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MSA - Q3 2014 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Welcome to the MSA third-quarter earnings conference call. My name is Lorraine and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to Mr. Ken Krause. Mr. Krause, you may begin.

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

Good morning, everyone, and welcome to our third-quarter earnings conference call for 2014. I am Ken Krause, Executive Director of Global Finance and Assistant Treasurer for MSA.

Joining me on the call this morning are Bill Lambert, President and Chief Executive Officer; Stacy McMahan, Senior Vice President and Chief Financial Officer; Ron Herring, President of MSA Europe; Nish Vartanian, President of MSA North America; Kerry Bove, President of MSA International.

Our third-quarter press release was issued last night and is available on our website at www.msasafety.com. This morning, Bill Lambert will provide his commentary on our quarter. Stacy will then review our financials and then Bill will conclude with his closing comments. After that, we will open up the call for your questions.

Before we began, I need to remind everyone that the matters discussed on this call, excluding historical information, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited, to all projections and anticipated levels of future performance and timing of new product approvals and related shipments.

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-K, which was filed on February 24, 2014.

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

In addition, 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. Reconciliations to the most directly comparable GAAP measures are available on our investor relations website at investors.msasafety.com within the financial information section.

And with that, let me introduce MSA's President and Chief Executive Officer, Bill Lambert.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Thank you very much, Ken, and good morning, everyone. As always, I want to begin by saying thank you for joining us this morning on this conference call and for your continued interest in MSA.

Presumably, all of you have seen our third-quarter press release, which was issued last night, and you have our financial figures, with all comparisons corresponding to the equivalent period in 2013.

I will begin this morning by reviewing the highlights of our third-quarter and I will give you an update on the G1 SCBA certification process. I also will share with you further details about some of our other exciting new core product offerings and give you more detail on a strategic initiative that will soon reach an inflection point.

After that, I will turn the call over to Stacy for a review of our financial results. And then we'll open up the call for your questions.

So why don't we begin? Sales in the third quarter were $275 million, which, as you know, includes continuing operations only and excludes $15 million of discontinued operations revenue from our South African distribution business and Zambian operations. Revenue of $275 million reflects a 4% increase from a year ago on a reported basis and a 5% increase in local currency terms.

Generating profitable growth in our five core product areas is a key pillar of our overall strategy. As a quick reminder, core products include fixed gas and flame detection systems, what we refer to as FGFD; portable gas detection instruments; industrial head protection products; fall protection products; and supplied air respirators, where self-contained breathing apparatus, or SCBA, is the principal product.

In the third quarter, sales of these products represented 74% of total revenue. We were able to grow our core sales by 6% from a year ago on a currency neutral basis, despite a 12% decline in SCBA sales. The decline in SCBA sales is a direct reflection of the ongoing delays in federal government approval of our revolutionary G1 SCBA platform.

On a local currency basis, core sales grew by 13% in the quarter, if you exclude SCBA sales from the comparison. This is evidence that our focus on the core is yielding solid growth opportunities for us and that once we clear this government approval hurdle on our new SCBA, we should benefit even further. More on the G1 and government approvals in just a minute.

Leading the growth during the quarter was a 20% increase in fixed gas and flame detection sales on double-digit growth across all three of our reporting segments, as we shipped several larger FGFD projects during the quarter.

We also continued to see success in the portable gas detection instruments, growing 13% in the quarter. Industrial head protection and fall protection were also sources of strength, most notably in North America, where sales were up 13% and 8%, respectively.

Globally, industrial head protection growth was a bit more moderated than we have seen in previous quarters, mostly driven by a decrease of activity in Brazil. Looking at our emerging markets, sales to these markets reflected 31% of total revenue in the quarter and grew a healthy 11% from a year ago, with core products increasing 13%.

As you all know, business conditions have been challenging this year in emerging markets throughout the world. While quarterly sales performance was strong across Asia and the Middle East, we saw sales decline 3% in Latin America.

While we expect our emerging market focus to be a source of long-term profitable growth for MSA, we also expect to see some choppiness over the next several quarters, in light of the stronger US dollar coupled with the general slowdown in activity in many of these emerging market regions.

In just a bit, Stacy will review our financials with you in much more detailed.

Now I would like to provide an update on the testing and approval process of our brand-new SCBA platform that we design side-by-side with firefighters. That's the MSA G1 SCBA.

On our last call, I commented that I expected to have the G1 SCBA approval process completed by the end of September and that we would begin shipping for the full fourth-quarter. However, that did not occur, as many of you know, and that is why we issued a statement on October 6, alerting our customers and the market that we now expect that approval to come in the fourth quarter.

Obviously, this was disappointing news for us and for our customers. But based on all we know at this point, I remain optimistic that certification will be granted in the coming weeks.

I say this because our product has performed extremely well against the significant battery of tests at NIOSH, the US Army, and the various independent test labs that comprise the federal government regulatory and NFPA certification requirements necessary for approval. And that, in and of itself, is no small accomplishment.

To give you an idea of how involved and demanding the SCBA certification process is, MSA has produced and submitted to the various test agencies 55 G1 SCBA test units to date. And these units have undergone a total of 340 individual tests, including a battery of extreme flame and heat tests, to gauge the ability of an SCBA and its electronics to withstand a catastrophic event like a flashover and still allow a firefighter to safely exit a building.

