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MSA - Q2 2014 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Welcome to the MSA second-quarter earnings conference call. My name is Paulette, 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 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 second-quarter earnings conference call for 2014. Joining us 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; and Nish Vartanian, President of MSA North America.

Our second-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 begin, 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, including without limitation all projections and anticipated levels of future performance, involve risk, 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 from time to time in our filings with the Securities and Exchange Commission, including our most recent 10-Q, which was filed on April 23, 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, our own website, and many other commercial sites.

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 included in our press release and on the Investor Relations section of our website. With that, let me introduce MSA's President and Chief Executive Officer, Bill Lambert.

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

Think 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 your continued interest in MSA. Presumably, all of you have seen our second-quarter press release issued last night and 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 second quarter, and I will talk about some of the exciting new core products that we've launched over the past several months. I also will share with you further details about some important corporate initiatives that we continue to focus on. And after that I will turn the call over to Stacy for a more detailed review of our financial results. Then we'll open up the call to your questions.

Second-quarter sales were just over $282 million, which, as you know, includes continuing operations only and excludes $11 million of discontinued operations revenue from our South African distribution business and our Zambian operations. Revenue of $282 million reflects a 1% decline from the same quarter a year ago on both a local currency and reported basis.

When comparing to the same period of 2013, it's important to keep in mind that the second quarter of last year was particularly strong from a revenue perspective -- most notably in the product areas of breathing apparatus and fixed gas and flame detection systems, where we delivered a large number of midsized shipments in this time period that drove double-digit core product growth.

Second-quarter SCBA sales this year continue to be challenged as we await federal government approval on our new SCBA, the G1. As you know, generating profitable growth in our core product areas is an important part of our overall strategy. As a quick reminder, core products include fixed gas and flame detection systems; portable gas detection instruments; industrial head protection products; and supplied air respirators, where self-contained breathing apparatus, or SCBA, is the principal product; and fall protection.

In the second quarter these products represented 73% of revenue and in total declined by 4% on the currency-neutral basis. As we have discussed with you on previous calls, delayed federal government product approvals from NIOSH continue to provide a significant challenge for us in the US fire service market. This, combined with the timing of delivery of a meaningful number of large FG/FD system sales, were the leading causes of the overall 4% decline.

Revenue from our other three core product areas increased 4% on strong performance in head protection and in portable gas detection. Emerging market sales collected 30% of total revenue in the quarter and were relatively flat in local currency terms compared to a year ago.

Lower project business across fixed gas and flame protection in Asia and in Latin America as well as a lower level of SCBA sales in China and ongoing labor unrest in Africa all had an impact on our international performance in the quarter. The headwinds I mentioned in international notwithstanding, the results we saw in the Middle East and in Eastern Europe provided a sense of optimism.

Quarterly local currency sales grew 21% in the quarter in the Middle East, while local currency sales in East Europe increased 34% on a smaller base. In just a bit, Stacy will review our sales by segment and sales by product line in more detail with you.

As we have discussed on previous calls, regulatory delays associated with approval of our revolutionary SCBA product for the fire service market, the MSA G1 SCBA, continued to be a significant headwind for us, but one that I still view as temporary. As you know, the G1 breathing apparatus was designed side-by-side with firefighters and has been the largest engineering product in MSA's history, resulting in impressive competitive advantages and lower total cost of ownership for our customers. In fact, the feedback we continue to receive from customers is quite promising and lets me know that we have hit the mark with this new product platform.

As I have mentioned on past calls, we introduced the G1 to customers at this year's Fire Department Instructors Conference with a very enthusiastic firefighter and channel partner response. During the second quarter we have produced quantities of fully functional sales samples that are being heavily demonstrated to fire departments in North America and globally in order to keep the momentum going.

We are accepting orders for the G1 and have started to build a very healthy backlog, but of course we cannot begin to ship G1 units until we received the required certifications for which we are well into the approval process. The approval process through the federal government test labs has been frustratingly slow. We now estimate that the testing and certification will be complete very late in the quarter, providing us with no opportunity to ship G1 SCBA against our amounting book of business within the third quarter.

At this time we do anticipate to begin shipping G1 units in the fourth quarter, echoing our discussion on the first-quarter earnings call. Related to this update, the tentative interim amendment, or TIA, issued by NFPA that allowed us to ship M7 SCBA units until June 30 has now expired. However, our M7XT SCBA was certified as NFPA-compliant early in the second quarter, and we continue to manufacture and ship the M7XT.

In fact, sales of the M7 XT have met our expectations in the second quarter. And I'm pleased with the progress this product continues to make. MSA is one of only three major manufacturers able to ship SCBA which are certified and compliant to the requirements of the new NFPA standard. Our M7XT SCBA is an approved product as we await approval and certification of our new G1 SCBA.

In other areas of new product development, we continue to develop and launch key products in our other core product categories. In North America we have launched the new Workman fall protection harness and EVOTECH fall protection harness products that are certified to new standards governing climbers working near energized electrical sources, who face special hazards due to sudden unexpected arc flashes that can ignite or melt clothing and protective gear.

New standards have been promulgated that require arc flash certified harnesses to be used by electrical workers. OSHA has stated that their enforcement of these new requirements will escalate sharply beginning in 2015.

