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PRESENTATION

Operator
Good day, and welcome to the MSA Q2 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 and Investor Relations
Thank you, Chad. Good morning, and welcome to MSA's Second Quarter 2022 Conference Call. This is Chris Hepler, Executive Director of Corporate Development and Investor Relations. I'm here with Nish Vartanian, Chairman, President and CEO; and Ken Krause, Senior Vice President, CFO and Treasurer.

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 anticipated levels of future performance. Forward-looking statements include 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 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 and the non-GAAP reconciliations as well as our second quarter press release are available on our Investor Relations website at investors.msasafety.com.

Moving on to today's agenda. Nish will discuss key highlights of the quarter and then turn the call over to Ken to discuss our financial performance. Nish will then provide 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
Thank you, Chris, and good morning, everyone. Before getting into the details of the quarter, I'll start today's call by sharing some information that has all of us at MSA, very excited. Within the past several weeks, we were able to finalize significant breathing apparatus contracts with 2 of the most recognized fire departments in the world.
As you may have read in our recent press release, the Los Angeles County Fire Department has selected the G1 SCBA as its new respiratory protection system. Then following up that exciting news, we learned that the London Fire Brigade selected the MSA M1 SCBA as its new breathing apparatus of choice. You can find more information on that contract in our press release issued Tuesday.

Today, the MSA brand is a global leader in the firefighter safety market, and we’re grateful for the trust that LA County and the London Fire Brigade continue to place in us. Both wins are excellent examples of cross-selling to existing customers who already know MSA from fire protective clothing and helmets, and as you know, a key element of our strategy is to “protect the firefighter” from head to toe. Through a combination of product development initiatives and inorganic investments in well-established brands like Globe and Bristol, our team continues to advance that strategy.

When we look at our business more broadly, overall demand continued to be very strong in the quarter across most all of our core products and markets. Orders were up 15% in the quarter on a constant currency basis and 10% organically. Book-to-bill continued to trend well above 1x again this quarter. And in July, we continue to see good growth in orders over the prior year.

Our quarterly revenue, which continues to be restrained by supply chain issues was $373 million, up 9% from a year ago on a reported basis and 12% on a constant currency basis. Currency translation was a 3% headwind in the quarter. Ken will discuss this in more detail in his remarks.

Backlog at quarter end was again at a record level of over $400 million as a result of strong demand and ongoing supply chain issues. Backlog has increased steadily over the past 1.5 years and is up across all product categories.

Supply chain and inflation continue to be factors, and we expect this to persist in the near term. As anticipated, supply chain issues were most pronounced in electronic components in our gas detection business. Our teams are working on a number of initiatives to address these challenges.

We continue to build supply chain resiliency, especially for electronic components, by engineering redesigns to increase flexibility for high-risk components, as well as qualifying alternative components and suppliers, and we’re using more technology to get better visibility to future availability of components. We’re also considering greater in-sourcing for certain key components, and we’re consciously building select inventory to serve our customers in high demand areas. As we see it, building inventory is a good use of our strong balance sheet in this challenging environment to ensure we can respond to our customers’ expectations. All things considered, I remain very optimistic around the fundamentals of our business and the durability of customer demand for MSA products and solutions.

Shifting gears a bit, in June, we published our annual Corporate Social Responsibility report. As I’ve said on many occasions, Corporate Social Responsibility is at the heart of what we do at MSA. Our mission is to keep the world’s workers safe each and every day so they may return home safe to their families.

As I reflect on our progress, I’m energized about both our vision for the future of worker safety and the next steps in our CSR journey. We continue to make investments in products, services and connected worker solutions that reimagine the next generation of worker safety. We also continue to enhance our programs around environmental sustainability and talent, as well as various risk reduction programs such as the supply chain resiliency programs I just talked about.

We do this because at MSA, we know these are the kind of investments that help us to build a better business model in these times. Our people continue to bring passion for our mission, which inspires us to design, develop, and manufacture the world’s best safety solutions that protect people who put their trust in the MSA brand. So while I’m very pleased with our results this quarter, our journey continues to make our company, our associates and our customers fit for the future.