In all, our test units have been subjected to more than 400 hours of actual test time, conducted at 7 different independent test facilities. So that will give you a sense of what is involved in this process and you can imagine the close coordination required among the various testing agencies. Nevertheless, we are encouraged by the way our product has performed and as of this week, we have completed and passed all testing necessary for approval.

So in summary, I can tell you that we are now in the final review stage of the approval process and we remain confident in the G1's ability to receive the necessary approvals during this fourth quarter.

So the next question you are most likely asking is what does NFPA certification in the fourth quarter mean to our business? Well, as you would expect, that depends entirely on the timing and receiving that certification.

If it happens in the next week or so, then that is obviously a good thing, particularly for our fire department customers, who have been so patiently awaiting this new technology. If for some reason, it drags on into the fourth quarter, then it hampers our ability to put a dent in shipping the meaningful backlog of G1 orders that we have on the books.

We don't usually talk about backlog in our SCBA product line, but I will make an exception on this particular call because it is a meaningful number. What I can tell you this morning is that our backlog of G1 SCBA orders has grown steadily since we first unveiled the product back in April.

To date, our current SCBA backlog is approaching $70 million, up $30 million from the end of the second quarter, due primarily to a higher level of G1 SCBA orders in North America and to a lesser degree, a growing European segment backlog for the G1, specifically in the Middle East.

Given the fact that we are now nearing the end of October, we will not be able to clear this order book by year end. However, our expectation is that we will make progress against it. How much, exactly, once again, depends on the timing of our certification and our ability to quickly ramp up production on this revolutionary new product offering.

While timing of the final approval remains beyond our control, the steps we are focusing on right now include identifying fire departments that have the greatest need and prioritizing shipments for them, developing various SCBA subassemblies, and ramping up our manufacturing processes so we can begin final assembly production as soon as we receive word of certification from NIOSH, the Safety Equipment Institute, and the various other approval agencies involved with certification.

While we continue to operate in this waiting mode, I should note that we continue to fulfill orders for our other NFPA compliant unit, the M7XT SCBA. Orders for this unit have been stronger than we expected, but clearly, our customers are waiting on the G1 SCBA.

Looking at another area of MSA innovation, I am pleased to report that several of our products were recognized by Occupational Health & Safety Magazine. OH&S magazine is the industry-leading news magazine, e-newsletter, and website for occupational health and safety professionals.

I had mentioned on past calls our new helmet suspension system called the Fas-Trac III. This is a product we introduced earlier this year and it has really been embraced by the market because of the high level of comfort and retention it provides for wearers.

And now I am pleased to say that that same new suspension system was recently recognized as a New Product of the Year in the head protection category by Occupational Health & Safety Magazine.

We are proud of the recognition, but the bottom line is that we continued to see success from this product launch, evidenced by the 13% increase in North American head protection sales in the quarter. In fact, 80% of head protection sales in the quarter were from products developed and introduced over the past five years, driven largely by the new Fas-Trac III offering.

I am equally pleased to note that MSA won a second New Product of the Year from OH&S magazine, this time in the gas detection category for our breakthrough ALTAIR 2XP handheld instrument. This is a new product we highlighted at our investor day back in June.

What makes this product unique is that it provides users with unique and significant cost of ownership advantages over competitive offerings by giving users the ability to perform their own daily bump test to make sure the instrument is functioning properly.

Building on the success of this platform, we launched several new sensors for the instrument during the third quarter, including a low level hydrogen sulfide sensor, which has significant application in the oil and gas market. And also a new hydrogen-resistant carbon monoxide sensor that has application in the steel, the oil and gas, automotive, and chemical verticals.

These new sensors were developed by MSA organically and offer unique capabilities that align with unmet customer needs.

I am really pleased and excited about the accomplishments our gas detection team has made over the past several years. And the ALTAIR 2X family is yet another example of their innovative work.

To give you more context on this, consider that our year-to-date portable gas detection instrument sales are up 9% from a year ago and we have achieved a 15% compound annual growth rate over the last four years, with gross margins growing even faster. It's an organic growth success story that we are quite proud of.

Now I would like to take a moment to give you an update on our Europe 2.0 project, a multifaceted initiative that is designed to drive improvements throughout the P&L and streamline the way that we do business in Europe. We've reviewed this project in detail during our recent investor day, so I'll just provide a high level overview for anyone who is new to MSA.

Europe 2.0 is truly a transformational initiative. It is a strategic project encompassing two phases. And our overall goal is to move away from the pre-EU structure of independently managed affiliates to one based on common data and a broad range of standardized processes.

And the linchpins for this transformation are a new pan-European IT platform and a single and transparent logistic system working out of one location.

To date, we have made solid progress against our goals. We now have four of our largest affiliates operating under the common IT system of SAP. We have moved to a functionally managed organization across Europe and identified and validated over 70 core processes by which we run the business.

We have previously consolidated our local warehouses in Italy and Spain and this quarter, consolidated our France warehouse into a centralized warehouse in Germany.

While I am pleased with this progress and the milestones we've reached so far, our work is not yet done. Now our focus has shifted to Phase 2 of the transformation, which involves establishing a principal operating company model in Rapperswil, Switzerland, to serve as our European headquarters.