At the present time many electrical workers are wearing non-arc certified fall protection harnesses. So these new performance standards and the accompanying OSHA enforcement movement is anticipated to provide good growth opportunities for our new harness systems while improving safety for these workers.

In addition, we continue to focus on global fall protection opportunities. In the first half of this year, we've launched three new harness platforms that have been certified to European norm requirements. Included in it is a new utility harness also certified to arc flash requirements; a new gravity harness designed for the rope access and rescue markets in Brazil and Australia; and a new harness we are calling the Superlight, which is positioned well for price-sensitive emerging markets.

As you can see, our fall protection new development pipeline is full of exciting launches as we continue to capitalize on the opportunities available within the global fall production space, which we believe represents one of the largest individual and fastest-growing sectors in the global safety market.

Looking across the core to head protection, we launched a new push-key helmet suspension system for our V-Gard helmet platform in Brazil. The push-key suspension is an easily adjusted and comfortable product that is targeted for the price-sensitive value segment of the market.

At the performance and of the helmet suspension spectrum, we continued to build on our Q1 launch of the Fas-Trac III suspension in North America with a follow-on Q2 launch of the product in Brazil. As I mentioned in our last call, the Fas-Trac III is at the pinnacle of comfort and adjustability, as reported by customers in blind voice-of-customer evaluations.

We are very excited about this product and our customers' enthusiastic reaction to it. Reflective of the Fas-Trac III success in North America, in the second quarter sales were up 7%, and year-to-date head protection sales were up 10% in North America.

So as you can see, our pipeline of innovations within the core are paying off. Sales from products developed and introduced within the last five years reflect 32% of core product sales and 27% of MSA's consolidated total sales.

Let me peel back the layers a bit more to give you a better idea of where new product developments and efforts are focused at MSA. In head protection over 60% of sales in the second quarter were from new products, reflecting the sound success of the recent Fas-Trac III launch that I just mentioned.

Additionally, in portable instruments, that continues to be a strength, with over 50% of sales coming from new products, including our Altair 4X and 5X portable instrument lines, which we have discussed you in the past. With the upcoming approval and the start of deliveries of the G1 SCBA, we would expect to see continued progress in sales vitality performance. Organic R&D investment is an important part of our growth strategy, and the products that we've launched over the past few years have solidified our position as a market leader.

Now I'd like to give you an update on another important and strategic initiative, what we call Europe 2.0, on which we continue to execute and make good progress. This is a significant transformational project that has two distinct phases. As we have noted in the past, this initiative involves moving away from the pre-European Union structure of independently managed affiliates to one based on common data and standardized processes, enabled by a single IT platform and incorporating a single and transparent logistics systems working out of one location.

I'm pleased to report that we have made significant progress on this first phase of the project. To date we have completed successful SAP implementations in over 70% of the region. Moving to a functionally managed organization, we have reengineered and streamlined business processes, and we've consolidated several finished goods warehouses to a Central European location.

With nice progress made on this phase, going in the second quarter we continued to focus on Phase II of the transformation, and that is further refining the organizational structure for Europe going forward, which we have determined to be in a principal operating company model format.

Ron Herring, President of Europe, reviewed the details of this model with many of you at our recent investor day, so I won't spend time talking about the structure here. However, at a high level the establishment of a principal operating company model in Switzerland provides us a centralized headquarters in a business-friendly environment that allows our European organizations to leverage the benefits that we've achieved over the Europe 2.0 restructuring program over the past few years.

I'm happy to report that we remain on track with our timeline, and we expect to go live in January in 2015. Europe 2.0 has been a multifaceted initiative that is positioned to drive benefits throughout the P&L to enhance shareholder value, all while keeping the customer experience as a key priority.

Some benefits that we have already begun to realize as a result of our efforts over the past few years include improved margins from a more favorable mix of core sales through distribution and benefits from restructuring to rationalize our cost structure, with both of these efforts driving a 700 basis point improvement in operating margin over the past four years. If we look at more recent performance, year-to-date European local currency sales are up 5%, and operating margin is up 100 basis points on improved gross profit.

In the future, as a result of implementing the principal operating company model in Europe, we expect to see continued financial benefits, such as MSA's consolidated tax rate declining meaningfully over the next several years. Although we have and will see higher SG&A in 2014 as we relocate and incur related expenses, the project is expected to drive value for our shareholders over the long term.

In other exciting news, last month we turned the page on MSA's 100-year anniversary. In addition to celebrating with a series of brand ads that highlight MSAs life-saving products, we hosted a Centennial Investor Day near our headquarters in Cranberry Township, Pennsylvania.

The event was a great success for us, and we enjoyed sharing further insight about the key pillars of our strategy, our new product development efforts, and important strategic initiatives that we are executing across our geographies. For those of you that attended the event, we want to thank you for taking the time to be with us; and if you were not able to make it and would like to participate, the archived webcast is still available on www.msasafety.com.

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

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

Thank you, Bill, and good morning, everyone. I will now share some further insight into our second-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 second quarter were $282 million, down $3 million or 1% from the prior year on a reported and local currency basis. Stronger growth in head protection, portable gas detection, and several key adjacent products was offset by continued regulatory delays affecting SCBA revenue in North America and a lower level of fixed gas and flame detection shipments.

