

LYDALL, INC.
"Lydall Announces First Quarter 2014 Financial Results"

Monday, May 05, 2014, 4:30 P.M. Eastern
Dale Barnhart

LYDALL, INC.
"Lydall Announces First Quarter 2014 Financial Results"

Monday, May 05, 2014, 4:30 P.M. Eastern
Dale Barnhart

OPERATOR: Good afternoon and welcome to the Lydall first quarter 2014 financial results conference call. All participants will be in listen only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your telephone keypad. To withdraw your question, please press star (*) then two (2). Please note this event is being recorded. I would now like to turn the conference over to David Glenn, Director of Business Development and Investor Relations. Please go ahead

DAVID GLENN: Thank you, Gary. Good afternoon, everyone, and welcome to Lydall's 2014 first quarter earnings conference call. Joining me on today's call is Dale Barnhart, President and Chief Executive Officer, and Robert Julian, Executive Vice President and Chief Financial Officer. Dale will start the call with comments about the progress we're making in executing against our long-term strategy, as well as provide an overview of current business conditions. Robert will follow with a summary of our financial performance for the quarter and discuss the key drivers by business segment. Once complete, we'll open up the line for questions. As you may be aware, our quarterly earnings press release and 10Q quarterly report were released earlier today. So that you can follow along with today's call, we'll be referring to the power point presentation entitled "Q1 2014 Earnings Conference Call", which can be found at lydall.com in the Investor Relations section. As noted on Slide 2 of this presentation, any comments made on this conference call that may constitute forward-looking statements are made available pursuant to the Safe Harbor Provision for forward-looking statements as defined in the Security's laws. Lydall's businesses are subject to a number of risk factors that may cause actual results to differ materially from those anticipated in forward-looking statements. For information identifying some of these important risk factors, please refer to Lydall's report on Form 10-K under cautionary note concerning forward-looking statements. In addition, during this conference call, we will be making reference to non-GAAP financial measures and the reconciliation to the GAAP financials can be found in the appendix of the presentation I just referenced. With that, I'd like to now turn the call over to Dale.

DALE BARNHART: Thanks, David, and good afternoon, everyone, and thanks for joining us today. I'm very pleased to report that we continue to make excellent progress in executing upon our long-term strategy for profitable growth. We are working toward achieving the internal goals that we established and, as a result, this continues to generate improved financial performance for our businesses, which we clearly delivered this past quarter. Turning to Slide 3, the recently published financial results for sales, normalized operating income and normalized earnings per share were the highest results of any quarter since I joined in late 2007. Adjusted earnings per share were \$0.40, up 135% compared with adjusted results for Q1 of 2013. The transformational acquisition of the industrial filtration business that we completed in Q1 helped to drive the significant sales increase of 26.5%, quarter over quarter. But just as important, all of our pre-acquisition business segments experienced solid organic growth in excess of 5% and were in line or above their market trend growth rates by sector. Turning to Slide 4, I am happy to announce that we are accelerating the anticipated target achievement date of our previously published long-term vision for the Company

by two years. Although the timing is changed to 2018 from 2020, our vision remains the same as we hope to achieve revenue of \$800 million, consolidate our operating margin of 15%, and generate less than 50% of our revenue from automotive segments to better balance the business. To date, we have made measurable progress since establishing this long-term vision back in 2012 and I feel we have a roadmap, supported by our strategy for profitable growth, to achieve this earlier than originally expected. Achieving this aspirational vision and continuing to deliver consistent improvement in our financial results, including the recent performance this quarter, is a direct result of our focused progress in executing upon the key elements of our long-term strategy.

This strategy, which is outlined on Slide 4, has four drivers for profitable growth: New product development, lean six sigma, geographic expansion and M&A. As it relates to progress in the quarter against these items, I will start by grouping the last two items together, which are geographic expansion and M&A, and addressing them first. As you may be aware, we previously reported that we closed a transformational acquisition in the industrial air filtration space on February 20, 2014. This was a very meaningful transaction as it further reinforces Lydall's position as an industry leading, worldwide provider of filtration and engineering materials. The acquired business, which we are now referring to and reporting separately as Industrial Filtration, is a leading global manufacturer and supplier of non-woven felt media and filter bags used primarily in industrial air filtration applications. As previously reported when we announced the acquisition, on a run rate basis, Industrial Filtration expected to increase Lydall's total revenue and EBITDA by approximately 1/3. The acquisition also brings balance to Lydall's overall portfolio where our filtration engineering materials business are now expected to be closer to 50% of the total revenue of the Company, which, as you may recall, was one of the tenets of our long-term vision. Once the business is fully integrated, we expect to leverage our operating discipline and support functions to generate anticipated annual cost savings of approximately \$4 million by 2016. Consistent with that, we shared with you a couple months ago the business is expected to be accretive to Lydall's 2014 full year earnings and free cash flow, inclusive of transaction expenses, the effect of inventory step-up, and the incremental amortization of intangible assets. Robert will take you through these figures in detail shortly.