The principal operating company model will provide a multitude of benefits for MSA, many of which we have discussed on previous calls and in our investor day presentation back in June.

However, at a high level, the establishment of a principal operating company in Switzerland not only provides us with a centralized headquarters and a business-friendly environment, it more importantly allows our European organization to drive optimal performance and leverage the benefits we have achieved under the Europe 2.0 program thus far.

We are fast approaching an inflection point in our Europe 2.0 transformation project and we remain on track for the go-live of our principal operating company model in early January 2015. We should begin to see the financial impacts throughout 2015.

Executing a transformational project like this one requires significant investment to create long-term value. Related to these investments, we have and will continue to see higher SG&A spend related to relocation of key personnel, project-related consulting costs, as well as leasing and other cost related to the new office in Switzerland.

Another area where you will see this transformation come through the financial results is in our effective tax rate. As we exit certain affiliates and streamline our European structure into a Switzerland-based principal operating company model, we expect to incur charges related to exit taxes, resulting in a higher effective tax rate in the first quarter of next year and for the full year 2015.

However, as we discussed at investor day, the POC model has longer-term benefits. And beginning in 2016, we expect to start to realize a 200 to 300 basis point reduction in MSA's ongoing effective tax rate as a result of implementing this model in Europe, more than offsetting the initial investments.

While the POC model is expected to drive long-term benefits, it is important to recognize our restructuring efforts have driven strong results over the past several years in Europe. As recent as 2010, we recorded a net loss in Europe and our operating margin was below 3% in that segment of our business. For the first nine months of 2014, operating margin is now 9.7%, an improvement of 700 basis points since 2009.

So in summary, I am very encouraged by the progress we have made so far and I know that our team is well positioned to execute our strategy as we head into 2015. It is also nice to see that even with a significant program underway, we grew sales in Europe by 14% in the third quarter and saw growth in core products of 25%. We look forward to continuing to report on the activities included in this key project going to future quarters.

Now I would like to turn the call over to our CFO, Stacy McMahan, to provide an overview of our third-quarter financial performance. After Stacy finishes with her report, I will provide some closing comments and then we'll open up a call for your questions. Stacy?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Thank you, Bill, and good morning to you. I will now share some further insight into our third-quarter financial performance. Additional information will be available when we file our Form 10-Q with the Securities and Exchange Commission later today.

As Bill mentioned, sales from continuing operations in the third quarter were $275 million, up $10 million or 4% from the prior year on a reported basis and up 5% on a local currency basis. Looking at the sequential quarter comparison, local currency sales have decreased by 2% compared to the second quarter.

Across core products, revenue was flat when compared to the second quarter, with stronger shipments of FGFD being offset by a lower level of SCBA sales in North America and weaker head protection results across our emerging markets.

Within the noncore portfolio, a lower level of fire helmet sales across Europe and North America drove a 6% sequential quarter decline. Order activity was healthy in the quarter, primarily driven by G1 SCBA orders and additional amounts received on our large ballistic helmet contract in Western Europe.

While we see an opportunity to clear a meaningful amount of backlog in the quarter, shipping activity is highly dependent on the timing of final approval for the G1 SCBA.

Additionally, business conditions have become uneven in certain key emerging market geographies. As a result, we are cautious in our outlook for the end of this year and early next year.

As you may have noticed in our earnings release last night, we have provided an additional exhibit that highlight sales growth in the quarter and year by segment and by product. While I will give a high level of detail -- a high-level review of our sales by product and segment here today, please refer to that table for additional detail.

As Bill already reviewed on our consolidated core product results with you, let's jump into the segment performance now. In North America, sales in the third quarter were $132 million, increasing $1 million from the same quarter a year ago.

Excluding SCBA, sales were up $8 million compared to the same quarter a year ago in North America. Core sales comprised 80% of total segment sales and were flat from a year ago, as increases in sales of FGFD systems and head protection were offset by a decline in SCBA sales to the US fire service, as we continue to await approval of our G1 SCBA.

We saw an improvement in head protection sales driven by our new Fas-Trac III suspension product, while FGFD sales were up on a higher level of project-oriented business. Noncore sales, representing 20% of the business, were up 2% on higher sales of gas masks and respirators.

Our European segment reported third-quarter sales of $76 million, up 14% in local currency terms. Core sales comprise 69% of total sales in the segment and increased 25%, driven by an increase in sales of SCBA and portable instruments as well as increased shipments of FGFD systems throughout the segment.

Noncore sales, representing 31% of sales in the segment, were down 5%, primarily on lower level of fire helmet and gas masks sales, partially offset by a higher level of ballistic helmet shipments. We continue to hold approximately $20 million to $25 million of backlog in ballistic helmets related to a large military order received earlier this year. We expect to clear a portion of this order in the fourth quarter and the remainder in 2015.

Lastly, for our international segment, continuing sales of $68 million were flat compared to a year ago, but increased 3% in local currency terms. Core sales comprise 68% of total sales and were relatively flat when compared to the same period a year ago.

Strong shipments of FGFD systems and portable gas detection were mostly offset by a lower level of large SCBA orders and weaker head protection sales, notably in Brazil, where economic conditions are a concern. Noncore products, representing 32% of sales in this segment, are up 7% in the quarter on a higher level of circuit breathing apparatus devices in Southeast Asia.

