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PRESENTATION

Operator
Good day, and welcome to the MSA Fourth Quarter and Full Year 2022 Earnings Conference Call. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Chris Hepler. Please go ahead.

Chris Hepler - MSA Safety Incorporated - Executive Director of Corporate Development & Investor Relations
Thank you. Good morning, and welcome to MSA Safety’s Fourth Quarter and Full Year 2022 Earnings Conference Call. This is Chris Hepler, Executive Director of Corporate Development and Investor Relations. With me today are Nish Vartanian, Chairman, President and CEO; Lee McChesney, Senior Vice President and CFO; and Steve Blanco, Segment President for Americas.

Before we begin, I'd like to remind everyone that matters discussed during this call may include 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 intended levels of future performance. Forward-looking statements involve a number of risks, uncertainties and other factors that may cause our actual results to differ materially from those discussed today. These risks, uncertainties and other factors are detailed in our SEC filings. MSA Safety undertakes no duty to publicly update any forward-looking statements made on this call except as required by law.

We have included certain non-GAAP financial measures as part of our discussion this morning. The non-GAAP reconciliations are available in the appendix of today's presentation. The presentation and press release are available on our Investor Relations website at investors.msasafety.com.

Moving on to today's agenda. First, Nish will discuss the key highlights of the quarter and full year. He will then turn the call over to Lee to discuss our financial performance and outlook. Nish will then conclude with closing remarks. Following our prepared remarks, we will open the call for questions. With that, I'll turn the call over to Nish.

Nishan J. Vartanian - MSA Safety Incorporated - Chairman, President & CEO
Thanks, Chris, and good morning, everyone, and thanks for joining us today. I'll start on Slide 4. MSA delivered another strong year with exceptional results in the fourth quarter. This was made possible by our team's unwavering commitment to our mission. Our purpose-driven culture and dedication to protecting the world’s workers is at the core of everything we do and sets the foundation for our strong performance. I want to thank all of our associates for their focused execution and hard work to get MSA’s leading safety technologies and solutions in the hands of our customers around the world. And thanks also to our shareholders and other stakeholders for helping us build MSA into a global safety leader that is making a positive impact on the health and safety of workers and our communities around the world.
Moving to Slide 5. Our team delivered outstanding results for the quarter and full year, including record sales and robust margin expansion through strong operational execution. Incremental operating margin was on the high side of our target for the year, and we generated strong cash flow. Even with ongoing supply chain challenges and inflation headwinds, we achieved broad-based growth across our platforms of firefighter safety, gas detection and industrial personal protective equipment. This growth was enabled by our laser focus on driving improved throughput and executing our strategic plan.

We continue to advance our strategy by developing and launching innovative safety solutions like the ALTAIR io 4 gas detector with full cloud connectivity, seamless integration into MSA’s Grid software and our proprietary XCell sensors, and the latest derivation of our V-Gard hard hat, the C1, with its patent-pending thermal barrier to help reduce worker heat stress, which has become a major focus for workplace safety. Notably, MSA’s V-Gard brand hard hat has recently celebrated its 60th anniversary, and the V-Gard with its iconic design has garnered strong commercial success around the world and across many industries.

These types of new technologies and connected solutions address customers’ unmet needs and enable them to improve worker safety, enhance productivity and simplify compliance. And these innovative and differentiated solutions have also helped us strengthen market share across our portfolio in 2022.

As The Safety Company, our commitment to corporate social responsibility begins with our mission, which has been unwavering since our founding in 1914 and is the basis for our key CSR pillars, our products, our people and our planet. And we are focused on advancing our programs across each of these pillars to make MSA fit for the future. Our continuous progress around environmental sustainability, talent development, diversity and inclusion and product stewardship has been recognized both locally and nationally.

MSA is proud to have been named one of America’s Most Responsible Companies by Newsweek for the second consecutive year. I believe that our advancements in this area have differentiated MSA as an employer of choice when it comes to our existing associates and prospective talent, and a preferred supplier when it comes to our customers.

