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LECO - Q2 2016 Lincoln Electric Holdings Inc Earnings Call

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## PRESENTATION

### Operator

Greetings, and welcome to Lincoln Electric 2016 second-quarter financial results conference call. At this time, all participants are in a listen-only mode, and this call is being recorded.

It is now my pleasure to introduce your host, Amanda Butler, Director of Investor Relations. Thank you. You may begin.

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**Amanda Butler** - *Lincoln Electric Holdings, Inc. - Director of IR*

Thank you, Andrea, and good morning, everyone. Welcome to Lincoln Electric's 2016 second-quarter conference call. We released our financial results earlier today, and you can find our release as an attachment to this call's slide presentation, as well as on the Lincoln Electric website at LincolnElectric.com in the Investor Relations section.

Joining me on the call today is Chris Mapes, Lincoln's Chairman, President, and Chief Executive Officer; as well as our Chief Financial Officer, Vince Petrella. Chris will begin the discussion with an overview of the quarter, and Vince will cover the quarterly performance in more detail. Following our prepared remarks, we're happy to take your questions.

Before we start our discussion, please note that certain statements made during this call may be forward-looking, and actual results may differ materially from our expectations due to a number of risk factors. A discussion of some of the risks and uncertainties that may affect our results are provided in our press release and in our SEC filings on Forms 10-K and 10-Q.

In addition, we discuss financial measures that do not conform to US GAAP. A reconciliation of non-GAAP measures to the most comparable GAAP measure is found in the financial tables in our earnings release, which is available in the Investor Relations section of our website at LincolnElectric.com.



And with that, I will turn the call over to Chris Mapes. Chris?

**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Thank you. Good morning, everyone. Let's turn to slide 3. We are pleased to report solid margin and cash flow performance in the second quarter. Despite ongoing tepid industrial end-market demand, sales declined 10.9% to \$592 million in the quarter, primarily due to 9.7% lower volumes. Demand trends continued to stabilize on a year-over-year basis during the quarter, and we benefited from easier comparisons as well as modest growth in our Harris Products Group segment.

We also achieved 3% sales growth from our automation acquisitions, Rimrock and Vizient, and from our specialty alloys acquisition, SWP. Price performance and foreign exchange translation, excluding Venezuela, held relatively steady as compared with first-quarter results. Second-quarter price declined 90 basis points, and we incurred a 1.5% unfavorable impact from foreign exchange translation.

In this challenged environment, we are aggressively executing on our operational and commercial initiatives. We are maximizing productivity and driving cost savings. We are focused on exceeding our customers' needs with enhanced solutions, greater automation, and a broader network of welding experts. We believe these efforts are generating real long-term value.

Margin performance was resilient in the quarter, given lower volumes. We achieved a slight increase in our gross profit margin and incurred an 80 basis point decline in our adjusted operating income margin, to 13.9%. This equates to a 22% decremental operating income margin.

EPS was \$0.45 in the quarter due to special items, including a \$0.48 charge related to the deconsolidation of our Venezuelan subsidiary. Excluding special items, adjusted EPS was \$0.83 in the quarter.

Return on invested capital and cash flow performance was solid in the quarter. Cash flows were aided by improved working capital management. We achieved a 148% cash conversion of adjusted net income in the quarter, and 91% year to date. Cash returns to shareholders remains a priority, and we returned \$122 million in the quarter through share buybacks and our 10% higher dividend payout rate.

Now turning to slide 4. While industrial end markets continued to impact most of our product areas, demand appears to be stabilizing and we have seen some pockets of growth, largely internationally. In Europe, many countries we serve achieved organic growth in the second quarter as demand trends continued to improve in that region. Countries with significant oil and gas exposure, such as the UK and Russia, continued to contract. Also, portions of our Asia markets generated growth. And our Harris Product Group grew in the second quarter on strength in the North American retail channel from new commercial programs launched earlier this year.

This growth continues to be offset by broad weakness across industrials and specifically in oil and gas, which decreased by approximately 35% globally, as improved oil prices have yet to trigger the release of significant oil and gas projects, nor has it translated into an uptick in welding demand due to the typical 2- to 3-quarter lag for our business. Additionally, heavy fabrication remained compressed on weak mining activity, and our US exports declined by approximately 26% in the second quarter, impacted by both weakness in oil and gas project activity and the stronger US dollar.

