Lydall, Inc.

Fourth Quarter Ended December 31, 2014 Earnings

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CORPORATE PARTICIPANTS

Dale Barnhart – *President and Chief Executive Officer*

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

David Glenn – *Investor Relations*

PRESENTATION

Operator

Hello. Welcome to Lydall, Inc. Fourth Quarter and December 31, 2014 Earnings conference call. All participants will be in listen-only mode. Should you need assistance please signal a conference specialist by pressing the * key followed by zero. After today's presentation there will be an opportunity to ask questions. To ask a question you may press * then one on your telephone keypad. To withdraw your question, please press * then two. Please note this event is being recorded.

Now I would like to turn the conference over to David Glenn. Mr. Glenn, please go ahead.

David Glenn

Thank you, operator. Good morning, everyone, and welcome to Lydall's 2014 Fourth Quarter Earnings conference call. Joining me on today's call are 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 more in-depth summary of our financial performance and discuss the key drivers by segment. Once complete, we'll open the line for Q&A.

As you may be aware, our quarterly earnings press release and annual report on Form 10-K were released earlier today. So you can follow along with today's call, please reference the PowerPoint presentation entitled, "Q4 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 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 annual 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. A reconciliation to GAAP financials can be found in the appendix of this 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 good quarter and a solid finish to what was an excellent 2014. The consistent progress we continue to make and the momentum we have built gives me confidence that we are on the right path to achieve our 2018 long-term vision for profitable growth.

Turning to slide 3, by many measures, 2014 was a very successful year for Lydall. As a company, we achieved record operating results. I will cover the highlights for our full year and let Robert take you through the quarterly performance when he provides the financial update.

Beginning with our topline, revenue increased in 2014 to $536 million; 35% over 2013 and organic growth was very strong at 8.3%. The substantial year-over-year growth was largely attributed to the acquisition of industrial filtration that we completed during the first quarter of 2014. This acquisition was the largest in the history of our company and I'm pleased to say that the integration has been substantially completed ahead of schedule.

With respect to profitability, adjusted gross margin increased by 70 basis points to 21.8% and adjusted operating margin improved 160 basis points to 8.7% over the prior year. The performance reflects the continued progress on our lean initiatives, coupled with leverage on higher sales and improved product mix coming from our automotive businesses during the year. We are particularly pleased with the results considering that the acquisition was slightly diluted from a margin perspective in comparison to the remainder of our portfolio on an adjusted full year basis. Over the long run, we anticipate operating margins for the industrial filtration business to improve as we realize the benefits of our synergy programs. For the full year, adjusted EPS increased 76% over the prior year to $1.80, which excludes one-time non-recurring expenses.

Before I provide an update on our progress against our long-term strategy, I wanted to briefly cover the divestiture of Charter Medical, which we reported as our Life Science Vital Fluid business which was announced on January 30, 2015. As many of you know, this sale represents the disposition of a non-core subscale business in comparison to the remainder of Lydall's portfolio. From an economic perspective, the business was sold for approximately $30 million and we anticipate realizing an after tax gain of approximately $10 million to $12 million. All in all, this was an excellent result for our shareholders.

Going forward, each business in the portfolio as it stands today is considered core and we are focused on being best-in-class in our markets of Thermal Insulation, Acoustics, Filtration and specialty engineering materials. For those of you who follow us closely, I anticipate that you're interested in an update on the continuing investigation being conducted by the German Federal Cartel office related to our Gerhardi operation, which was initiated in the second quarter of 2014. From our perspective, there is no new information to report since our last update, which was during the third quarter earnings release. We are still uncertain as to when we will receive further information from the Cartel office. Timing could be sometime this year or even in 2016, but as soon as we have something to share, we will.

Turning to slide 4, these are the pillars our strategy for profitable growth that includes four components: New product development, Lean Six Sigma, geographic expansion and M&A. Starting with M&A and specifically the industrial filtration business, we continue to remain on track to deliver the key synergy programs that comprise the targeted annual net savings of approximately $4 million by the end of 2016. The adoption of lean is well underway globally and we are confident that we'll be able to see the benefits in our 2015 financial performance. From both a financial and resource perspective, we have the means, the wherewithal and desire to execute additional deals primarily in the Filtration and specialty material spaces. Naturally we cannot predict the timing of these, but we will continue to focus on expanding and refining our pipeline and hope to put our strong balance sheet to good use through selective M&A.

Moving on to both geographic expansion and product development, our facility in China is an excellent example that illustrates both of these topics. As you may know, we have been working to ramp up volume in our Thermal/Acoustics Metals China facility which was a Greenfield expansion that we completed in 2014. While this was originally slated to be a metals only location, we are in the process of establishing capability to bring some of our Thermal/Acoustic Fibers products to markets through this facility. Through new product development on both Fiber and our metal product offerings, we are working to gain access to one of the largest automotive markets in the world.