With that, I’ll now turn the call over to Ken for his comments. Ken?
Quarterly sales were $372 million, up 9% on a reported basis. On a constant currency basis, quarterly sales were up 12% and 8% organically, driven by both price realization and improvements in volume. Currency translation impacted consolidated sales by 3% this quarter, largely due to euro and British pound exposure in our International business.

Orders were very strong in the quarter across the portfolio, up 15% on a constant currency basis over last year. Organic orders also showed double-digit improvement, reflecting healthy trends across both price and volume. Quarterly book-to-bill was in excess of 1.1x, and we saw double-digit year-over-year growth in orders each month throughout Q2 and continue to see a robust order pace into July.

While we saw strong sales and order growth in the quarter, supply chain issues continue to constrain our growth and drive up our backlog. As Nish had mentioned, we finished the quarter with record backlog, driven by robust customer demand and ongoing supply chain challenges. Backlog was up by another $50 million from the first quarter. The increase was primarily attributable to SCBA, firefighter protective clothing and gas detection.

Now turning to profitability, gross profit was 44.2% of sales in the quarter. Acquisition-related intangible asset amortization impacted gross margin by 60 basis points in the quarter. Adjusting for amortization in both periods, quarterly gross margin was down slightly on a year-over-year basis. This was driven by higher inflationary pressures and product warranty charges, offset by improved pricing, especially in the Americas segment. Pricing remains at the top of our agenda, and our team is focused on managing the price/cost equation.

SG&A expense in the quarter was $86 million or 23.1% of sales, up $3 million from the prior year. The increase was largely attributable to higher employee wages and costs associated with increased business activity. As a percent of sales, we realized strong leverage in SG&A on the double-digit sales growth, which offset the gross profit headwinds I mentioned previously.

Reported operating margin was 16.5%, up 620 basis points over the prior year. On an adjusted basis, operating margin was 17.6%, up 40 basis points on margin accretion from Bacharach. With that, I'll provide a closer look at our segment performance.

In our Americas segment, we had strong growth in sales, up 16% or 10% organically. Adjusted operating margin was 22.6%, in line with the prior year.

In our International segment, sales were down 3% on a reported basis but up 5% in constant currency, or up 2% in organic constant currency terms. The quarterly currency translation headwind was significant at 8% on the weaker euro and pound that I mentioned previously. Adjusted operating margin was 14.3%, down 220 basis points from last year due to unfavorable currency headwinds, large orders and higher input costs impacting gross profit, offset partially by improvements in SG&A performance. We continue to see very good leverage in international SG&A from our restructuring programs that we've executed over the past couple of years.

GAAP net income was $48 million or $1.21 in earnings per share, compared to GAAP net income of $25 million or $0.64 in earnings per share in the prior year. On an adjusted basis, adding back in both periods, product liability expense, restructuring and similar items, net income was $51 million or $1.29 in adjusted EPS, which was a 22% increase over the prior year on the 9% increase in reported sales.

Just over a year ago now, we completed the acquisition of Bacharach. Bacharach expanded our gas detection business into new applications and expanded our addressable market. The business is performing very well. Demand is strong and backlog is robust. Margin performance has been very strong, quite frankly, ahead of our expectations with adjusted operating margins trending just under 30% for the quarter and year-to-date periods.

Turning to cash flow and the balance sheet. Quarterly free cash flow was $4 million. Free cash flow was impacted by an increase in working capital, notably inventory and receivables, in response to strong customer demand and ongoing supply chain bottlenecks and receivables associated with strong shipping at the end of the quarter.
Inventory is up approximately $60 million from year-end on the over $100 million increase in backlog. Given the dynamic nature of the supply chain and availability of certain components, we are investing in inventory to help deliver our backlog. We do expect to see improvements in inventory as we expect to see sequential strengthening in the second half revenue performance versus the first half.

Quarterly CapEx was $12 million. We paid $18 million of dividends to shareholders and deployed $28 million to repurchase shares during the quarter.

At the end of the quarter, we had cash of $134 million and net debt of $489 million or 1.6x adjusted EBITDA for the trailing 12 months.

