

Lydall, Inc.

Third Quarter 2014 Earnings Release

11:00 AM Eastern

**CORPORATE PARTICIPANTS**

**David Glenn** – *Director of Business Development and Investor Relations*

**Dale Barnhart** – *President and Chief Executive Officer*

**Robert Julian** - *Executive Vice President and Chief Financial Officer*

## **PRESENTATION**

### **Operator**

Good morning, and welcome to the Lydall's third quarter 2014 earnings release 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 Mr. David Glenn. Please go ahead.

### **David Glenn**

Thank you, operator. Good morning everyone and welcome to Lydall's 2014 third 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 continued progress we're making in executing our long-term strategy as well as provide an overview of current business conditions. Robert will follow with a summary of our financial performance and discuss the key drivers by operating segment. Once complete, we'll open the line up for questions. As you may be aware, our quarterly earnings press release and 10-Q quarterly report were released earlier today. So that you can follow along with today's call, we will be referring to the PowerPoint presentation entitled "Q3 2014 Earnings Conference Call", which can be found at [lydall.com](http://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 securities laws. Lydall's businesses are subject to a number of risk factors that may cause actual results to differ materially from those anticipated in the 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 a reconciliation to GAAP financials can be found in the appendix of the presentation I just referenced. With that, I'd now like to turn the call over to Dale.

### **Dale Barnhart**

Thank you, David. Good morning to everyone and thanks for joining us today. I'm very pleased to report that we had another strong quarter and believe we remain on the right path to achieve our 2018 vision of \$800 million in revenue and 15% operating margin. Turning to slide 3, which outlines our recently published financial results for sales, operating income, and earnings per share, our adjusted earnings per share were \$0.43, up 59% versus the third quarter of 2013 earnings of \$0.27. On a GAAP basis, third quarter 2014 diluted earnings per share were \$0.24. Net sales growth grew 37% to \$134.2 million. The majority of the top line growth came from the acquisition of our industrial filtration business, which increased sales by 31.2%, while 5.8% of the growth was organic. Excluding the impact of lower tooling revenue this quarter versus the same period last year, the business grew 8.3% organically.

With respect to the ongoing investigation relating to the possible violations of German anti-trust laws, we are still waiting a response from the German Federal Cartel Office, and at this point, we're unable to estimate you the timing or the amount of liability associated with this matter.

Turning to slide 4, this slide is an overview of our long-term growth strategy for profitable growth, which includes four drivers; new product development, Lean Six Sigma, geographic

expansion, and M&A. To provide an update on our four drivers, I will first cover the last two items together, geographic expansion and M&A.

With respect to the acquisition of the Industrial Filtration business in the first quarter of this year, we are making continued progress on integration. To-date, the majority of the cross functional integration has been completed. The team continues to focus on and drive the execution of key synergy programs behind the targeted annual cost savings of approximately \$4 million by the end of 2016. The adoption of Lean is underway and we have begun supplying the first orders of automotive raw goods to our Thermal/Acoustical Fibers division. This will continue to ramp up through the first quarter of 2015.

Moving to new product development, our ability to introduce and commercialize new products is the key element in expanding our margin profile. Earlier this quarter, the conversion partner that sells our Arioso Membrane product for air intake filtration of natural gas turbines received a repeat order from a major utility company based on the continued favorable performance of the product. Lastly, I would like to update you on the improvement of our operations through our Lydall Lean Six Sigma. Although, we have already realized a significant improvement over the past few years, we continue to look at new ways to operate more efficiently to serve our customers. At a consolidated level in the third quarter, we achieved operating margin expansion of 60 basis points to 8.1% after adjusting for one-timers. We were particularly pleased with the result given the margin dilution from the recent Industrial Filtration acquisition.

On Slide 4, I will review the current business conditions that we saw through each of our business segments in the third quarter. As we discussed on our last quarterly call, we expected sales trends to temper in the second half, mostly as a result of some seasonality in our business. Specifically within our automotive business, plant shutdowns and additional holidays yield less production days for our customers. Despite these items, we are very pleased with the 5.8% of organic growth experienced in the quarter. Looking forward, current visibility suggests that the overall demand within the global automotive market remains stable as North America continues to remain strong, and we are keeping a close eye on the pace of the recovery of the European market. In our filtration business, this pace generally characterized to grow greater than GDP, given the consumable nature and replacement cycle for these products, and we anticipate that this trend will continue for the remainder of the year. However, within the performance materialistic segment, we expect sales to be tempered due to lower demand for our Thermal Insulation products.