Before I turn the call over to Lee, I also want to recognize an important team accomplishment from 2022. I’m proud to share that our 5,000 associates operated 12 consecutive months without a lost time injury. At MSA, we’re living our mission of protecting workers’ health and leading by example.

MSA is well positioned from our leading product platforms, diversification across end markets and geographies, to our talented associates across the globe. I’m proud of the progress we’ve made and excited for the prospects ahead.

With that, I’ll pass the call on to Lee to discuss our financial results and 2023 outlook.

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

Thanks, Nish, and good morning, everyone. Let’s get started on Slide 6 with the quarterly highlights. Our MSA team had a strong finish to the year with double-digit organic sales growth across firefighter safety, gas detection and industrial PPE. Sales were a quarterly record of $443 million. We executed sequential volume growth, which is consistent with seasonal trends in our business.

Orders remained healthy again this quarter. Design reengineering we performed throughout 2022 and moderate improvements in the supply chain enabled us to reduce backlog sequentially. However, supply chains are still constrained and unpredictable, and we expect that to continue into 2023. We entered 2023 with an elevated backlog of approximately 25% from a year ago. In January, orders again paced ahead of last year and backlog has also increased slightly. This is consistent with trends in prior years.

Gross margin in the quarter was 44.5%, up 110 basis points year-over-year from strong volume leverage, favorable mix and positive price/cost dynamics. We are encouraged with the progress we are starting to see in our gross margin rate and remain focused on making further progress in 2023 despite a challenging environment.
Fourth quarter adjusted operating margin was 21.6%, up 210 basis points from last year. Incremental operating margin was 48% in the quarter as we benefited from pricing and strong operating leverage from the higher volume.

Adjusted net income was $71 million, which resulted in diluted EPS of $1.80, up 8% over last year. This year, we had a normalized tax rate and slightly higher interest expense in the quarter.

Now I’d like to take a moment to review our segment performance. In our Americas segment, we had robust results with 14% growth in the quarter, driven by strength in North America and Latin America. Americas saw double-digit growth in our firefighter safety, portable gas detection and industrial head protection. Adjusted operating margin in the quarter was 28.6%, up 470 basis points year-over-year as a result of solid commercial execution, volume leverage and cost management.

And in our International segment, we made progress despite some very challenging headwinds and delivered a resilient 7% constant currency growth in the quarter. From a regional perspective, we saw double-digit growth in the APAC region, offset by a mid-single-digit growth in EMEA. Currency headwinds of 9%, largely related to the euro and British pound, resulted in a reported 2% sales decline. Adjusted operating margin was 17% in the quarter, down 290 basis points year-over-year but up 900 basis points from the third quarter. Price/cost was unfavorable due to currency headwinds on cross-border transactions and the conversion of longer-dated backlog, particularly in gas detection.

Now moving on to Slide 7. For the full year 2022, broad-based demand drove record sales of $1.5 billion, up 9% versus last year and up a strong 12% on a constant currency basis. Price realization represented about 2/3 of the growth with volume being about 1/3 as well.

For the full year, gross margin was 44.1%. Volume leverage and price actions offset significant inflation headwinds and yielded 20 basis points of improvement.

For the year, adjusted operating margin was 19%, up 180 basis points from last year. Incremental operating margin was 39% for the year, towards the high end of our target range.

Adjusted net income was $223 million, which resulted in diluted EPS of $5.65, up 21% over last year.

Now turning to Slide 8. We recently announced an important transaction that strengthens our company for the future. On January 5th, we completed the sale of a subsidiary holding legacy liabilities. This transaction materially reduces risk in our business, simplifies our balance sheet and enhances cash flow predictability. In funding the transaction, MSA contributed $341 million at closing, which included $315 million in incremental borrowings. We are committed to deleveraging quickly, and we anticipate utilizing excess cash flow in 2023 to repay borrowings. As the closing occurred in early January, this transaction will be reflected in our first quarter 2023 financial results.