Our gross profit rate for this quarter was 45%, an increase of 140 basis points from last year. We continue to see strong margin performance in the quarter, driven by improvements in mix, improvements in pricing across a number of new products we continue to introduce, and lower manufacturing-related cost.

Selling, general, and administrative costs were $77 million, increasing $6 million or 8% from a year ago. The higher level of SG&A is primarily related to strategic projects in Europe and increasing selling- and marketing-related costs on the higher core sales volume.

Compared to the second quarter of this year, SG&A is down $6 million as reported or $5 million on a local currency basis. Lower spending on strategic initiatives and trade shows reduced the sequential quarter comparison by $2 million, while the timing of product liability-related expenses reduced expense by $3 million.

Our investment in research and develop this quarter was $13 million, up $1 million from a year ago, as we continue to invest in innovative new core products like the G1 SCBA. We recorded nearly $4 million in restructuring expense across our European and international segments in the quarter as we continue to work towards implementing an improved cost structure.

Approximately $3 million of this expense was incurred in Europe, as we continue to focus on our corporate strategy and executing our Europe 2.0 program, while the rest was related to severance costs across the international segment as we reduced headcount to mitigate the effect of weaker business conditions in certain markets.

Operating income, which excludes currency gains, restructuring, interest, and other income, was $33 million, or 12% of sales in the quarter, flat from a year ago. While net income margins improved across our North American segment on stronger gross profit, margins declined in Europe, as higher gross profit margins were offset by higher SG&A to support strategic projects and an increase in restructuring costs. We also saw weakness in international net income margin on a flat level of sales across the segment.

Our consolidated tax rate this quarter was 32.1%, up 260 basis points from the same period a year ago on a less favorable mix and delayed approval of the R&D tax credit. Our year-to-date effective tax rate is now 32.6%.

Net income from continuing operations was $19 million in the third quarter or $0.50 per basic share. Excluding $4 million of pre-tax restructuring and foreign exchange losses net of associated tax, adjusted earnings were $21 million, or $0.57 per basic share, increasing 2% from a year ago.

Free cash flow was $26 million in the quarter, approximately 134% of net income. We paid down debt by $11 million and issued dividends of $12 million. At the end of the quarter, total debt approximated $277 million, while cash was $97 million, comprised substantially of balances outside of the United States.

In closing, strong shipments of core products drove results in the quarter and we continue to see success with expanding product margins. Though the backlog is healthy and provides an opportunity to drive higher sales volume in the fourth quarter, we see risk over the next few quarters due to challenging conditions across several of our key emerging markets, while our ability to convert North America's backlog in the fourth quarter is largely dependent upon the timing of the G1 SCBA approval.

Thank you for your attention. I will now return the microphone to Bill.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Thank you, Stacy. While challenges associated with SCBA approval delays continued to weigh on us in the third quarter, the progress we are making at driving a higher level of core product sales throughout the world continues to generate value for our shareholders.

As we near the end of our historic 100th year in business, we remain committed to the pillars of our corporate strategy that have provided value to our shareholders over the past several years, even as we've battled through various challenges.

While our Company has evolved in many different ways over the past 100 years, our spirit of innovation and our mission of protecting people's health and safety have remained unchanged. Thank you for your attention and your interest in our Company this morning.

At this time, Nish Vartanian, Kerry Bove, and Ron Herring have joined Stacy, Ken, and me and we will be happy to take any questions you may have.

Please remember that MSA does not give what is referred to as guidance and that precludes most discussion related to our expectations for future sales and earnings. Having said that, we will now open the call up to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Edward Marshall, Sidoti & Company.

Edward Marshall - *Sidoti & Company - Analyst*

Good morning. I wanted to start with Europe, because I thought that was a pretty good result there on the topline. And I think I caught it, but I just wanted to confirm -- did you say that was related to sales to, say, the Middle East and Africa due to energy?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

That's right, Ed. Core products really drove the results in the quarter over in Europe, specifically gas detection and SCBA. And a big piece of that was the Middle East, as you heard.

In fact, the Middle East continued to be a success story for us this year, up nearly 40% year to date. And a lot of that is FGFD business, but plus supplied air respirator business or SCBA.

Edward Marshall - *Sidoti & Company - Analyst*

And then I wanted to talk about, if I could, the R&D expense, which in the third quarter was probably the highest I think I have ever seen from you guys, but really outpaced the last 12 months.

Is that one time in nature? Was that related to the SCBA? What might be driving that? I know you are working on several new products, but that seemed a little bit high.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Well, that was a 9% increase over the quarter a year ago. And if you look at it on a year-to-date basis, we are running about 4.4% of sales versus 4.2% of sales a year ago. So it is not that out of line, but it was definitely an indication of the increased emphasis we are putting on getting some new products out the door.

Also related that, Ed, as we have more of our focus on those core areas of the business -- be it fixed gas and flame detection, portable gas detection, supplied air respirators, fall protection, or head protection -- those are the areas of the business that require more R&D and are more technology related, have -- require us to have greater investments in those types of technologies to gain advantage.

