, which we acquired in late 2015.

Overall, the investments we have made in new product development and strategic acquisitions, which I will talk about in more detail momentarily, are fueling our growth and positioning us well for the future.

Today I will start by giving everyone an overall performance review followed by an update on our Latchways integration efforts, and then I will talk about strategic investments we’ve made in the FGFD area of our business. I will then wrap up with an update on our G1 SCBA business including some details about a recent competitive conversion with one of the largest fire departments in the US. After that, I’ll turn the call over to Ken for his financial review.

As you saw in our press release, reported sales were up 2% in the quarter in total. In constant currency and excluding Latchways, sales were down 3%. While we saw an uptick in FGFD shipments in the quarter and solid growth in portable instruments and fall protection, a decline in SCBA revenue due to a temporary supply chain interruption, weighed on our overall results. I’ll discuss that in a bit more detail in just a few minutes.

On the expense side, the restructuring program that we executed in late 2015 continues to yield expected results. The reduction in SG&A has driven 160 basis points in operating leverage for the year-to-date. Coupled with gross profit improvements, our year-to-date operating margin, excluding restructuring and FX loss is 14.4%. That’s up 230 basis points from a year ago.

While we’re certainly pleased with the financial results from our 2015 restructuring program, uneven and challenging macro conditions require a continued focus on cost management. For that reason, we will be investing in an additional restructuring program to drive further cost savings in 2017, and Ken will provide you with more details on this initiative in his commentary.

Looking at other investments that are driving our business forward, Latchways had another strong quarter, and we continue to see a rebound in their base business. Excluding a 13% foreign currency translation headwind due to a weakening of the British pound, Latchways’ revenue increased 7% in constant currency for the quarter, bringing our year-to-date growth to 17% in constant currency. As I’ve mentioned before, the strategic rationale behind this acquisition included the ability to penetrate new end markets and geographies where MSA did not previously have a stronghold in fall protection.

We are achieving our goals, as our revenue growth was driven by wins in the utilities and renewable energy industries and our order book reflects increased activity in other key industries like aircraft production and maintenance. Further, Latchways sales are heavily weighted toward the UK and Europe, which represents a very nice complement to our established fall protection business in the US.

This strong revenue performance coupled with cost synergies we’ve been able to realize from our integration efforts resulted in Latchways’ contributing earnings of $0.03 per share for the quarter, bringing year-to-date accretion to $0.08 per share, fully loaded with purchase accounting and interest expense.

The integration work is progressing well, and we’re leveraging the strengths of our combined organizations to realize the strategic and financial benefits that we envisioned when we embarked on this journey a year ago.
Shifting gears to another core product area, we continue to make strides in advancing our market leadership position in fixed gas and flame detection. As I've mentioned in the past, FGFD systems are installed or mounted at a fixed point, and they protect assets and workers within a facility by sensing toxic or combustible gases in the air. On the last call, I discussed the launch of our new fixed gas and flame detection platform. As I noted then, these new instruments integrate the most innovative and advanced sensing technologies from both MSA and General Monitors, the California-based company that we acquired in 2010.

I am pleased to announce that we remain on track to launch this new platform in the fourth quarter and anticipate a lot of excitement around it because we believe it provides greatly improved facility safety at lower costs of operation for our customers. Additionally, our product line is a direct drop-in replacement to the more than 100,000 points of detection in the installed base of detectors MSA and General Monitors has around the world.

Clearly, innovation is a major focus of our FGFD strategy, and to further enhance our FGFD product offerings, during the third quarter we completed the acquisition of Senscient. Based in the UK, Senscient designs and manufactures laser-based, open path gas detection technology that can be used in a broad range of industrial, oil and gas production, and petrochemical processing applications.

Their patented technology known as "enhanced laser diode spectroscopy," or ELDS for short, provides a solution for gas detection in demanding applications. Without going into too much technical detail, Senscient's technology eliminates false alarms and enables fast, reliable detection of hazardous gases helping provide customers with lower cost of ownership.

While laser-based toxic open path gas detection technology is relatively new, it's been gaining greater traction and is viewed as an important emerging technology in this space. With this advanced technology now under MSA’s umbrella of FGFD products, we will leverage our broad product reach and long-standing relationships to offer even more differentiated FGFD solutions for our global customers.

Moving on to another key area of differentiation for MSA, I'd like to provide an update on the momentum of our G1 SCBA. While we have seen extraordinary growth rates over the past several quarters as we’ve ramped up manufacturing and worked down our sizable backlog, we previously indicated to you that the third quarter would bring moderated growth due to a difficult comparison for 2015. As expected, that trend played out in the quarter. And while I did anticipate moderated growth, SCBA revenue fell far below our internal expectations this quarter.

