S&P CAPITAL IQ
McGRAW HILL FINANCIAL

CONTENTS



# Lydall, Inc. NYSE:LDL

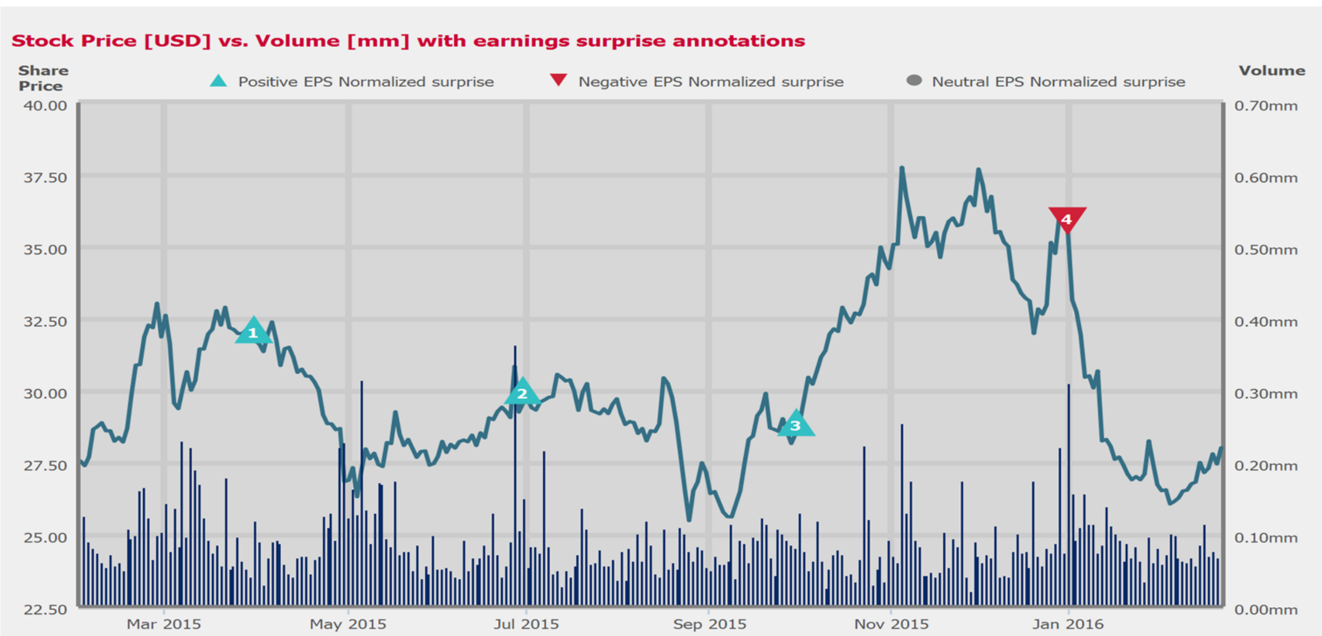
## *FQ1 2016 Earnings Call Transcripts*

Wednesday, May 04, 2016 2:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ1 2016- | | | -FQ2 2016- | -FY 2016- | -FY 2017- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| EPS Normalized | 0.50 | 0.54 | ▲5.88 | 0.65 | 2.30 | 2.60 |
| Revenue (mm) | 130.94 | 129.70 | ▼(0.95 %) | 142.55 | 549.16 | 568.20 |

Currency: USD
Consensus as of May-04-2016 1:51 PM GMT




| - EPS NORMALIZED - | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| FQ1 2015 | 0.40 | 0.42 | ▲5.00 % |
| FQ2 2015 | 0.47 | 0.64 | ▲36.17 % |
| FQ3 2015 | 0.49 | 0.59 | ▲20.41 % |
| FQ4 2015 | 0.46 | 0.46 | ▼(2.13 %) |

# Call Participants

EXECUTIVES

**Chad A. McDaniel**
*Chief Administrative Officer, Senior Vice President, General Counsel and Secretary*

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

**Scott M. Deakin**
*Chief Financial Officer and Executive Vice President*

ANALYSTS

**Edward Marshall**
*Sidoti & Company, LLC*

**Robert S. Majek**
*CJS Securities, Inc.*

# Presentation

**Operator**

Good morning, and welcome to the Lydall First Quarter 2016 Financial Results Conference Call. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Chad McDaniel, Senior Vice President and General Counsel. Please go ahead.