Our second quarter performance demonstrated the strength of our diversified business. As we navigate through an increasingly uncertain economic environment, our teams continue to focus on getting product out the door and managing the price/cost equation. We entered the second half of the year with solid underlying demand in our end markets and a robust backlog. Our strong balance sheet positions us well to invest in our business and provides good optionality as we continue to focus on execution and driving long-term, profitable growth for our shareholders.

Before wrapping up, I just want to comment on our outlook. Despite the dynamic macro environment, our end markets remain very healthy. Funding in the fire service is healthy. The OGP market is supported by strong commodity prices, and construction and utilities are performing well. That said, there are increasing risks of a recession in many of our key regions. As such, our internal planning continues to consider a range of economic scenarios, and we are prepared to take actions in the event we see a softening in our business.

With that, I’ll turn the call back over to Nish for closing remarks. Nish?

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

Thank you, Ken, In closing, I want to highlight a couple of things. We certainly acknowledge the growing economic uncertainties from rising interest rates, high inflation and recession risks, but I remain very confident in the fundamentals of our business and our team’s ability to work through the challenges of today’s macroeconomic environment. Our end markets remain healthy, and robust underlying demand for our products and technologies continued in the second quarter and well into July. And we entered the second half with a record backlog and a very healthy balance sheet, which we're putting to work, building some inventory in high-demand product areas to better serve customers who put their trust in the MSA brand.

I look forward to our team executing our plan in the second half to continue to bring strong results. I thank you for your interest in MSA. And at this time, Ken and I will be glad to take any questions you may have.

QUESTIONS AND ANSWERS

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

What kind of what you’re seeing within the Americas? I mean the breathing apparatus up 26%, head protection up 18%. Is some of that just supply chain may be catching up a little bit for you all. Just curious how to balance that kind of thinking about the rest of the year?
Nishan J. Vartanian - MSA Safety Incorporated - Chairman, President & CEO

So Stanley, the end-user markets are really strong. The oil and gas industry is strong. As Ken mentioned, the construction industry continues to do quite well for us. Our general industrial business is good, along with utilities, so that drives an awful lot of the hard hat business, portable gas detection business that we’re seeing. We continue to see good demand for fixed gas and flame detection products, and as you know, we’re restrained in getting that out the door. We expect to see that improve over the second half of the year.

The fire service business is just really well funded; we see some -- the opportunity pipeline has been very strong for us, and we’re starting to realize some of that business, as you’ve heard with L.A. County Fire Department. We’ve realized some other decent sized orders. And of course, now we’re going into the assistance to firefighter grant season. So those funds are going to begin to be released here in the second half of the year.

So we should see good demand for breathing apparatus over the back half of the year. Overall, the end-user markets are really good. It’s not a matter of distributors restocking or any situation like that because a number of our products, as you know, are built to order. So we don’t see a whole lot built into that backlog. Just the overall environment is pretty strong for us.

Kenneth D. Krause - MSA Safety Incorporated - Senior VP, CFO & Treasurer

Stanley, if I could put a finer point on it, what I would also say looking at the financial performance and using a bit more data. The Americas segment book-to-bill ratio was north of 110% and breathing apparatus, even despite having 26% constant currency revenue growth, had a book-to-bill of north of 1x. So the demand continues to be exceptional -- industrial head protection also above 1. That’s a business you don’t normally want to see be above 1 because you want to be able to respond to your customers quickly. But demand continues to be very strong as we navigate through and manage through the quarter.

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

And basically, it sounds like demand is tracking ahead of expectation, but then you have the FX piece. So just kind of putting all those together. Help us with the wins. Very nice to see a lot of the investments you guys have made on the SCBA side. When should you start to see the flow through for either for L.A. or for London?

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

So the L.A. order will ship for the most part in the third quarter. We expect to start shipping those in late August, maybe September. So we should see most of that order go in the third quarter. Some of it may stray into the fourth quarter, based on the customer expectations and what they’re looking for.

London will probably start to ship beginning in the fourth quarter, and that will extend into actually the second quarter. They have laid out a delivery schedule for us and continue to refine that. So we expect that to be spread out over 3 quarters.