To wrap up my comments before turn it over to Robert, we are proud of our performance through the third quarter and I would like to congratulate our team members for their consistent execution. As a result of their efforts, we remain on track for executing our long-term business initiatives, and we're underway to a successful integration of the Industrial Filtration business. With that, I will now turn the call over to Robert.

### **Robert Julian**

Thank you Dale, and good morning everyone. I'll start my comments by providing a brief overview of our quarterly and year-to-date consolidated financial results, and will then give an overview of each of our operating segments individually. Turning to Slide 6, this quarter the Company achieved record third quarter sales of \$134.2 million. Our sales grew 37%, of which 31.2% is attributable to our recently acquired Industrial Filtration business, and 5.8% attributable to organic growth. As Dale mentioned earlier, excluding the impact of lower tooling revenue this quarter versus last year, the business grew 8.3% organically. Our adjusted operating margin for the quarter was 8.1%, versus 7.5% in Q3 of 2013.

It's important to note that the adjusted results exclude two items. The first is a voluntary non-cash pension plan settlement charge of \$4.9 million, and the second is a non-cash purchase accounting adjustment of \$0.2 million associated with our Industrial Filtration acquisition.

The effective tax rate for the quarter was 30.2%, compared to 37.5% in the third quarter of 2013. Our current result was positively impacted by the mix of taxable income generated in countries with lower tax rates compared to the U.S., coupled with tax benefits from the pension settlement. The pension settlement expense favorably impacted our effective tax rate this quarter by approximately 350 basis points. For the full year, we anticipate that our tax rate will settle somewhere in the range of low to mid 30s.

Adjusted earnings per diluted share, excluding onetime items, were \$0.43, compared to \$0.27 in the prior year. GAAP diluted EPS were \$0.24 in the third quarter of 2014. Turning to Slide 7, I would like to discuss the financial progress we've made on a year-to-date basis. Sales for the first nine months of 2014 were up 37% year-over-year. Excluding the acquisition of Industrial Filtration, sales growth has been strong across all of our businesses, yielding an 8.3% increase in organic growth year-to-date. We have also made very good progress on operating margin. After adjusting for non-recurring charges, our year-to-date operating margin increased 210 basis points over the prior year, to 9.4%. Reported operating margin on a year-to-date basis was down 150 basis points, to 6.4% as a result of the sales commission settlement, transaction-related expenses, purchase accounting adjustments, and the pension plan settlement charge.

Our adjusted EPS for the nine months of 2014 grew 91%, to \$1.47, compared to \$0.77 in the prior year. Reported EPS is also up 6.8%, to \$0.95. We're proud of this performance and commend our team for their solid execution of our focused business initiatives. Moving to the balance sheet, our liquidity remains strong. Our cash balance of approximately \$77 million exceeds our total debt as of September 30, 2014. Our cash balance is little changed from year-end 2013, in spite of using considerable cash to fund the acquisition of Industrial Filtration. From an operating cash flow perspective, the Company generated \$30.5 million of cash through the end of Q3 2014, compared to \$10.9 million in the prior year. Cash from operations came in just under 200% of net income. This demonstrates the strong execution from our team in implementing our lean initiatives, especially in the Industrial Filtration business as reflected in their reduction in inventory.

Free cash flow year-to-date is \$21.7 million, compared to \$1.4 million in the prior year. Finally, as it relates to capital expenditures, we spent approximately \$8.6 million through the first nine months of the year with an additional \$2.6 million in accounts payable as CIP, compared to \$9.5 million for CAPEX in the prior year. At this point, we anticipate total CAPEX spend in 2014 to be in the range of \$15 million to \$18 million, including the impact from Industrial Filtration.

That concludes my summary level financial review for the third quarter. I'll now walk through the financial highlights by segment. Turning to Slide 8, I'll start with our Thermal/Acoustical Metals business. 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 are extremely happy to see the continued growth in this business, with 7.5% growth year-to-date and 11.6% during the third quarter of 2014, compared to the same period last year. From a geographic standpoint, demand in North America continues to be strong and we continue to be pleased by part sales growth in Europe of approximately 6% year-over-year. In addition, we are very proud of our Lydall Gerhardi business in Germany for recently being awarded the General Motors' Supplier Quality Excellence Award.

As we have mentioned on previous earning calls, our China startup continues to be behind schedule due to the delay of platform launches. We now anticipate that this facility will break even in the second half of 2015, as programs will come on line throughout the year.

The current quarter includes start-up costs in China that negatively impacted segment margin by approximately 80 basis points. Looking at operating margin performance, segment level margin improved 30 basis points in the third quarter to 10.7%, compared to the third quarter of 2013, reflecting continued progress on our Lean initiatives and our ability to leverage higher volumes.