Let's move to slide 5. While clearly a challenging environment, we are focused on our customers, on driving value, and achieving our 2020 Vision and Strategy growth goals in priority areas such as equipment systems, automation, alloys and aluminum consumables, and in education solutions.

In the Americas welding region, we created a new leadership position responsible for driving long-term growth and development in smaller yet attractive solutions such as alloys, welding accessories, and education.

We continued to invest in innovation. During the last several months, we have continued to launch new products and scale their distribution to support our growth strategies. These include a new version of our virtual welding training solution for students, new and proprietary robotic and manual solutions for aluminum and galvanized steel welding processes, a global TIG-welding portfolio that is localized for different geographies,

an improved line of cutting tables, and a remote-controlled operating system using our Flextec 350 welders for use in industrial construction applications, all examples of our continued investment in technology and solutions.

Additionally, we are continuing to focus on markets where we can leverage our solutions to expand the Lincoln Electric brand, such as in Germany and in targeted developing regions such as China, the Middle East, and Africa, where we are adding commercial resources to drive long-term growth and are introducing proprietary solutions, like our automated PythonX 3-D plasma cutting solution, which will further differentiate our brand in these markets.

During the second quarter, we acquired Vizient Manufacturing Solutions and are pleased to welcome the team into Lincoln Electric. Vizient is based in Bettendorf, Iowa, and is one of the leading integrators in North America for heavy fabrication applications. With Vizient, our automation portfolio is approaching \$400 million in annual sales; its revenue is diversifying across multiple industry segments; and we continue to expect long-term growth as we expand our global automation capabilities.

While we invest for long-term growth, we remain cautious and are maintaining the cost reduction actions that were launched last year. These broad actions, combined with the dynamic alignment of productive work hours to demand in our US business and worldwide continuous improvement productivity initiatives that were deployed to reduce costs, will continue to support our margin profile at current sales levels.

Lincoln Electric is also advantaged by our global capabilities, balance sheet strength, and our diversified end markets. So while we navigate a challenging portion of the cycle, we are confident in our ability to lead our industry in innovation, expand the reach and breadth of our solutions, and generate solid cash flows to drive value for all of our stakeholders.

And now I will pass the call to Vince to discuss our second-quarter results and uses of cash in more detail.

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Thank you, Chris. Looking at our second-quarter income statement highlights on slide 6, our consolidated sales decreased 10.9% compared with the prior year. Volumes decreased 9.7%, and acquisitions contributed 3% to the top line. Excluding the results of our Venezuelan operation, the Company incurred a 90 basis point decline in pricing in the quarter, and a 1.5% unfavorable impact from foreign exchange translation.

Our second-quarter gross profit margin increased 30 basis points to 34.3% compared with 34% in the prior year. We incurred a \$2 million LIFO charge in the quarter due to expected raw material price inflation. However, cost reduction benefits and price management improved margin performance in the quarter.

Our SG&A expense declined 5.7% or \$7.3 million, primarily due to lower bonus costs and favorable foreign exchange. SG&A as a percentage of sales increased 110 basis points to 20.3%, reflecting the unfavorable impact of lower volumes.

Operating income declined approximately 50% in the quarter to \$48 million, reflecting the \$34.3 million pre-tax charge associated with the deconsolidation of our Venezuelan subsidiary. On an adjusted basis, operating income declined approximately 16% to \$82 million or 13.9% of sales.

Our adjusted operating income margin declined 80 basis points versus the prior year on lower sales. Our decremental margin was 22% in the quarter, in line with expectations. Margin performance reflected benefits from prior cost reduction actions, ongoing cost controls, and price/cost management.

Interest expense it was a \$4.2 million in the quarter from interest accrued on higher borrowings.

We now expect our full-year 2016 interest expense to be approximately \$18 million. Our estimate includes contingent consideration and interest expense on our new \$350 million private placement senior notes that have a weighted average effective interest rate of 3.1%, and maturities that will range from 12 to 25 years. We expect to draw down the proceeds of this placement in the fourth quarter.

Our second-quarter effective tax rate was 31.6% due to the impact of the deconsolidation of Venezuela, partially offset by the reversal of an income tax valuation allowance. Excluding special items, the effective tax rate was 28.4%. For 2016, we continue to expect our effective tax rate to be in the high 20% range. This range is subject to the future mix of earnings and the utilization of US tax credits.