Coming back to the other elements of our long-term strategy to drive profitable growth, our ability to continue and develop in commercialized new products is paramount. To give you some color on how we progressed against this in the past quarter, one example would be our recent commissioning of the new filtration manufacturing asset within our performance materials division, which we refer to as the Mini Mill. This asset is designed to be flexible and more responsive to the needs of customer and as contrary to the large manufacturing assets that have dominated the industry for over a hundred years. This technology will provide customers with customized high-quality products in smaller batch sizes and allow us a better focus on more attractive life science filtration media segment, as well as support our continued research and development initiatives.

In addition, with respect to new product development, we continue to see increased activity in customer trials of our Solupor membrane filtration material for multiple applications, from air intake filtration for natural gas turbines, room air purifiers and filtration for vacuum cleaners, among others. Many of these items, with the exception of the natural gas turbine application, are in their infancy and may not ultimately prove to be successful, but are a good indication of our ability to develop new customized products to meet the needs of our customers. These

products specifically, if commercialized, have the ability to substantially enrich the overall operating margin of Lydall if they were to become scale at some point in the future.

The last value driver of our strategy that I will touch upon is the continuous improvement of our operations through the use and application of Lydall Lean Six Sigma. As I have previously mentioned, the best turnaround of a company that I have ever seen in my career was what the management team in the thermal/acoustic fiber business achieved in the past few years. The application of good manufacturing processes and lean practices were second to none and the results are evident in the reported financial performance for this segment. Given the proven success of this and the fact that the industrial filtration business has similar manufacturing assets as those in our thermal/acoustic fibers business, the general manager of the fiber business has been reassigned to run the recently acquired industrial filtration business. I know that he and the management team that remains in place with the acquired business will be able to use these tools to drive continued operating improvement in this business through the adoption of a lean culture.

Turning to Slide 6, I will touch on the business conditions that we are currently seeing in the market through the second quarter. I will begin with our automotive businesses, where we continue to see global factory production in line with our previous expectations and market forecast. North America continues to remain strong and, while we continue to take share, given the strong platforms that we are on and continue to win, we are watching inventory days with all of our customers closely. In addition, we are keeping an eye on the changeover of the Ford F150 platform to support the new aluminum design. Currently, we do not see any signs of a material slowdown through the second quarter, as our customers will not be going through their tooling change over their plants until later this year and into next year. That being said, they are not changing everything over at once and they appear to be working to balance this change over between their plants. With respect to the European automotive demand, we continue to see signs of a recovery and total market production is growing, year over year, which is an encouraging, given the annual declines in production we have become accustomed to since the global recession.

With respect to our filtration business overall, as you may know, this space is generally characterized as growing at approximately 2X GDPE, given the consumable nature and replacement cycle for the products. Historically, our performance material business has not achieved this on an organic basis, but we continue to see positive signs for growth, year to date, in the European and Asian market, especially in air and fluid...fluid power filtration. In our newly acquired industrial filtration business, the first quarter of the calendar year is typically the strongest, considering that many industrial plants serving the cement and asphalt industry are coming online. While we've had only a couple months of performance under our ownership, the business seems to be continuing to perform well and demand for the business remains stable. The key driver for this business in the near term is our ability to successfully integrate it. Although it has only been about 75 days since the close of the acquisition, I am happy to report that all integration initiatives are either on track or ahead of schedule.

Wrapping up my comments before I turn it over to Robert to take you through the financial performance, I am very pleased with the strong first quarter performance after adjusting for expenses related to the acquisition. While the results speak for themselves, we continue to work diligently and remain focused

on the execution of our long-term strategy for profitable growth and providing shareholders attractive returns. With that, I now turn the call over to Robert.

ROBERT JULIAN: Thank you, Dale, and good afternoon, everyone. I'll start, today, by providing a quick recap of the key financial highlights from the quarter and will then give an overview of the business performance of each of our reportable segments.

