CORPORATE PARTICIPANTS

Chris Hepler MSA Safety Incorporated - Executive Director of Corporate Development & Investor Relations
Jonathan D. Buck MSA Safety Incorporated - Chief Accounting Officer
Lee B. McChesney MSA Safety Incorporated - Senior Vice President & CFO
Nishan J. Vartanian MSA Safety Incorporated - Chairman, President & CEO

CONFERENCE CALL PARTICIPANTS

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 Third Quarter 2022 Earnings Conference Call. (Operator Instructions) Please note that this event is being recorded.

I would now like to turn the conference over to Chris Hepler, Executive Director of Corporate Development and Investor Relations. Please go ahead, sir.

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

Thank you. Good morning, and welcome to MSA’s Third 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; Lee McChesney, Senior Vice President and CFO; and Jon Buck, Chief Accounting Officer.

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

We have included certain non-GAAP financial measures as part of our discussion this morning, and the non-GAAP reconciliations as well as our third quarter press release are available on our Investor Relations website at investors.msasafety.com.

Moving on to today’s agenda. First, Nish will discuss key highlights of the quarter. Lee will then provide a few remarks on our results before turning the call to Jon to discuss the details of the quarter. Finally, Nish will provide closing comments. Following our prepared remarks, we will open the call for questions.

With that, I'll turn the call over to Nish.
Nishan J. Vartanian - MSA Safety Incorporated - Chairman, President & CEO

Thanks, Chris, and good morning, everyone. I'll start my comments by thanking the MSA team for delivering excellent results in the third quarter. At MSA, it all starts with safety. I'm pleased to report we're closing in on our 12th consecutive month of not having a lost time incident. While we've enjoyed a very strong safety record over time, this is truly exceptional performance.

Shifting gears and looking more closely at the quarter, we saw strong financial performance with organic double-digit year-over-year growth in both orders and sales, healthy incremental margins drove adjusted operating margin of 19.7%, another step toward our aspirational goal of above 20%.

Order activity continued at a robust pace, and our backlog remains at historically high levels, up more than $150 million year-over-year. The pace of orders increased each month during the quarter and order activity remains healthy in October. Demand has been broad-based across products and markets. Book-to-bill remained above 1 for the quarter.

We saw a slight easing in the supply chain during the quarter. That, combined with various engineering and supply chain initiatives we've implemented throughout the year has resulted in improved deliveries and lead times for our customers. It's great to see that progress, and we're happy to get product into the hands of our customers.

Inflationary pressures continue to be present across our business. In response, we continue to be proactive on the pricing front to keep pace with rising costs.

Our balance sheet remains strong, and we continue investing in our business. As I mentioned last quarter, we continue to add inventory in key areas to mitigate supply chain risk as we work to improve delivery times for our customers.

I'm also pleased that we continue to see customers recognize our market-leading innovation and differentiated products. Even in this challenging environment, we continue to be rewarded with a strong order pace and solid margins, as a credit to the value we deliver with our safety technologies and solutions.

Lastly, before we start the review of our quarterly financial highlights, I want to take a moment to welcome Lee McChesney to our team. Lee joined MSA last week as our Senior Vice President and Chief Financial Officer. I'm delighted to have Lee on board to help drive continued growth and leadership in our industry.

With that, I'll now turn the call over to Lee. Lee?

Lee B. McChesney - MSA Safety Incorporated - Senior Vice President & CFO

Nish. Thank you, and good morning, everyone. Let me start by saying that I'm really excited to join the MSA team, a company with such a great mission, passion and purpose. The history of MSA speaks for itself, and I'm delighted to work with Nish and the management team on the growth opportunities that lie ahead that ultimately will drive sustained long-term value for our stakeholders.

I look forward to getting to know many of you on the call over the coming weeks and months. Now let's jump into the key highlights of the third quarter. Overall, our team executed a very strong quarter in a dynamic environment.

Incoming orders were up a robust 20% year-over-year with sales of $382 million, up 12% organically on a reported basis and up 16% on a constant currency basis versus last year. This was the second consecutive quarter of double-digit constant currency growth. And that growth in the quarter was balanced across price realization and unit volume.
Importantly, profitability was also healthy in the quarter, and we saw a year-over-year improvement in gross and operating margins. Adjusted operating margin was 19.7%, up 370 basis points over the prior year. These growth and margin executions combined to fuel adjusted earnings per share of $1.45, up 45% over last year’s third quarter.

