Lydall, Inc.

Third Quarter 2015 Financial Results

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CORPORATE PARTICIPANTS

David Glenn – *Vice President, Corporate Development and Investor Relations*

Dale Barnhart – *President and Chief Executive Officer*

Scott Deakin – *Executive Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the Lydall Third Quarter 2015 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. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your touchtone phone. To withdraw your question, please press star then two. Please note this event is being recorded.

I would now like to turn the conference over to Mr. David Glenn, Vice President of Corporate Development and Investor Relations. Please go ahead.

David Glenn
Thank you, Danielle. Good morning, everyone, and welcome to Lydall's Third Quarter 2015 Earnings conference call. Joining me on today's call are Dale Barnhart, President and Chief Executive Officer, and Scott Deakin, Executive Vice President and Chief Financial Officer.

Dale will start the call with comments about the continued progress we are making in executing our long-term strategy as well as provide an overview of current business conditions. Scott will follow with a summary of our financial performance and discuss the key drivers by segment. At the end of our remarks, we will open the line for questions.

As you may be aware, our quarterly earnings were released yesterday so you can follow along with today's call. Please reference the PowerPoint presentation entitled Q3 2015 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 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 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, everyone, and thanks for joining us today. I am pleased to report that we had an excellent quarter and we are on track for another great year. Our most recent results and year-to-date performance demonstrate that we remain on the right path to achieve our 2018 long-term vision for profitable growth, that includes a goal of $800 million in revenue and an operating margin target of 15%.

Slide 3 outlines the key takeaways for the quarter. Total net sales quarter-on-quarter increased 1.6% to $131.2 million, excluding the impact of the divestiture that we completed in the first quarter of 2015. As we have experienced for most of the year, foreign currency translation impacted us unfavorably by 4.8%, but organic growth for the quarter was a strong 5.9%. Similar with how our businesses have been performing all year, all segments experienced solid positive organic growth, with the exception of

Performance Materials, which had a small decline of 1.3%.

With respect to operating performance, we were able to achieve excellent margin expansion. Gross margin was up 280 basis points to 24.1%, primarily from lower raw material prices, continued execution of lean initiatives across our business and realization of synergy programs in our Industrial Filtration segment. Operating margin was up 330 basis points to 11.3% on an adjusted basis. This level of progress demonstrates our continued ability to further drive improvements in the operating performance of our company. Adjusted earnings per share of $0.59 were up 44% versus third quarter of 2014. Reported earnings per share for the quarter were $0.66, which includes the benefit of $0.07 per share from discrete tax credits.

Moving on to a few other matters, first, I'm delighted to announce that Scott Deakin has joined as CFO. As you may have seen in the press release, Scott brings to Lydall several years of significant financial, strategic and general management experience in complex global manufacturing businesses as well as a proven ability to drive profitable growth. He is a great addition to our strong management team and we look forward to his future contributions.

Second, I'm sure many of you have been following what has been happening at Volkswagen with respect to their emissions situation. Today we have not seen any material impact on our business nor do we have any reason to anticipate one, primarily given the platforms we supply. Despite this, I did want to take the opportunity to further outline our relationship with VW in more detail so that you are fully informed.

Volkswagen is one of many important customers to our Thermal/Acoustical Metals segment and we primarily provide them with single wall heat shield solutions. Only a very small fraction of our business, less than one-half of 1% of Lydall's total revenue, is attributed to diesel platforms that are produced and sold in the United States. Given this and the excellent customer and platform diversification we have in the Thermal/Acoustical Metals, we feel we are insulated from any potential large risk. As you would expect, we remain in very close contact with our customer and continue to follow this matter.

Lastly, with respect to the ongoing investigation related to the possible violations of German anti-trust laws, we continue to work with the German Federal Cartel Office and anticipate that this matter will carry into 2016. Despite our regular communications with the German authorities, unfortunately we're still unable to estimate either the timing or the amount of the liability associated with the matter, but we will continue to provide updates when we have any material developments.

Turning to Slide 4, this is an overview of our long-term growth strategy which includes four key drivers, new product development, Lean Six Sigma, geographic expansion and M&A. With respect to new product development, all of our businesses are focused on developing next-generation solutions in order to continue to create value for our customers. One example that I will highlight today is a product family that our Industrial Filtration team has been able to successfully commercialize in the Chinese marketplace.