Lastly, I would like to update you on the improvement to our operations through Lydall Lean Six Sigma. Although, we have realized significant improvements over the past few years, we continue to look at new ways to operate more efficiently to serve our customers. Over the past five years, we have been able to drive consistent margin improvement in the business. And while this improvement can be attributed to multiple factors, Lean is a critical component and contributor to the improvement.

Turning to slide 5, with respect to the business conditions, overall we are seeing stable demand for our products globally and anticipate meeting or exceeding industry growth rates by geographic region and the segments we participate in during 2015. With our automotive business, selective plant shutdowns for key customers are in the process of ramping up and we anticipate any headwind from this offset by continued strong demand for products associated with platforms that we are on.

Looking forward, current visibility suggests that overall demand within the global automotive market remains stable. North America continues to remain strong and we are keeping a close eye on the European economy. In our Filtration businesses, this pace is generally characterized to grow greater than GDP given the consumable nature and replacement cycle for these products, and we anticipate this trend to continue for the reminder of the year. A primary focus for us this year is to fill the volume we lost in 2014 as a result of key customer failed products launch in the HVAC space.

Wrapping up my comments before I turn it over to Robert, I wanted to reiterate that we are extremely proud of our performance during 2014 and I'd like to congratulate our employees for their consistent execution. As a result of their efforts, we remain on track for achieving our 2018 vision.

With that, I'll turn it over to Robert.

Robert Julian
Thank you, Dale, and good morning, everyone. Since Dale already walked through our full year performance, I'll provide a brief overview of our consolidated financial highlights for Q4 and then speak to the performance of each of our segments individually.

Turning to slide 6, the company achieved record sales of $127.6 million in Q4 2014. Sales grew 27.7%, of which 5.7% was organic, with the remainder primarily attributable to the recently acquired industrial filtration business. These increases were partially offset by lower tooling sales and unfavorable foreign currency translation due to the weakening euro.

Gross margin for the quarter was down 40 basis points to 20.0%. This slight decline was entirely a result of mix, due to relatively lower gross margins in our acquired Industrial Filtration business compared to our legacy businesses. The gross margin in our legacy businesses actually improved nicely both quarter-over-quarter and year-over-year.

Our operating margin for the quarter was 6.3%, which was down 10 basis points versus the adjusted operating margin of Q4 2013. Fourth quarter earnings per diluted share were $0.34, compared to $0.24 of adjusted earnings in the prior year, or an increase of 42%.

The effective tax rate for the quarter was 31.3%, compared to 20.4% in the prior year. The fourth quarter of 2013 was positively impacted by the reversal of the state tax valuation allowance of $0.9 million. Looking out into 2015, we anticipate that our full year effective tax rate will fall somewhere in the range of mid to low 30s.

Moving to the balance sheet, cash at year end was $62.1 million as compared to $75.4 million at year end 2013. As you may recall, in Q1 we funded the acquisition of Industrial Filtration with approximately $23 million in cash and $60 million of debt from our revolver. In Q4 of this year, we repaid $20 million of this debt, given the strong cash flow generation that we experienced during the year. Looking at our debt to EBITDA ratio, we are currently at 0.7 times.

With respect to free cash flow, the company generated $27.7 million of cash from operations for the full year, compared to $16.5 million in 2013. Free cash from operations was more than 120% of net income, even while continuing to fund organic growth, which reflects the strong execution by our team in implementing our Lean initiatives.

Finally, as it relates to capital expenditures, we spent approximately $13.9 million in cash on cap ex for the year, while there was an additional $5 million in accounts payable for cap ex at CIP on December 31, 2014. So, you might want to think of that as about $19 million in cap ex in 2014, compared to roughly $14 million in the prior year. Looking forward to 2015, we expect total capital expenditures to be in the range of $20 million to $25 million. That concludes my summary level financial review for the fourth quarter and I'll now walk through the financial highlights by segment.

Turning to slide 7, I'll start with our Thermal/Acoustical Metals business. This is one of our automotive segments that has a global footprint and specializes in providing under hood and underbody engineered thermal solutions for vehicles. During the fourth quarter, total sales were $38.5 million, a decline of 7.2% from Q4 2013. Despite an absolute decrease in total segment sales, the underlying growth trends in this business remain largely positive. Organic growth was 4.9%, which was offset by lower tooling revenue of 7.3% and unfavorable foreign exchange impact of 4.8%.

From a geographic standpoint, we experienced mid-single-digit growth in both North America and Europe, which was good to see as we continue to monitor the European economy. For the full year, segment level sales increased 3.7% to $164.3 million, driven mostly by organic growth of 5.8%, offset by declining tooling revenue of 2.1%. We also continued efforts to get our China facility back on track in meeting our expectations as a business.