So I think yes, to answer your question, the third quarter was high on a standalone basis, but year to date, it is only moderately higher. And I think on an ongoing basis, you would expect to see MSA probably in that 4% to 4.5% of sales range for R&D expense.

Edward Marshall - *Sidoti & Company - Analyst*

Okay. Then finally, I wanted to talk about the SCBA test. And I am not sure what the relevant measure that is meaningful for us to understand where we are in the process. Obviously, we are in extra innings here. We anticipated it was going to be out here already.

But I am just curious -- is it one test, is it two tests, that might be coming up the pipeline? And you put 400 hours in -- how much more hours do you anticipate are actually necessary for the approvals to happen? Whatever you think may be the right and meaningful measure for us to really understand exactly where we are in the process.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Ed, what I tried to indicate in my commentary was that there are no more tests to be run. We have completed and passed all the necessary testing by the various approval agencies. And I indicated we are in that final review stage with the agencies.

And what I mean by that is that they look over the quality assurance package that we provide, they look over the drawings, they look over the instructions for use, the warnings, the limitations of use that we provide to our customers. Most recently, last week, they asked us for a revision to one of our instructions.

So we are going through that paperwork stage now, where they are looking at our warnings, looking at our limitations of use, looking at our instructions to operators, and they provide commentary in that regard. So that is that final review process.

All of that heavy lifting, so to speak, all of the testing that I described on those 55 SCBA, that is behind us and we have passed all of that testing.

Edward Marshall - *Sidoti & Company - Analyst*

Okay. So it is just a matter of the editing the document at this point, I guess is essentially the way to look at it.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Well, they approve the entire SCBA, which is inclusive of not just the product itself and how it performs, but also the instructions that we provide users, the limitations of use that we provide, and the warnings that we provide.

Edward Marshall - *Sidoti & Company - Analyst*

Okay. Great. Thanks, guys, I appreciate it.

Operator

Shivangi Tipnis, Global Hunter.

Shivangi Tipnis - *Global Hunter Securities, LLC - Analyst*

My first question is on the SCBA. You mentioned that you had the orders in play is about $70 million between Q2 and Q3. Can you just talk about how the orders trended between since you pre-released [of the announce] that getting it's into Q4 and what are the cost impacts on the inventory since then?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Yes, let me correct you. We indicated that our total backlog for supplied air respirators was $70 million. That was up about $30 million from the second quarter --

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Shivangi Tipnis - *Global Hunter Securities, LLC - Analyst*

Okay.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

So the sequential increase was about $30 million. And a big portion of that was G1 SCBA-related here in North America and to a lesser degree, G1-related in Europe, primarily in the Middle East.

And then your question is what might be the backlog as we look at Q4. We don't provide guidance in that regard. I will say that our continuing order book for the G1 SCBA is quite healthy and quite strong. We are very pleased by that.

We will have an impact on the balance sheet, certainly, as we ramp up production. We are bringing inventory in; we are producing product at a subassembly level so that we can as quickly as possible convert those subassemblies into final assembly and see shipments during the fourth quarter.

Shivangi Tipnis - *Global Hunter Securities, LLC - Analyst*

Okay, thank you. And on the 2.0 platform, you talked about some financial implications in the ACN. You also detailed (inaudible) and move and all that. So is it [about connect] actually or quantify these measures for us?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Ken, I will look to you on safety.

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

What I would say, Shivangi, Bill had spoke a little bit about exit charges that we might incur in the first quarter. What I would like to -- what I would say on that is a lot of those exit charges are dependent upon how we finish 2014.

So a lot of those charges are yet to be determined, but we will know much better -- we will have much better information as we close out the year and we report the year-end results in February.

So I would say maybe stay tuned on that front, but right now, we do expect some short-term increases in the effective tax rate associated with the effective tax -- associated with the exit charges. But we still remain confident in our ability to go after that 200 to 300 basis points of improvement longer term in the effective tax rate.

Shivangi Tipnis - *Global Hunter Securities, LLC - Analyst*

Okay. Sounds good. Thank you, guys.

Operator

Stanley Elliott, Stifel.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Good morning, everyone. Quick question on the oil and gas businesses. So [you know], prevalent through most of your products. But with oil really taking a step down, hovering near $80 per barrel, is there a price for your customers that have started saying that they would be willing to delay projects in terms of some of their capital spending, which might impact some of your fixed gas or even portable gas or head protection business?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Yes, that is a very good question, Stan, and I don't think there is a -- there is not a clear answer one way or the other, but let me give you a sense of what we are thinking here.

Certainly as crude prices fall, that is going to crimp oil producers' profit margins and eventually it is going to deter them from making the necessary investments in exploration and production upstream. So depending on how low oil gets, it is going to impact the oil producers' view of their capital spend.

Now to put it in context, we estimate our totals from our total sales about one-third to 40% of our sales are related to oil and gas, the gas industry -- upstream, midstream, downstream.

The biggest impact, really, then would be on the fixed gas and flame detection side of our business. And yet, two-thirds of that fixed gas and flame detection business is really day-to-day operations and maintenance and repair of and replacement of sensors and the instruments.

So we are really looking at about one-third of our FGFD business and how might it be impacted as capital spending might slow down or be pushed out. It is really on a project-by-project basis with the oil producers. We have seen some projects be delayed or be pushed out into 2015, but is it so meaningful or material to us?