There were a few reasons for this, but the principal reason related to a temporary supply chain interruption for a critical G1 component, which is provided by an external supplier. This quality hold caused by our external supplier significantly reduced our shipping capabilities in July and into August. And because of this disruption, we were not able to return to full G1 production levels until mid-August.

The good news is the issue has since been resolved, and we had very robust shipping activity in September. But that was not enough to make up for the weeks lost earlier in the quarter.

Additionally, we are seeing the buying cycle, an evaluation process by fire departments, being extended. This is due to both increased competitors now in the market and a delay in federal government firefighter funding over the summer, which, also good news, has since been released. These delays, though, are slowing purchasing decisions for SCBA.

Looking at the order book for SCBA, though, we continue to see strong market interest and continue to convert competitive accounts for the G1 during the quarter. As you may have seen in the press release we issued last week, I am proud to announce that one of those conversions was the Boston Fire Department, one of the largest fire departments in the US. We delivered the order to Boston, worth approximately $4 million, during the third quarter, and the units were put into service on October 22nd.

With that, I'd like to turn it over to Ken for his financial review. Ken?
Ken Krause - MSA Safety Inc. - VP & CFO

Thanks, Bill, and good morning, everyone. I'd like to take some time to walk you through our third quarter financial results and to provide more insight into the drivers of performance. Additional information will be available when we file our Form 10-Q with the Securities and Exchange Commission.

Let's start with a few highlights and then we'll take a closer look at the quarterly performance drivers. Net income from continuing operations was $25 million in the quarter, or $0.67 per diluted share, increasing 63% year-over-year. Adjusted earnings were $27 million, or $0.72 per diluted share, up 22% in the quarter. On a year-to-date basis, net income and adjusted earnings were up 38% and 18%, respectively.

Reported SG&A expense is relatively flat in the quarter and down $1 million on a constant currency organic basis. Year-to-date reported SG&A expense is down $4 million, and constant currency organic SG&A is down $9 million. This improvement is a key driver of the year-to-date adjusted earnings growth. And this is an area we continue to focus on, and I'll talk more about that in a bit.

The Latchways acquisition provided earnings of $0.03 per diluted share in the quarter, bringing year-to-date earnings accretion to $0.08. We have met our full-year target range of $0.05 to $0.10 per share, and excluding integration costs and amortization associated with purchase accounting, earnings accretion is $0.17 per diluted share for the first nine months of 2016. We're certainly seeing solid returns on the acquisition we made a year ago.

During the quarter, free cash flow was $13 million, or 53% of net income. We expect improvements in cash flow in the fourth quarter as we've reached a confidential negotiated settlement with two of our insurance carriers related to a significant portion of our insurance receivable. We had a very successful quarter on this front, and while there is more activity to come, we secured payment on a significant portion of the outstanding insurance receivable. Our recent settlements will be paid over a number of years starting in the fourth quarter of this year.

Through a combination of these recent settlements and other settlements that we’ve reached in the past, we expect to receive between $35 million and $40 million in the fourth quarter, which should drive an improvement in cash flow conversion.

Let’s take a closer look at the quarterly financial results. Sales from continuing operations in the third quarter were $278 million, which includes $14 million of Latchways sales. Revenue was up 2% on both an as-reported and a constant currency basis.

Looking closer at year-over-year quarterly results comparison, core product sales increased by 2% on a constant currency basis, but declined 4 percent excluding Latchways. If you remember, during the third quarter of 2015, we were running three shifts in our factory to reduce the pent-up demand in sizable SCBA backlog we had at the time. Compare that 24/7 manufacturing a year ago to a significant reduction to shipments that we experienced in July and August due to the temporary supply chain interruption Bill mentioned, and you can understand why SCBA revenue was down 21% in the quarter.

While we’re certainly disappointed with the quarterly results in this area, we continue to see strong interest in the G1 SCBA and saw an uptick in quoting activity in the quarter, indicating that we have the opportunity to continue converting competitive accounts, moving forward.

The decline in SCBA was offset by 9% growth in fixed gas and flame detection on shipments of large orders in the US, the Middle East and Asia. We also saw a modest pickup in industrial products in the quarter as we shipped higher levels of head protection and portable gas detection into the utilities, petrochemical, and the oil and gas markets driving 3% and 10% growth, respectively.