Second-quarter diluted earnings per share decreased approximately 52% to \$0.45 per share compared with \$0.94 per share in 2015, reflecting the \$0.48 EPS charge from the deconsolidation of the Venezuelan subsidiary. This charge was partially offset by a \$0.10 per share benefit related to the reversal of an income tax valuation allowance.

Second-quarter adjusted EPS declined 13% to \$0.83 compared with \$0.95 in the prior-year period, primarily due to lower volumes. Our share repurchase program contributed a \$0.07 benefit to adjusted EPS in the quarter.

Now moving to our reportable segments on slide 7. Our Americas welding segment adjusted EBIT margins declined 90 basis points to 15.8%. End markets remained challenged in the quarter, notably in oil and gas, general fabrication, heavy fabrication, and in exports. However, demand trends continued to stabilize on a year-over-year basis. Margin performance reflects prior cost reduction actions, ongoing use of our flexible incentive management system, as well as price/cost management.

Excluding Venezuelan results, the Americas welding segment sales declined approximately 11% on 12.9% lower volumes. Pricing remained relatively stable, with a 30 basis point decline, and the segment benefited from 3.8% higher sales from our Rimrock and Vizient automation acquisitions.

Moving to slide 8, we deconsolidated our Venezuelan subsidiary from our financials on June 30, 2016, and incurred a \$34.3 million pre-tax charge, predominantly non-cash. As market and operating conditions continue to weaken in the country, we concluded the Company could no longer meet the accounting criteria for control of our Venezuelan subsidiary, and we will now use a cost method of accounting for Venezuela going forward.

So while we will continue to operate in the country, we have written off our investment and will only include future Venezuelan income once cash is received. As Venezuelan sales have been immaterial year-to-date at approximately \$5 million per quarter, and the EBIT contribution has been insignificant, we do not expect the deconsolidation to have a significant impact to our financial statements in the future.

In our international welding segment, adjusted EBIT margin was 7.1% or down 40 basis points versus the prior year on 3.6% lower volumes. While international welding demand continues to face declining oil and gas markets, the segment saw growth in India and portions of Southeast Asia, as well as ongoing improvement in European demand in Southern and Eastern European countries.

The Harris Products Group's second-quarter adjusted EBIT margin was 12.5%, an increase of 140 basis points compared with the prior year, which reflects benefits of mix, improving raw material cost trends, and inventory adjustments. Volumes grew 1% from a continued double-digit increase in the retail channel. Pricing decreased 1.1% on year-over-year metal cost changes.

Moving to slide 11. Cash flow from operations increased 31% to \$101 million, benefiting from lower operating working capital. Average operating working capital was 17.4% at June 30, a 130 basis point improvement versus the prior year.

Capital expenditure pacing increased to \$16 million in the quarter after a slow start, reflecting the timing of projects, including the groundbreaking of our new welding technology center in Cleveland. We now estimate full-year CapEx spending to be in the range of \$55 million to \$65 million.

During the second quarter, we paid a cash dividend to shareholders of \$22 million, reflecting the 10% higher dividend payout rate. We also spent \$100 million repurchasing 1.7 million shares for Treasury. Through June, we have repurchased 3.6 million shares, or approximately 5% of our outstanding share count. We continue to target \$400 million of share buybacks in 2016.

And now I'd like to turn the call over to questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Mig Dobre, Robert W. Baird.

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### Mig Dobre - Robert W. Baird & Company, Inc. - Analyst

Chris, maybe going back to your comments surrounding demand. I know you used the term stabilization. But I guess the way I'm looking at it, if I look at your Americas segment, decline has lessened maybe to the tune of, call it, 370 basis points volume-wise, but your comp is something like 600 basis points easier.

So, I'm trying to equate your comment for stabilization with this notion. And then I'm also wondering why, at this point, you are not talking about any incremental cost savings or action on the cost side.

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### Chris Mapes - Lincoln Electric Holdings, Inc. - Chairman, President and CEO

Look, I think the first comment I'd make is that when we're thinking about stabilization, we're talking about the global portfolio. So when we think about the global portfolio, we are seeing improvements in a multitude of areas around the world. We are seeing more favorable trending in our international business. We saw positive trending within our Harris segment business.