Turning to Slide 7, the Company achieved record sales of \$125.2 million in Q1. This strong performance includes the contribution from our recently acquired industrial filtration segments, which closed in February, in mid February. However, even excluding the performance from industrial filtration, the total quarterly sales from our pre-acquisition businesses were at record levels. In all, sales for the quarter were up nearly 27%, which includes 7% organic growth. As Dale said earlier, all of our businesses were up organically, but the most significant contributor to this growth was our thermal/acoustical fibers business, which continues to grow profitably, given the strong platforms we are on and the new programs we are winning. Reported operating margin for the quarter was 6.1% vs. 6.6% in Q1 2013. It's important to note that the current period results include \$3.6 million of expenses associate with our acquisition of the industrial filtration business. The \$3.6 million could be broken down into two pieces.

First, our expenses of \$1.3 million related to purchase accounting, primarily the write-up of finished goods inventory, which will impact cost of sales upon shipment. The remaining \$2.4 million was related to transaction costs to complete the deal. If we normalize Q1 for unusual or nonrecurring items in both time periods, Q1 2014 operating margin was 9.0% compared to 4.9% in Q1 2013. From a tax perspective, a large portion of the \$2.4 million of transaction costs were nondeductible, which contributed to our effective tax rate for the quarter increasing to 49.5%. Without this item, the effective tax rate would have been closer to the statutory rate, somewhere in the mid 30's. Looking forward to the rest of the year, we anticipate the tax rate will settle somewhere in the range of the mid 30's, given our geographical business mix. We also expect to begin realizing the benefits from some of the tax projects that we have been working on.

Similar to what I just discussed for operating margin, the impact of purchase accounting in transaction expenses also significantly impacted net income in earnings per share, as you would expect. Normalizing earnings per share for these items, adjusted diluted EPS would have been \$0.40 for the quarter, vs. \$0.17 for Q1 2013. Again, as Dale mentioned earlier, this is the highest level of normalized quarterly earnings per share that the business has experienced since Dale joined the Company in 2007. This demonstrates that our long-term strategy for profitable growth is generating tangible results.

Moving over to the balance sheet, our liquidity continues to remain strong as we've effectively have zero net debt. At the end of the first quarter, we had just over \$50 million in cash, while borrowings increased to approximately \$60 million as we drew against our recently amended credit facility in order to help finance the acquisition. As you may recall, in advance of completing the industrial filtration acquisition, we increased our credit facility from \$35 million to \$100 million, which not only provided us with additional borrowing capability, but actually lowered our borrowing rates, provided us with more favorable financial covenance, and included a \$50 million accordion feature. From a financial leverage perspective, the \$60 million of debt at the end of the first quarter puts us at about 1.4 times from a debt to EBITDA ratio perspective, which is about half of our allowed ratio, per the covenance. Clearly, we have dry powder if we need

it, but as we have mentioned in the past, as a matter of comfort, we feel that 2.0-2.5 times debt is the maximum leverage we would like to carry. With the respect to how we are continuing to think about capital allocation strategy, our priorities for cash remain unchanged. We are focused on supporting new product development, insuring the businesses have adequate access to capital for CAPEX needs, and being able to support additional M&A activities.

Furthermore, as it relates to the balance sheet, as you would expect with the recent acquisition, total assets increased substantially, given the addition of industrial filtration. Focusing on goodwill and other intangible assets, goodwill increased by \$3.7 million and intangible assets by \$5.6 million based on the purchase accounting for the acquisition. The intangible assets will be amortized over a period of approximately eleven years, which will result in a negative impact to the segment's operating income by approximately \$.5 million, annually, during this timeframe. From a cash conversion cycle perspective, we did see an unfavorable impact to our inventory and receivable stays, as they increased by approximately five and ten days, respectively. This is due primarily to the inclusion of the industrial filtration business. As mentioned earlier, one of the synergy opportunities that we see with this business is to improve the working capital performance while maintaining exceptional customer service levels. Working capital performance was not a primary focus of the previous management group. Improving working capital will take some time, but it is a key area of focus for us.

Lastly, as it relates to capital expenditures, we spent approximately \$3 million in the first quarter. We anticipate total CAPEX in 2014 to be in the range of \$17-\$22 million, including the impact from industrial filtration. That concludes my summary level financial review for Q1 and I'll now take you through the financial highlights by reportable business segment.