Although products sold into energy markets contributed to our revenue growth in the quarter, and we saw some pickup attributable to the fall turnaround season, our outlook is very cautious. The energy market remains soft, and we expect headwinds to persist into 2017. With that said, we saw nice improvement in the quarter across the portfolio and, notably, in FGFD where revenues were up 9% on large order shipments across our geographies and good demand in the Middle East region. We are seeing good results in the Middle East this year with overall revenue up 23% year-to-date.
Several other emerging markets had solid results this quarter as well. China had strong shipments to the fire service, and Southeast Asia benefited from large FGFD orders. But the near-term outlook across all emerging markets remains mixed.

To mitigate the challenging environment in these areas, we have executed a number of restructuring initiatives in these locations, and we are seeing strong results from those efforts. For example, revenue in China is up 10% in constant currency for the year-to-date while GAAP operating income is up 33%.

Our gross profit rate for the quarter was 46.3% improving 250 basis points from a year ago. Our value engineering activities associated with the G1 SCBA are producing good results. In the quarter, gross margins on breathing apparatus in the Americas where the primary product is the G1, were up 520 basis points from a year ago. We also realized the benefit from a more favorable product mix in the quarter with higher sales of gas detection products and lower sales of SCBA.

SG&A costs were $73 million in the quarter, relatively flat on a reported basis and up 2% on a constant currency basis. Excluding SG&A related to Latchways, constant currency SG&A was down $1 million, or 2% in the quarter and is down $9 million, or 4% in the year-to-date period. We are tracking very well against our full-year target of $10 million of cost savings for 2016.

As you can see, the restructuring steps we have taken to reduce operating costs both through headcount reduction and improved discretionary cost controls are proving effective in driving operating leverage. We are capturing the savings that we targeted when designing these cost-reduction programs, and with continued sluggish industrial demand and a depressed energy market, we foresee the slower growth environment extending into 2017.

To position ourselves for continued improvements and profitability, we have started executing on an additional cost-reduction program to drive savings and margin expansion in 2017. Among the steps taken so far, we have offered a voluntary retirement incentive plan to qualified associates in the US. We have also reduced headcount across many of our international regions through an ongoing reduction-in-force program that began in the third quarter and will continue into 2017.

Through these initiatives, we expect to incur, roughly, $12 million to $15 million in restructuring to drive another $10 million of operating cost savings into 2017. When thinking about the investment and return, keep in mind that the restructuring expense associated with the voluntary retirement incentive plan, about $10 million, will be a noncash expense as we are funding it from our over-funded North American pension plan.

While these decisions are never easy, we are taking the necessary steps to remain on track with our long-term financial targets and are focused on creating value in a challenging macro environment.

Looking closer at one of those investments, research and development expense this quarter was $13 million, or 4.7% of sales. As I indicated on the July call, we expected to see an uptick in R&D spend in the second half as we prepared to launch our new FGFD platform. Our previous investments are paying strong returns with 34% of overall sales for products developed and launched in the past five years. Year-to-date R&D is trending at 4.1% of sales within the 4% to 4.5% range that we target.

GAAP operating income improved 51 percent in the quarter on strong performance but also reflective of higher FX losses and restructuring charges in this quarter a year ago. Adjusted operating margin excluding restructuring and currency exchange losses in the third quarter was 15.3% of sales reflecting a 270 basis-point improvement from a year ago.

Quarterly adjusted operating income increased by 24% on the 2% increase in sales. On a year-to-date basis, adjusted operating margin is trending at 14.4% of sales, increasing 230 basis points from this same period a year ago. Good performance driven by a number of initiatives focused on both growth and improvements in productivity.

Our effective tax rate this quarter was 30.1% compared to 37.1% in the same quarter a year ago. Key drivers of the quarterly rate include a more favorable mix of income on the improved profitability in our international segment, the R&D tax credit, and a lower level of non-deductible charges.
Excluding exit taxes associated with our European reorganization, our year-to-date effective tax rate was 32.7% compared to 34.5% a year ago. The R&D tax credit and lower non-deductible expenses drove the year-to-date improvement.

Net income from continuing operations was $25 million in the quarter, or $0.67 per diluted share on a GAAP basis, compared to $16 million, or $0.41 per diluted share in the same period a year ago, an increase of 63%. Adjusted earnings were $0.72 per diluted share in the quarter compared to $0.59 per diluted share a year ago, increasing 22%.

Quarterly free cash flow was $13 million, or 53% of net income, increasing $20 million from a year ago on a higher net income, collection of accounts receivable, lower inventory, and lower product liability payments. Year-to-date free cash flow was $15 million compared to a use of $15 million in the same period a year ago.