I would acknowledge that certainly one of the most challenged segment areas that we have is the Americas business. Certainly the positioning that we have here with the strength in oil and gas, strength and heavy fabrication, and long-term relationships with the OEMs that are participating in those particular segments creates a more challenging environment for us. Although an environment that we do see as improving, although certainly not at the rate that we had expected to see as we entered 2016.

As it relates to further cost reductions, as we stated in the presentation, look, we are going to continue to drive productivity throughout the business. We think we've done a very good job of managing that cost/price analysis for us at Lincoln, as it relates to this particular cycle in 2015 and 2016.

We will continue to aggressively push those issues throughout the rest of 2016; and, just at this point, don't have any other large restructuring activities that we're prepared to move forward with at this point.

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### Mig Dobre - Robert W. Baird & Company, Inc. - Analyst

Great. I appreciate the color there. And then this is obviously a question we get often from investors in terms of framing a good way to think about margins into the back half of the year, based on your comments on cost savings, but also recognizing that raw material prices have escalated as the year progressed. Can you help us think about this issue?

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### Chris Mapes - Lincoln Electric Holdings, Inc. - Chairman, President and CEO

Well, look, I certainly think that we are challenged now by the risks of escalating raw material prices in the broad portfolio. I'd first say that we have historically been able to very effectively manage that element, whether that's with aggressive cost reductions within our portfolio or needing to move commercial actions out in the marketplace to mitigate the costs or the risks associated with rising raw material costs.

So we will continue to aggressively manage those. Although I do see us having more challenges in the back half of the year with raw material inflation risks than what we've seen so far in 2016.

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**Mig Dobre** - *Robert W. Baird & Company, Inc. - Analyst*

I'm sorry; can you talk at all about decrementals? How you are thinking about decrementals in the back half versus what you normally would see historically?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Right. We had a 14% decremental margin in the first quarter, as our cost savings initiatives fully matured in the fourth quarter of last year, and we continued to benefit from falling raw material inputs. We did increase our decremental margin to about 22% in the second quarter.

And I would expect, Mig, that in the second half of the year, there will continue to be pressure on our decrementals as those cost -- the most substantial cost-cutting initiatives that are still being maintained in 2016 mature themselves in the second half of the year and fourth quarter, whilst raw material prices continue to put pressure on the upside.

So, I think it's too early to make any kind of estimates at this point in time, but I would expect that that 22% in the second half of the year will be under further pressure.

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**Mig Dobre** - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Thank you, guys.

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**Operator**

Schon Williams, BB&T Capital.

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**Schon Williams** - *BB&T Capital Markets - Analyst*

I just wanted to be crystal clear on the pricing. So in the Americas, it's flat to slightly down sequentially. There was talk of some industry competitors actually moving through price here during the summer. So I just wonder, are there already Lincoln initiatives out there specifically on equipment or consumables that have already gone out into the marketplace, or anything that you can talk about you have already specifically done?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Yes, Schon. So that -- so the 30 basis point decline is -- manifests in an increase on the -- a slight increase on the equipment side and a larger decline on the consumables side. So there have been modest increases in equipment pricing this year that have been more than offset by consumable price decreases across our portfolio.

As far as what it is contemplated, moving forward, I think that we will continue to evaluate where we stand on our input costs and what the marketplace is doing. And I would just reiterate what Chris said earlier about our posture on inputs and pricing policies in the second half of the year.

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**Schon Williams** - *BB&T Capital Markets - Analyst*

Okay. And then just to follow up, silver has been moving here recently. That's a significant input for Harris. Can you just talk about how should we -- will you be able to -- are you already passing that through to your customers there? Is there going to be a period where -- I don't know, Harris to some extent, I think, has been benefiting -- price declines trailing some of the actual raw material deflation there historically. So margins have actually done quite well at Harris.

Are we going to see a transition period for a quarter or two, where we see margin compression there? Or do you feel confident you can maintain the margin profile even as silver moves up in that segment?

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

We really think about that business as how are we adding value to these products that we're moving into the OEM customers and into the channel. Our goal within that business is actually to be able to pass the metal prices through, and we do that very effectively. We think about arbitraging the silver costs from an input perspective into our products. We're pricing those products on the same day that we're moving those products through our manufacturing process and to our customers.

So we don't see any inflection point relative to where the margins will be under pressure, or have any opportunities relative to that. It is an adder-based business with some of the value that's created, so there's slight improvements in some of the margins in very high-escalating silver environments.