We are not seeing that as of yet. I will say that our fixed gas and flame detection business year to date is right at plan. It is growing at about mid-single digits over a year ago.

We don't believe that the head protection side or the portable gas detection side is really going to be impacted here. Those are primarily related to downstream activities and what goes on in the plants or refineries during a turnaround operation.

And so we see less of an impact on portable gas detection and in head protection. Probably the area of risk we have is related to FGFD and I have tried to give you a sense of what we see or what kind of an impact we might feel there.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Yes, well, that does have such a nice replacement business and good margins. That it should continue, regardless, would be my guess. And for the product liability in the quarter on the SG&A -- has that changed anything or this just more of a timing type of event?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

It is timing, Stanley. It is related to the progress of our insurance litigation. And we essentially just didn't have anything on the docket that generated expense, but we do expect that expense will return.

Stanley Elliott - *Stifel Nicolaus - Analyst*

And I hate to ask for anything that related to guidance, but when we talk about a higher SG&A spend into next year, are you talking about a percentage points difference as a percent of sales or is there a dollar number that we should gauge, just to try to get a better feel for the cadence?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

No, I think you'll see something very similar to what you have seen in the last couple of quarters. So I would just use history as a bit of a guide, because we have had some strategic initiatives already baked into the SG&A.

Stanley Elliott - *Stifel Nicolaus - Analyst*

And that would be -- would that be history excluding, like, the FDIC and the centennial anniversary-type expenses?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Look at the last couple of quarters.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Okay. And then one last question. As far as the tax rate, when we look at 200 basis points to 300 basis points of improvement into 2016 and beyond, will that be off of the higher effective tax rate that we are looking at for 2015 or would that be more historical normalized numbers?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Historical normalized numbers.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Perfect. Congratulations, guys.

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Thanks so much.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Thanks, Stan.

Operator

Richard Eastman, Robert W. Baird.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Good morning. Maybe speak -- we have got the backlog -- a really good feel for the backlog on the G1. You had mentioned you largely replaced your military helmet shipments regarding the backlog in orders.

But how does the FG&F backlog look? And maybe even SCBA backlog non-G1, because both of those businesses can be subject to some lumpy shipments and backlog timing. How do they look relative to your sales here in this quarter, which were quite good?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Rick, I will ask Ken Krause. I think Ken has a little better understanding there.

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

Yes, sure. I would say without going into too much detail, that overall, the backlog is healthy. We specifically pointed out the backlog in the SCBA, but outside of the SCBA and we look at fixed gas and flame detection, I would classify it at healthy levels going into the fourth quarter of 2014 here.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And the -- again, timing-wise, when we look at larger shipments year over year, fourth quarter over fourth quarter, are we going to hold up okay there? I mean, will we be able to match that or will we have any really tough comparisons from fourth quarter last year?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Stacy, do you want to take that one?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Yes. I think in Q -- fourth quarter last year, we did have a lump of larger orders that shipped. So but overall, the quarter was a fairly -- a lower quarter, historically.

So you are going to have two things moving. We have the SCBA being at a lower, level, because we were deep into our waiting period for the G1. But then you also see that there were some larger orders that shipped in the fourth quarter, mainly project business-related to FGFD. So it is going to be a mixed bag.

And our order book indicates again we should have a fairly healthy fourth-quarter, totally dependent on that SCBA ship -- the G1 shipping.

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

The only thing I would add, Stacy, is related to the emerging markets and our finish last year in the emerging markets, they were -- it was extremely strong point for us to finish the year.

And as Bill had indicated in his comments, those emerging markets are a bit concerning in certain areas. So that might be a challenging comp as we finish the year, Rick.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Could you just -- you kind of lead me right into my second question here -- but regarding the emerging markets, Bill, you threw out a couple warning flags on Brazil and I think we have all been tracking their economy, tracking it down, I guess.

Asia, you took some incremental restructuring, it sounds like, in international. Does that market place stay with some positive growth -- I mean, low single digits? Ken, it you mentioned a tough compare in the fourth quarter. I think it was a 20% compare.

But how -- over the next maybe 12 months, should our caution start with a negative sign or can we at least feel like we have got enough new product momentum to at least grow the international peace?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Yes, let me take a stab at it and then I will ask Stacy or Ken, or Kerry or Ron to jump in here.

Rick, as you know, our emerging markets are -- include both those areas that are in the European segment as well as what we consider the international segment. And while we saw growth in our emerging markets, we look at all of those. In the third quarter we saw growth of almost 11% I think, maybe a little bit higher.

Ken is looking at me like it was maybe 13% --

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

13%, right.

Bill Lambert - *MSA Safety Incorporated - President and CEO*

-- in the third quarter. I think the caution flag is out. When we look at Europe, I will try to break this apart a little bit for us. When we look at Europe, the European emerging markets were up 39% in the third quarter and that was related to, as I indicated earlier, the fixed gas and flame detection project business across the region, but most notably in the Middle East. And we had large order of SCBA shipments in the Middle East.

But when we also consider Europe, we look at Russia, which is a part of that, our emerging market there. The economic outlook is quite poor there. And it is very, very difficult for us to predict what the future may hold there.