Since we acquired this business in 2014, we have seen emissions standards in China evolve with tighter requirements and continuous monitoring. These new levels of mandated pollution control represent an 80% reduction from the current national standards. Our new filter design has been successfully integrated into state-of-the-art pollution control systems and performed well in excess of the target emissions capture for new coal power plants in certain regions of China. Although the commercialization of the product of this family is in its early stages, we are encouraged by its performance and the promise of its future success.

As it relates to Lydall Lean Six Sigma, we are always looking for ways to operate more efficiently. During the third quarter, we continued to execute on this strategy, and as I mentioned before, we experienced solid gross margin expansion, which is a key indicator of our success in driving lean.

All of our businesses are focused on operational excellence, but to give you a specific example, you can see the success of our efforts in the P&L of our Performance Materials business. Despite significant challenges on the top line revenue, the business has done an excellent job in controlling costs, but most importantly, operating more efficiently in order to protect margins. While these lean improvements are imperative during the shift in the business conditions we have experienced this year, they also position the business very well to deliver excellent margin expansion, once we see demand return.

As it relates to geographic expansion element of our growth strategy, one of the largest opportunities that we are working on is the globalization of our Thermal/Acoustics Fibers segment. Currently, this business is only serving the North American market, but we are actively working to expand organically into Europe and China and also considering additional opportunities in Mexico. Given the duration of the automotive platform award cycle, it may take a few years to begin to see increased sales from this initiative, but we are very excited about the long-term profitable growth opportunity.

Lastly, with respect to M&A, as I have previously communicated from both a financial and resource perspective, we have the means, wherewithal and strong desire to execute additional acquisitions primarily in the filtration and specialty engineering materials spaces. We have a robust target pipeline, and although we cannot predict timing, we expect to put our balance sheet to good use through selective and well-executed M&A.

Turning to Slide 5, with respect to business conditions, overall we believe the underlying fundamentals of our businesses remain solid. We expect to close out Q4 with anticipated sales and earnings growth compared to the final quarter of 2014.

Within our automotive business, scheduled holiday plant shutdowns will result in fewer production days in the fourth quarter versus the third quarter of 2015. However, we expect overall demand within the global auto market to remain stable. North America continues to remain solid and Europe production continues to show strengths. Quarter on quarter, we saw nearly 14% growth in Europe on constant currency basis.

In China, at our new Metals operation, sales were up modestly as customers have experienced slight delays on launch of some of their platforms. Unfortunately, despite our best efforts, given a mix of both top line sales and operating performance, this facility is still not profitable. While this is a disappointment, our team continues to remain focused on this and I expect the business to breakeven in early 2016.

In our Performance Materials business, we continue to experience soft demand but we are seeing improved order activity in Europe and Asia. Overall, this business has delivered disappointing results this year, but we are hopeful to realize improvement as we move forward.

In our Industrial Filtration business, we continue to experience solid order activity, especially encouraging backlog in China, entering Q4. However, consistent with prior years, we still anticipate seasonality in the filtration component of this business where the first half of the year is typically stronger than the second half. Offsetting some of this seasonality will be the continued supply of the automotive rolled goods used by the Thermal/Acoustical Fibers segment as we continue to realize the benefit of our in-sourcing synergy program.

To wrap up my comments before turning it over to Scott, we are very pleased with the performance in the third quarter and look forward in turning in what will be an excellent 2015. With that, I will now turn the call over to Scott.

Scott Deakin
Dale, thank you. Before I take everyone through our consolidated results and overview of our segment performance, I want to say that I am very excited to join Lydall. I truly look forward to building upon Lydall's accomplishments and look to continue our momentum to achieve the company's long-term vision for profitable growth. I'll keep my comments for the third quarter performance brief this morning as Dale previously discussed many of the highlights.

Turning to Slide 6, consolidated net sales were down 2.2% to $131.2 million as unfavorable foreign currency translation and a divestiture earlier this year masked organic growth of 5.9%. Despite the lower sales, we were able to achieve excellent margin expansion. Gross margins were up 280 basis points to 24.1% and operating margin improved by 330 basis points to 11.3%, compared to adjusted Q3 2014. Adjusted earnings per share of $0.59, which excludes $0.07 of discrete tax benefits, were up 44% versus third quarter 2014 adjusted earnings per share of $0.41.

The effective tax rate for the quarter was 24.4% compared to 30.2% in the same period of 2014. The tax rate in the current period was lower primarily due to the receipt of R&D tax credits and the release of reserves for previously uncertain tax positions that have now statutorily closed. Looking at the full-year, we anticipate our effective rate is going to fall somewhere in the low 30s.