When looking at the year-to-date comparison, it is important to note that we paid $53 million, net, in product liability settlements in the first nine months of this year compared to $16 million, net, in the same period a year ago. Even in considering the additional $37 million in product liability net cash outflows that we paid this year, our free cash flow still improved by over $30 million on the higher profitability and improvements in receivables and inventory.

And as I mentioned at the beginning of my commentary, we reached a confidential negotiated settlement with two of our insurance carriers in the quarter. This recent activity combined with other settlements that we've reached in the past will result in $35 million to $40 million of cash inflows in the fourth quarter. As part of these activities, we have reclassified just under $100 million from our insurance receivable to notes receivables in our balance sheet in the third quarter.

The insurance receivable balance is now at just over $154 million compared to $248 million at the end of the second quarter. Additionally, as we have disclosed in the past, we had an insurance coverage trial scheduled in September. I am pleased to report that we had successful outcome at the trial with the Pennsylvania State Court jury returning a verdict in MSA's favor on all aspects including breach of contract for the three policies in question as well as bad faith.

A hearing to determine the damages to be awarded as a result of the statutory bad faith violation is scheduled for December 2016. We believe this activity continues to demonstrate that we have strong legal positions concerning our rights to coverage. The outcome of the trial will be disclosed in greater detail in our Form 10-Q.

We finished the quarter with a cash balance of $106 million and debt of $471 million or 2.2 times debt to EBITDA. The increased debt balance compared to the second quarter is a result of the Senscient acquisition. The purchase price for the acquisition was approximately $19 million, $18 million net of cash acquired, and was financed with our revolving credit facility. The acquisition is an important step in executing our corporate strategy and differentiating our FGFD portfolio with Senscient's ELDS technology. In the near term, we do not expect the material impact on revenue, earnings, or liquidity as a result of this transaction.

In summary, we had a relatively strong quarter with improved profitability despite ongoing challenges in certain end markets. We saw a modest pickup in sales of industrial head protection and portable gas detection instruments and strong shipments of FGFD. Coupled with continued growth at Latchways and solid results from our cost reduction program, we were able to realize 22% adjusted earnings growth in the quarter. Additionally, we had some very noteworthy success on the insurance receivable front.

While our backlog of business is healthy heading into the fourth quarter, we are facing a difficult year-over-year comparison. Furthermore, we expect that macro headwinds in the energy industry will continue into 2017 and, as a result, managing our cost structure will remain a priority, moving forward. However, we are committed to making investments that drive profitable growth and competitive advantage.

I will now turn the call back over to Bill for some concluding commentary.
Thank you very much, Ken. Looking at our earnings growth, it’s clear that the investments we’ve made, along with our cost containment activities are driving strong profitability in the face of challenging economic conditions in certain markets and geographies.

As Ken said, we expect the slower growth environment to extend into 2017 and as he mentioned, that will require us to maintain a focus on cost control and improved efficiency of our operations. However, be assured we will continue to invest in programs and growth initiatives that expand profitability and position MSA to provide enhanced shareholder value for many years to come.

I want to thank you for your attention this morning and, at this time, Ron Herring has joined Ken and me, and we will be happy to answer any questions that you might have. Please remember that MSA does not give guidance, and that precludes most discussion related to our expectations for future sales and earnings.

Having said that, we will now open up the call for your questions.

Q U E S T I O N S  A N D  A N S W E R S

Operator

Thank you. (Operator Instructions) Richard Eastman, Robert W. Baird.

Richard Eastman - Robert W. Baird - Analyst

All right, so good morning, and, Bill, nice quarter, and Ken and Ron. Just a couple of questions. One is, when I look at the fixed gas and flame business, and I look at the sales both internationally as well as in the Americas in the third quarter, could you maybe just speak to what the backlog looks like FGNF? Was the book-to-bill one or just how does that backlog look, going forward?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Well, I’ll comment on the overall business, Ken. Maybe you have the book-to-bill ratio. I don’t have that at the top of my head. But, Rick, the backlog of business as we look into the fourth quarter looks pretty healthy, actually. FGF has withstand this downturn in the oil and gas sector over the last two years fairly well. We’re not seeing the dropoff there that most other companies perhaps experienced in that oil and gas sector.

I think that’s attributable to a number of things. Number one, the replacement cycle for some of our sensors and points of gas detection in the market is quite robust. So that base business, so to speak, just has not been affected. What has been affected is maybe 20% of that FGF business, which is related to large projects and greenfield sites. We have seen that slowing and extending out in its buying decisions, especially here in North America.