That then spills over into the Eastern European markets. And so that is why we have got the warning flag out in the European emerging markets. When we look at international, which consists of Africa and Latin America, Southeast Asia and China, they were up combined 3% in the quarter.

But China was up on large order shipments in SCBA and fixed gas and flame detection, but it was against a weaker comp. So we can't -- we don't expect to see that kind of continued growth in China itself.

In Southeast Asia, growth was a little bit more moderated than what we have seen in the past on some delays in shipping FGFD orders. And it was related to the weakness in the Indonesian mining and the Thailand political crisis.

So when we look at some of those emerging markets in Asia and Southeast Asia, there is a warning flag up. And then as you are indicating in Latin America, most concerning is Brazil and maybe to a lesser degree, but still a concern, is Argentina.

Both economies are in recession. We are absolutely feeling it in Brazil. Argentina, we are skirting it a little bit in the sense that we made a strategic initiative to actually produce product down there.

We invested in our Argentinean operations and that has -- we had benefited from that in spite of the fact that Argentina is in a recession right now. So there's some concern there. But offsetting that a bit is good strength in Chile and Peru and Colombia, where we continue to see some good performance.

So it is really a mixed message. I hope I don't -- didn't confuse you in that regard, but it is really a mixed message when we look across the emerging markets and I think that is where the statements of caution that Stacy indicated and I indicated, that is where that is coming from.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And Bill, you had -- did you give the emerging market percentage of sales? Is it 20%, 22% -- or we know what international was in Europe, but was there an emerging market number percentage of total sales?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

It was 31%.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

31%. Okay. Then Stacy, just is follow-on, I promise. All of this is local currency commentary, but presumably, currency has an impact on sales, strengthening dollar, certainly becomes a bigger issue in the fourth quarter and into 2015, correct?

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Yes, it certainly does. And that is another flag.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Okay, thank you.

Operator

Brian Rafn, Morgan Dempsey.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Good morning, everybody. Question for you. You talked a little bit about some of the weakness in the emerging markets. I am assuming you are talking from a sales revenue standpoint.

In those areas like Brazil and like Argentina, where you may be having some more -- a little difficulty, are the follow-on bid quote activities also finding a maxed erosion with a decline in sales?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Are you referring specifically to Brazil and Argentina?

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Well, yes, maybe just open it up just -- emerging markets, where you are seeing difficulties in markets where maybe from the standpoint of sales revenue? Are you also seen the follow-on where it is applicable, a weakness in the long term?

We are seeing fall off in sales; we are also seeing less bid quote activity, less activity in business.

Stacy McMahan - *MSA Safety Incorporated - SVP, CFO*

Well, our emerging market orders that -- have been sort of mixed for the quarter, so we see a good pace in the Middle East, as we talked about. But we have seen a pullback in Russia, Eastern Europe, and Latin America due to the conditions we cited earlier. And a relatively flat order pace, excluding any large one-time shipments in Southeast Asia and China.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay, all right. Let me ask on the G1, you guys had a great presentation at your analyst day. Bill, and I know it is a tough question, is there any possibility that that could be delayed beyond the fourth quarter or is there any communications back and forth with some of the regulatory that it might go into 2015 before a decision is made?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Brian, that is such a hard question to answer. Is there any possibility, based on what we have been through over the last 18 months? Then I would say yes. There is a possibility. I feel that it is unlikely, but there is always that possibility.

But it is out of our control at this point, at this moment. I know that the product that we have submitted, the products we have submitted, have performed really, really well in all of the testing. All of the testing is behind it.

It is now a matter of paperwork review and assurances. And I really feel, based on our history, based on all the decades we have been in business and we have been having product approved by NIOSH and by the SEI, that we feel pretty confident we will have this in the fourth quarter.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Yes. Good answer. Let me ask you, Bill, from the standpoint of the new G1 SCBA -- with a $70 million backlog, do you get the sense in with the -- where you are on the threshold of a new product launch that you may see many or a few years in the front end of that product have fairly substantial sales growth?

Or is the backlog such that it is kind of a one-time $70 million and then you will be more at normalized? I am just trying to get a sense of what the pent-up demand for this new G1 might be over multiple years?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Yes. Let me try to clarify something first, Brian. The $70 million is for all of our supplied air respirator products. That is inclusive of more than the G1. Now most of that third-quarter ramp-up in backlog was related to the G1, but of that $70 million, I would say maybe a little bit more than one-half, one-half to two-thirds is related to the G1 SCBA, which is still very, very healthy.

Now is that sustainable? Or I guess what you are asking really is the growth sustainable in the SCBA business. We think that it is. There are only two manufacturers in the industry right now who have approvals to the new NFPA standard. Both of those products are older generation products. The G1 is an entirely new generation product.

Two major manufactures don't have approval. And so we believe there is great opportunity to gain market share with this product, with this platform. We are seeing it and I think it is reflective of the large backlog that we have, of our ability to convert competitive accounts with this new platform product. So we feel very optimistic looking forward and we think it has got a pretty long runway.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. Let me ask you on -- I think you guys call it the M7 that the self-contained breathing apparatus that you still can sell. Is that -- maybe not have a perpetual lifespan, but once you get into active production, delivery of the G1, is that phased out or is that a second-tier price point SCBA?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Well, I think what you'll see is you see both of those things happening. It is definitely at a different price point than the G1 SCBA, a lower price point than the G1 SCBA.