**Chad A. McDaniel**
*Chief Administrative Officer, Senior Vice President, General Counsel and Secretary*

Thank you, Cleo, and good morning, everyone. Welcome to Lydall's First Quarter 2016 Earnings Conference Call.

Joining me on the call today 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 providing an overview of current business conditions. Scott will follow with a review of our financial performance and discuss the key drivers by segment. At the end of our remarks, we'll open the line for questions.

As you may be aware, our quarterly earnings press release and 10-Q quarterly report were released yesterday. So that you can follow along with today's call, please reference the Q1 2016 Earnings Conference Call presentation, which can be found on our website 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 as defined in the securities laws. Please also refer to Lydall's report on Form 10-K under cautionary note concerning forward-looking statements for further information.

In addition, during this call, we will be making reference to non-GAAP financial measures. A reconciliation to GAAP financials will be found on the appendix in the presentation I just referenced. With that, I'll now turn the call over to Dale.

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Thank you, Chad. Good morning, everyone, and thanks for joining us today. I am very pleased to report that we had an excellent start to the year, and our continued progress gives me confidence that we remain on the right path to achieve our 2018 long-term vision for profitable growth that includes $800 million in revenue and operating margin of 15%.

Slide 3 outlines our recently published financial results for net sales, operating margins and earnings per share. Our diluted earnings per share were $0.54, up 29% versus first quarter 2015 adjusted earnings per share of $0.42.

On a GAAP basis, first quarter 2015 diluted earnings per share were $1.11, which included $0.69 per share gain related to the sale of the Vital Fluids business.

Reported net sales grew approximately 2% to $129.7 million. Excluded from these numbers is the 2015 divestiture of the Vital Fluids business, which had a 1.3 percentage point impact on quarter-to-quarter sales, also excluded foreign currency translation of 1 point. The company delivered organic sales growth of 2.9%.

With strong organic growth across 3 of the company's 4 segments, our results were principally the result of continued strength in the automotive markets, coupled with share gains on several platforms. Moreover, we delivered organic growth of nearly 6% in our Performance Materials segment, largely driven by early signs of recovery in the air filtration markets.

Despite continued growth in the intercompany supply of material to the Fibers segment, Industrial Filtration posted a decline in organic sales of 6.8% as softness in power generation market dampened the demand for the segment's filtration products.

With respect to profitability, adjusted gross margin increased by 340 basis points to 25%, and operating margin improved 260 basis points over the prior year to 10.5%. This performance reflects the benefit from lower raw material cost, favorable product mix and further progression on the company's Lean Six Sigma continuous improvement programs.

Moving on to a couple other matters. First, with respect to the ongoing investigation related to the possible violations of the German antitrust laws, we continue to actively work with the Federal -- German Federal Cartel Office. While we expect to bring this matter to conclusion sometime in 2016, we are unfortunately still unable to fully estimate the specific timing of the quantity -- or quantify the liability associated with the matter.

Second, with a 30% increase in capital expenditures in Q1 2016 versus Q1 2015, we continue to progress in our deployment of strategic capital across the company. Notably including growth in productivity investments made in both our Fibers and metals operations. For the full year 2016, we expect to invest between $25 million and $30 million in capital for strategic growth and operational improvement programs.

Turning to Slide 4, this is an overview of our long-term growth strategy, which includes 4 drivers: New product development, Lean Six Sigma, geographic expansion and M&A.

First with respect to M&A, we have previously communicated from both a financial and organizational resource perspective, we have the means, wherewithal, strong desire and proven track record to execute additional acquisitions, focused primarily in the filtration and specialty engineering materials spaces. We have a robust target pipeline, and although we cannot predict specific timing, we are encouraged by our various pursuits and expect to put our balance sheet to good use through selective and well-executed M&A.

With respect to Lydall Lean Six Sigma, we already benefited from significant improvements over the past years, and we continue to look at new ways to operate more efficiently to serve our customers. During the first quarter, we continued to execute on the strategy and realize additional operating margin expansion over the prior year across all of our businesses. Together with favorable mix and raw material savings realized from beneficial market conditions as well as the result of strategic sourcing programs, the company delivered incremental gross profit on organic sales of more than 135%.

In terms of international growth, our newest operation in China for the Metals segment continues to progress with a solid base of customer demand. With supplier qualification issues behind us and the installation of a second press largely completed, we are seeing marked improvement in the financial performance in this facility and expect to achieve at least break even in operating income for the full year of 2016.