Looking at the sequential-quarter comparison, local currency sales have increased by 6% compared to the first quarter on improved performance across all reporting segments. Notably, North American SCBA and head protection were key contributors to the increase of 15% and 16%, respectively, driven by sales of new products, such as the M7XT SCBA, launched in April; and the Fas-Trac III suspension system, launched earlier this year.

While order activity was choppy in the quarter, backlog is healthy, reflecting strong demand for fixed gas and flame detection and SCBA, comprised of both M7XT and G1 SCBA orders. Though a portion of our backlog orders are scheduled for shipment in the next several months, I do expect challenges to persist into the third quarter as we navigate the regulatory approval process in North America and enter the traditional summer holiday season in Europe.

As you may remember from the first quarter, we have streamlined our discussion on sales, and I will comment on two views of our sales performance -- by product group and by geographic reporting segment. Let's start with our core product sales performance in the quarter, where local currency sales in our combined five core product groups declined by 4% and reflected 73% of total sales.

As Bill mentioned, we had a very strong second quarter last year in sales of breeding apparatus and fixed gas and flame detection, making this an especially challenging year-over-year comparison. Results remained strong across head protection in the quarter, increasing 5%, with encouraging levels of growth across North America and Europe. We also saw strength in portable instruments, increasing 4%.

These bright spots were offset by an 11% decline in supplied-air respirators, led by a 16% decline in SCBA in North America associated with ongoing delays in new product approvals in the US fire service market. Fixed gas and flame detection sales decreased 7% on a lower level of large order shipments.

Fall protection sales growth was flat for the quarter. Excluding sales of SCBA and fixed gas and flame detection, local currency core product sales were up 4% in the quarter.

We also had strong growth across several of our non-core product lines in the quarter. Fire helmets increased by 14%, primarily driven by the successful launch of our new helmet platform in Europe, the F1XF that Bill mentioned on the Q4 earnings call. And ballistic helmets revenue doubled from last year, also driven by strong performance in Europe.

While we divested our North American ballistics business in 2012, our European ballistics business continues to be an excellent source of value. As we mentioned in the first quarter, we have a robust backlog of a number of these orders that are expected to clear in the second half of this year and on into early 2015.

Next I will offer more texture on our geographic reporting segments. In North America sales in the second quarter were $139 million, down $4 million on 3% compared to prior year. Core sales comprised 79% of total segment sales and were down 4% in the quarter, driven by the decline in SCBA shipments due to regulatory delays and timing of larger fixed gas and flame detection shipments that I mentioned earlier.

Excluding revenue in these product groups, the base business remained healthy, with core product growth of 5%. We continue to see success in head protection, up 7% in the quarter; and continued growth in portable gas detection, growing 6%, driven by our innovative Altair suite of products.

Non-core sales were up 2% on growth in thermal imaging cameras, fire helmets, and respirators. Our European segment reported second-quarter sales of $79 million, up $8 million or 11% from the same period a year ago in local currency terms, on strong results in market verticals such as energy and the military.

Local currency core product sales represented 64% of total sales and were up 4% on strong invoicing of fixed gas and flame detection orders to the oil and gas market in the Middle East and on head protection growth throughout the region, partially offset by a relatively flat level of portable gas detection and SCBA sales. Non-core sales were up 25% on higher large-order invoicing of ballistic helmets to a military customer and an increase in fire helmets across Western Europe on new product sales.

Finally, second-quarter continuing sales in our international segment were $65 million, reflecting a 9% decline in local currency terms. Local currency core product sales represented 70% of total sales and increased by 11% compared to a year ago.

We had a challenging comparison across many of these products in the quarter, with last year recording higher fixed gas and flame detection project business in the oil and gas markets of Asia and Latin America, and a large SCBA shipment in Asia. Excluding breathing apparatus and fixed gas and flame, remaining core products grew 2%.

Local currency non-core product sales were down 2% when compared to the same quarter a year ago, as we faced ongoing labor unrest in Africa as well as continued weakness in the mining markets of Australia.

Our gross profit rate for this quarter was 45.9%, an increase of 50 basis points from last year. Core product margins continued to be the leading driver of strength, up 180 basis points from a year ago. While a favorable product and order mix drove a portion of this improvement, we saw meaningful expansion across every core product on improved pricing and cost management.

Selling, general, and administrative costs were $83 million, increasing 5% or $4 million on a local currency basis compared to last year. The increase was driven by almost $3 million of costs associated with several corporate initiatives: $1 million associated with our Europe 2.0 program as we prepare to launch the principal operating company in early 2015, $1 million of increased legal fees as we pursue the collection of our insurance receivables, and $1 million increase in customer-facing costs. These were partially offset by a $1 million decline in stock compensation expense related to time phasing of retirement eligibility accounting and a $1 million improvement in pension income on our overfunded pension plan in the United States.

Our investment in research and development this quarter was $12 million, up nearly $1 million as we continued to invest in innovative new core products like the G1 SCBA and a host of other launches in fall protection, head protection, and gas detection. As Bill indicated, we continue to see meaningful returns from these investments as sales from products launched in the last five years represent 32% of core product revenue in the quarter, up from 22% in the same period a year ago.

We recorded $1 million in restructuring expense from our ongoing initiatives to reduce our footprint in Australia and in the continuing business of Africa. As you know, we have a solid record of realizing payback on restructuring efforts, and we are confident that the steps we are taking to streamline the organization, including the Europe 2.0 program, will be drivers of value in the coming years.