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

And then lastly, we’re hearing concerns about manufacturing especially in Europe with energy cost, et cetera. How big of a concern is that for you all? Maybe some of the things you all can do to kind of help mitigate some of those higher costs over there?

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

So we continue to analyze the situation in Europe. We’re staying close to it, obviously, with some of the challenges that might arise due to pure economic impact of a recession in Europe. And then secondly, the impact that, that might have on our supply chains and inflation. We continue
to look at some alternative solutions to where we are sourcing some products out of Germany to have secondary resources, and we continue to look at strengthening and working with some of those suppliers and making sure we stay close to them to work on supply chain there. And that's where we're not shy about building some inventory. We talk about building inventory and using the balance sheet to build inventory, where we have the opportunity to do that to offset some of those unknowns in the marketplace. We'll certainly do that, Stanley.

Operator
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

Nice job and outlook. A question, incrementals were a little bit below what we expected, but still, obviously, overall good performance given the choppy environment. But can you just talk to your ability to hit those mid-30s incrementals in the second half, which I think we're all hoping for, but can you just give some color on that?

Kenneth D. Krause - MSA Safety Incorporated - Senior VP, CFO & Treasurer

Yes. That's a great question, Larry, and thank you for the question. This is Ken. As we look at the back half of the plan, we do feel like we have an opportunity to get back to that level of incremental margin profile that you identify. And in fact, our internal plans indicate us doing that. So we certainly think it's very realistic. When we think about the second half and some of the drivers associated with that, as we've talked about in some of our prepared commentary, the one point that we want to emphasize is, we do expect a sequential stronger second half in terms of revenue performance. And if we do see that come through, which we do have confidence in that, we do expect to see a significant leveraging across our business, across SG&A. We don't see major drivers of SG&A increasing sequentially between now and the second half. And so that additional revenue volume that would come through, would certainly help boost the incremental margins to a much higher level first.

Secondarily, product mix would certainly have an impact. When we look at our backlog, we look at our business, the products that we -- the gas detection products, for example, some of our higher-margin products are certainly being hampered by some of the supply chain challenges. So if we do see that improve into the second half, that also will be a bit of a tailwind in our incremental margin profile.

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

That's very helpful. And should we consider it still an incremental margin build through 3Q to 4Q or hopefully hit those numbers both quarters? Or is it kind of fourth quarter heavy? I think last year, obviously, we had a good fourth quarter.

Kenneth D. Krause - MSA Safety Incorporated - Senior VP, CFO & Treasurer

I think that when you look at the business and you look at historically how the business profiles in terms of seasonality, Q3 is normally a pretty healthy quarter. We expect it to be healthy. However, Q3 also is impacted by European holidays and other sorts of events. But we do have some confidence in our ability to see high mid-single-digit year-over-year growth to low double-digit year-over-year growth in Q3 versus last year. Q4 has historically been our strongest quarter of our year, so we expect that to be very similar again here as we think about the second half of 2022. But summing it all up and looking at our business, it wouldn't be unreasonable to expect a high single, low double-digit sort of increase in revenue in the second half versus what we saw here historically.
Lawrence Tighe De Maria - William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure

Perfect. And then secondly, on the new wins, I think you called that $9 million for London. Can you just put some perspective, is this a -- is that the start, is there a possibility for bringing on turnout year? And how is LUNAR doing, is LUNAR an option? Or just kind of put some perspective in, if that's the start of what could happen in London and L.A. or if that's the entirety?

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

The beauty of both departments. So one with L.A.: L.A. has been an MSA customer for turnout gear. So they've been a user of Globe turnout gear for many years, and that helped us to build our relationship in L.A. to win that business. That's part of the cross-selling advantage we have with covering the firefighter from head to toe. So that's what we saw in that. LA had ordered all their units with integrated thermal imaging cameras, the iTIC. They are evaluating and will continue to look at LUNAR as an opportunity. That would be a longer-term project with Los Angeles because of the size of the department, the magnitude and putting that into their SOPs. So they chose to go with the iTIC.