As a reminder, this facility had a 120 basis point drag on the Metals' full year operating margin in 2015.

Finally, as previously discussed, one of the best examples of progress in the new product development exists in our Fibers segment, where we will start delivering, later this summer, an integrated flooring product for the interior cabin of several pickup truck models. The product entered us into the Class A interior segment, where we will provide our first molded product with surfaces that customers can regularly see and touch. Our flooring is a one piece molded fiber solution that significantly improves product durability and styling while also offering acoustical attenuation.

Turning to Slide 5, with respect to business conditions. Although it is early in the year, we continue to see generally stable demand for our products with pockets of continued strength and improvement, offset by some other pockets of softness.

Within our Automotive business, current visibility suggests that overall demand in global automotive market remains healthy. Light vehicle production, both in North America and in Europe, is forecasted to increase by mid-single digits in 2016 and our planned new product and platform launches throughout the year give me confidence that we will remain well positioned to not only growth with the market, but to continue to capture platform share.

With respect to China, we are excited to be ramping up our operations so that we can progressively participate in one of the largest automotive markets in the world.

In our Performance Materials segment, while demand for insulation products remains muted due to the continued softness in liquid natural gas markets, we saw some early signs of improvement in demand in other product lines, particularly for our air filtration markets. Moreover, share gains in Europe remain a highlight for this segment.

Finally, in our Industrial Filtration segment. We continue to benefit from solid pull through on our nonfiltration product demand as part of the successful implementation of our acquisition synergy programs. We are facing headwinds in certain markets giving tight competitive environment, coupled with softness in demand from power generation customers.

To wrap up my comments, we are very pleased with our performance in the first quarter. We've demonstrated both growth in excess of end markets as well as exceptional margin expansion, and I'm very proud of the work of the Lydall team. We continue to operate well, allowing us to take full advantage of favorable market conditions. The team looks forward to delivering another year of solid performance in 2016.

With that, I will now turn the call over to Scott.

**Scott M. Deakin**
*Chief Financial Officer and Executive Vice President*

Thank you, Dale, and good morning, everyone. Today, I'll provide a brief overview of our consolidated financial highlights for the quarter, and then speak to the performance of our segments individually.

Turning to Slide 6. In the first quarter 2016, the company achieved net sales of $129.7 million, an increase of 1.9% over the prior year. There were several discrete items affecting this growth. First, the divestiture of the company's Vital Fluids segment, which occurred on January 30, 2015, had an unfavorable impact on the quarter-on-quarter sales comparison of 1.3%. Second foreign currency translation reduced our quarterly comparison by 1 percentage point, principally due to differences between the euro and U.S. dollar.

Third, tooling sales, which reflect requirements for customer-funded capital associated with new platform launches, particularly in our Metals segment, were up 1.3% over the prior year.

Considering these factors, the company posted net organic growth of 2.9%. This was principally the result of continued strength in automotive markets, where Lydall enjoyed a favorable quarterly comparison given a plant shutdown at a key customer in the first quarter of 2015 as well as growth in excess of market realized through platform share gains.

Performance Materials also had a solid growth quarter-on-quarter given promising signs of recovery in air filtration markets. Our only area of softness at the segment level, as Dale noted, was seen in the Industrial Filtration segment, where thin demand in the power generation market and a tighter near-term competitive environment outpaced the continued strength in the intercompany demand from Thermal/Acoustical Fibers.

In terms of profit, our adjusted operating margin for the quarter was 10.5%, up 260 basis points compared to the Q1 2015 adjusted operating margin. This gain was driven by several positive factors, including the effect of strategic sourcing programs in an environment of generally attractive commodity pricing, a favorable absorption on increased sales, beneficial mix and continued progress of our Lydall Lean Six Sigma program.

The effective tax rate for the quarter was 33.1% compared to 35.9% in the first quarter of 2015. We continue to anticipate our effective tax rate going forward will fall somewhere in the range of mid- to low 30s.

Diluted earnings per share were $0.54 compared to adjusted earnings of $0.42 in the first quarter of 2015. Reported GAAP diluted EPS was $1.11 in the first quarter of 2015, which reflected the gain on the divestiture of Vital Fluids of $0.69 per diluted share.

Moving to the balance sheet, our liquidity remains strong. At the end of the quarter, cash was $69.5 million after reflecting a further pay down of our debt of $10 million during the quarter. At the end of the quarter, our remaining debt was $10.1 million.