Operating income, or pretax income excluding currency gains, restructuring, interest and other income, was $35 million or 12.4% of sales in the quarter, a 130 basis point decrease from the prior year. While quarterly operating margins improved in Europe and North America, we saw a pullback in international on the lower level of sales, a less favorable sales mix, and higher levels of research and development costs.

As I mentioned at investor day, we remain committed and are cautiously optimistic about achieving our goal of 15% operating margin by the end of 2015. Our consolidated tax rate this quarter was 30.7%, up 80 basis points from the same period a year ago, primarily because we have yet to see the R&D tax credit enacted in the current year.

Our year-to-date effective tax rate is now 32.9%, and we expect this rate to approximate 32% for the full year, assuming the R&D tax credit is enacted later this year. Net income from continuing operations was $22 million in the second quarter or $0.59 per basic share. Excluding $1 million of pretax restructuring and foreign exchange gains, adjusted earnings were $23 million or $0.60 per basic share, a 13% decrease from prior year.

Free cash flow was down $8 million compared to the second quarter of last year on lower net income and a higher level of working capital, primarily related to timing of prepaid expenses; and to a lesser degree, an uptick in inventory levels, as we prepare to launch new products, fill large helmet orders in Europe, and align inventory levels for the fall turnaround season in the oil and gas market.

Our cash balance was $96 million at the end of the quarter and composed largely of cash outside of the United States. Total debt was $289 million at the end of the quarter, up $20 million from the end of 2013.

Throughout the first half of this year, Ken has led a significant effort to modernize our capital structure. Along these lines, during the second quarter his team finalized efforts to secure an additional $100 million of capacity through a senior unsecured term facility, bringing our total capacity up to nearly $600 million. We continue to review acquisition scenarios across our core product groups to expand in those areas where we have the most knowledge and sustainable competitive advantage.

In closing, the quarterly comp was challenging, with a robust level of fixed gas and flame detection product sales in last year's second quarter and the continued delays in SCBA approvals in North America impacting our quarterly results. Though the backlog remains relatively healthy and reflects solid prospects heading into the second half, the incoming order pace has been uneven, and the ongoing approval situation in the North American SCBA market continues to provide uncertainty as we start the third quarter.

Thank you for your attention, and I will now turn the microphone to Bill.

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

Thanks, Stacy. While we continued to face challenges in certain markets in the second quarter and we expect certain conditions to linger into the second half, I continue to believe we are positioned well and our strategy continues to drive improved performance.

We view these challenges as mostly temporary, and I'm cautiously optimistic that we are well positioned to see an uptick in performance as we move towards the end of this year. We remain deeply committed to our continued focus on driving profitable core revenue growth, developing innovative products with voice-of-customer feedback, executing key operational excellence programs, and completing important strategic initiatives that will enhance shareholder value for years to come.

I want to thank you for your attention and your interest this morning. And at this time, Nish Vartanian and Ron Herring have joined Stacy, Ken, and me. And we are happy to take any questions that 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 up the call to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Edward Marshall, Sidoti & Company.

Edward Marshall - *Sidoti & Company - Analyst*

So I first want to touch, if I could, on the operating expenses, which have peeled back a little bit, but probably not as much as I would have thought. And, Stacy, I was wondering -- I know in prior quarters, we talked about product liability expenses. We also broke out in this call about some details of Europe; and I'm curious if that's detailed in the restructuring expense? Or is there additional drag on the operating expenses, as well? And then, also, if you can quantify any drag to the SCBA efforts now that may subside as you start to see some revenue?

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

Okay. Let me give you some color on the SG&A expenses. First of all, I want to clarify that in this quarter there were no restructuring expenses for Europe 2.0, although that program is not complete yet. So there just didn't happen to be any recognition this quarter.

So what occurred in SG&A, however, is some investment in opening an office in our new principal operating company headquarters in Switzerland and some relocation costs you see hitting our SG&A expenses. We also see defense fees for our legal strategy to recover our insurance receivable. And it really knocked product liability expenses in the quarter.

We continue to have some expenses associated with our corporate restructuring as we execute globally the restructuring plan. And in addition we spent some money in the quarter on our rebranding efforts associated with our Centennial celebration and on strategy refresh works -- that work that we are doing. Those were the primary things, aside from some marketing costs associated with product launches.

Edward Marshall - *Sidoti & Company - Analyst*

Such as the SCBA?

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

Yes, and the other products that Bill and I have talked about in prior quarters.

Edward Marshall - *Sidoti & Company - Analyst*

As far as the SCBA, can we quantify any of the drag that's produced in the quarter? I mean, you have talked about shipping some products -- I assume there are some salesmen out there, as well, and so forth. Is there a product drag in the SG&A line that I should be thinking about?

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

No. Not in the SG&A line. Not in the SG&A line. Not materially.

Edward Marshall - *Sidoti & Company - Analyst*

And then secondly, if I talk about the fall protection a second -- Bill, you highlighted a particular product that was rolling out. I'm curious; you've been kind of a smaller player in North America relative to some of the other businesses in other segments in the core product group that you sell into.

I'm curious. Is this particular product -- this change in regulation -- potential for a competitive advantage for MSA, and therefore a share gain? Or is this just -- you know, is there something unique to your new product that others cannot provide? Maybe you can give me a little bit more detail on that.