With that overview, I will now turn the call over to Jon so he can provide you with more insight into these results. But before doing that, I do want to thank and recognize Jon and the entire finance team at MSA for their leadership during this period of transition, really well done. With that, I will turn the call over to Jon for his commentary.

Jonathan D. Buck - MSA Safety Incorporated - Chief Accounting Officer

Thank you, Lee. On today’s call, I’ll provide a recap of our third quarter financial performance and review key balance sheet and cash flow metrics. Before getting into the results, I want to note that on July 1, we reached the 1-year anniversary date of the Bacharach acquisition. So the data discussed on the call today and in our filings this quarter are on an organic comparison basis, unless otherwise noted.

As Lee mentioned, third quarter sales were up 16% on a constant currency basis. Foreign currency translation was a 4% headwind in the quarter and most pronounced in our International segment, resulting primarily from euro and British pound exposure.

Strong growth in orders and ongoing supply chain challenges resulted in a book-to-bill of approximately 1.1x and record backlog at the end of the quarter. While we saw some improvements in the supply chain during the quarter, we do not expect a normalized supply chain, at least until well into 2023.

Now turning to profitability. Our gross profit margin was 44.4% of sales in the quarter, an increase of 50 basis points over the prior year. Pricing initiatives implemented throughout the year drove healthy improvement in underlying product margins, and this was offset by indirect charges related to inventory and warranty. We continue to be active on the pricing front to keep pace with rising costs in our business. A price increase recently went into effect in October for both segments.

SG&A expenses were 21.7% of sales in the quarter compared with 25.7% in the prior year. We had approximately $2 million of favorable, nonrecurring adjustments in the quarter. In addition, the prior year amount included transaction expenses related to the Bacharach acquisition.

Reported operating margin was 16.8% in the quarter compared to 9.5% of sales in the prior year. On an adjusted basis, operating margin was 19.7% compared to 16% in the prior year. We levered well on the sales increase with incremental margin of 50% in the quarter. On a year-to-date basis, incremental margin was 36%, in line with our targeted range of 30% to 40%.

With that, I’ll now provide a closer look at the financial performance of our segments. In our Americas segment, sales were up a strong 21% year-over-year and adjusted operating margin improved 640 basis points to 27.2%. The higher sales volume, positive price realization and disciplined cost management shows the margin improvement.

In our International segment, reported sales declined 5% year-over-year, and adjusted operating margin contracted by 350 basis points to 8%. Currency translation was an 11% headwind on sales during the quarter. Results were impacted by lower sales volumes, FX headwinds on cross-border purchases and less favorable product mix due to supply chain constraints on gas detection products. Book-to-book was elevated at more than 1.2x, and backlog increased in the quarter.

GAAP net income was $45 million or $1.14 per diluted share, compared to GAAP net income of $21 million or $0.54 per diluted share in the prior year. On an adjusted basis, adding back restructuring, product liability and similar items, net income was $57 million or $1.45 per diluted share, compared to $39 million or $1.00 per diluted share in the prior year.

Now turning to cash flow and the balance sheet. Quarterly free cash flow was $55 million, up 55% compared to a year ago. Year-to-date free cash flow for the first 9 months was $75 million. As we discussed last quarter, we have been carrying an elevated level of inventory throughout the year in response to strong demand, high backlog levels and input shortages. We expect to realize improvements in working capital in the fourth quarter.
Quarterly CapEx was $9 million. We paid $18 million of dividends to shareholders and deployed $2 million to repurchase shares in the quarter. Year-to-date, we have returned more than $80 million to shareholders through dividends and share repurchases.

Our balance sheet remains strong. At the end of the quarter, we had cash of $160 million and net debt was $445 million or 1.4x adjusted EBITDA for the trailing 12 months.

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, Jon. In closing, I'd like to provide some thoughts on our near-term outlook. We entered our fourth quarter with good momentum. As I noted earlier, order pace remains healthy, and our backlog continues to trend at record levels. This gives us good line of sight over the next 90 days and into next year. Despite foreign currency headwinds and an uneven supply chain, we expect our fourth quarter sales to be ahead of last year’s record quarter.

I'm very optimistic about MSA's position in the market. The diversified products and broad range of end markets we serve position us well against the backdrop of an uncertain global economy. The resiliency in our business is strong, with leading positions in the fire service market and our longer-cycle fixed gas and flame detection business. While current demand is robust, we're closely watching for any signs of softening given the weakening macroeconomic outlook. As always, the MSA team remains focused on managing the controllables and delivering value for our stakeholders. I’m confident in our ability to meet any challenges that may lie ahead.