But over time, we would expect to see the M7XT phase out. That is just a natural attrition on that product. We will continue to have it in our product line for likely the next five years to support those customers that are committed to the M7XT and are happy with it. But new SCBA sales will likely move toward, shift toward the G1 SCBA without question.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Yes, okay. Anecdotally, Bill, any fire departments that just couldn't wait any longer and may have purchased that for the G1 or is that really not applicable to that channel?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

No, I think it is applicable to that channel. I think there are a number of instances where fire departments who really believed in the G1, they were competitive accounts, but for various reasons just could not wait any longer. So there is a small percentage of our business that we actually lost because we did not have the G1 SCBA.

And that is really unfortunate and we feel horrible about that, but I think it is a little bit inevitable, because the fire departments have got to move on and they have got to continue to do their work. They have issues like expiring cylinders in their inventories, expiring in the sense that the cylinders have gone to their full lifecycle of 15 years.

They need to buy new SCBA; they need to buy new cylinders. And because we don't have -- did not have the G1 SCBA, they had to commit to the current product line that they had, which happens to be a competitive product line. So we have lost a little bit of business, no question.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. All right. May I ask a little more of a strategic question, Bill. When you guys get through 2015, 2016 on your Europe 2.0 restructuring, you look at Europe from the standpoint of cost structure, productivity, efficiency, best practices.

Does Europe then move to a parity, with your operations in the United States or North America? Or will Europe be ahead and then causing maybe a restructure on the North American side?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

Well, I think that over the horizon that you have indicated, Brian, it is aspirational that Europe would achieve operating margins similar to North America. I don't foresee over the horizon you're indicating where Europe would actually have better operating margins than North America.

And that is fundamentally driven, quite honestly, by topline growth and the ability to leverage those operating expenses. We don't have any expectation that Europe is going to be able to grow at double-digit growth rates over the next three to five years, as you are indicating there. I just don't think that is possible.

Europe will be a much more efficient operation with a much lower tax base, so they will be much more profitable and value generating. But to really expect them to get into a leadership pace among all of our segments, I think that is -- I don't think that's in the cards for the next three to five years. I would be very happy if our European operations achieved operating margins similar to what we see today in North America.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. Okay. And just one final question. Are you guys the on the raw material feedstocks, commodity inflation, you seeing anything in raw materials inflation or deflation?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

We saw inflation and cost increases associated with high density polyethylene. There is something happening within the supply chain market, global supply chain market, on high density polyethylene, which we use in our hardhats.

But we think that is only temporary. We think that the falling price of crude oil will ultimately result in lower costs for feedstocks. So we see that as a benefit and certainly an offset to whatever we have seen, the slight increases we have seen in high density polyethylene.

So a bit of a mixed story there, but I think that with oil prices now down around $80 a barrel, we should ultimately see lower cost feedstocks.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Thanks, Bill. Appreciate it.

Operator

Rudy Hokanson, Barrington Research.

Rudy Hokanson - *Barrington Research Associates, Inc. - Analyst*

A lot of good questions have already been asked. Very quickly, if it is possible to answer this, in terms of looking at the emerging markets and expected orders and areas, as in the fixed gas detection, what kind of visibility do you have where you can see an order coming and the turnaround time where it becomes an actual sale?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

We have fairly good, but not great, visibility into that, Rudy. The fixed gas and flame detection side of our business is a very long sale cycle part of our business. And what I mean by that is that we are working with the engineering and procurement contractors, early stages of projects in that business. And those are years in the making.

Now the two-thirds of our FGFD business which is maintenance related, which is replacement related, that is -- that has a little bit better clarity on it, but again, not great. Not great clarity for us. So it is mixed.

Rudy Hokanson - *Barrington Research Associates, Inc. - Analyst*

All right. So as we look at emerging markets right now and you are talking about their volatility or, you know, the current economic conditions, it is more related to smaller individual units that would be sold, such as head protection or something, like that that you are not sure on the timing of when things may and may not come in, rather than whether or not somebody would be making an order or placing an order for something related to fixed gas and fire detection?

Bill Lambert - *MSA Safety Incorporated - President and CEO*

That is a very complex question, because our emerging markets are made up of quite a few different areas in regions in the world. In the Latin American area, I think you are absolutely right. It is related to the smaller orders or a pace associated with things like head protection or even supplied air respirators that you have seen.

In some other large parts of the world, like Southeast Asia and in China, we have seen it is related to the fixed gas and flame protection, the larger orders, those that are more related to capital spending.

Rudy Hokanson - *Barrington Research Associates, Inc. - Analyst*

Okay. Thank you very much.

Operator

I would now like to turn the call over to Mr. Ken Krause for closing remarks.

Ken Krause - *MSA Safety Incorporated - Executive Director, Global Finance and Assistant Treasurer*

Great. Thank you so much. Seeing that we have no more questions, that concludes this morning's call. If you missed a portion of the conference, an audio replay will be available on our website for the next 90 days, as will a transcript of the call.

On behalf of our entire team here, I want to thank you again for joining us and we look forward to talking with you again soon. Have a great day.

Operator

Thank you. And thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.