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

Yes, sure. I think in the big scheme of things, Ed, it's probably not so unique where we have first-mover advantage. All the major competitors have been a part of the new standards that have been promulgated here for arc flash protection for a number of years.

So I would not go so far as to say that we have significant competitive advantage in that regard or first-mover advantage in that regard. All of the competitors have been well aware of this and are moving at probably the same pace.

But on the other hand, I would say that there are some new, unique, and difficult-to-copy advantages that we have put into our new products that we think can provide us with some competitive advantage. And so, sure, I mean, there are some differentiators that we have; and how we are then taking our global scale and applying some of these new products to global markets that would have the same kinds of concerns -- I think that also provides us with some opportunity to take share.

Edward Marshall - *Sidoti & Company - Analyst*

Is it still fair to characterize this business as more of a global focus for you and less so -- I mean, all of your businesses are, but less so in North America here and more so on the global and maybe emerging markets kind of area for growth?

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

It definitely is a global focus for MSA.

Edward Marshall - *Sidoti & Company - Analyst*

Okay. And finally, you talked about the SCBA rollouts. You have mentioned just -- still there's just three producers approved, and that means to me that there is still a rather large customer not approved ahead of you in the queue. Is there any chance that you guys can kind of leapfrog them in the queue? Or have those discussions kind of transpired? It seems like that's the holdup there, right?

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

Well, it's one of the many holdups, that's right. As I indicated in my comments, the approval process has been frustratingly slow for a number of different reasons. There are two major competitors who are also in the queue along with us in the G1, and they do not currently have a product that meets certification requirement.

So they are obviously doing all that they can to make sure that they get a product out there in the market. We at least have the M7XT SCBA that we are successfully selling and marketing. And two other competitors -- one major competitor and one smaller competitor -- also have approval to the new standard.

As far as leapfrogging in the approvals process line with the federal agencies, I think that, to my knowledge, is impossible. And I'm not aware that that is occurring in any way.

But for all the things that we have talked about over the last six months, where the test agencies had problems in their labs; they don't have available resources; they don't have available manpower -- it has just been really, really frustrating for us, as well as those competitors who don't currently have a product approved, I'm sure.

Edward Marshall - *Sidoti & Company - Analyst*

And just to clarify, the G1 has not been inspected as of yet? It hasn't been looked at at all?

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

Oh, no, it has been looked at, and it's in the process. It's in the process.

We had really fully expected it to be approved by now, by late July. And we meet with our regulator on a fairly frequent basis, and they give us updates on where we stand and just recently told us that it would likely now be very late third quarter before we get it through the system. And that is based entirely on their resources and their capability.

Edward Marshall - *Sidoti & Company - Analyst*

Has there been any holdups on your end? Have certain things not been approved, and you had to go back and redraft?

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

Yes. There's a bit of iteration that goes on in that sense, Ed, but nothing that we feel is of a significant nature. It's a fairly complex process, both from a hardware standpoint as well as all the documentation and quality plans that they inspect and review. And there's always a little bit of iteration that goes back and forth. But I would not say anything that is so major and so significant that it was completely unexpected.

Edward Marshall - *Sidoti & Company - Analyst*

Fair enough. Thanks, guys.

Operator

Richard Eastman, Robert W. Baird.

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

Bill or Stacy, could you just provide maybe a little bit of color on international sales? We've hit on a few things, but it would seem to me in this quarter that down 8% in local currency would be a bit of a disappointment.

I'm just curious; what maybe surprised you there? What does the second-half trend line look like on the international side?

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

Well, we were actually down 9% in local currency terms, just to reframe that a bit. Really, it was the timing of the realization of the orders for the larger orders that are in the pipeline for the fixed gas and flame detection, as well as the comparison to the prior year, where we had really favorable timing of shipments in fixed gas and flame detection, as well as a large order that went into China for SCBA.

So those just didn't repeat this quarter. We tried to explain that our underlying business, if you exclude those lumpier businesses -- the breathing apparatus and fixed gas and flame -- grew 2%.

But that's in the core products that grew 2%. But you know, a lot of those non-core products are down based upon the mining markets in Australia as well as continuing labor unrest in our important market of Africa.

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

So maybe the non-core is not a surprise. But the core products excluding FG&F and SCBA sales, plus 2% -- again, that seems to be maybe a loss of momentum sequentially. So we should, again, expect better in the second half?

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

Rick, let me provide some commentary there. It is a little bit concerning to us that we lost what felt like some momentum in the international markets.

I don't think that there's -- we don't feel that there's any major issue that is going on in that regard. We don't believe we are losing market share; we just feel that there has been, just during the second quarter, a general slowdown in some of those market areas.

To answer your question, what do we expect for the second half? We don't expect a hockey stick turnaround in improvement in those international and emerging markets, but we don't expect it to get any worse, either.

There have been some exogenous factors on the international front. Stacy mentioned some of them. We all know that in Latin America -- and those of us doing business in Latin America, the World Cup was certainly a bit disruptive, not just to our operations but to the customers that we're calling on and selling product to.

So we think we get that cleared out, and we think that things should return back to maybe a low/mid single-digit growth rate in those emerging markets. We don't think we are off track there.