Finally, as it relates to capital expenditures, we spent approximately $9.6 million through the first 3 months of the year compared to $7.4 million in the prior year.

For the full year 2016, we expect total capital expenditures to be in the range of $25 million to $30 million.

Moving to Slide 7, I'll discuss our segment results. I'll start with our Thermal/Acoustical Metals business. This is our global automotive segment, which specializes in providing underhood and underbody engineered thermal solutions for vehicles. This business delivered healthy organic sales growth of 5.6% during the quarter. Net part sales increased $1.8 million or approximately 5% compared to the prior year. Tooling sales were also up significantly in the first quarter of 2016 given the timing of new product launches. While operating profit dollars were flat relative to prior year, segment operating margin declined 90 basis points from the quarter to 8.5%. The favorable material costs were offset by the mix impact of low margin tooling sales in the quarter, coupled with what we believe to be short-term operating inefficiencies as the business ramps up to support growth across all regions.

Slide 8 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 underbody applications for vehicles in North America. Segment level sales were $35.9 million in the quarter, which was a significant increase over the reported $31.1 million in the prior year. While tooling sales decreased modestly in the quarter, part sales were up significantly on relative growth in the automotive sector and favorable positioning on well-performing platforms, notably including sales to one customer, who had a plant shut down in the first quarter of 2015.

The revenue strength in the segment dropped through nicely to profit as operating margin in the quarter increased by 600 basis points quarter-on-quarter to 28.8%, reflecting favorable absorption, material pricing and lean days continuous improvements.

Moving to Slide 9. I'll cover our Performance Materials segment, which provides specialty filtration and insulation to a variety of end markets globally.

Net sales in the first quarter increased 5.3% quarter-on-quarter to $26.4 million. Improving on several prior quarters of headwinds in Performance Material markets, the business saw encouraging early signs of improvement in air filtration during the quarter. Together with termination buys in life science filtration by certain customers due to a discontinuation of certain raw materials used in the manufacturing, excuse me -- used in the production process, these 2 product lines saw quarter-on-quarter gains of 13.9% and 17.7%, respectively.

Conversely thermal insulation products, which are sold in the market serving liquid natural gas applications, faced further declines as these end markets continue to be soft.

Segment level operating margin improved by nearly 3 points to 8.1% during the quarter as a result of leverage on the increased sales and the effect of continuous improvement programs.

Slide 10 covers the Industrial Filtration segment. This business focuses on providing needle felt filtration solutions, primarily for the global industrial air filtration segment and nonwoven rolled-good media for various commercial applications.

For the first quarter of 2016, sales were $31.2 million and operating margin was 12.6%. While intercompany sales of rolled goods to Lydall's fiber segment remained strong, sales of the unit's filtration products were down in the quarter, primarily as a result of general softness in the power generation markets, where these products are sold, coupled with otherwise tightening competition.

Conversely, sales of the segment's other filtration products remain healthy, creating a favorable mix on profit. This, together with favorable material costs and lean improvements, continued -- contributed to the 340 basis point improvement in segment operating margin.

This concludes my comments regarding Lydall's financial performance for the quarter. I'll now turn the call back to Dale.

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Thank you, Scott. To summarize, we had another excellent quarter. Our end markets are stable, and we continue to remain focused on executing new product development, implementing Lydall Lean Six Sigma and putting our very strong balance sheet to good use.
With that, I would now like to turn the call back over to the operator to begin our question-and-answer session.

# Question and Answer

**Operator**

[Operator Instructions] The first question comes from Robert Majek from CJS Securities.

**Robert S. Majek**
*CJS Securities, Inc.*

You touched on in your prepared remarks, but I was hoping you could give us a little more color on the weakness you're seeing in the power generation end market, and what you're seeing in Q2. Has it leveled off here or are we likely to see further sequential revenue decline?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

What we're seeing is -- what's driving the power generation market softness, one, we're seeing a slowdown in new major products or commissionings of new coal-fired power plants, particularly in North America, and we had anticipated that. We know that, that's a trend in that space. But what we're seeing is a delay in the replacement cycle. I think utilities are pushing off some of the expenses that they have as it relates to replacement filters. So that's the primary impact in North America. And also, we're seeing a similar decline in pushout of orders in China as it relates to the overall macroeconomic issues in that country.

Going forward, in the second quarter, we actually see a second quarter at or slightly better than first quarter revenue in that space.