The London Fire Brigade were also a Bristol Uniforms customer, and so again, able to leverage some of those relationships to help us with that business, with some of the familiarity with the customer. And they have their own type of unit that they use very specific to the London Fire Brigade. That million dollars is for all of the business from London. But what we do anticipate is surrounding departments to follow London. This is our first major win in the U.K., and a number of departments are looking to London and what they did with their choice of breathing apparatus. So we certainly expect that this is going to help us with our business profile in the U.K., probably Scotland, Ireland and some of the other countries in that region, just as the win with Boston helped us with the Northeast part of the U.S. So it's a pivotal win for us.

A number of departments around the world look to that win. London is also taking a look at LUNAR and find the technology intriguing. But again, for a large department like that, that would be a much longer-term decision due to putting that into their SOPs and rolling out a major change in product like that. So those opportunities continue to be out there for us.

Operator

(Operator Instructions) The next question is from Rob Mason from Baird.

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

I just wanted to see if you could update us on, I guess, your pricing plans for the second half of the year. You mentioned along with supply chain components still being a challenge at times, inflation as well. I'm just curious what you're seeing on the inflationary front and whether it's triggered any additional thoughts around adding price?

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

Rob, we did see inflation kind of tempered down a bit in the second quarter. We had higher inflation in the first quarter, and it came down a bit in the second quarter as far as the pace of inflation. But in the U.S., in North America, we implemented a price increase in April. We have one planned in June, price increase in June, for our International organization, and we continue to evaluate if there will be a need for additional price increases in the back part of the year.

So clearly, we're still catching up to the pricing. The price cost equation, we're still playing catch up to some of that. And so we expect that, obviously, the April and the June price increase will come through here in the next couple of quarters. And we're going to -- if we need to, we'll certainly push the button on increases later in the year. The North American organization did an off-cycle price increase in November. So that's something we're discussing based upon what we see as far as inflation in the supply chain as we go forward.
Robert W. Mason - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Just perhaps relatedly, Nish, you mentioned AFG funding cycle about to get underway. Any prospects for inflation to be accounted for in some of the thresholds around products. I guess the funding levels themselves may be fixed. But could that anything that could help you on that front deal with the inflation or the customer deal with inflation as well?

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

A really insightful question. We are, in fact, working with the administration on pricing and increase in pricing. And they have just recognized when we brought it to their attention, the fact that all manufacturers are seeing inflation in the supply chain, and we are working with them to up the limits on the amount that the fire departments can spend on turnout gear, breathing apparatus, et cetera.

So they're aware; we'll probably see that work into the cycle for 2023, but they're certainly aware of it. We're working with them on it. But there's still room in the current funding pricing levels for them to purchase the breathing apparatus. And again, a number of departments, municipalities will supplement some of those dollars with local dollars. So we are working on it.

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

Sure. Just maybe last question around some of the supply chain challenges, component availability. At one point, we were speaking to fixed gas flame -- all the gas detection products and SCBA, I'm not hearing is much around SCBA now and your volumes are rising. Is -- has the SCBA constraint been solved?

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

I wouldn't use the word solved. I would say that we're in a much better position with SCBA. Our suppliers have met their commitments certainly through the second quarter and supplying us with components. The outlook for Q3 and Q4 is good, but what we can say about supply chains today is that they're consistently inconsistent, and we're certainly going to get surprises along the way.

But right now, yes, the supply chain looks good for breathing apparatus, and we hope that, that continues through the balance of the year because obviously, we have a nice backlog and want to get that out the door. As far as fixed gas and flame detection, we've talked about the self-help and qualifying alternative electronic components. We certainly hope to see some volume come through on what we call the X&S 5000. That's the mainstay of fixed gas and flame detection line, and we believe that we should be able to get those out in volume here in the -- starting in the third quarter and certainly larger volumes in the fourth quarter. So that should improve as we work through the year here. But again, there's always the risk in supply chains and people keeping commitments.

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 and Investor Relations

Thank you for joining us this morning. If you missed a portion of the conference call, an audio replay and transcript will be available on our Investor Relations website for the next 90 days. We look forward to speaking with you again soon. Thank you.
Operator

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