Moving to the balance sheet, our liquidity continues to remain very strong. At the end of the quarter, cash was $80.3 million. The amount is net of a $5 million voluntary contribution we made during the quarter to further de-risk our frozen pension program. Total debt at the end of the quarter was approximately $40 million, which from a leverage perspective puts us at a debt-to-EBITDA ratio of approximately 0.6 times, giving us plenty of financial flexibility. As previously communicated, we continue to feel that we'd be comfortable carrying leverage up to 2.5 times debt-to-EBITDA.

As it relates to capital expenditures, we spent $15.5 million for the first nine months of the year, compared to $8.6 million in the prior year. A significant portion of this capital has been invested for growth in our automotive facilities in order to support future platform awards. For full-year 2015, we expect total capital expenditures to be in the range of $20 million to $25 million.

Turning to Slide 7, with nine months of the year behind us, sales of $393.1 million are up organically by 180 basis points. Unfavorable foreign currency translation impacted the business during this period by 5.3 percentage points. All segments were up at least mid-single-digits organically in the first three quarters of 2015, with the exception of Performance Materials, which offset this growth with a reduction of 6.1 points. This decline was due to soft demand primarily for filtration products in North America and Asia as well as cryogenic insulation products globally.

With respect to operating margin, we continue to make progress on improving profitability and realized a 130 basis point improvement to 10.7% versus the adjusted operating margin for the same period in 2014. The continued improvements were driven by lower raw material costs, the progression of Lean Six Sigma and the realization of synergy programs in the Industrial Filtration business. This improvement is especially strong in light of the headwinds on demand experienced within our Performance Materials segment.

I'll now briefly take you through the financial performance by business segment, turning to Slide 8. I'll start with our Thermal/Acoustical Metals business. This is our global automotive segment that specializes in providing under-hood and under-body engineered thermal solutions. Overall, this business performed well during the quarter despite sales of $39.9 million being heavily impacted by unfavorable foreign currency translation of 10%. From a geographic standpoint, demand in North America remained strong and we continue to be very pleased by parts sales growth in Europe which was approximately 14% after normalizing for currency.

We are still continuing our efforts to get our China facility on track to meet our performance expectations. Unfortunately, timing of the turnaround is pushed further to the right due to customer production launch delays and slower progress in improving operating inefficiencies. The China facility negatively impacted segment operating margin this quarter by approximately 130 basis points and year-to-date by approximately 140 basis points.

As Dale indicated, we now anticipate that the facility will achieve breakeven in early 2016. We expect that the facility will most likely operate at these moderated levels of profitability for the majority of 2016 as we make investments in the operations that are needed to support incremental volume that is expected to fully materialize in 2017.

Slide 9 refers to our Thermal/Acoustical Fibers business. Similar to Thermal/Acoustical Metals, this business serves the automotive industry and provides molded polyester acoustical solutions primarily for under-body applications, principally in North America. Segment sales of $35.7 million in the quarter were up nearly 14% organically. This strong growth was primarily related to increased customer demand in existing platforms as a key customer is now producing at full rate production versus last year where planned facility shutdowns were required to support a tooling changeover.

Fibers operating margin in the quarter increased 600 basis points over the prior year to a third quarter record of 28.3%. This excellent performance reflects the continued execution of lean, lower raw material costs and fixed cost leverage on the higher sales volume.

Moving to Slide 10, I'll cover our Performance Materials segment that provides specialty filtration and insulation to a variety of global end markets. The quarter on quarter net sales decline of 7.6% to $26.4 million was primarily driven by unfavorable foreign currency translation of 6.3%. Similar to the conditions that we have experienced all year in this business, during the third quarter of 2015 we saw continued softness in demand in the North American filtration products market as well as for our cryogenic insulation products globally, as driven by the sustained low price of oil.

Segment level operating margin increased 160 basis points to 9.5% during the quarter as a result of reduced operating, selling and administrative expenses. As Dale mentioned earlier, this business has done an excellent job with continuing to drive lean improvements and controlling costs in response to the shift in business conditions.