**Robert S. Majek**
*CJS Securities, Inc.*

And corporate expenses were up $1 million or so year-over-year, and it sounds like the increase was almost all personnel costs. What was behind all the expenses and how much of that was possibly onetime in nature?

**Scott M. Deakin**
*Chief Financial Officer and Executive Vice President*

Robert, I would say all was really onetime in nature, about half of it was related to compensation expenses for principally equity-based compensation and the second piece was related to some professional fees that, as you note, were really one-time in nature. We see a little bit of that go into the second quarter, but it will start to equal out after that point.

**Robert S. Majek**
*CJS Securities, Inc.*

Great. And the Fibers business continues to generate solid margin. If volume holds here, can you give us an update on how sustainable margins are at this level in the near term?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

I think, the -- longer term, as we've always said, we think that the margins will probably drift down some. Right now, we had exceptional volume in that space in material -- positive material impact in the first quarter. But we expect for the full year that the margins in that business will be comparable to what we had in 2015. You may see some quarter-to-quarter swings, but on the full year, we should be able to deliver the operating margins we had last year.

**Robert S. Majek**
*CJS Securities, Inc.*

Great. And on the lower raw material costs, can you quantify the benefit there, and how many quarters of benefit we have until that lapses?

**Scott M. Deakin**
*Chief Financial Officer and Executive Vice President*

Yes, we had about, called about $2 million of commodity-based savings in the quarter, coupled with probably about another $1.5 million that's related to material productivity. I think if you take that commodity piece, you'll see similar kinds of benefit into the second quarter and then we'll start to see it reduce down into the third and fourth quarter.

**Operator**

The next question comes from Edward Marshall of Sidoti & Co.

**Edward Marshall**
*Sidoti & Company, LLC*

So I wanted to ask about the Metals segment in the margin, I guess, specifically. I'd say probably it wasn't as strong as I thought maybe you'd enter the year with and -- especially with sales up 10% year-over-year. So I assume maybe it was still the sourcing issue that's lingering around there, maybe some disruptions from the second press going in. But maybe you can kind of talk to me through maybe what happened with the year-over-year decline in the margin? And then maybe discuss some of the geographic or may be platforms that was responsible for the growth as we move into Q1?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Okay. There's -- first of all, it was -- the material issue in China is behind us, and it had no impact on the quarter-to-quarter performance. If anything, it would've been positive because we do have that issue behind us. The significant erosion in the margin was due to a couple of things. One, we're launching several new platforms in North America, one for the Chrysler Pacifica, their RU line, where we have significant content. And during your ramp up of a product, you have inefficiencies, because you're not running at full rate, you're running at sample or rates and so on. That's pretty much behind us now. As we're going into the second quarter, we're pretty much running at rate now so that inefficiency should be behind us.

In addition, one of our European sites wasn't running quite as well as it should. We had some issues with excessive overtime due to what was reported as illness from the flu in that location of the world. That seems to be behind us, and we are addressing that with longer-term basis as we continue to focus lean in that area. As far as some of the new platforms, I mentioned the Chrysler Pacifica, which is a very exciting platform for us. We've also won significant contact on the Honda Civic, and we're providing that -- product on that platform now to -- out of both, one of our European operations and our North America operation, and they have significantly increased their demand on us. So we hope to see that to continue for the balance of the year. And then in the second half, in the Fibers -- you're talking Metals so those are the key platforms that we've won and things are, I think, should be improving as we go forward.

**Edward Marshall**
*Sidoti & Company, LLC*

So this is kind of your low watermark for the year as far as the margin in the Metals?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

We think so. We will be disappointed if we don't see quarter-on-quarter improvement.

**Edward Marshall**
*Sidoti & Company, LLC*

Got it. The conversion to -- in the metals business to say double wall insulators, first, is that what you're referencing when you talk about the Chrysler Pacifica? I thought that was more of a late 2017 kind of driver? And then can you talk about maybe the timing of how that ramps up and maybe the percentages of new vehicle rollouts that you anticipate that you're going to be on?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

To the last point, the percentage of new, I don't have that off the top of my head, but we could get that to you later, Ed. But as it relates to the Pacifica, yes, those are all dual wall applications, and they are large parts. It's one of the platforms that required us to make the $5 million investment in a new high-speed line to produce that product. So that, again, that's part of the inefficiencies that we had in the first quarter as that new asset was ramping up, and we're trying it -- you're really not running at full rate. So the Chrysler Pacifica is a very significant application for us, and it's starting to be sold now, it’s being advertised on TV, and we expect it to be a really good winner for us going forward.