But as you stated, we have generally, over the last two or three years, seen a declining silver environment. And that operation has been able to maintain and actually make slight improvements in its margin portfolio over the last 8 to 12 quarters.

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**Schon Williams** - *BB&T Capital Markets - Analyst*

All right. Perfect, guys. Thanks for the color.

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**Operator**

Walter Liptak, Seaport Global.

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**Walter Liptak** - *Seaport Global Securities - Analyst*

I wanted to ask about the cost savings first. How much of a benefit do you expect to get in the back half of the year from some of those cost savings that have already been done? Or are the benefits already through your business?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

The benefits have matured in the fourth quarter of last year, Walt. So as a reminder, we had talked about a total of \$37 million of cost savings, \$25 million of which we characterized as temporary, another \$12 million that we characterized as fixed and permanent. And so, we're running at least those levels currently, and we would expect that those levels would largely anniversary in the fourth quarter of this year.

We have continued to chip away at our cost structure with cost savings initiatives across our portfolio. But as Chris pointed out, there are no major actions that were taken in the first half of this year that we would have announced and put a label on as substantial cost savings, over and above what we had achieved at the tail end of last year.

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**Walter Liptak** - *Seaport Global Securities - Analyst*

Okay. Sounds great. And if you wouldn't mind, I'll switch gears over to your comments, Chris, about the oil and gas markets. And you talked about oil and gas down 35%, and you called out release of projects. And I wondered if you could talk about the kind of projects that you are looking for, because I thought a lot of those products went through the distribution channel. And if you do get visibility on particular projects, are you seeing any increase in quote activity, especially from the upstream, which is something that we've been hearing recently.





**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, my first comment would be, first of all, as we think about this oil gas cycle, remember in the first quarter of 2015 when, quite frankly, various market participants had various levels of compression in oil and gas. And any time we look at one individual quarter, it can be kind of lumpy data, and you might have had projects the year before that impact that. So my first caution is, I don't necessarily over-read any one quarter relative to looking at the broad market.

We do see projects associated with oil and gas. You can see major projects associated in the offshore area. We see major projects associated with refinery or transportation. So a portion of these products are going into those types of large projects. And we would say that historically, when we think about that particular industry segment, as we've seen a migration up from -- in oil pricing, we've generally seen broader welding activity that generally trails that 2 to 3 quarters.

So, we talked about we've seen some broader stability in oil pricing, and we like the stability. But we have not yet seen stability, or stability long enough, for us to see any broader capital that we believe is moving into that industry segment space.

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**Walter Liptak** - *Seaport Global Securities - Analyst*

Okay, got it. So it's more of a general commentary, is opposed to seeing any new projects that are coming to you for quotes, et cetera?

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Yes. Historically, as we had looked at that segment, we have generally lagged by 2 or 3 quarters when we start to see more welding activity, when we've seen an uptick in the oil and gas space.

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**Walter Liptak** - *Seaport Global Securities - Analyst*

All right. Sounds great. Thank you.

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**Operator**

Chase Jacobson, William Blair.

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**Chase Jacobson** - *William Blair & Company - Analyst*

Appreciate the demand commentary you've given so far. Can you maybe talk about the demand trends throughout the quarter on a month-to-month basis, and if you've seen any change in the competitive intensity within the market, specifically in North America?

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, my first comment would be I don't think there's any competitive intensity that's impacting our demand trends. I think what's impacting our demand trends are just the broad challenges that are out there in a host of these segments.

It was a very choppy quarter. We actually came into the quarter at more favorable activity, especially here in our Americas business, and then saw some challenges as we migrated through towards the back end of the quarter.

And it was just, I would say, a very lumpy, kind of a challenging quarter for us to really try to estimate or get a feel for the demand profile for us as we are moving through the rest of 2016.

But again, I think that as we evaluate that demand, we see that from some shallowness that we didn't expect in some of our large OEM customers in the oil and gas and the heavy fabrication segments specifically, and can point back towards those areas as it relates to the choppiness that we experienced in Q2.

