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MSA.N - Q1 2022 MSA Safety Inc Earnings Call

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OVERVIEW:

Co. reported 1Q22 revenue of $331m, GAAP net income of $35.5m and GAAP diluted EPS of $0.90.

CORPORATE PARTICIPANTS

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

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

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

PRESENTATION

Operator

Good day, and welcome to the MSA Safety's First Quarter 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. Good morning, and welcome to MSA's First 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; Ken Krause, Senior Vice President, CFO and Treasurer; and Steve Blanco, President of 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 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 the first quarter 2022 press release are available on our Investor Relations website at investors.msasafety.com.

Moving 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. I'll start today's call by recognizing a key milestone at MSA, then talk about highlights for the quarter and the progress we're making around new innovative technologies.

First, with the milestone, which I'm particularly proud of. We officially completed the first quarter without a lost time incident. We often talk about a "culture of safety" at MSA. This milestone certainly reflects that mindset and is a great start to the year from this perspective. It reflects the hard work and commitment to safety our associates bring to work every day. As a company focused on workplace safety, we know we have a responsibility to lead by example, to help create a safe work environment. So I want to thank our entire team on this very important achievement.

Now moving on to the highlights for the first quarter. We're off to a solid start to the year, performing in line with our expectations. Demand for our products and technology continue to be robust across our core product groups and key geographies. And our teams did a nice job of navigating various challenges throughout the quarter.

Our quarterly revenue was $331 million, a 7% increase from a year ago and 9% on a constant currency basis. Organic orders were exceptionally strong, up double digits, resulting in a book-to-bill of 1.2x and record backlog up more than $60 million from the end of the year. Gross margin was healthy, and adjusted operating margin improved 90 basis points year-over-year. It was good to see the healthy operating margin again this quarter. This is a trend we believe can continue, provided we successfully manage supply chain disruptions going forward. This is a key priority of ours, along with pricing, as inflation doesn't show signs of moderating.

Supply chain constraints continue to be a challenge, particularly around electronic components. This is most pronounced in our gas detection business. The tight supply chain environment has resulted in price escalation on many of our input costs. Our teams are managing through it, and while there are no quick fixes, we're working diligently to get products into the hands of our customers.

To that end, we've invested in resources to help us address these challenges. This includes investments in artificial intelligence software that help our supply chain teams anticipate issues around key inventory items. We're building visibility deeper into our supply chain, adding resources to our sourcing team, and working through engineering and approvals to increase flexibility around certain constrained components. We're also working on initiatives to increase flexibility within our production lines, so that when constrained parts are obtained, we're able to better accelerate throughput.

All that said, given the current environment, we expect these supply chain challenges to continue in the coming quarters.

We're staying close to our customers and are actively monitoring our backlog. To date, we're not seeing any signs of material cancellations, which makes sense given the nature of our business and is in line with what we'd expect as our products are specified into their processes and procedures. So that gives us confidence that our backlog will ultimately be converted to revenue over the coming quarters.

Moving on I want to provide color on 2 of our end markets: firefighter safety and energy. Starting with firefighter safety, we saw a very strong level of new incoming orders and 5% constant currency sales growth in the quarter. The funding environment remains healthy in support of continued growth of our key products. In the quarter, we saw several meaningful U.S. fire service orders for our G1 SCBA. Demand for turnout gear remains strong, and we continue to work to reach our output goals.

Next, to energy, across the energy sector, we're focused on protecting the health and safety of workers and facilities, whether in oil, gas, petrochemical or renewable applications. Historically, elevated oil and natural gas prices, like we're seeing today, have positive impacts on employment and expenditures in the sector. Ultimately, that translates into a nice tailwind for our business, as approximately 25% to 30% of our annual sales are related to this sector, and we're seeing strong demand across all our product lines.

Lastly, before I turn the call over to Ken, I want to highlight the progress we're making in the connected worker space where our innovations are driving improvements in worker safety. Last year, we previewed at the National Safety Congress MSA's Connected Work Platform for industrial markets. This platform is a powerful hardware/software combination. It starts with the ALTAIR io4, a wearable, cloud-ready gas detector device. When connected with our MSA+ safety subscription service, safety managers will have a powerful platform to enhance worker safety while driving efficiency and simplifying safety program management.

It's incredibly exciting to see this area of MSA's business begin to gain traction. We've already begun taking preorders for the ALTAIR io4, and shipments to customers will begin in early May. Also in May, our team will be hosting a Connectivity Summit. This is a virtual, 3-day event focused on how gas detection wearables and software solutions can help enhance workers' safety and productivity. The Summit is scheduled for May 17th, 18th and 19th and will feature MSA experts discussing the future of connected work, the ALTAIR io4 and our cloud-based software solutions.