Turning to Slide 8, I'll start with our thermal/acoustical metals business. As you may know, this is one of our automotive segments that has a global footprint. It specializes in providing under-hood and underbody engineered thermal solutions for vehicles. Overall, we were pleased to see strong growth for the business, globally. Total parts sales for this quarter were up \$3.9 million, or 11.8% compared to the same period last year. We continue to outperform factory production and saw growth of approximately 15% in North America and nearly 10% in Europe. We're particularly encouraged by the growth in Europe, as this region has experienced annual production volume declines since the global recession. Hopefully, this is evidence that the trend is reversing.

With the respect to our startup facility in China, we are pleased to announce that the business sold its first production parts in April, which was in line with our plans. In addition, although the investment in this facility was predicated on supporting production for only our metals customers, we are currently actively working on being able to produce and bring some of our thermal/acoustical fibers products to market through this facility. With respect to operating margin, this business reported results of 8.6%, representing a 110 basis point improvement over Q1 2013. The current period results include continued startup cost of our China operation, which negatively impacted margin by approximately 80 basis points.

Slide 9 shows the result of the thermal/acoustical fibers business. Similar to metals, this business serves the automotive industry and provides molded polyester acoustical solutions primarily for underbody applications for vehicles in North America. This business continues to be a great success story. We

experienced strong parts sales growth of \$2.5 million, or 9.1% compared to the same period last year. As Dale mentioned earlier, we supply content to the Ford F series platform and these vehicles have continued to have great success in the marketplace. Ford will be upgrading the tooling in their plants later this year and into 2015 in their transition to the aluminum F150 pickup truck. We do not see a material impact on our business outside of some timing considerations.

Operating margin continues to improve, as we were able to benefit from leverage due to available capacity that we built in this business through the implementation of Lean Six Sigma over the last few years. Reported operating margin was up 60 basis points to 22.6%. However, last year Q1 results included the benefit of \$1.8 million of nonrecurring operating income due to a special customer project, as well as the settlement of a price in negotiation. Therefore, the improvement in operating margin is even stronger than the nominal figures suggest.

Slide 10 details the results of our performance material segment. This business provides specialty filtration and insulation products to a variety of end market, globally. Net sales for this business were up \$1.4 million, or 5.0%, quarter over quarter, as we experienced strong demand for our fluid power and air filtration products, primarily in Europe. North America was a bit softer and we continue to keep an eye on this. Overall, we are encouraged by the recent growth in this business and, as Dale mentioned earlier, we are excited about the new product development opportunities that this business continues to generate, especially with respect to continuing to further commercialize our Solupor membrane filtration technology for a variety of applications. Operating income for this business improved by \$.6 million, or 190 basis points, quarter over quarter, primarily due to the increased sales volume. This business has a high amount of fixed overhead, given the scale of the paper making equipment that we use to manufacture the filtration media. As the business sees increased volume, we fully expect to see favorable drop through to operating income.

Slide 11 covers our newly acquired industrial filtration business. This business focuses on providing needle felt filtration solutions, primarily for the industrial air segment, globally. Given that this business is now its own reportable segment, you can clearly see its contribution since we closed the deal. During the five weeks that we owned the business in the first quarter, the business generated nearly \$18 million in sales. This strong performance was in line with our expectations. The first quarter of the year is typically the most robust for the business, as some of the industrial plants supporting asphalt and cement come online at this time of the year. The reported operating margin for this business of 4.5% was impacted negatively by the \$1.3 million of purchase accounting expenses I discussed earlier. On an adjusted basis, operating margin was 11.7%. Looking forward into Q2, we anticipate transaction related expenses, purchase accounting adjustments and incremental amortization of intangible assets to be in the range of \$.8-\$1.0 million.

Turning to Slide 12, we have our vital fluid segment, which we go to market under the name of Charter Medical. This business is focused on serving the life sciences market, which includes blood filtration, blood transfusion, and single use solutions for the bio processing segment. Sales for this business, quarter over quarter, were up nearly 10%, driven by demand for our bio processing products. The bio product line, specifically, was up nearly 50%, quarter over quarter, which was very encouraging as this is the growth engine for Charter Medical and is the key to getting this business to an appropriate scale for its current cost structure.

Overall, it was an excellent quarter for all of our businesses. We are making great progress in improving the business and executing against our long-term strategy for profitable growth. That concludes my remarks on the first quarter performance of our businesses. With that, I will now turn the call back over to the Operator to start the question and answer portion of the call. Gary?