Slide 9 refers to our Thermal/Acoustical Fibers business. Similar to our Metal segment, this business serves the automotive industry and provides molded polyester acoustical solutions, primarily for underbody applications for vehicles in North America. Part sales in this segment continued to be strong as we saw growth of \$4.2 million, or 15.6% compared to the same period last year. Sales growth in this quarter was attributable to strong demand in North America despite a key customer shutting down one of their plants for platform changeover. Operating margin in this quarter increased 560 basis points over the prior year to 22.3%, reflecting a significant mix shift between part sales and tooling sales, as well as the continued strong execution by our team on Lean initiatives.

Moving to Slide 10, I will cover our Performance Material segment. This business provides specialty filtration and insulation to a variety of global end markets. Net sales in the third quarter for this business increased \$0.8 million or 2.7%, primarily due to strong growth in filtration and Life Science products within the segment's European operations. The Thermal Insulation segment experienced a decline in sales due to significantly lower sales from a key customer. Higher margins typically generated by these products affected the overall operating margin performance of the business. As a result, segment level operating margin declined 80 basis points to 7.9% during the quarter.

Slide 11 covers the Industrial Filtration business acquired earlier this year. This business focuses on providing needle felt filtration solutions, primarily for the global industrial air segment. For the third quarter of 2014, which was the second full quarter under Lydall's ownership, the business achieved \$30.6 million in sales. Normalized operating margin in the quarter was 6.8%, which excludes the impact of the inventory step-up purchase accounting adjustment. Demand in all regions was stable, and while the fourth quarter is typically less robust due to seasonality in the industrial air business, we are in the process of ramping up shipments of raw goods to our Thermal/Acoustical Fibers business. Over time, this will provide more stability in the revenues of this business.

Turning to Slide 12 is our Vital Fluids segment that we go to the market under the name of Charter Medical. This business focuses on the life sciences market, which includes blood filtration, blood transfusion, and single-use solutions for the bioprocessing market. Sales for this business increased \$1.1 million, or 25.5% year-over-year, driven by strong demand for our bioprocessing and cell therapy products. The backlog in this business continues to remain strong, and we are pleased by the continued success that this business has experienced year-to-date. Operating margin for this segment was 10.4%. The improvement over last year was primarily due to favorable absorption of fixed costs as a result of increased volume.

That concludes my comments on the financial performance of our segments for the quarter. Overall, we saw another strong quarter of performance. We look forward to continued progress and believe we are well positioned heading into the fourth quarter. With that, I would now like to

turn the call back to the operator to begin our question-and-answer session.

## **QUESTIONS AND ANSWERS**

### **Operator**

Thank you. We will now begin the question-and-answer session. To ask a question, you may press star (\*) then one (1) on your telephone keypad. 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. The first question comes from Arnie Ursner with CJS Securities. Please go ahead.

### **Arnie Ursner**

Hi, good morning.

### **Dale Barnhart**

Good morning.

### **Robert Julian**

Good morning, Arnie.

### **Arnie Ursner**

I guess my first specific question, you know, we're relatively new with you and vice versa, relative to our model, the largest variable was in T/A fiber revenue and I think in your prepared remarks, you mentioned timing of new launches. Is this revenue we should expect you'll make up in the balance of the year?

### **Robert Julian**

Yes. The fibers revenue, Arnie, was impacted by two things; one is much higher part revenue, but also lower tooling revenue. So, we're not concerned in terms of the volume that's coming in the programs we're on, in fact the tooling revenue is sort of indicative of future business. Of course that segment is impacted by Ford, which has shut down their facility in Dearborn for the changeover to the aluminum F150. And so that did certainly have some impact on us. And I'd believe we mentioned in our previous quarter call that maybe there were even some sales pulled into the prior quarter, but our understanding is that Ford is on track in terms of their plans for the change-over, and so we anticipate that we'll continue to see good result with them going forward.

### **Arnie Ursner**

Okay. And my second question relates to the Andrews Filtration unit that you acquired. Can you update us on the integration of it, cost synergies you hope to achieve, and more importantly, I think for the future, some revenue synergies you might be able to get?

### **Dale Barnhart**

Arnie, this is Dale, and the integration is going very well. From a cultural standpoint, the management team has done a very nice job of bringing lean to the company and the existing management team there is receiving it well. We had a significant reduction in inventory as a result of some of the lean practices we're putting in place. As it relates to achieving the \$4 million synergies by 2016, we're well on track of that, probably a little ahead of it. And I mentioned on the call that we have already initiated the initial shipments of the raw goods to our Thermal/Acoustic Fibers business, which is very significant for Industrial Filtration as far as incremental revenue that we will be able to bring in through the synergies. That revenue could,

over the next two years will exceed \$10 million a year.