For the industrial worker, we also launched the V-Gard C1 hard hat. Head protection is an area where we continue to leverage our strong market position to drive innovation. The new V-Gard C1 is a cooling hard hat. By that, I mean, it has a heat-reflective interior liner that essentially reduces the temperature inside the hard hat by as much as 20 degrees Fahrenheit. As we near the summer months here in the Northern Hemisphere, we're seeing a lot of interest in the C1 in Florida, the Gulf Coast region and other markets where heat stress is an important safety issue that we're helping to address.

It's a really exciting time to be at MSA. We're making meaningful strides in advancing our mission of worker safety. And with that, I'll turn the call over to Ken to take you through more detail on our financial results. Ken?

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

Thanks, Nish, and good morning, everyone. I'll review our consolidated financial results for the quarter and our balance sheet on today's call. I'd like to start with a focus on first demand and secondly, margins. First, demand remains exceptionally strong across our core products and key geographies.

Overall, we saw organic orders in the quarter, up mid-teens over last year. There was strong demand across our core products and each of our segments. Book-to-bill for the quarter was 1.2x, and we continue to build backlog, ending the quarter at another record level. Order pace continues to be robust in April with orders growing approximately 20% organically.

Gross profit margins remained healthy in the quarter. We continue to take action on the pricing side, and that is helping us navigate the inflationary environment. Incremental margins finished the quarter at just under 30%. It was good to see healthy incremental margins for a second quarter in a row. We remain committed to delivering strong incremental margins going forward.

Let's now review the quarterly details, starting with a focus on sales. First quarter sales were $331 million, up 9% on a constant currency basis, driven by core growth of 11%. The 9% growth was balanced with acquisitions adding 5% and organic activity contributing 4%. It was good to see healthy growth across the core and across both of our reporting segments.

Sales in our Americas segment were up 9% on a constant currency basis, with acquisitions contributing 6% and organic activity driving 3% of growth. Sales in our International segment were up 10% on a constant currency basis with growth of 5% equally from acquisitions and organic activity. Currency translation drove a 5% reduction in International's reported sales in the quarter on a strong dollar relative to a number of international currencies, most notably the euro.

Orders were very healthy in the quarter. Unfortunately, we continue to navigate ongoing supply chain constraints and tight labor conditions. The supply chain challenges and the strong order pace I spoke about earlier led to us ending the quarter with record backlog. Backlog was up more than $60 million from year-end and more than $150 million from the end of Q1 2021.

While revenues benefited from the strong pricing environment, we are seeing strong demand and unit growth across the business, as evidenced by the 16% organic order growth in the quarter.

As Nish mentioned, availability of electronic components continues to be a challenge. Supplier allocations are unpredictable and have not been pacing with the growth and demand for our products. Our global teams are working together to secure components where and when available. They're designing in and qualifying new components and expediting approvals when required. As far as we can tell, supply chain constraints will most likely persist for the remainder of the year.

Now turning to profitability and earnings. Gross profit totaled $143 million or 43.2% of sales in the quarter compared to $135 million or 43.7% of sales in the prior year. Higher amortization from acquisitions was the primary driver of the gross profit decline as well as a less favorable mix. Looking at the underlying performance, it's good to see that price/cost held in well despite the challenging inflationary environment.

I commented earlier on the constrained nature of the supply chain. Another aspect that is prevalent is the cost of labor and materials, which have risen sharply. This has been particularly pronounced in the electronic components we source. It's a challenging and dynamic environment. With that said, we continue to be proactive with the variables under our control.

Our increased volumes and pricing actions helped us offset inflation in the quarter. We are keeping inflation and pricing front and center. We continue to evaluate and implement price increases to mitigate the impact of the rising costs. As we've said in the past, we continue to be focused on staying positive on the price/cost equation. While it may vary quarter-to-quarter, when we think about the year, our objective is to stay positive.

Given the robust demand and broad-based nature of inflation in wages and materials throughout the value chain, pricing remains healthy. We had an off-cycle price increase take effect in April in our Americas segment, and we announced an off-cycle price increase in our International segment that will take effect midyear. We'll continue to have a sharp focus on price cost going forward to mitigate the impact on our margins and profitability profile.

SG&A expense in the quarter was $78.6 million or 23.8% of sales, up about $3 million from the prior year. Despite the inclusion of additional costs associated with our acquisitions, SG&A leverage improved 70 basis points as a percentage of sales.