As we have previously shared, the business fell behind schedule mostly due to customer delays in program launches. In addition, this past quarter, we experienced some material sourcing and qualification issues, which has since been resolved. We still expect this facility to be a break-even operation at some point in the second half of 2015 and continue to believe in its long-term viability. The material sourcing issue negatively impacted segment margin in the quarter by approximately 330 basis points and 140 basis points on a full year basis.

Looking at operating margin performance, segment level margin improved 170 basis points in the fourth quarter to 8.7%, reflecting continued progress on our Lean initiatives and fixed cost leverage from greater volume. Of course, segment operating margin would have been much stronger than reported if not for the negative impact from the China operations.

Slide 8 shows our Thermal/Acoustical Fibers business performance. Similar to our Metals business, this business serves the automotive industry and provides molded polyester acoustical solutions primarily for underbody applications for vehicles in North America. Segment level sales increased 5.5% to $28.8 million in the fourth quarter and increased 12.5% to $128.6 million for the full year. Organic growth for both the quarter and year was very strong in the mid-teens as we benefited from robust sales from the platforms we are on and continue to win new business. We achieved this performance despite a major customer going through the sequential shutdown of one their plants in order to perform a platform changeover. Operating margin in the quarter increased 240 basis points over the prior year to 19.6%, reflecting a favorable mix of part sales and good drop through to the bottom line from strong execution and continued progress on Lean initiatives.

Moving to slide 9, I will cover the Performance Material segment. This business provides specialty, filtration and insulation to a variety of end markets globally. Net sales in the fourth quarter declined to $27.1 million compared to $27.7 million in the prior year. The decline in sales was mostly attributable to reduced sales to a key customer as we have previously disclosed, partially offset by very strong double digit growth in the Filtration and Life Science segments. For the full year, sales increased by 3.5% to $115.9 million. As a result of unfavorable mix and modestly lower volumes, segment level operating margin declined 160 basis points to 7.4% during the quarter.

Slide 10 covers the Industrial Filtration business. This business focuses on providing needle felt filtration solutions primarily for the Industrial Air segment globally. The Industrial Filtration business achieved sales of $29.9 million in Q4 2014 and contributed $112.2 million in total sales for the full year. Demand for our filtration products remained positive in the fourth quarter and backlog increased compared to the prior year quarter. Segment level operating margin was 5.3%, reflecting year end seasonality for this business and unfavorable product mix. For the full year, our normalized operating margin, excluding the impact of purchase accounting, was 7.5%.

Turning to slide 11, this is our Vital Fluids segment that we recently divested. Given the sale and the size of the business, I won't spend any time going through the financials as you can see the information on the slide and find the financials in our filings.

This concludes my comments for the financial performance of our segments for the quarter. We are very proud of the progress we have made in 2014 posting record results across the board. Looking forward to 2015, we expect to make continued progress on our initiatives and overall are very pleased with where we are currently positioned to reach our aspirational 2018 goals.

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
Yes. Thank you. We will now begin the question and answer session. To ask a question, you may press * then one 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 * then two. At this time we will pause momentarily to assemble our roster.

And, the first question comes from Bob Labick with CJS Securities.

Robert Magic
Good morning. This is Robert Magic filling in for Bob Labick.

Robert Julian
Good morning, Robert.

Dale Barnhart
Good morning, Robert.

Robert Magic
In your release you discussed meeting or exceeding industry volumes, which we take to be mid-single-digits. Can you remind us on pricing and the amount of operating leverage with such growth, perhaps 200 bps on EBIT, more or less?

Robert Julian
You are correct, Rob, that we are based on SAR both in the US and Europe mid-single-digits is what we are expecting from the automotive businesses. I would say similar industry growth when you are talking about our Filtration and Specialty Materials businesses. In terms of leverage, we do have fixed costs in all of our businesses and corporate and so we do expect to see some drop through. I don't think that we've really sort of calculated that or discussed that in detail, but certainly as we get volume we do get leverage on that incremental business.

Robert Magic
And what's the expected impact of FX on the top line?

Robert Julian
So we'll start by looking back a little bit. FX did have an impact on Q4 in 2014, but it was totally neutral for the full year. Looking forward, you can think of approximately 35% of our business is subject to what I would describe as translational foreign exchange impact. In terms of operating margins, we are mostly naturally hedged and so we don't see a large impact on the bottom-line. But from a revenue point of view, you can think of it as 35% of our revenue is subject to translation effect. If we got a 10% movement in foreign exchange, that would translate to a 3.5% impact to our top line revenue.