But in the Middle East we have not seen that effect, and so we’ve been able to offset some of that downturn in the North American market by nice increases in the Middle East and in Asia.

Ken, I’ll ask you to provide any further color on that.
Ken Krause - MSA Safety Inc. - VP & CFO

Yes, sure, Rick. We did see a little bit of a reduction in backlog in the quarter, which indicates the book-to-bill is a little lower than one, but it's not significantly below one. We still maintain a pretty healthy backlog, quite honestly, as we look at that business and we compare it to levels we've had in past quarters and past years.

So still hanging in there, actually. A pretty good business and, as Bill indicated, continue to see good growth in the quarter in the Middle East outside of the US.

Richard Eastman - Robert W. Baird - Analyst

So not to conclude for you but, I mean, do we have a backlog and visibility that maybe suggests at least fixed gas and flame could run out at a mid single-digit kind of growth rate? I mean, just for the foreseeable horizon here? Maybe 12-month horizon? Is that out-of-the-box thinking here?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

I think mid single-digit growth rates might be a little bit on the optimistic side, Rick, if you're looking at a full year looking out into 2017. That might be a little bit on the optimistic side. I mean, through nine months our sales in FGFD are down 1%, you know, relatively flat. If we can see some moderated improvement there I'd be quite pleased.

Richard Eastman - Robert W. Baird - Analyst

Yes, okay. And then, just, I wanted to flip over for a second to the SCBA business. Just a couple of thoughts here, I mean, maybe our math suggests that maybe this supply chain hiccup in the quarter maybe cost you $10 million to $15 million of sales in the SCBA product line? And my question maybe is around, Ken, you made a comment that the gross margin on SCBA and, in particular, the G1, was actually up 500 bps, 520 basis points? And how did we manage to do that with the supply chain hiccup? And then also is my math about right on the SCBA side?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

I think your math is pretty close, Rick. Good math skills there. Right. Ken, I think, mentioned we were up 520 basis points in the Americas segment of SCBA margins, and that was driven by reduced costs from our value engineering activities. I think we spoke about that last year. We talked about the additional costs that we were experiencing last year as we ramped up our production to the full rates. And additionally what we saw in the quarter were nice shipments of accessories to those SCBAs. So the accessories were a little bit slower in getting their NIOSH approvals, but once those approvals were received, we were able to ship a backlog of accessories and they have, actually, higher gross margins.

So while the G1 SCBA margins are still a little bit below the corporate average, I am pleased with the improvements that we're seeing, and we think we've got some additional runway to improve those even further, especially as we look out into 2017 and the new integrated TIC becomes approved and available for shipment.

Ken Krause - MSA Safety Inc. - VP & CFO

The only thing I'd add there, Bill, is the second quarter, you know, this is the second quarter in which we've seen some good performance in the gross profit line with the SCBA area. In the second quarter we saw about a 460 basis point, as we talked about it in our last call, about a 450 basis point improvement in margin in this area.

So good work by the team on the cost side but then also on the accessories as well.
Richard Eastman - Robert W. Baird - Analyst

I got you, okay. And then just a last question, and I'll turn it over, promise, here. When I look at the international adjusted operating margin, kind of at 9.3. I'm curious, is that the number we're primarily going to attack with this newer restructuring effort here for 2017? Because that still seems reasonably sluggish progress to date on the international op margin -- adjusted op margin?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Well, I think, Rick, that the areas that Ken talked about in the way of restructuring are across MSA. So the voluntary retirement incentive program that Ken mentioned is primarily leading North American initiative. So North America is involved in that, and we would expect to see our cost structure here in North America come down a bit as well.

But, you're absolutely right. We're not entirely pleased with or satisfied with the operating margins that we're seeing in international. And so part of, as Ken mentioned, this reduction in force that we have, this restructuring and realignment of activities internationally, a piece of that investment in restructuring that Ken mentioned is really targeted at improving international operating margins.

Operator

Rudy Hokanson, Barrington Research.

Rudy Hokanson - Barrington Research - Analyst

Thank you. I had a follow-up on the question on the international and the adjusted operating margin. When you were reporting on a net income basis by the various regions, that's when there was a considerable amount of discussion about what you were doing in Europe in terms of the consolidation of manufacturing and warehousing, et cetera, and the plans that were going on there. But those results were always going to be measured in terms of how you'd be reporting the net income.

So now that you are on the operating income line for what we can monitor and trace, I was wondering if you could maybe give us an update on the international side in the perspective or in the context of your program that -- I think it was called "Europe 2.0" or I forgot the name for it. But if you could let us know how that's progressed and how that's met your expectations and rather than the issue of current cost reduction programs, just how that has filled out or how that has come to fruition? Hopefully, that's clear.