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

Okay. All right. And Bill, you had commented maybe specifically on a few product lines about backlog. But I'm curious, outside of the fixed gas and flame backlog, it sounds like that business still has pretty substantial backlog. Are there any other -- you know, of the core products that you would flag from a backlog perspective -- I guess the SCBA, at least the G1?

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

Yes. That's right. Those would be the two major core product areas where we have significant backlog. The third area that I'd mention, only because it's so significant, is the European ballistic helmets. We've been very successful in winning contracts both in Western Europe and in Eastern Europe for our ballistic helmets and some of the supporting products there. And that's fairly significant. It takes us out into the balance of this year and into 2015 as well.

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

And on the fixed gas and flame, again, I'm not trying to pin you down too much here, but the way it looks to me year to date, maybe that business is modestly negative year-over-year -- fixed glass and flame, but we have a big, a significant backlog? Does that fixed gas and flame business end up for the full year kind of in a high single-digit growth number? Just -- that's kind of what you target for your core products; that's why I picked that number. But is the backlog big enough to support that type of growth for the full year in that product category?

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

I would not say that it high single digits, Rick. I would probably put it more at moderate and low single-digit growth rates with the backlog and the shipping schedules that we have supporting that. It probably takes it into -- it's positive for the year, but probably in the low single digits -- 4% to 5% -- just 5%.

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

And then one quick question on Europe's net income at 8% -- a really nice number, kind of responded, I guess, with the volume; and it sounds like absorbed some cost with the Swiss HQ. But can I ask: was there anything funky at the tax rate line there? Or was your EBIT maybe in the low double digits, call it 12%, if I just normalize the tax rate?

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

We did not realize any change in tax rate in the quarter, so that's sort of apples-to-apples versus prior quarters.

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

Okay. So we -- okay. And then just lastly, Stacy, on the cash flow -- and I think of free cash flow -- we throw the dividend. But even if you take the dividend out of the free cash flow assumption, how does free cash flow shake out for the year? Should we be a positive number here?

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

We should be a positive number of free cash flow -- or you mean compared to the prior year?

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

Just -- should we generate free cash flow -- again, you can leave the dividend out if you want to, but I put it in; and again, year to date with the dividend payments, we are maybe $15 million negative. I understand you are building some inventory. And your receivables are up, too; that might be distribution shift in Europe. But what does our free cash flow look like for the full year?

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

Yes, Rick. It's Ken here. So when you look at our trend line in the past several years -- and just look at the first six months of this year versus the first six months of last year -- we are actually showing a little bit of improvement in terms of working capital management, although we have been building a bit of working capital here, as Bill alluded to.

The second half has historically been a pretty solid half for us in terms of free cash flow generation. You are right point out there is some workaround inventory and things like that with some really big product launches, but our history and our pattern has been pretty robust performance in the second half. So we would expect to see some improvements as we go into the second half of the year.

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

Okay. All right. Thanks so much.

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

Rick, I've get one slight piece of information on the Europe bottom line. I just wanted to remind you there was a fairly favorable currency effect for Europe as the euro strengthened.

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

Okay.

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

So that certainly did impact the net income performance.

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

Okay. Got you. All right, so the translation at the net income line -- okay.

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

Absolutely.

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

Great point. Thank you.

Operator

Walter Liptak, Global Hunter.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

I wanted to ask about Europe as well. On the helmet business to a military customer, it sounds as if that's sustainable. I wonder if you could just provide some more color -- maybe on the size of those orders, and how much shipped this quarter? And what do we have to go in the back half?

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

Well, let me provide some commentary on the product, Walt -- this is Bill -- and also on the competitiveness over there. We've got a very good relationship with customers. We've got a very established product in the Western European and Eastern European markets. And we've been very, very successful for many years with our ballistic helmets out of France.

And so we expect that to continue. This is both police helmets and military-style helmets that we manufacture and sell over there. So we expect that to continue. As far as the size of that backlog, I look to Stacy, or Ken, maybe, on some detail there? Or Ron, perhaps you can provide some input on the level of that backlog and how much of that moves into 2015? Ron?

Ron Herring - *MSA Safety Incorporated - President, MSA International, Europe*

Yes, Bill. Sorry, I'm trying to pull that information up right now. But it is -- as you were saying, it is a sizable backlog. It will probably run through at least the middle of 2015 as it's scheduled right now.

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

On the order size of $25 million? Does that sound about right?

Ron Herring - *MSA Safety Incorporated - President, MSA International, Europe*

That's correct.

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

We don't have that right here handy, Walt. But order of magnitude it's about $25 million in revenue.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Thanks for the color on that. That helps. And then, staying in Europe, the FG/FD business -- it sounded like you are building backlog, but there's some projects that are pushing to the right. And I wondered why.

And then you mentioned the timing in the back half. I wonder if we could get a little bit more color on that as well?

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

I mean, the FG/FD business is always dependent on the end-use customer and the major projects that they have in development -- the engineering contractors and procurement providers. So some projects moved to the right, Walt, but I wouldn't say that in general that's a trend that we are seeing. It's just the timing of when those projects hit and when the deliveries are scheduled for.

So we don't see a tremendous amount of the projects moving to the right being delayed tremendously. It's just -- again, it's just the timing of those major projects and when they have scheduled delivery of our product to support those projects.

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

FG/FD actually grew in the quarter over 8%, and we're really encouraged by the strengths of the Middle East market in particular.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Just in Europe you are referring to?

