

Lydall, Inc.

Second Quarter 2015 Financial Results

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CORPORATE PARTICIPANTS

David Glenn – *Vice President, Investor Relations*

Dale Barnhart – *President and Chief Executive Officer*

James Laughlan – *Vice President, Chief Accounting Officer & Treasurer*

PRESENTATION

Operator

Good morning and welcome to the Lydall Second Quarter 2015 Financial Results conference call. All participants will be 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 telephone keypad. Please note this event is being recorded.

I would now like to turn the conference over to David Glenn. Please go ahead, sir.

David Glenn

Thank you, Chad. Good morning, everyone, and welcome to Lydall's second quarter 2015 earnings conference call. Joining me on today's call are Dale Barnhart, President and Chief Executive Officer; and Jim Laughlan, Vice President, Chief Accounting Officer & Treasurer.

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. Jim will follow with a summary 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 were released yesterday so you can follow along with today's call. Please reference the PowerPoint presentation entitled, Q2 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 another great quarter. These results on our 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 revenue goal of \$800 million and an operating margin target of 15%.

Slide 3 outlines the key takeaways for the quarter. Total net sales quarter-on-quarter declined 9.6% to \$134.6 million. Nearly all this reduction was due to unfavorable foreign currency translation of 5.5% and from a divestiture of 3.3%. Organic growth for the quarter was slightly down at 70 basis points. All segments experienced solid positive organic growth with the exception of performance materials which had a decline of 10%.

Even with lower consolidated net sales, we were able to achieve excellent gross margin expansion. Margin expanded 190 basis points to 25.2% primarily on the continued execution of lean initiatives

across our businesses and a realization of synergy programs in our industrial filtration segment. Operating margin was up 160 basis points to 12.7% versus adjusted operating margin for 2014, the highest level in over 10 years and demonstrates our focused effort on improving the operating performance of the company.

Earnings per share of \$0.64, which included \$0.03 of unfavorable foreign currency translation, were up 2% versus second quarter 2014 adjusted earnings per share of \$0.63, or up 6% excluding foreign currency.

With respect to the ongoing investigation related to the possible violation of German antitrust laws, we continue to work with the German Federal Cartel office and anticipate that this matter will carry into 2016. Despite our regular communication with the German authorities, we are unfortunately still unable to estimate either the timing or the amount of the liability associated with the matter but we'll continue to provide updates when we have any material development.

As it relates to our CFO search, candidate evaluations began shortly after Robert Julian announced his departure in April and are still currently ongoing but I am hopeful for resolution within the quarter.

Turning to Slide 4. This is an overview of our long-term growth strategy which includes four drivers: new product development, lean Six Sigma, geographic expansion and M&A. With respect to M&A, we completed the acquisition of Industrial Filtration in the first quarter of 2014. Operating margins in this segment reached 12.7% in the second quarter of 2015 and are 11% for the first half of the year. These results demonstrate the earnings power of this business under our lean initiatives and we anticipate the business will continue to improve. Over the long term, we are on track to exceed the \$4 million of annual cost savings by the end of 2016 as we originally communicated and we expect to continue to see incremental operating margin improvement annually.

Looking forward, 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. Naturally we cannot predict the timing of these but we hope to put our balance sheet to good use through our selective M&A.

With respect to Lydall lean Six Sigma, we have already realized significant improvements over the past few years and we continue to look at new ways to operate more efficiently to better serve our customers. During the second quarter we continued to execute on this strategy and realized significant operating margin expansion over the prior year in both our thermal/acoustic fibers and industrial filtration segments which grew at 410 and 470 basis points respectively.

On an adjusted basis for the quarter, consolidated operating margin increased by 160 basis points to 12.7%, which is an excellent result and includes the drag from lower sales and margins from our performance materials segment. As it relates to geographic expansion element of our growth strategy, one of the largest opportunities we are working on is the globalization of our thermal/acoustic fibers segment. This business is our highest performing segment and achieved operating margins of 29.7% in the second quarter. Currently this business is only serving the North American market but we are actively looking to expand into Europe and China organically. Given the duration of automotive platform award cycle, it may take a few years to begin to see the increased sales from this initiative but we are very excited about the long-term profitable growth opportunity.

Turning to Slide 5, with respect to business conditions. Overall, we believe the underlying fundamentals of our businesses remain solid and we are well positioned for the remainder of the year despite the typical seasonality we can expect in some of our end markets.

With our automotive business, the scheduled plant shutdown for a key customer have been completed and these plants are currently back online at full production. Early signals on market demand from a key customer indicate that the volume for the second half should be at least as strong as the first half. Looking forward, current visibility suggests that overall demand within the global automotive markets remains stable. North America continues to remain strong and European production continues to recover and expand.