And finally Slide 11 covers the Industrial Filtration business. This business focuses on providing filtration solutions primarily for the industrial air segment globally as well as engineered material used in myriad automotive and commercial applications. For the third quarter of 2015, sales were $34.2 million and operating margin increased to 9.8%. Strong growth of 13.9% in the quarter was primarily driven by continued execution of the automotive rolled goods in-sourcing program in which this business is a supplier to Thermal/Acoustical Fibers. On an adjusted basis, this business delivered 300 basis points of operating margin expansion, driven by favorable mix and favorable absorption on its increased sales.

This concludes my comments, and I'll now turn the call back to Dale.

Dale Barnhart
Thank you, Scott. To summarize, we had another strong quarter, and these results as well as our year-to-date performance demonstrate that we remain on the right path to achieve our 2018 long-term vision for profitable growth. Our end markets are stable and we continue to remain focused on executing new product development, implementing Lean Six Sigma, driving geographic expansion and putting our very strong balance sheet to good use.

With that, I'll turn the call over for questions.

QUESTIONS AND ANSWERS

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

The first question comes from Robert Majek of CJS Securities. Please go ahead.

Robert Majek
Good morning.

Dale Barnhart
Good morning, Rob. How are you?

Robert Majek
Can you talk a little about what drove the solid volume growth in the Metals business and perhaps by product line and maybe break out growth in North America versus Europe?

Dale Barnhart
What's really driving the growth are a couple of things. One, the overall strength of the European automotive market, we've been riding that increase in volume with our platforms that we have there. In North America, is actually where we saw the most significant growth quarter-over-quarter, and again, that's a result of some of the new platform wins we've had with the RU product line and other product lines we've won in North America. So it was really driving that.

Robert Majek
Great. And you touched on it, but could you give us a little more color on what you're seeing in China in terms of revenue trends on both the filtration side as well as the startup Metals plant?

Dale Barnhart
With regard to the startup of the Metals plants, we're just seeing some slowdown and releases of some of the new platforms. So that's having an impact on our top line. From an operating standpoint, we're also seeing time to get local material, local source material approved by our customers taking longer than what we anticipated, therefore having a negative impact on our operating performance. But as we move forward, that business will grow in 2016 as the platforms we have ramp up and we win new ones, and from an operating standpoint we will get that under control as we move into 2016.

With regard to Asia filtration, it's been soft most of the year due to a lot of things going on in China. We're seeing slight impact or increase in those orders right now for Performance Materials. As it relates for Industrial Filtration in China, those are material that we sell for dust collection from industrial applications. A large consumer of that product are coal-fired power plants and we've seen a strong demand in backlog for our PPS material that is used for coal-fired power plants. So the Chinese government is continuing to tighten air quality standards, and also more importantly, enforce the standards. And as that goes on, that's one of our longer-term growth opportunities we see on IF is in the China market.

Robert Majek
Great. And now my last one, could you just give us a general update on the synergy program in Industrial Filtration, perhaps how much you have achieved so far and if your target or the timing has changed at all?

Dale Barnhart
Our overall target as we stated was to deliver $4 million in synergies by 2016. We're actually ahead of that and we will deliver something in excess of $4 million.

Robert Majek
Appreciate it. Congrats on a good quarter, guys.

Dale Barnhart
Thank you, Rob.

Operator
Again, if you have a question, please press star one. The next question comes from Edward Marshall of Sidoti. Please go ahead.

Edward Marshall
Hi, guys.

Dale Barnhart
Good morning, Ed. How are you?

Edward Marshall
I'm well, thanks. How are you?

Dale Barnhart
We're doing quite well.

Edward Marshall
So my first question I guess is on the Performance Materials. I think you've had some pretty good success in getting a turnaround in what I'd characterize as a rough sales environment. But how much of that is kind of the lean, you mentioned lean, but how is that sustainable? Do you think that's sustainable throughout the remainder of this year and into next or do you think you grow from this level, or how do you look at the margin there?

Dale Barnhart
From an operating standpoint, the lean will continue to—we hope to actually continue to improve our operating efficiencies. What's key for that business to see the type of returns we should be getting out of that business is a return in the top line, and the business is clearly focused on areas through new product development and share gain in our existing product lines to return growth on the top line. What excites us about that business is the overall space it operates in, filtration and specialty insulation, and the fact that we've been aggressive with our lean initiatives to improve operating performance, it's not

when we get top line growth coming in, we're going to leverage that very well to the bottom line.

Edward Marshall
And just to be clear, I mean we've talked about a 15% target in that business for some time. You're not going to get there without the sales improvement. Is that correct?

Dale Barnhart
Absolutely. We have to have the revenue.