Now turning to cash flow and leverage on Slide 9. Quarterly free cash flow was $40 million or 77% of net income. For the year, free cash flow was $115 million or 64% of net income, down 26% versus last year. Cash flow was impacted by purposeful investments we made in certain inventory to meet demand and to improve customer delivery times amid the supply challenges throughout the year.

In the quarter, we invested $14 million in CapEx, paid $18 million of dividends to our shareholders and repaid $40 million of debt. Cash at year-end was $163 million, and we have no significant near-term debt maturities. In 2022, as part of our commitment to return value to the shareholders, we returned more than $100 million through dividends and share buybacks.

Full year adjusted EBITDA increased 18% to $337 million. Our net leverage ratio at year-end was 1.2x adjusted EBITDA compared to 1.6x in the prior year. On a pro forma basis, adjusting for the legacy liability and additional borrowings, net leverage was 2.2x. We anticipate returning to our historical leverage ratio within 12 to 18 months.

Now let’s move to 2023 outlook on Slide 10. We enter 2023 with strong momentum and reasons to be cautiously optimistic about the year. Our leading safety technologies and solutions balanced across firefighter safety, gas detection and industrial PPE are sold around the world in a broad range of markets. These attractive and diversified markets remain healthy. We see growing demand globally for differentiated safety products that
not only protect workers but make them more productive. Demand trends in our business remain healthy and we entered the year with elevated backlog.

That said, we’re cognizant of the challenges in the macroeconomic and geopolitical environment, and that is resulting in less visibility as we look to the back half of the year. We do expect below-the-line headwinds to EPS from higher interest expense related to the higher rates for our existing debt and the incremental borrowings related to the divestiture, as well as lower noncash pension income. We expect pension and other nonoperating income to be between $13 million and $15 million for the year.

MSA’s business is diversified across products and geographies and time tested across economic cycles. While 2023 will surely have its own challenges, we are confident in our team’s ability to execute and drive another year of sales growth in the mid-single-digit range and further improve our operating margin.

With that, I’ll pass the call back to Nish for his closing remarks.

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

Thanks, Lee. Moving on to Slide 11. In closing, I’m incredibly proud of our accomplishments in 2022. Despite the many challenges of the past year, our team executed well and continued to make progress against our strategic priorities.

We enter 2023 from a position of strength and we expect to build on our momentum. Our balanced and diversified portfolio of innovative safety technologies has never been stronger and more relevant to our customers. We have exceptional talent throughout the company with a deep passion for our mission and proven capability of executing across economic cycles. I’m confident in our ability to continue to deliver long-term value creation to our shareholders.

With that, I’ll turn the call back over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question is from Stanley Elliott from Stifel.

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

Congratulations on the strong finish to the year.

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

Thank you, Stanley.

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

Could you all talk a little bit more about the strength in the Americas margins? Quite good, really this whole second half of the year despite what’s happening on the supply chain. I’m sure pricing is helping a bit. But could you give us a sense of the sustainability and kind of how we should think about the margin cadence really into ‘23, especially given kind of some of the first half disability versus some of the second half uncertainties that you’re talking about?
Sure. And Lee, why don’t you take that one?

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

All right. So really appreciate the questions, a good call out. I think it speaks to some really good momentum from the team. You’ve seen throughout the year some nice progression on both gross margin and with SG&A leverage. So I think you’ve seen that come together in the second half. Certainly, you get nice volume leverage. We’ve got some good productivity and then certainly price and costs are now in better alignment.

As we look towards next year, I mean, I think certainly for the first half of the year, you have to be positive. That dynamic could continue. So we’re pretty confident in where those levels are. You do have to adjust for the seasonality, Stanley; obviously, you’ve got some different quarterly sizes. But you’re going to see, I think, some nice progression year-over-year, similar to what you’ve seen in the back half of ’22 here.

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

Great. And you mentioned the backlog strength. Have you all seen any customers, either municipal or otherwise, canceling or pushing out any orders at this point? I’m assuming not, but would love to get a little color on that, if I could.