Robert Magic
Thanks for the clarification. And just one more, what are priorities for cash on the balance sheet and what's the current acquisition environment like?

Dale Barnhart
Well, as we've stated and we're consistent with, cash first priority is to support organic growth initiatives and M&A to drive growth that way and we believe we can deliver. With the discipline we have on M&A and in our organic programs, we can deliver excellent returns to our shareholders for that. Other areas we're looking at is exercising the balance that's left on our share repurchase program that has been stated and is published. And then finally, we may consider a dividend at some point in time. We are also considering de-funding or de-risking our pension plan.

Robert Magic
Alright. Thanks a lot. I'll get back in the queue.

Dale Barnhart
Thank you.

Operator
Thank you. And once again if you would like to ask a question, please press * and then one. And next question comes from Robert Kosowsky of Sidoti.

Robert Kosowsky
Good morning, guys. How are you doing?

Robert Julian
Good morning.

Dale Barnhart
Just fine, Rob. How are you?

Robert Kosowsky

Doing pretty good. Question on the Fibers business. Can you quantify what the growth rate was of the non-Ford business in 2014 and also was there a negative impact from the changeover at Ford in 4Q and should we be expecting an uptick in 1Q if there was such a negative impact?

Dale Barnhart
First of all, we won't disclose mix of customers within the business and what the growth story was. We, though, have continued to execute on our strategy of gaining share outside of Ford. So that was executed on and successful in 2014. With regard to the fourth quarter impact of the retooling of the major platform, yes, that did have some drag in the fourth quarter. Actually it'll have a little bit of drag in the first quarter, but as we sit here today, both sides now have been retooled, both sides are ramping up. And on a full year basis we expect to recoup any of the downturn we saw in the fourth quarter and/or the first quarter of this year.

Robert Kosowsky
Okay. Would you expect the drag to be, would it have been a bigger impact in the 4Q or 1Q?

Dale Barnhart
It was about balanced because they staggered their retooling efforts, one in the fourth quarter and the other one in the first quarter of this year. So they had two major facilities, one went down in the fourth quarter and came back up. It actually went down in the third quarter, came back up in the fourth quarter and the other one went down in December and is coming back up now.

Robert Kosowsky
Okay. And then I guess switching to metals, can you talk about the China plant, the material sourcing issues. Can you just expand on what that was and currently what the status of that plant is right now? Are you making products for commercial revenue, just any extra details you can provide?

Dale Barnhart
Absolutely. Yes, we are making product now. Initially the drag was a delay in the launch of the products. They have been launched. The impact on the operating performance related to getting material, local sourcing of material approved. That didn't happen as fast as we thought it would, so we had to import product from Europe and in some cases we airfreighted some of that product. So that's really what created the miss from an operating performance.

We're achieving the pricing for the product and the productivity in the plant. Going forward we now have approval to use local sourced material. That will be transitioned in through the first quarter and by the end of the second quarter that business will be breakeven and we are also adding new applications. In addition to the metals, we're sharing that facility and we are ramping up our zero clearance fiber product there now also.

Robert Julian
Just one clarification. I think we have said that the business would be breakeven sometime in the second half of the year, not necessarily by end of Q2.

Robert Kosowsky
Okay, that's helpful. Then I guess just finally, can you update us on some of the growth initiatives on the Solupor products.

Dale Barnhart
Well, Ken, we continue to work as for the air filtration, air and lights for the gas turbine, our power generation we continue to get orders. We continue to have very good success at the sealed

evaluations, some extending over two years now. So, we have the confidence that again as we've said before, there is a tipping point out there. We really can't say exactly when it is because of the very conservative nature of the utilities in applying this technology. We continue to work in areas such as filtration for vacuum cleaners. We continue to have progress there. We continue to look at different filtration applications such as static filters, using that material in a molded form which could be significant for us, the super capacitors. So, they're all going mainstream and also we have a ballistic—a manufacturer making material for ballistic vests that we are starting to see volume also occur. So, we remain very bullish on the product line. It's just very difficult for us to identify that tipping point when the volume will take off.

Robert Kosowsky
Okay, so it's hard to quantify your points of like material, I guess new revenue in 2015, but developmental initiatives are still on track. Is that kind of a way of looking at it?

Dale Barnhart
Yes, and we anticipate continued growth in revenue over prior year.

Robert Kosowsky
All right, thank you very much and good luck.

Dale Barnhart
Thank you.

Operator
Thank you, and just once again as a reminder, please press * and then one if you would like to ask a question. All right, well, there is nothing more at the present time, so I would like to return the call back over to management for any closing comments.

CONCLUSION

Dale Barnhart
Well, we appreciate as always everybody's participation on the call. Management is clearly focused on the continuous improvement process that we've established within the company and we're looking forward to a very promising 2015. Thank you.

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