Q1 reported operating margin was 12.9%, down 140 basis points compared to the prior year. Adjusted operating margin was 16.3%, up 90 basis points versus last year, as a result of higher volumes and improved SG&A leverage. It was especially good to see about 60 basis points of accretion from our Bacharach acquisition in the quarter, with a positive impact in both gross profit and SG&A leverage.

Looking at our segment performance, Americas adjusted operating margin was just over 23%, up 150 basis points over the comparable period. International's adjusted operating margin was 8.6%, down 20 basis points over the comparable period, driven primarily by lower gross margins on a less favorable product mix. We are continuing to execute on initiatives to increase throughput and deliver cost savings across our business.

On a GAAP basis, we reported net income of $35.5 million, which equates to $0.90 per diluted share. This compares to GAAP earnings of $36.5 million or $0.92 in the prior year. On an adjusted basis, adding back in both periods, product liability expense, restructuring and similar items, net income was $43.6 million or $1.10 earnings per diluted share, which is a 16% increase over the prior year.

Turning to cash flow and the balance sheet. Quarterly cash flow was $16.5 million. We invested in inventory in the quarter, as we secured scarce components to help us serve demand and orders for the year ahead. Inventory was up 15% from year-end, driven in part by higher costs and also by an increase in volume associated with the higher backlog in our business. In the quarter, we invested $8 million in CapEx and paid $17.3 million of dividends to shareholders. At the end of the quarter, we had cash of $147 million and net debt of $452 million or 1.5x our last 12 months adjusted EBITDA.

The health of our balance sheet and our liquidity position provide us with ample capacity to invest in the long-term growth opportunities for our business. We will continue to execute our capital allocation strategy that balances profitable growth and returning capital to our shareholders.

In summary, Q1 provides a solid start to the year. We had balanced growth and improvement in adjusted operating margin, driven by both acquisitions as well as organic activity. Our end markets are healthy. Demand is strong, and our team is working diligently to deliver products for our customers. We continue to navigate a very challenging environment and remain focused on driving improvements in our supply chain to meet the growing demand for our products. At the same time, we also continue to manage our margin profile in light of the ongoing inflationary pressures.

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. As Ken mentioned, it was good to see Bacharach contributing positively to our overall performance. The integration work is on track, and we're seeing the benefits of the synergies we expected from this acquisition. And lastly, you'll see that we issued a press release earlier this week regarding the annual Fire Department Instructors Conference. As many of you know, this is among the largest fire service shows in the world, and it returns to a full-scale event for the first time since the start of the pandemic. We're excited to be in Indianapolis again this week, where we'll be showcasing our market-leading fire safety products and our Connected Firefighter Platform, including LUNAR and FireGrid. We're rolling out several new features, which will help keep firefighters connected in ways never before possible. It will be an exciting time to be with our customers and distributors, demonstrating our latest innovations.

Overall, I'm really pleased with how we executed in Q1, and a robust pace of incoming business through April gives me a high level of confidence in our business going forward. At this time, Ken and I will be glad to take any questions you may have.

QUESTIONS AND ANSWERS

Operator

We will now begin the question-and-answer session.

(Operator Instructions)

And the first question will be from Stanley Elliott from Stifel.

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

Thank you all for taking the call -- the question. Quick question. Ken, you mentioned the supply chain continue to persist through the remainder of the year. With some of the news coming out of China about certain markets they're shutting down or -- what sort of expectations should we have around the supply chain? Does it get better? Does it get worse? Just curious how you're thinking about that with all the moving parts.

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

Stanley, thanks for calling in today. Yes. So on the supply chain, and as far as China is concerned, at this point, we're not seeing any impact from China on our supply chain and any issues with their recent shutdowns. We may start to see some impact in Suzhou, our plant that manufactures in China for China. There could be some impact there as we go forward. But we haven't seen any of that at this point.

When we look at the overall supply chain, as I sit here today at the end of April, I have a higher degree of confidence in where we are and our ability to deliver our plan for 2022 than I did back in February. We have some good agreements with some suppliers. We have some higher level of confidence that we'll get some of these electronic components that will start coming in, in the third, fourth quarters; and we're doing some good work to prepare ourselves for the throughput in our factories, so we can certainly get the product out the door.

So I do, at this time, have a higher degree of confidence in what we can do for the balance of the year, but as we know, we're in an unknown environment where things change day to day. A lot of times, the commitments that are made by suppliers, they're not able to keep. But that said, I do have a higher level of confidence today than I did back in February.

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

Great news. And along the supply chain, I mean, certainly, the volume put out on the fixed gas flame detection, is something happening internally or externally as it relates to the chip shortage issues that everybody has been hearing about because there's lots of momentum in that business currently?