**Arnie Ursner**

Okay, I'll jump back in queue. Thank you very much.

**Dale Barnhart**

Thank you, Arnie.

**Operator**

The next question comes from Robert Kosowsky with Sidoti. Please go ahead.

**Robert Kosowsky**

Good morning guys, how are you doing?

**Dale Barnhart**

Good morning Robert, we're doing very well. Thank you.

**Robert Kosowsky**

Good to hear. Dale, in your commentary in the press release you mentioned there is some caution regarding fourth quarter results and the step down seasonally, and because of the Ford shut down, and I was wondering if you can give us little more of quantification for what we should be expecting on this step down?

**Dale Barnhart**

Well we really won't, as you know Rob, we don't actually quantify or give guidance other than just the general macros that we're seeing. The significant pressures down will be automotive tends to shut down in the fourth quarter for retooling holidays. So the normal production days that they have is down, plus we did have a little bit of the transition of the Ford F150. Dearborn was down to the end of October and they're having a slow ramp up. And as we go into the first quarter, Kansas City will be down during the first quarter, as they re-tool. So that will have some impact on the revenues in that business. As it relates to filtration, you tend to see normal seasonality in the fourth quarter, where sales tend to be a little softer. I think that will impact both Performance Materials and Industrial Filtration. And then the one, I guess one-off event that has occurred is we have the one Thermal Insulation application where we have a customer who has come out with a new product who has changed their design philosophy, going to a lower cost product, and we'll see a negative impact of the loss of that revenue in the fourth quarter.

**Robert Kosowsky**

Okay, so given that, do you think it's possible that you could see, I guess, year-over-year growth in any of your segments in the fourth quarter?

**Dale Barnhart**

I believe so.

**Robert Kosowsky**

Okay, so down sequentially, but there is still opportunity to get year-over-year growth in few of the segments?

**Dale Barnhart**

Yes.

**Robert Kosowsky**

Okay, and then otherwise just to continue to talk about Ford, did you start to feel the impact of the changeover in the third quarter, and has that subsided it at all, is it in kind of a steady state? I'm just kind of curious on that impact?

**Dale Barnhart**

Yes, we did start feeling the impact of that, I mean the nice thing is we continue to win new products and new applications that mitigated it if we didn't have that. And also, as they're ramping up, they're going very slow. They want to make sure that the product launch is very successful, so while I'm sure they have a pretty good demand backlog for the new product because of; it's offering a lot of new features besides just the aluminum body. Ford is making sure that they're executing well on that launch. I mean, it's their number one selling vehicle and they are going to be very cautious. So they are back in production, we are shipping parts, we've made our initial shipments for the new vehicle, and that's starting to ramp up

**Robert Kosowsky**

Okay, and then otherwise on Andrew or the Industrial Filtration segment, it looks like year-to-date the margins are weaker than the 8% or so operating, you know, 11% EBITDA margin say, that you disclosed when you did the deal in the fourth quarter, and I am wondering, or first quarter, I was wondering if there's any reason for the underperformance on the margin profile and what your thoughts are for margin expansion into next year?

**Robert Julian**

Yes, Rob, this is Robert. I think what you're seeing on that sequential basis is fairly significant purchase accounting did affect margins in the first quarter that we owned the Industrial Filtration business. It was much, much less in Q3, only about \$200,000. But it's a couple of million dollars on a year-to-date basis, and the majority of that occurred in the second quarter. So on a sequential basis; I think you're just seeing the impact of purchase accounting. Going forward, we feel very confident that the integration is going well and that the synergies that we have communicated will be achieved, so we're optimistic looking forward.

**Robert Kosowsky**

Thank you. And then finally you mentioned the Arioso follow-on order? I'm wondering if you could expand on that, and maybe how meaningful that could be?

**Dale Barnhart**

As we've stated several times, we're very excited about the membrane technology we're bringing into the gas turbine intake market. Its performance has been excellent. The one area that we've been disappointed in is most of the utilities want almost two years of field testing before they will do a repeat order because it has such a big impact on the ability to run that turbine. So, what we saw there was one of the utilities who has gone through not quite two years, has ordered a replacement order for those filters through the OEM that converts our material into filters. So again, it's another positive sign that the product is meeting the expectations of the marketplace.

**Robert Kosowsky**

All right, thank you very much.

**Dale Barnhart**

Thank you, Rob.



**Operator**

Again, if you have a question, please press star (\*) then one (1). The next question comes from Arnie Ursner. Please go ahead.