OPERATOR: We will now begin the question and answer session. To ask a question, you may press star (*) then one (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) then two (2). At this time, we will pause momentarily to assemble our roster. And our first question comes from Robert Kosowsky with Sidoti. Please go ahead.

ROBERT KOSOWSKY: Good morning, guys, how're you doing?

DALE BARNHART: Just fine, Rob, how are you?

ROBERT JULIAN: Hi, Rob.

ROBERT KOSOWSKY: Doing all right. Okay, so I was just curious on looking into Q2. So if we start from 1Q's adjusted base of \$0.40, we have to account for about a million dollars of headwinds from the Andrew acquisition. Is there anything else that's a major headwind going against us? And, also, could you maybe talk a little bit more about the seasonality of Andrew, as well?

DALE BARNHART: To answer the first part of the question, no, we don't see any significant headwinds as we go into the second quarter. The first half of the year tends to be the strongest for the industrial filtration segment and it tapers off in the second half of the year.

ROBERT KOSOWSKY: Okay, any sense as to what the first half, second half usually looks like?

DALE BARNHART: Not at this time. I mean, the first quarter, or what we've seen so far, as we stated, was up over last year at the same period, so the general economy seems to be quite stronger this year compared to last year.

ROBERT KOSOWSKY: Okay.

ROBERT JULIAN: The historical trends, probably, Robert, are as good any, as you know, without us projecting forward. But if you look at our seasonality in prior years, then in, I think Q4 tends to be probably the lowest quarter of the year.

ROBERT KOSOWSKY: Okay, that's helpful, and then also on thermal/acoustical fibers, those are fantastic margins there. How sustainable is this above 22%, going forward? Or was this really inflated because you might have had some higher parts sales as the F-Series is really ramping up before kind of some changeover time, so meaning, was there any artificially inflated volume in there and, if not, how sustainable is this 22% margin?

DALE BARNHART: The volume was higher, significantly higher, and, yes, that did benefit our margins benefited from that. As we've always stated, you know, mid teens to twenty is probably about what you can expect out of a Tier 1 automotive supplier.

ROBERT JULIAN: We do remind folks that those are margins, operating margins without any allocation of the corporate overhead, so it's not, you have to take that into account when you think about the overall profitability of any of our segments. Those are all non-allocated with respect to corporate expenses.

ROBERT KOSOWSKY: Okay, that's helpful, and then one last question on the margin profile. Performance material seems to step down from what it was in the second half of last year and I was wondering if you could maybe bridge or just give us a better sense as to why.

DALE BARNHART: It's mostly mix. Compared, we had a very strong fourth quarter as it related to some of our industrial insulation products, which tend to carry pretty good margins. So we've had a very strong fourth quarter. We're not seeing that demand as strong in the first quarter of this year. But on a positive note, we anticipate Solupor to continue to pick up as we go through with new applications, which will have favorable. And we're also seeing, we saw strength in the first quarter in Europe, particularly, in air filtration and in fluid power. North America seemed to lag a little. We're starting to see that pick up now as we go into the second quarter, on the filtration side.

ROBERT KOSOWSKY: Okay and then, finally, just one last question on your filtration product going into gas turbines, where does that stand right now? Because I think it was being tested by some customers and how close are we to some commercialization of that product?

DALE BARNHART: It is commercially available, but the first hurdle is to get through several significant field tests and we have a couple significant ones going in over the next sixty days with some major utilities in the United States that are viewed as the technology leaders. With success there, I think we'll be getting close to the tipping point on this as we exit this year going into 2015. It's really hard to predict exactly when that's going to happen, Rob. The good news is there's been no significant product performance issues in the field and everything we've seen to date has performed up to our expectations and our customers' expectations. So it's really getting the confidence in a very conservative space utilizing a new filtration media that is protecting a very expensive asset.

ROBERT KOSOWSKY: All right. Thank you very much and good luck.

DALE BARNHART: Thank you, Rob.

OPERATOR: Again, if you have a question, please press star (*) then one (1). As we have no further questions, this concludes the question and answer session. I would like to turn the conference back over to Dale Barnhart for any closing remarks.

DALE BARNHART: Again, the Management team is very pleased with the performance in the first quarter of this year. But we continue to maintain focus on continuing to improve the business as we go forward and I want to thank everybody for joining us on the call. Thank you.

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