That concludes our formal remarks, so at this time, I'll turn the call over to our operator so we can begin our Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question today will come from Stanley Elliott with Stifel.

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

Congratulations on the results, and Lee, welcome to the call. Nish, the commentary you had about kind of the strong double-digit orders, a lot of momentum in the business and the outlook. Is there any more that you could share kind of what you're seeing right now, kind of what's giving this level of confidence despite some of the macro indicators to being a little more mixed?

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

Sure, Stanley. When we look at the business, it's strong across all segments of our business and surprisingly strong, quite frankly, when it comes to those industrial construction products. The incoming business has been good, and as you saw, as evidenced in the hard hat revenue that we reported.

As we look out into the future for the business, we have confidence with the fourth quarter due to the backlog we have. We're seeing some improvement in the supply chain. It's not perfect. It's still touch and go in certain areas. As you saw, the portable gas detection business was down slightly on a global basis, and that's really a matter of components. We feel we're in a better position for that in the fourth quarter, so we should catch up there and be in pretty good shape.
We just don’t know what other supply chain issues might pop up as we work our way through the quarter. But as far as the business is concerned, the backlog is very strong. We’re certainly looking at ’23 and doing some planning and when we look at our markets, the fire service market, we have a high degree of confidence that, that is going to be positive for us through 2023. The backlog is solid. The pipeline for new business is good. We’re competing well in the marketplace.

And you consider fixed gas and flame detection. This is really a late-cycle product. We have a nice backlog for that business. The outlook is good for 2023 for fixed gas and flame, particularly here in North America and the Middle East.

I think with oil and gas, I doubt we’ll see a significant drop in spending as we look forward into ’23. That business should be relatively good, as demand for oil continues to be strong and the Middle East, the Americas and other parts of the world will need to react to that. So I think that we’ll have some good business in that area, and the utilities business continues to be fine. It’s commercial construction, we continue to watch. That’s where we could possibly see a slowdown in some business. So we’re watching that closely, and hopefully, maybe we’ll see some federal infrastructure spend come through to help us.

So the outlook for the business is good. We think we’ve built a good, resilient portfolio. When you look at those factors in our markets, and we also have the backstop of an outsized backlog. The backlog is at a record level. If we do have a slowdown, obviously, that backlog helps us with getting product into the market.

Plus, we’re getting pricing. As Jon mentioned, we had a price increase around the world, October 1, so we’ll see 9 months of price benefit in 2023; we should get some help there. But we just don’t know where things are going to go in the back half of the year, so we’re watching things very closely. We’ve done a nice job in managing our SG&A and making sure we get that aligned, so we feel pretty optimistic about the outlook, despite some of the concerns on the macroeconomic side.

We’ll watch our headcount closely. We’re going to hire engineers. We’re going to hire in production, but we’re going to certainly watch our headcount in other parts of the business and go slow until we get a better feel for where we are. And hopefully, as we get into ’23, we’ll be there.

I expect margins to continue to improve. We had some nice margin performance here in the third quarter, which pulled our number up for the year. Hopefully, we’ll see the same in the fourth quarter, and we’ll continue on that path of margin improvement as we get into 2023.

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

Great. That’s great color. Big volumes in North America and some of the core products, you mentioned supply chain feels like it’s improving modestly. Is that the result of the work that you all have done to find additional sources? Are you still using kind of the vendor buys third parties as much? And when we think about kind of ’23, does some of those broker buys actually wind down just because the improvements you guys have made internally?

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

Exactly. So the team has done an exceptional job internally. Our engineering team did an exceptional job in qualifying additional electronic components for our products, and now that they’ve got that complete and the approvals in a relatively short period of time. Just a great job by them.

Now we have options. We have options of suppliers to help us with the supply chain piece, number one. Number two, we’re being told that supply chains for electronic components should get much better in the back half of ’23. So certainly, I would expect to see some of those broker buys drop off. Maybe we’ll see a few in the first half of the year, but certainly would expect those to drop off in the back half.
And then the beauty is we'll have more optionality, with regard to electronic components and hopefully do a nice job on driving down our costs on some of those components as supply chains get better. So it's a combination of things that we've done that we think puts us in a good position going forward.

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

And on the European or the International business, could you help us with what you're seeing maybe out of Europe versus maybe out of China 6% organic growth is pretty good. I think some of it was getting masked by what's happened there is on the FX side. But any sort of commentary there would be helpful, too.

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

That's exactly right, Stanley. So we had positive growth for our International segment. They had obviously a very big FX headwind, I think, of about 11%. So that created some challenges for them. The demand for product continues to be very strong in Asia. We saw some good business from an incoming standpoint in Asia and the Middle East.