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

That's the European FG/FD. Yes.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Got it. And then this is just I guess what I think is interesting: you mentioned that you built backlog of the G1, I think you said a healthy backlog. How does that work, where customers have already tested and decided that they want to purchase a product; they place orders; you get your pricing done; and it goes into backlog, just waiting for the certification?

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

Well, a bit of that, Walt. What we typically see happening is that, as I indicated in my call comments, that we have developed a large number of samples that we have -- fully functional samples that we have sent out into the field. We are continuing to build on the momentum that we created at the FDIC show with those samples and holding awareness events and trial run events at fire departments across the country.

And in many, many cases those fire departments, based on their utilization of that fully functional sample end use, are placing orders through distributors; as well as our distribution channel partners being quite excited by it, and they're placing orders on MSA as well. So is a combination of those.

In some of the really big fire departments, they require a fully certified breathing apparatus before they would put them through a complete evaluation. So there is quite a number of those that we are in the queue, and we are waiting for, and that the fire departments are excited about trying the G1 SCBA; but we don't have orders from some of those. But there's plenty of others where we have been able to win an evaluation, so to speak, based on the samples -- the fully functional samples we have provided.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Thanks. So the thought after your analyst day was that you might get a little bit of ordering in the fourth quarter and first quarter, but it would be the second quarter of 2015 where the market would really get going. But after these comments about the healthy backlog for SCBA, I'm starting to think that maybe you finally get some renewed sales in SCBA in the fourth quarter and then deeper on from there. Is that an okay way of characterizing it?

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

Well, I think that's an okay way of characterizing it. I mean, we are pleased with where we are right now. We are pleased by the backlog, the book of business that we are building. We are displeased by the approval process that we are mired in.

But depending on when we get those approvals and the configurations of those approvals, we should see some improvement in the fourth quarter. And I think momentum building from there in the first quarter and second quarter of next year, just as we described to you.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Thanks very much.

Operator

Brian Rafn, Morgan Dempsey.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Bill, you talked a little bit about it, but what is the sense of -- before you start rolling out with the G1 next year, what is the sense of the M7XT system, its durability of sales once the G1 is launched?

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

Well, I think we talked about that in the investor day presentation. I think it's a very, very good question. What we are finding is that the durability of that product in the market is actually quite good and quite strong.

I was pleased by the sales performance of the M7XT during the second quarter. And we continue to see customers who were M7 customers who have upgraded to or want to continue on that platform of product and go with the M7XT.

So I guess it's better than I expected is my answer, Brian. But once the G1 actually gets into the market and it's available, I guess that's when we will really determine how much of the M7XT business does the G1 then begin to chew into -- which is okay by us, because it's really a revolutionary product and provides some significant advantages for us and for our customers.

But right now I'm pretty pleased with the M7XT and its sustainability. A little bit better than I thought it would be by this time of the year.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Bill, your thoughts on -- now, obviously, they could change -- but is the M7XT still scheduled to be a dual product to run parallel to the G1, or if at some point the G1, if it cannibalizes enough sales, the M7XT would be canceled?

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

That could occur, but probably not for at least a couple of years. We would run -- I would imagine we will run the M7XT through the next NFPA approval cycle process. So we'd probably have another three, four, five years on that product, again, depending on what that cannibalization rate is.

But we've got plenty of customers out there who are dependent on the M7 and the M7XT. And our past practice has been to run that for at least one five-year NFPA recertification cycle.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. All right. Back to the G1, Bill, talk a little -- once you get going building that, is that G1 -- with that revolutionary new engineering design, is that a book and ship business? Or is there a lot of specific engineering customization and iterations that any one individual fire department might be significantly different from somebody else, where you are not building a lot of inventory?

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

There are -- let me backtrack. It's primarily a book and ship business. Now, having said that, there are configurations over time that we develop that require certification and approval. And there are certain instances where a certain fire department, especially large fire departments, will like a little bit of customization on that SCBA. And that requires us to book the business, but then get the certifications through the agencies. So it slows things down a little bit.

But that's the minor part of the business, Brian. 90% of the SCBA business, once we have our certifications and approval, our foundational approvals -- 90% of that is book and ship.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

And, Bill, what might your thoughts be on a book and ship? Is that sales cycle, and shipment, and production -- is that a period of months, or half a year? Or how fast can that book and ship cycle be defined in once you get G1 going?

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

I would put it at a month or two months at the very most.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. All right, thanks. Good, good, good.

Tell me a little bit about -- and maybe refresh my memory: what for you is different with the ballistic helmet business in Europe? Be it -- if it's just a lot of, between armed forces, there is a lot of NATO standardization between the US and overseas? Obviously, we've talked certainly about weakening military budgets under the Obama administration. What has kept you guys in the ballistic market in Europe that's different than America?

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

I think that that's a very good question. As you know, probably three years ago, I guess it was, we began a process to divest ourselves of the ballistic helmet business and ballistic vest business here in North America, and for good reason. The profitability and margins for that product were getting thinner and thinner. And we had a customer that, let's just say, wasn't -- didn't fit the profile of the kind of customer that we wanted to have going forward.