Ken Krause - MSA Safety Inc. - VP & CFO

Yes, a number of questions there, Rudy, but I'll take the first question. I'll also ask Ron to add a little bit of texture and color to the European story. But what I would say is we're making -- we've made, and we continue to make, very solid progress in Europe. But not only in Europe but around the world as well.

When we look at our operating margins in the quarter, in the international sector in the segment, we saw margins go from 1.5% to 9.3% in the quarter -- considerable improvement. Each and every region in the international segment showed considerable improvement, and Europe being one that showed the most significant improvement.

And what we're seeing there is we're seeing improvements on the gross profit line. We're seeing improvements on the SG&A line. So we're seeing improvements throughout the entire P&L, quite honestly. And so making good progress, but we're meeting with the team, and as part of these ongoing restructuring programs that we talk about, Europe is a major part of that. So we're continuing to focus in on that geography to make additional progress.
Ron Herring - MSA Safety Inc. - SVP & President MSA International

Yes, I would just add at the end of the third quarter we went live with our last -- the last scheduled facility, which is our Galway location. So now Europe 2.0 is complete as we had originally designed it, and we’re continuing to find additional efficiencies there. We’re finding them not only in the SG&A line, we find them in the other cost of sales. And the team there is continuing to drive improvement. So I think that investment will continue to provide productivity for us, efficiencies for us here going forward.

Ken Krause - MSA Safety Inc. - VP & CFO

And then you had another part of your question, Rudy, so if you could just clarify the second part of your question?

Rudy Hokanson - Barrington Research - Analyst

I have to be honest, I’m trying to remember it. Let me ask you, then, maybe another way. In looking at the 9.3 and with what you’re doing throughout the company, how should we look at the product mix on international? Because some of your highest-margin business in the FGFD area is being sold in the Middle East, which is under that international, certainly. So is there anything in the product mix that would be suppressing the operating margin right now that we could see that if the product mix improves given your hopes for what you’ll be able to do now that you have Latchways, which is also very profitable. But you’re looking for some crossover selling, that we could see the margin improvement from product mix?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Sure. To talk about the product -- well, let’s focus on FGFD first. We actually sell FGFD, or fixed gas and flame detection products, in all four of the international regions. It’s an important product group in China and the Pacific Asia region, the Middle East, obviously, and actually we’re making some inroads into India and then in Europe it’s an important product group, too. So it’s not just a Middle East play for us, it really is a product group that we’re selling in all four regions and have a lot focus on that.

In regards to the product mix, one of the core strategies here is to continue to focus on the core product area, and that’s a strategy we have across international where we’re moving away from peripherals or adjacent products and really focusing on driving core products. And that should have -- or it will have -- a favorable impact on the product mix.

Rudy Hokanson - Barrington Research - Analyst

So that -- that -- as we look at the operating profit margin on international, there should be a number of forces at work to improve that? Not just cost savings but also product mix?

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Oh, absolutely, absolutely.

Ken Krause - MSA Safety Inc. - VP & CFO

And that’s reflective of what happened in the quarter, quite honestly, Rudy. I mean, if we look at the improvement from 1.5% to 9.3%, gross profit was -- we saw margin improvement of about 390 basis points. We saw SG&A leverage of about 370 basis points. Latchways added about 30 basis points. So we had a whole host of things that drove that margin up significantly and, actually, that trend has followed out throughout the first nine months as well. So good progress on all fronts across the P&L.
Hey, guys, good morning and congratulations on the nice quarter. A quick question for you when thinking about, kind of, the additional $12 million to $15 million of costs out from the new restructuring plan. One, do we have any legacy spillover caused from the actions this year? How quickly does this $12 million to $15 million impact next year? And then the last part of that is with the settlement, I believe you guys have been spending close to 1% of sales to keep this active in the court system -- does that go away or does it become less of an impact? And how should we think about that -- all of those kind of mixing together for next year?

So I'll take that question. On the insurance front and on the litigation front, we're not finished with that effort, and so we're going to continue to spend, unfortunately, on that -- in that area for the foreseeable future as we go through the process. So we're working through it. A very successful quarter, making good progress and strides but still more work left to go on that side.

On the restructuring program, we're expecting to incur between $12 million and $15 million. Our savings target is about $10 million at this point, just as it was last year on our program. We expect to see costs start to come out of the business more aggressively in the first quarter of next year. The effective date on the voluntary retirement program is February 1 of next year. So we expect to see costs start to come out more considerably in the latter half of the first quarter. So we're making progress on that.