What you saw with the business was a matter of timing. The fire service market, that's timing of orders that will ship as we go forward. And then I mentioned the gas detection piece. Fixed gas and flame detection could be better for the International segment because of the backlog we have. So we should be able to get volume there out the door in the fourth quarter and into next year and also portable instrumentation.

The team's done a really nice job. When we look across the Americas and International, the team has done a nice job from an SG&A standpoint and really managing our expenses. We think we're positioned really well with International, as those volumes come back. We have our cost structure in place, and Bob is doing some things on pricing. So I think you'll start to see us get back to those normal levels of margins that we expect as we get into 2023.

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

Perfect.

Operator

And our next question will come from Rob Mason with Baird.

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

Yes. Good morning, everyone, and I'll extend my welcome to Lee as well. Nish, thanks for all the color around the demand strength that you're seeing. I was curious in the quarter, did the shipments on a couple of the large SCBA wins that we talked about last quarter. Did that get underway in the quarter?

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

Yes we did. In fact, we shipped the L.A. County, I think, is what you're referring to. We shipped L.A. County; that was completed in the third quarter. The fact of the matter is, had we shipped that order or not, we would have seen the results we had in the third quarter for self-contained breathing apparatus. We're going into the fourth quarter with a very large backlog of business for self-contained breathing apparatus that will certainly carry us into ’23. It's been so strong.
So whether we shipped L.A. County we would have shipped other orders. But that order did, in fact, go out in the third and actually, I think it went in the month of September. Steve, is that correct? Correct, yes.


Yes. Good. Okay. Fine. And then just noting that you took additional price, I guess, in October, can you just update us where we sit on your current kind of price/cost ratio. You've been able to walk the gross margin higher sequentially as we've gone through the year. So obviously, you're catching up, but I'm just curious where you currently sit, whether we're at parity or just where you currently reside there.

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

So when we look at the quarter, we think we're at parity. When you look at the growth of the business, we probably saw 2/3 of that from price and 1/3 on volume. So you look at about 8% on price, and we think that, that from an inflation standpoint, that's what we've seen in our product costs. So we think we've done a pretty good job in walking that, staying at par with the inflation that we're seeing in the marketplace.

The October increase that we had, we think that, that will continue to position us well as we go forward. And we're evaluating '23. As we get into '23, and we look at inflation and watch our costs closely, we're pretty confident that if there is some adjustment in our expenses, we'll certainly make the adjustments in pricing as we go forward. So we're evaluating that as we go into the '23 year, and we're pretty confident that we'll be able to execute just as we have this year.


And just at the operating margin line, to go back to the geographic segments. I think there was a mention that there was a couple of million of onetime maybe a one-time benefit in the cluster. Did that show up in Americas, International, the incrementals or decrementals, however you want to look at it, depending on the geography. We're both more extreme. And I'm just trying to reconcile that.

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

Right, on the SG&A piece, that was predominantly in the Americas, so they did have the benefit of that. And Jon, was there anything else? There are probably charges for the acquisition?

**Jonathan D. Buck** - MSA Safety Incorporated - Chief Accounting Officer

Yes, so in the prior year, we had a couple of million dollars of Bacharach transaction costs. I'll say that the currency also had about a 3% impact on SG&A in the quarter.


Okay. And the -- perhaps the currency challenges at the EBIT line in International, are those -- should we expect that those continue to work their way through? I thought you made mention that maybe you're trying to address that, but I'm just trying to think about as we look forward here in the very near term, how to.

**Lee B. McChesney** - MSA Safety Incorporated - Senior Vice President & CFO

Yes, to your point, Europe went through a pretty extreme quarter for, I think, for all companies. As Nish just talked about, we've done a lot of really good things on price. That's a nice macro statement in certain parts of the world where there's been more FX pressure; those will be areas we focus
on going forward here as well. But yes, I think certainly, if the FX stays at the level it is, you have those pressures, but we have actions. We're still going to do more, as I just said, in the pricing space.

And we're certainly focused on getting as much efficiency out of SG&A as well. Then we'll continue to drive productivity. So I think it goes back to our earlier comment; over, I'd say, the next 6 months, I think you're going to get the margins back in to more expected levels. And we'll make progress in the fourth quarter, but it will take a bit of time here just given the extreme pressures that have come into the European market.

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


Operator

(Operator Instructions) And this will conclude our question-and-answer session. I'd like to turn the conference back over to Chris Hepler for any closing remarks.

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

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

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time.