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**Chase Jacobson** - *William Blair & Company - Analyst*

Okay. And then on the balance sheet capital allocation side, I know you had communicated that you were looking at taking on incremental debt. Is this it? Or should we expect -- could there be more debt taken on? Is there any read here as it relates to your willingness to do larger deals, or the opportunity to do larger deals going forward?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

I would say, at this point, this latest effort to raise another \$350 million will be it for now. This is in accord with a long-term plan that we have had for the last four or five years to adjust and readjust our capital allocation plan on our ultimate capital structure. I don't believe it is an indication of any change in posture in terms of our acquisition strategy. Our debt to total cap, as well as our debt to EBITDA, is still a very modest and comfortable range for a company with Lincoln's cash-generating capabilities and balance sheet.

So, I would just say that we have optimized our capital structure more than what we've seen in the last few years. But it won't change our view of how we deploy our capital towards both organic and inorganic growth opportunities, and will not limit our options from a strategic initiative and 2020 Vision perspective.

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**Chase Jacobson** - *William Blair & Company - Analyst*

Okay. Thank you.

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**Operator**

Stanley Elliott, Stifel.

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**Stanley Elliott** - *Stifel Nicolaus - Analyst*

A quick question, going back, could you remind us how far volumes fell in the 2009-ish time frame? My memory had something like 30%. And it looks like we're tracking down maybe 20% or so, since 2012. One, could you make sure that I was correct in those numbers, and then maybe talk about how much of the business that you essentially walked away from) And the point is, I guess I'm trying to figure out how close we are to a trough as we were in -- during the last downturn. Thanks.

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Stanley, those are pretty accurate numbers. We were actually down 29% in the Great Recession. Ex-acquisitions, we are down approximately 20% from the rebound levels. So we're not where we were in 2009, but we're probably within about 10% of where we were in 2009 from a pure volume perspective. And that does not take into account, as you point out, the strategic repositioning of the business away from, and towards, a more attractive mix on a global basis. So those numbers are in line with what we would have seen since 2009.

**Stanley Elliott** - *Stifel Nicolaus - Analyst*

Okay, perfect. And you mentioned some positive coming out of Southeast Asia. Can you highlight that a little bit? Is this the automation platform taking hold over there? Is it equipment, consumables? Just trying to get a better feel for what's happening in that part of the world.

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, I think part of what's driving it is the investment that we've been talking about for the last couple of years in both people and technologies in other regions around the world. So we're seeing some of the benefits from the technology center that we opened up in Singapore in the last 12 months, providing those solutions closer to those customers and seeing some of those opportunities materialize. And, fortunately, that Singapore technical center assists us in a host of various countries in the region.

I'd also say that our long-term investment in the Indian market has continued to be favorable. So, that was one of those areas where we repositioned the business away from, we thought, products that weren't driving the type of economic value that we could provide to our customers, or drive the financial value that we wanted for our shareholders. And we have repositioned that business over the last 8 to 10 quarters, and it's really performing very well, showing organic growth as well as driving more and more of our global solutions into that particular market.

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**Stanley Elliott** - *Stifel Nicolaus - Analyst*

Perfect. And then the last for me, you guys talked about the heavy fab business being down. There is certainly lots of restructuring going on at the OEMs. Should we think of this -- obviously it's tougher volumes, given where these markets are currently; but is it reasonable to think that with your automation platform, that those are good opportunities to either win share or continue to push along the automation business, as these OEMs reposition and try to take cost out of their own manufacturing process? Thanks.

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, I know that everyone who participates in that industry is challenged by the current global demand levels, but I like our positioning in heavy fabrication long-term. We have great welding solutions for those markets. We have great long-term relationships with the industry leaders in those markets; and automation, and their continuing drive for automation in that space, has been strong.

I'd reference our recent Vizient acquisition and Wolf acquisitions. Both those acquisitions were companies that had targeted automation solutions into the heavy fabrication space. The combination of those businesses, as well as the welding solutions we have at Lincoln electric, clearly position us as the number-one global automation solutions provider into heavy fabrication. And we have great confidence that we can convert that into the sale of even more and more products into that space. So, challenging current demand market, but really like our positioning long-term in heavy fabrication.

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**Stanley Elliott** - *Stifel Nicolaus - Analyst*

Great, guys. Thanks.

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**Operator**

Joe O'Dea, Vertical Research Partners.

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**Joe O'Dea** - Vertical Research Partners - Analyst

Just to make sure I understand the back-half-of-the-year expectations, and then some comments about stabilization. But do you think that demand in the back half of the year will be even slightly better than what you saw in the second quarter? The back half of the year -- comps are easier, just with what you saw last year. So when I think about that on growth-on-growth, will we see improvements in the back half of the year, based on where you see things right now?