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

Stanley, no, we really haven’t seen any cancellations. A lot of our business is custom order. It’s specced in by the customer, and we really haven’t seen any cancellation of orders due to our inability to shift the backlog. We probably lost some business, to be upfront, especially in the area of fall protection where we’ve had opportunities with some orders and we’ve struggled with the supply chain and probably lost some business. But that type business never really got on our books. Our backlog is really healthy from the standpoint of being able to deliver and customers waiting on that.

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

And then lastly for me, you guys have talked about some larger potential orders on the fire services side. Is there any update you can share with us on that? And maybe what sort of timing should investors think about if you were to end up winning some of those contracts?

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

Yes, the pipeline is really healthy. When you think about the fire service, the municipal budgets and state budgets are really strong. We’ve got the AFG funding coming in again this year, so there’s a number of orders in the pipeline, some fairly large business. And that’s just a matter of working through the municipalities and getting their approvals and pacing from that standpoint.

We’re optimistic about the fire service business. We’re competing well in the marketplace with our products. We continue to enhance those products and be optimistic about that business. Regardless as to what the economy does in 2023, that business, as you know, is somewhat insulated from an economic recession that may occur in the back half of the year. That represents about 40% of our business. So we’re optimistic about the fire service here in ’23.

Operator

And the next question is from Rob Mason from Baird.
Robert W. Mason - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

I had a question around -- there was commentary around your 2023 outlook, but also, I think, in the press release just aiming for mid-single-digit growth for the year. If that proved to be the case, mid-single digit, how would that break down between contributions from price versus volume? And am I correct in thinking that FX is maybe neutral to even slightly positive for the year at this point?

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

It's a good question. We laid out our scenario planning for 2023. We went through a number of different scenarios on demand, price and there's even some backlog there. So we went through various scenarios. And the pricing, we're going to get some price, which is the overhang we'll have from our fourth quarter 2022 price increase. As we go through the first 9 months of '23, we'll get some price there.

And then we're looking at some demand, unit volume increasing. We do think in some of those core markets that we have, the fire service business, oil and gas business, we'll probably see low single-digit growth in those areas, and then the price on top of that gets us to that mid-single-digit level. So that's how we come to that scenario. We've worked through a number of different scenarios based on a possible economic slowdown in the back half of the year. There's the possibility of maybe obtaining some additional price in '23.

But we're still working through those scenarios, and we'll see how the year plays out. And then obviously, backlog plays into all of this and having an opportunity to possibly reduce backlog as supply chains improve for us. There are a lot of variables that could play out here in '23, but we keep coming back to, regardless of the scenario we go through, that we have a high degree of confidence in that mid-single-digit growth rate.

Robert W. Mason - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Nish, how do -- go ahead.

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

I was just going to add to your FX question. You have, I think, a pretty good view. It will be a bit of a headwind in the first half of the year and then be a positive in the back half. It will be a slight negative based on the current FX, Rob, right now.

Robert W. Mason - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

For the year, okay. Nish or Lee, just how are you -- you speak to orders. Just maybe dissect between your longer cycle and shorter cycle, longer cycle fire service may be set aside because it's -- on its own dynamic. But fixed gas and flame detection, I think, are being longer cycle, more potentially some project-based and then shorter cycle, obviously, industrial PPE. But can you speak to the 2 dynamics going on there?

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

Right. So on the short-cycle products, that business is really strong. In the fourth quarter, we had natural seasonality of that being a little lower than third quarter, which is very natural for us to see, but it was still strong when we consider the order pace across those short-cycle products. Quarter-to-date here in the first quarter from a booking standpoint, new orders: that business remains really good. Surprisingly good, to be quite honest, a little better than we anticipated coming into the quarter. And the outlook for that business remains solid based on some of the markets.

Obviously, we're watching some of the markets in those areas, the utilities business, the nonresidential construction and that whole other pie of other industrial manufacturing. We're watching those closely, as we can, and that business remains good. On the longer-cycle products, being fixed gas and flame detection, there's good demand there. The oil price being $75 and above, and that's the outlook for the future. That's healthy
for us. That's healthy for us from the standpoint of employment within the oil and gas industry, number one. And then number two, for projects. There will be some projects and funding of projects and the fixed gas and flame detection plays into that piece.