In China, we expect sales to modestly ramp-up in our new metals operation in accordance with our business plan and anticipate improved operating results from this facility as the year progresses. In our industrial filtration business, we continue to experience solid order activity for Q3. However, consistent with prior years, we still anticipate typical seasonality in air filtration component of this business where the first half of the year is typically stronger than the second half.

In our performance materials business, we continue to expect soft demand but we are seeing improved order activity in the North American and Asian filtration markets and for our cryogenic insulation products globally. Overall, this business has had a very disappointing result in the first half of the year but we believe the worse might be over. And as such, we anticipate improved results in the second half of the year compared to the first half of 2015.

To wrap up my comments before turning it over to Jim, we are very pleased with our performance in both the second quarter as well as the first half of the year. We continue to operate well and look forward to delivering solid financial results for 2015.

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

James Laughlan

Thank you, Dale, and good morning, everybody. I'll briefly cover our consolidated results and then provide an overview of operating segment results.

Turning to Slide 6, I will be brief on the second quarter performance as Dale previously discussed many of the key points. Despite lower consolidated sales which were primary driven by unfavorable foreign currency translation and a divestiture, we were able to achieve excellent margin expansion. Gross margin expanded 190 basis points to 25.2% and operating margin was up 160 basis points to 12.7%. Earnings per share of \$0.64, which included \$0.03 of unfavorable foreign currency translation, were up 2% versus second quarter 2014 adjusted earnings per share, or up 6% when excluding foreign currency translation.

The effective tax rate for the quarter was 33.6% compared to 31.3% in the second quarter of 2014. The tax rate in the current period was slightly higher primarily due to less favorable geographic mix where our earnings were generated. Looking at the full-year, we anticipate that our effective tax rate will continue to fall somewhere in the range of low to mid 30s.

Moving over to our balance sheet, our liquidity continues to remain very strong. At the end of the quarter, cash was approximately \$74 million and our debt was approximately \$40 million. From a leverage perspective, our debt to EBITDA ratio was approximately 0.6 times which gives us financial flexibility going forward. We continue to feel that up to 2.5 times debt is the upper end of leverage we would be comfortable carrying.

During the six months of 2015 we used cash of \$8.3 million to purchase the remaining shares under our share repurchase program which closed out this initiative. Cumulatively, since 2012 we have

purchased 1 million shares on this program at an average price of \$18.20 per share. As it relates to capital expenditures, we spent \$11.7 million through the first 6 months of the year compared to \$5.6 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 the full year 2015 we expect total capital expenditures to be in the range of \$20 million to \$25 million.

Lastly, as noted in our earnings release issued yesterday, on July 31, 2015 the company became aware of alleged inaccuracies in the timing of revenue recognition in our industrial filtration business in China which we acquired back in February 2014. This China business represents no more than 6% of Lydall's consolidated net sales and no more than 3% of Lydall's consolidated gross profit in any quarterly or annual period since the date of acquisition. While the internal investigation is ongoing, we currently believe that the outcome will not have a material impact on the company's consolidated financial results.

Now turning to Slide 7. With half of the year behind us, I'll take a moment and walk you through the progress we have made on a year-to-date basis. Sales in the first half were essentially flat from an organic perspective. All segments with the exception of performance materials were up organically while performance materials offset this growth with the reduction of 8.4% due to soft demand for filtration products in North America and Asia and cryogenic insulation products globally.

With respect to operating margin, we continue to make progress on improving year-to-date profitability with a 30 basis point improvement to 10.4% versus the adjusted operating margin for the first half of 2014. The continued improvements at the consolidated level driven primarily by lean initiatives across the businesses and the realization of synergy programs in industrial filtration business are especially strong given the headwinds experienced to date within performance materials.

I will now review the financial performance by business segment. Turning to Slide 8. I will start with our thermal/acoustical metals business. This is our global automotive segment that specializes in providing under hood and underbody engineered thermal solutions for vehicles. Overall, this business performed well during the quarter despite sales of \$41.4 million being heavily impacted by unfavorable foreign currency translation of 12.7%. Excluding this, parts grew organically by 5.3% compared to the prior year. Tooling sales were significantly higher than second quarter of 2015, especially normalizing for currency translation. This was due to timing of new product launches, especially in Europe.

We have continued our efforts to get our China automotive facility back on track and to meet our expectations for business performance. As we communicated last quarter, we have solved our materials sourcing issues and expect the operating results at this facility to improve during the second half of 2015. The China facility negatively impacted segment operating margin this quarter by approximately 100 basis points and year-to-date by approximately 150 basis points.

Considering the results of the China facility and headwinds we faced related to currency translation, segment operating margin for the quarter was strong at 11.7%, especially given the increased level of tooling in this period which creates unfavorable mix for the business.