**Arnie Ursner**

Okay. I'll immediately follow-up the question you just had. The utility that placed that order for a replacement, have they broadened the use to other facilities, do they intend to broaden their use? What feedback are you getting from that utility?

**Dale Barnhart**

Well, they've added, what they've done is put the filters into, yes, another turbine, so another site, so they have at least two sites now running with our material. Technically, it's still in their qualification process, but everything is going well. So, we have some small sites now that are running well over two years with no issues. So, we are meeting or exceeding the life expectancy. As you know, Arnie, this is a premium-price product because of the efficiency it delivers and the durability and life. And all those factors, so far, are proving out in the real world. So we're quite excited about the opportunity, and when that will actually hit the tipping point to start driving some significant volume in the company.

**Arnie Ursner**

Okay. The next question is in your CAPEX. I think you indicated that you spent just under \$9 million year-to-date, but plan to spend \$15 million to \$18 million for the year. Where will the incremental capital will be spent? And the perception I had is that in some of your facilities you had some excess capacity, so maybe help us to better understand the priorities for the CAPEX?

**Robert Julian**

Yeah, Arnie, this is Robert. We have several programs that we will be tooling up before in automotive, specifically in the Metals segment. And so, I think we have a history that the CAPEX sort of comes later in the year. We may end up at the lower end of the range for the full-year, but we do have some new programs launching in automotive that we should see some impact for that in Q4.

**Arnie Ursner**

Okay. And my final question goes back to your free cash flow and balance sheet and priorities for free cash flow. It's pretty impressive that you've been able to get to a net cash position after an enormously large and successful acquisition that you completed. What are your priorities for free cash flow, and a little more specific question on your cash balance, where is it located and is it pretty usable for you to enhance shareholder value?

**Robert Julian**

Yeah, Arnie, this is Robert again. The majority of the cash is in fact in the U.S. Say there is a range of, I don't know, \$15 million to \$20 million maybe that's overseas. In terms of our priorities, that really hasn't change, I mean we are, continued to invest in organic growth, in Lean initiatives. We would like to have our powder drive for a potential acquisition. We will certainly look at paying down our debt. Although it may not be the ideal capital structure, if we have the cash available we will probably reduce our debt outstanding. In the long run there could be a discussion about a dividend and so on; if we've satisfied all of the other business needs that I just mentioned, that's not really something imminent. And I'm sorry Arnie, is there something else that I didn't answer in your question that you just asked?

**Arnie Ursner**

No, I think, you captured the key points. Thank you very much.

**Robert Julian**

Sure thing.

**Operator**

The next question comes from Robert Kosowsky. Please go ahead.

**Robert Kosowsky**

Yes, just two quick follow-ons. One is on the Thermal Insulation business. How much longer this customer headwind going to be persisting and do you see any opportunities for incremental growth as you get more CNG fleets and what not going out in the field?

**Dale Barnhart**

Well, that's not, the particular product we are talking about was not the cryogenic product; I mean that is still running well. I believe our sales year-to-date are up over prior year, and we expect that to continue to grow in the future. So it's not the cryogenic product. This was a veil that was used in an HVAC application. As I mentioned earlier, the customer changed their design philosophy and have gone to a lower-cost approach. We have, again, a very green product, that's very interesting to that market place, and we're out marketing at other customers at this time. So, and we are continuing to work with that customer. As far as revenue, within Performance Materials we've already seen significant growth this year in filtration products to mitigate that loss. And as we go forward, whether we pick up that given customer or not, our expectations are that going forward, Performance Materials will continue to grow at a faster rate.

**Robert Kosowsky**

Okay. And then otherwise the, you've had very good results or growth in Vital Fluids or other, and I'm wondering the sustainability of these growth rates that you see and the potential to throw more products through, I guess, the good distribution network that you have?

**Dale Barnhart**

The growth has been principally in the bio area and cell therapy, and that really doesn't go through our distribution. We are selling that direct to the biopharmaceutical companies. That has a lot of promise. There's a lot of interest in cell therapy. We believe we have a lead and a niche in that space, and that's what's driving the growth right now. And from an asset standpoint, we are well-positioned in our facility in North Carolina, with two clean rooms, very, very strong FDA compliance to be able to satisfy the market needs as that grows.

**Arnie Ursner**

All right. Thank you very much.

**Operator**

Once again, if you have a question, please press the star (\*) key then one (1). This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Dale Barnhart for any closing remarks. Please go ahead.

**CONCLUSION****Dale Barnhart**

Thank you. I want to thank everybody for participating in the call, and just to reaffirm that Lydall

and our management team and our associates are clearly focused on achieving our 2018 goal as demonstrated by our recent performance. Thank you.

**Operator**

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