And that sounds a little bit harsh, but the fact of the matter is we had done a lot -- we felt we had done a lot in the way of developing and putting a lot into R&D for that customer and not getting a lot out of that in the way of return on our investment. So we decided that ballistic helmets and ballistic vests in North America was not where we wanted to put our resources, and that we wanted to focus our resources in the core areas of the business.

Having said all of that, the European market is quite different. And while the helmets are quite similar, they do differ in some meaningful ways. And we are able to generate very respectable margins on those products. We've got great relationships with those customers as we develop products for their specific needs.

It was just a very different environment. It is just a very different environment over there than we found it to be here. So we backed away from the market here. We continued to excel and hold a dominant position in quite a few markets over there.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. Your centralization of your warehouse in Europe with the new Europe 2.0 -- how big is that warehouse? And as you consolidate warehouses over there, are you going to be carrying any less inventory? Or is it about a push? I'm just wondering if we're streamlining that.

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

We intend to be carrying less inventory.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

And what is the size of that warehouse? By chance, you have a square footage from that?

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

I do not have one. I do not have that off the top of my head, Brian.

Brian Rafn - *Morgan Dempsey Capital Management - Analyst*

Okay. Thanks much, guys.

Operator

(Operator Instructions) Stanley Elliott, Stifel Nicolaus.

Stanley Elliott - *Stifel Nicolaus - Analyst*

A quick question on the European profitability: you guys mentioned the translation; obviously, the volumes helped out. Did the consolidation to any of the warehousing -- did that help? Or is there a way to split out kind of between the volumes and some of the prior restructuring within that improvement at all?

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

Stacy, I look to you.

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

Yes. Stanley, we don't have a meaningful split out of that at this moment to be able to share with you. Certainly, we didn't see the operating margin improvement on a local currency basis. That had a lot -- probably more to do with mix. We just need to take another closer look at the inventory levels to get you a good answer there.

Stanley Elliott - *Stifel Nicolaus - Analyst*

No, that's fair. That's fair. And some of the new products that we are talking about, you guys have talked about, in emerging markets -- a lot of value-type products for those kind of in-country specific. Should we assume that those margins on new products on a go-forward basis will be at least in line with the Company average or maybe even a little bit better than that?

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

I think that's a very good assumption to make.

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Stanley Elliott - *Stifel Nicolaus - Analyst*

And lastly, with the additional capacity on the credit side, any update on M&A activity? Maybe kind of refresh us with the target size and some of the areas of focus?

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

Well, I think as we've said on previous occasions, our focus is in those core areas of the business that we've described many times in the past and in those growing emerging markets in order to access channels of distribution there. Size of the acquisitions: as we've said in the past, we completed in 2010 the acquisition of General Monitors. That was a $285 million acquisition.

That was the largest in the Company's history to that point in time. And we successfully acquired that company and integrated it well into the organization. So that's in a comfortable range for us.

Bolt-on acquisitions is what we're looking to do. We've got a very active pipeline of evaluations going on. And so core areas; emerging markets of the business; in the range that you've seen us make in the past; bolt-on; accretive. Those are some of the principles that we look for as we make acquisitions.

Stanley Elliott - *Stifel Nicolaus - Analyst*

Perfect. Thanks again and best of luck.

Operator

Richard Eastman, Robert W. Baird.

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

Thanks. I thought I would get back in the queue and save Ken a little time later.

The gross profit margin -- really, given the commentary around the sales mix, both geographic as well as by product line, the gross margin was just -- it was a very good number at 45.9%. And I'm curious; it sounds -- maybe you got a little bit of help on the inventory build and absorption, but is there any other single factor in there that kind of drove that? The new products? I suppose that would be sustainable. Is that the primary thing, is your vitality index being up and the contribution from those products?

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

I'd say that order mix is also a fairly significant one. I mean, the mix of products that we are selling are more profitable. But having fewer large orders, where the large order usually has a price discount associated with it -- having fewer of those ship in the quarter certainly impacted the margin as well. It's one of the other factors.

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

But it is -- to your point, Rick, it is something that we've talked about with you in the past. It is not just changing the mix to be more focused on core product areas, but it is pricing and the pricing initiatives we have. It is related to the new product development process and that improving vitality number that we see for the new products that we are introducing, having higher gross margins -- it's a number of those elements. And the 50 basis point improvement that we saw in gross margins in the second quarter, I think, continue to reflect that.

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

A good balanced mix of those items. Yes.

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

As Stacy had pointed out in her comments, across the core products area, we saw a nice expansion across just about every one of those categories. So it continues to be a source of strength.

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

Okay. Great, great. And just one last question. Just trying to think of the pacing here with the challenges you have and pacing on the quarters. But typically the third quarter is a bit -- you know, in revenue is lower than the second. And a lot of that has to do with Europe is slower.

But again, the commentary around the G1, the SCBA market, even the backlog sound like they are a little bit more weighted towards the fourth quarter. Again, I would presume that we will see that typical lower third-quarter versus second-quarter sales pattern that historically has been seasonal but also seems to be supported by your product commentary. Is that a good starting spot?

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

Well, I think that's fair. Yes, Rick.

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

Yes? Okay. All right. Well, thanks again. Nice profit quarter.

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

Thanks, Rick.

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

Thank you.

Operator

I will now turn to call back over to Ken Krause for closing comments.

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

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 30 days, as will a transcript of the call.

On behalf of the 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. Goodbye.

Operator

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