Turning to Slide 9, it refers to our thermal/acoustical fibers business. Similar to metals, this business serves the automotive industry and provides molded polyester and acoustical solutions primarily for underbody applications for vehicles in North America. Segment level sales were \$35.5 million in the quarter, which was a slight reduction from the prior year due to lower tooling for approximately \$1.5 million. Part organic sales growth was nearly 2%, which was especially encouraging, given that the second quarter of 2014 was set up to be a tough comparison to 2015 due to a key customer building inventory ahead of planned factory shutdowns in 2014.

Operating margin in the quarter increased 410 basis points over the prior year to a record 29.7% reflecting the continuation of our lean initiatives, favorable mix and ability to leverage the higher sales volume during the quarter.

Moving to Slide 10. I will cover our performance materials segment that provides specialty filtration and installations for a variety of end-markets globally. Net sales in the second quarter declined 16.7% quarter on quarter to \$26 million including unfavorable foreign currency translation of 6.7%. The organic sales decline is primarily due to lower demand for our filtration products in North America and Europe, as well as our cryogenic insulation products given the sharp decline in the price of oil. Segment level operating margin also declined 270 basis points to 8.7% during the quarter as a result of loss leverage on the lower sales volume. As Dale mentioned earlier, despite these headwinds and performance to date in this business, we do anticipate improved results in the second half compared to the first half of the year.

Moving to Slide 11, this covers our industrial filtration business. This business focuses on providing needle felt filtration solutions primarily for industrial air segments globally. For the second quarter of 2015, sales were \$35.9 million and operating margin was 12.7%. On adjusted basis, the business experienced 470 basis points of operating margin expansion primarily due to favorable mix, increased sales and realization of synergy programs.

This concludes my comments and I will now turn the call back to Dale.

Dale Barnhart

Thank you, Jim. 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 on new product development, implementing lean Six Sigma and putting a very strong balance sheet to good use.

With that I will now turn the call back over 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 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. Once again, pressing star then one will allow you to ask a question. At this time we will pause momentarily to assemble our roster.

Our first question comes today from Robert Magic with CJS Securities.

Robert Magic

Good morning.

Dale Barnhart

Good morning, Robert. How are you?

Robert Magic

Could you speak a little about the sustainability of the margins you reported this quarter by segment on

both a short-term and long-term basis, if you can?

Dale Barnhart

Sure. In both the automotive segments, the thermal/acoustic fibers and the thermal/acoustic metals, with the demand we're seeing right now through the balance of the year, we believe those margins that you're seeing now are sustainable for the balance of the year. Longer term, we believe there is upside improvement opportunities in the thermal/acoustic metals and we would anticipate some degradation in the margins in the fibers business, which are running very high at this time.

With regard to performance materials, it's all about revenue in that business. They have done a very nice job through lean initiatives and improving their cost position and their efficiencies in their operations. It's really about top line and as we indicated, we are anticipating right now that the balance of the year should be a little stronger than the first half so we would anticipate margin improvement in the balance of the year in that business. And longer term we fully expect that business as some of our new product opportunities come on board, to be substantially above 15% operating margins.

And then in the industrial filtration, good improvement in net operating margins for the balance of the year. We are seeing stability where we are now and as we continue to drive further synergy into that business and look at market adjacencies and top line growth, we expect that business over the longer term to get to the 15% operating margins.

Robert Magic

Great. And could you give us a little more color on the mix shift occurring within fiber auto parts that's partially responsible for the margin expansion there?

Dale Barnhart

Well, as we've gone through and won new awards, one of the things that the business is very good at is being selective in quoting where we have sweet spots in our product lines. And some of the margin opportunities are driven in areas where we have what we feel is product superiority. And one of the areas that we we've been very successful in is developing these underbody shields where we believe we have a material advantage and a construction advantage that enables us to enrich our margins.

Robert Magic

And on performance materials, filtration, what's causing the lower demand there? Is it certain products or is it broad-based? And if you could, what's the magnitude of the possible improvement you expect in the back half?

Dale Barnhart

It's broad-based. We have seen really weakness in North America and Asia. Asia is driven by the overall weakness principally in China. So that's what's driving that softness in filtration. And going forward, we expect an improvement but I really wouldn't want to quantify the magnitude of that because it can be volatile.

Robert Magic

Thank you.

Operator

Once again if you would like to ask a question, please press star then one. There appears to be no further questions so I would like to turn the conference back over to management for any closing remarks.

CONCLUSION**Dale Barnhart**

Again we appreciate everybody's participation on the call and there is clear focus within the company on moving towards our 2018 goals. Thank you.

Operator

Thank you, sir. The conference is now concluded. Thank you for attending. You may now disconnect.