The beauty there is if there's some sort of recession in the back half of the year or a slowdown in business, that fixed gas and flame detection business is another stabilizer for our business. We often talk about our diversified portfolio and having resiliency and durability through different economic cycles. That's how we see some of that playing out. So we're fairly optimistic about our business as we get into '23 here.

Robert W. Mason - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Good, good. Maybe just one last housekeeping question, Lee. You mentioned pension income would be lower year-over-year at that level. Was it $22 million, $23 million in this past year roughly? Is that the level of decline we're talking about?

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

Year-over-year, it's going to be about a $6 million or $7 million difference. I can have Chris follow up the exact model difference, but that's the headwind going into us for '23.

Operator

(Operator Instructions) The next question is from Larry De Maria with William Blair.

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

Maybe I missed this, but can you just give maybe a little bit more color on orders, book-to-bill, lead times? And kind of curious if we're starting to see the order book sort of normalize as supply chains get better or is this still well into the second half? Any color there, first off, please?

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

So Larry, the order pace has been good. We're really pleased with the order pace, the order pace that we saw throughout the year. We saw a good strong order pace. For the year, the book-to-bill was 106% so obviously, we had good strength in orders. Supply chain created a bit of a headwind for us. And quite frankly, supply chain continues to be an issue. It has improved, and the way we would define it best is to complete a product, we might have been waiting for 8 or 9 different components to finish some products. Today, we're waiting for a couple of components. So that has improved, but we're still not perfect and still working through some of that.

The demand for product remains strong here in the first quarter, and we're optimistic about the business certainly through the first half of the year. And the back half, we think that we have some resiliency in our portfolio that will withstand an economic slowdown, and that's where, obviously, the backlog could help us. If things slow down in the back half of the year, we certainly have that backlog as a cushion going throughout the year.

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

Okay. And then within a mid-single-digit growth outlook for '23, but you've mentioned a couple of times, obviously, some concern on the second half macro but obviously also some resiliency there. How do we think about first half or second half and apply that to the mid-single-digit growth? Should we have close to maybe double-digit growth in the first half and flatter growth in the second half and see what happens? Or how are we kind of breaking that down first half, second half?
Nishan J. Vartanian - MSA Safety Incorporated - Chairman, President & CEO

So I'll let Lee take that for us.

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

All right. So Larry, it’s a good question. Certainly, we have more visibility to the first half than we do to the second half. I’d guide you to: we’re probably going to be in the more positive side of that mid-single digit in the first half of the year. And then if you just take the math with less outlook visibility for the second half, it could be lower. But to Nish’s points earlier, we’re going to have to see how that plays out.

There is an element of price that’s out there but there’s also an element of volume. So based on the mid-single-digit guide, again, I’d guide a little bit higher in the first half than the second half. We’ll just have to see how the first half plays out here, but we’re optimistic.

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

Yes. That’s fair enough, and that’s exactly what I was wondering. The second part of the question and the last one would be around incremental margins in ’23. Are we in the 30% to 40% normal range or are there some weird things in there?

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

No, I think that 30% to 40%, which is what we’ve committed to, we still see that opportunity in ’23. Certainly, we’ve covered below OM, you’ve got some of those temporary headwinds, things like the interest and stuff like that. But as you saw, really strong incrementals and a lot of those dynamics, whether it’s the price/cost dynamic, whether it’s this mix we have into North America, I mean, these are all positive things that should continue certainly in the first half of ’23 as well.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Chris Hepler for any closing remarks.

Chris Hepler - MSA Safety Incorporated - Executive Director of Corporate Development & Investor Relations

Thank you. If you missed the portion of today’s call, an audio replay will be made available later today on our Investor Relations website and will be available for the next 90 days. We appreciate you joining us this morning, and we look forward to speaking with you again soon. Thanks.

Operator

The conference has now concluded. Thank you for attending today’s presentation. You may now disconnect.