Edward Marshall
Okay. Moving to I guess Fibers, you've talked about globalization in that division, and I'm curious what kind of capital is necessary for you guys to grow internationally, whether it's Europe or Asia?

Dale Barnhart
Well, the nice thing about that business is the manufacturing process is you make a needle felt material, you take that roll good and you mold it into the final part that we supply to the OEMs. The roll good, we have capacity and wherewithal to supply that out of our Industrial Filtration business. That's one of the synergies. And as you know, our Industrial Filtration business has a strong presence in China and in Europe.

So if we find applications—when we win applications in Europe and China, what we'll be able to do to minimize the capital investment to ramp up is we'll use the bricks and mortar of our thermal/acoustic metals sites in Europe and China, we can put the molding lines in there, the capital investment will be basically the molding lines, and then the roll goods will be supplied by our Industrial Filtration group. So it minimizes our investment.

Also, through our lean initiatives in the Thermal/Acoustic Fibers business, over the years while we have more than doubled our revenue, we have dramatically increased the capacity of the assets by increasing the throughput, and today we have the equivalent of four molding lines that we could repurpose either to Europe, China and also we're looking at the potential of winning some platforms in Mexico. So we can get in with minimal capital investment and we're very sensitive to how we use those dollars.

Edward Marshall
So just to be clear, you're predominantly expecting to do local production and therefore you won't be competing on the cost side of the equation as it relates to currency? It will be—

Dale Barnhart
Correct. Yes, we would produce in Europe and sell in euros; we produce in China, sell in RMB.

Edward Marshall
And with very little upfront cost I guess to you?

Dale Barnhart
Yes, some, but compared to the revenue and earnings potential, it would give an excellent return.

Edward Marshall
Good. And then when I look at the Filtration business, you've done some pretty good year-over-year improvements in there. I know that lean has been the focus. I also know that the utilization rates in the roll goods has improved as well and that's helping out. Can you quantify maybe the delta between the two over the year-over-year comp and how much is related to lean and how much is related to the

utilization rates, and then how far more can you go on lean in that division?

Dale Barnhart
I mean it's hard for us to actually quantify how much is lean. I mean in our model that we put together, we thought about a third of it would come from a raw material sourcing and leveraging that across all of our businesses, a third from lean, and a third from the in-sourcing of the roll goods. Maybe a little more skewed right now to the in-sourcing of roll goods and raw material benefit. The lean is just really starting to take traction in that business. So I think as you go forward, we expect a much more significant impact of lean, particularly in China and Europe.

Edward Marshall
So as sales in the large customer kind of slowed down a little bit on Fibers, the in-sourcing materials kind of tempered down a little bit, but you'll replace that margin improvement with the lean. Is that kind of the right way to think about it?

Dale Barnhart
I don't say we would replace the margin; we would augment the margin improvement with lean.

Edward Marshall
Okay. So what's the utilization rates on roll goods now and when you acquired the business?

Dale Barnhart
We're still dividing that. I mean we use a metric called OEE to measure the efficiency of our assets and it varies from region to region. North America, we're getting good utilization of our assets. In China, we have a significant amount of available capacity and somewhere in between China and the US is Europe.

Edward Marshall
Very good. And then lastly on the long-term goals of $800 million, that's roughly $300 million or so of incremental revenue. How much of that do you plan to achieve organically and how much of that's through acquisition?

Dale Barnhart
Right now we're looking at organic growth from here on out through 2018 of anywhere from 3% to 5%, depending upon the economic conditions, which means we're going to have to do from an M&A standpoint anywhere from $125 million to $200 million. And we're very comfortable in doing that, not only from a capital standpoint, but as I've mentioned before, one of the benefits I saw from the team in the acquisition of Andrew filtration is the ability to handle a very complex deal, and we've done it very well. So we're ready to go but we also have discipline in our process. We will make sure that we buy something that's going to improve the overall operations of our business and create shareholder value.

Edward Marshall
It's good to hear. Okay, guys, thanks very much. I appreciate it.

Dale Barnhart
Thank you, Ed.

Operator
This concludes our question and answer session. I would now like to turn the conference back over to Mr. Barnhart for closing remarks.

CONCLUSION

Dale Barnhart
Again, I do want to extend a thank you to the management team, a great quarter but it was done through a lot of hard work from all of our associates in Lydall. It's refreshing for me to see the enthusiasm we have in our organization, with our people and how energized we are in marching towards our 2018 goal. Thank you very much.

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