But we think that -- we certainly think, and we have a pretty high degree of confidence that we're going to be able to continue to take an additional $10 million out as we head into 2017.

Perfect, and thanks for clarifying that. And then on the FGFD on the new products, how quickly can you start shipping those products with the better -- I don't know if it's a better sensor technology or the better cost advantage position, however you want to frame it. But how quickly, I guess, can you start shipping that product when we think about next year?

This is Bill. I'll take that question. The new sensors that I talked about in FGFD, what we call the S5000 under the General Monitors brand, and the X5000 under the MSA brand. Those, we expect to have approved and ready for shipment in the month of November. So we are imminent there in our ability to ship that product.

And before we get too excited about that ability, we do have to keep in mind that on the FGFD side it is a longer buying cycle. So the amount of time when you bring new technologies to market, that they get into the field; that they get evaluated by customers.

We're probably looking at a relatively slow ramp-up, at least that's our anticipation at this point in time as we look into 2017 on that front. But having said that, the approach that our engineers took to that product and its design, the lower cost of ownership, the direct drop-in replacement to our existing product line, which then allows us to go after the 100,000-plus installed detection sites that we have in the field. That does get us excited. And so we might see a ramp-up here that's a bit faster.
On the Senscient acquisition, that product is available today and is shipping today, and we think there’s immediate application for us to then take that product through our channels of distribution and through our sales organization and begin to see an impact.

Stanley Elliott - Stifel - Analyst

Perfect. And then, lastly, in the past you talked about -- and back to Rudy’s question about that -- Europe 2.0 is a 15% op margin in Europe. Is it fair to say what these numbers that we are on that trajectory right now? And then, I guess, a second point is -- second part, rather -- would be when do we start to see the 200 basis points to 300 basis points of tax benefit that you had been targeting as part of that plan? Thank you.

Ken Krause - MSA Safety Inc. - VP & CFO

Sure. I'll talk to the tax benefit side. On that side, we’ve talked a couple of quarters here around that and especially in the second quarter you saw the impact of a higher degree of profitability coming out of the US. And, as we know, the US has the highest rate in the world. And so as that continues, that has an impact.

What we saw in the third quarter, though, was we actually saw a good performance in profitability coming out of our international segments and especially in Europe. And so what you saw in the third quarter with a tax rate that came down to just about 30%, down from about 35% in the second quarter. So you saw a really nice performance.

So a lot of it is going to be driven by the level of profitability that we see come out of these various regions and level of ongoing profitability. So that has an impact, and you saw it come through. But as we continue to take costs out, as we continue to grow our business in these regions, we certainly expect that tax benefit to come to fruition.

Bill Lambert - MSA Safety Inc. - Chairman, President & CEO

Ron, can you have some commentary on a trajectory that you see in operating margin improvement and the 9.3% that we saw this quarter. How do you envision that, going forward, towards those goals that you have for Europe?

Ron Herring - MSA Safety Inc. - SVP & President MSA International

Sure, Bill. In regards to Europe, I mean, it’s a program that we implemented a few years ago. You’ve all been following it for a while here. We are now fully implemented, and we continue to find efficiencies with the ECC 6.0 system, being able to have everybody under one IT platform. We’ve reduced everything down to one warehouse, so we’re down from 10 warehouses down to one. And so we continue to find those efficiencies. And so that trajectory is going to continue. The improvement on the operating margin, our expectation is that will continue. And we have targets set out there with specific action plans for us to be able to achieve those.

Operator

We will take our last question coming from Ed Marshall, Sidoti.

Ed Marshall - Sidoti & Company - Analyst

Sidoti & Company. So I just wanted to ask -- listen, I just wanted to ask -- by the way, good award with the Boston Fire Department. I'm curious if there are other large cities that you're working on throughout the country from a -- I'm sure you are -- but I'm curious if there's any kind of detail that you could provide around that.
And, secondly, when you land one of these deals, and I respect the technology that’s in the new product, but are there discounts awarded, as well, to help win that business. Help me think about it from a margin perspective.

**Bill Lambert - MSA Safety Inc. - Chairman, President & CEO**

Well, certainly, we’re working in all major fire departments across the country with the G1. It’s getting attention from quite a few of the largest fire departments in the US, and I think it would be inappropriate for me to run down that list. But I can assure you that their interest, their awareness is pulling us into those competitive accounts, which is terrific.

So we are having success and as I think maybe I’ve mentioned in previous calls and we’ve talked about before, we are still seeing that, roughly, one-half of all the incoming orders we’re booking on that G1 SCBA are competitive conversions. So the market share gains that we continue to see on the G1 is terrific, nothing short of that.