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

Yes, there is. So from an incoming standpoint, the business is super healthy. We had one real large order that was shipped internationally and a lot of that build for that delivery was done in the fourth quarter. We shipped that in the first quarter, so that helped the revenue in the first quarter. But with fixed gas and flame detection and portable gas detection, those are 2 areas that have been really constrained by electronic components.

And we're going to continue to battle through that in the second quarter, but we believe that we'll have some daylight as we get into third and fourth quarters due to some of the commitments we're getting from some of our suppliers.

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

And then lastly, kind of thinking about incremental margins with margins and price cost staying a focus. Should we think about incrementals staying pretty similar both for the 2 regions through the balance of the year? Or do they improve? Just curious how we're thinking about the ramp there.

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

Yes, Stanley, it's Ken. Just a few comments on the incremental margins. As I had indicated in my prepared comments, we do expect to continue to aggressively pursue the 30% to 40% incremental margin profile. When I step back and I look at the first quarter, 29%, I'm certainly pleased by the performance that we saw in the first quarter in the inflationary environment that we continue to operate in. As we move forward, we are hopeful that we will continue to see improvements, especially in the International segment.

The first quarter was certainly a low -- I would call it, a low point with respect to margins in our International segment, as we've continued to aggressively pursue price. And we also should see an improvement in our mix of business that we're shipping. As Nish had indicated, we shipped some large orders with lower margins which we felt the pain in the margin profile of that business. So as we go throughout the year, we do expect to continue to gain traction and gain momentum in the margin profile across our business.

Operator

And the next question is from Rob Mason with Baird.

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

Nish, I don't want to put words in your mouth, but your commentary around feeling more confident on the plan for the year. At one point, we were talking about prospects for high single-digit growth for revenue. Can I assign the confidence to that level of growth through the year, sales growth?

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

Rob, yes, absolutely. We have a high degree of confidence of that mid-high single-digit level growth rate for the business. And again, that's providing we can get the components in. And then I have a higher degree of confidence that we can get those components in versus when I was sitting here in February. So I do feel better about the business. The demand is strong. The pipeline is strong. We just have to work hard to make sure that our suppliers hold up to their commitments to get those components to us.

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

Rob, it's Ken. Maybe I'd just add a little color to that in terms of scenarios that we're looking at for our business as we think about '22. The order pace continues to be very robust. As I had indicated in my comments, we're seeing almost a 20% increase organically in business in the month of

April after a 16% gain in the first quarter. And so if we were to see, and it's a big word, I know, but if we were to see an improvement in the supply chain, we could probably see a really strong finish to the year in the second half, which could drive strong double-digit growth in our business.

However, as Nish indicated, when we look at our business today and the challenges we have, that high single-digit growth rate is probably very realistic in terms of our expectations for the business for 2022.

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

Right, right. Yes. I mean the supply chain tightness continuing, that's become a familiar refrain. I think most companies are dealing with that. So it's just when does it start to loosen up. You had also mentioned, I think, in the remarks, you -- just labor as well. Again, that's kind of been an ongoing challenge. How do you -- how does that factor in to being able to scale up and how you feel about that aspect of the business?

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

Rob, that aspect has really impacted our turnout gear sales. And that comes out of -- predominantly out of our Pittsfield, New Hampshire facility. That has been a tight labor market, and it has improved. We've seen more job applicants. We've increased the headcount. We're doing a nice job in ramping up and training and retaining employees. So we're seeing some nice improvement in the throughput in that plant, but we're still well below our internal goals and what we expect. And Anne, Steve and the team are working hard to make sure we continue to ramp up on the headcount and get the throughput in that plant. But that's predominantly an issue around labor and tightness of labor, but we're beginning to see that improve a bit, and we hope that, that continues to show improvement throughout the year.

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

Sure. Just finally, I hear you on your incremental margin expectations. Just actually in the quarter, SG&A was a positive variance from what I was expecting and maybe where you would finish the second half of the year, just the level of SG&A. Is that -- how does that trend through the balance of the year off the first quarter level? Or what's your thoughts there?

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

Yes. So the cost structure continues to be a focus for us, Rob, as we look at our business, both internationally as well as in our Americas and Corporate segments. I think we finished the quarter at roughly 23.8% of sales. As we see the business improve, we expect to continue to gain leverage in SG&A and that should benefit us on the operating margin profile. Historically, we've leveraged SG&A fairly nicely in terms of being at around 23% to 24% of sales when we think about the SG&A performance. So that's generally the view and the expectation for us as we think about the SG&A performance for the balance of the year.

Operator

(Operator Instructions) 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, Chad. And thank you all 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

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