**Edward Marshall**
*Sidoti & Company, LLC*

Because of -- because that you're reducing the amount of competition by moving to double wall insulators, because I think there's only one other competitor that does this. How does it affect your pricing and therefore margin as you kind of progress and get ramped up? Do you -- can you circumvent some of the OEM pressures to pricing as a result, or is this just another product line that you're make and you just have less competition and so it's more of a sales driver than volume?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

There are more than just 1 principal competitor. I mean, ElringKlinger is our strongest global competitor. But there are probably 4 or 5 others that can compete with dual wall technology. As far as pricing, it's the creativity and the relationship we have with the OEMs, and you know that -- these parts are custom designed for the space that they're in. And our application and engineering team in Detroit is excellent in working with the customers and speed at design and delivering those design, and then going into production and really with flawless launches. So that's the key driver. Does it have margin expansion? Absolutely. It's a higher value product, it is a higher -- more engineered product. The majority of the glass insulating material that we use in between the layers of metal is produced in our Performance Materials. So again, more margin for Lydall corporate so it -- and it is the strategy of the business, and we've taken it to where it's over 50% of our product sales now are the higher value dual wall applications.

**Edward Marshall**
*Sidoti & Company, LLC*

And lastly, I touched on maybe capital deployment. I mean, you reduced that almost to nothing, I guess, in the second quarter that will probably go to 0. As you look at, kind of spending $25 million to $30 million, which, I guess, is quite high for Lydall on a historic basis. First, what you're building in, and secondly, what are your thoughts from a capital deployment, now that you're moving towards a net cash position? Or rather, a cash -- a debt-free balance sheet, rather?

**Scott M. Deakin**
*Chief Financial Officer and Executive Vice President*

Obviously, we're focused on the $25 million to $30 million we're working on this year. As we talked about principally that's in our Metals and Fibers business is based on the new programs we won. So that's why you're seeing numbers that are higher than what a sort of through the cycle run rate would be. We had higher numbers also in '15, but you'll start to see in '17 that start to work its way down to kind of a '15 kind of a level going forward. Beyond that, I think we've been pretty open around what our capital deployment priorities are, first is around M&A, and we're pursuing that very actively. You will see some other things in terms of pension derisking that are small by comparison. And then beyond that, we're looking at other things like dividends in the long term, but you won't see us keep pursuing those actively here in the next few years.

**Operator**

[Operator Instructions] We have another question from Edward Marshall of Sidoti & Co.

**Edward Marshall**
*Sidoti & Company, LLC*

Just a follow-up, your guidance of $800 million, 15% op margins, do you want to kind of put a time frame as to when you anticipate that you expect to kind of achieve the -- it's probably -- I assume it's probably moving, there is a lot of moving pieces to your business, but any help in clarification?

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Yes. One of the key elements to get there as we stated all along will be achieving -- acquiring $100 million, $150 million of revenue through our M&A activity. So it's hard to predict when that would happen. As Scott said, we have a very active pipeline. We think we have some very interested opportunities ahead of us. But we really can't predict that. If we look at our businesses between now and 2018, we would say that they range anywhere from 4% to 6% organic growth over that period. So you can do the math, and that would show you where we would be.

As far as the 15% operating margin, we're doing very well against that. I mean, at 10.5% in the first quarter, we continue to make improvements there. And as we get some of these inefficiencies behind us, as you noted in the Metals business, that will continue to improve. So I feel very comfortable where we -- for us achieving that by 2018. Again with the uncertainty of timing of acquisitions, it's really hard to say exactly when we'll be there. But 2018, I am confident we will.

**Edward Marshall**
*Sidoti & Company, LLC*

Do you think that you can get to a higher-margin x M&A opportunities because that is sometimes dilutive to the margin initially like, for instance, your filtration business was. Do you think the margin expectations could be even higher x M&A or is...

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Again, I don't want to -- obviously, we're going to strive to continue to go past that. But I would say right now, if you're looking at it, stick to our vision of $815 million, and let's hopefully we'll surprise you.

**Operator**

[Operator Instructions] Excuse me, this concludes our question-and-answer session. I'd like to turn the conference back over to Dale Barnhart for any closing remarks.

**Dale G. Barnhart**
*Chief Executive Officer, President and Director*

Well, I thank everybody for their participation on the call. And most importantly, thank the Lydall team for another excellent quarter. Thank you very much.

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