On those large accounts, you’re asking do we have to discount, and the answer is certainly, we do. And that competitive environment is getting even tougher for a couple of reasons. Number one, there are now five competitors to the G1 SCBA in the market. A year ago there were only two. So other producers of SCBA have, in fact, over the last year, now received their NFPA performance certifications. And so the competition is a little bit hotter right now.

And because of our competitive win rate, the pricing pressures are very evident, so in some cases, we are having to discount. But as you see in the margin improvement that Ken talked about, and if we focus in on the Americas segment, we’re still able to see margin expansion. We’re able to maintain some of our premium pricing strategy, and the technology and everything we’ve put into that product is still allowing us to gain share and win in these competitive accounts.

I still feel pretty good about that, but it is getting more difficult, not less difficult, and we’ve got more competitors, not less, than we did a year ago in this area.

**Ed Marshall - Sidoti & Company - Analyst**

I’m curious, too, what are the -- what’s the biggest deciding factor from -- I mean, is it the family of products that is combined with the technology that is clearly a winner? Or has it now really come down to price as we can kind of extend on that last question.

**Bill Lambert - MSA Safety Inc. - Chairman, President & CEO**

Yes, the competitive evaluations that we see by US Fire Departments is quite sophisticated. So, generally, an evaluation committee is formed and all of the competitors are invited to show their latest wares and talk about the technology that they offer, talk about the cost of ownership, talk about the ability to upgrade that product in the future and add new technologies in the future. So it’s pretty sophisticated, and it’s extended, and it includes an evaluation period on the fire ground, where the firefighters get to choose.

Purchasing and pricing is always an element of that, but I would not say that that’s the major element, and the “deciding factor” here. At the end of the day, the firefighters choose the SCBA that they think will best protect them and provide them with the greatest ability to do their job in the safest manner possible. And I’m really pleased to say that MSA is winning that evaluation in most cases.

**Ed Marshall - Sidoti & Company - Analyst**

Good. When I look at -- and I know we have a lot of things can change between now and year-end, especially with interest rates. But as I look at the discount curve, it’s changed 80 basis points since the end of the year. If the year was to close today, what would be the impact to the pension expense or income, and I forget what you have right now, to the P&L?
Ken Krause - MSA Safety Inc. - VP & CFO

Yes, and I'll take that. So you're exactly right, that interest rates certainly will have an impact on our over-funded pension plan and our noncash expense that we record associated with that. If we look at where we are right now in the yield curve and use something similar to that, you'd probably see a $2 million to $4 million reduction in pension income between what we have now and what we would have for next year. That's about the magnitude or the range of the magnitude.

But, again, as you indicated, who knows what will happen with interest rates between now and year-end?

Ed Marshall - Sidoti & Company - Analyst

Right. And what's the pension income for the years -- for 2016?

Ken Krause - MSA Safety Inc. - VP & CFO

Yes, I'd have to go back and check that, Ed, to confirm that number. But it's in the low single-digit million range. It's something between $3 million and $5 million. It's not overly significant. And it hasn't really, over the last year or two, it hasn't been a big driver like it was, going back in time when we -- at one point, seven or eight years ago when interest rates were much higher, we had a much more significant impact on that.

Ed Marshall - Sidoti & Company - Analyst

A last question on repurchases. You've been generating a lot of cash. Historically, MSA has not been a big acquirer of maybe just offset options. I'm curious what the capital deployment -- obviously, you've made some acquisitions here and that's important, but are share repurchases in the future? I mean, is that something that you will do especially if we happen to hit a rough spot in the market, would you step back in and support the shares? Thanks.

Ken Krause - MSA Safety Inc. - VP & CFO

Yes, just as we've said a number of times, we really deploy a balanced approach to capital allocation, Ed. With the dividend that we've been paying for as long as we've been paying it and increasing it for as long as we've been increasing it, the acquisitions that we've made and then the share repurchase. We'll continue to look at the share repurchase program and take action when we think it's appropriate. But at this point, it's not a major part of the capital allocation program merely just to be used to be --offset the dilution that we would see from stock compensation.

Mark Deasy - MSA Safety Inc. - Director of Corporate Communications

Well, seeing that we have no more questions, that will conclude today's call. I'll remind everybody that if you missed a portion of the call, an audio replay and the transcript will be available on our 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. Have a good day, goodbye.
OCTOBER 28, 2016 / 12:30PM, MSA - Q3 2016 MSA Safety Inc Earnings Call

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