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**Vince Petrella** - Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer

Yes, Joe. That certainly is true that the back half of the year have easier comps. We did show a progression and a moderation of the year-over-year declines between the first and the second quarter, where the first quarter was down roughly 14% in volumes; and the second quarter, year-over-year, 9%.

As we enter the third quarter of the year, I think those declines continue to moderate. And we're hopeful that the second half of the year will continue along that path, although we don't see the second half of the year improving substantially from where we sit today, and expect to see the same kind of trends that we exited the second quarter, at least into the third quarter, as we see July shaping up now.

And the fourth quarter is a little bit too far ahead to make any kind of predictions. But I think we're going to see more of the same going into the second half of the year as we saw in the second quarter of the year.

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**Joe O'Dea** - Vertical Research Partners - Analyst

Got it. Thank you. And then just on some of the rising input cost considerations, should we think about anything from a LIFO credit standpoint? Whether there were any adjustments in the quarter, or whether you anticipate that adjustments in 3Q, or whether most of that would be 4Q? And any ability to size those expectations right now. I know you commented on the decremental being a little bit higher maybe than 2Q, but whether the LIFO is a component of that.

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**Vince Petrella** - Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer

Yes, Joe. So in the second quarter, we did take a LIFO charge or expense of approximately \$2 million. The prior year did have LIFO credits in excess of \$3 million. So we have seen a year-over-year shift in at least domestic US input costs, as depicted by our LIFO accounting requirements.

What that would tell us for the second half of the year is that at least US domestic LIFO charges will continue. And we'll have at least another \$2 million or more LIFO charges in the second half of the year, depending upon how input costs shape up as we finish off the third and fourth quarters. So, charges as compared to credits in the prior year.

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**Joe O'Dea** - Vertical Research Partners - Analyst

Got it. Thanks very much. Appreciate it.

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**Operator**

Robert Wertheimer, Barclays.



**Robert Wertheimer** - *Barclays Capital - Analyst*

Vince, my question was also on the LIFO charges. I wonder if you can just mechanically explain it. Does the charge this quarter, and I guess the implied charge next quarter -- it's small enough -- does that imply that at that point, you'll be really mark-to-market on current steel prices in the US? Or would there potentially be more pressure ahead, reflecting current steel prices, not future increases?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Actually, the LIFO accounting convention requires an estimate of what your expected input costs will be at the end of the period, or end of the fiscal year. Those estimates are heavily influenced upon what we're seeing today, as most costs have not been fully negotiated or crystallized at this point in time. So, you use what your current, most recent costs are, and you make your best effort to determine where those costs might be at the end of the year.

The booking of the \$2 million is an interim accounting requirement, which means that the expectation is that we will have continuing charges through the end of the year, based on our current outlook for where input costs will finish up at December 31.

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**Robert Wertheimer** - *Barclays Capital - Analyst*

All right, so perfect. That's a good mechanical answer. And then just versus the market, does that imply that this quarter or next, you are more or less pricing -- costing in line with steel prices as they exist now? You answered the question, but I'm not sure really how much of the increase is priced in, even given that.

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Well, to take charges whilst pricing has remained stable with -- or gave up 30 basis points -- would indicate that, in that respect, we're giving up a little bit of price/cost in the quarter. So the expectations would be that that will continue through the second half of the year, as far as what is being charged to the income statement for current estimates of LIFO inflationary impact as compared with what the top-line pricing is doing currently.

So that is a -- it helps explain the additional decremental margin expansion that we saw in the second quarter versus the first quarter of this year.

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**Robert Wertheimer** - *Barclays Capital - Analyst*

Okay. Thank you much.

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**Operator**

Eli Lustgarten, Longbow Securities.

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**Eli Lustgarten** - *Longbow Research - Analyst*

Can you just remind us, as a clarification, what the LIFO credits were in the third and fourth quarter last year, and what Venezuela sales were in the third and fourth quarter last year, which we have to pull out from the comparison standpoint?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Yes, so Venezuela, third and fourth quarter of 2015, we had approximately \$35 million of sales in the third quarter last year, and about \$4 million of sales in the fourth quarter of last year.



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**Eli Lustgarten** - Longbow Research - Analyst

And what were the LIFO benefits in the third and fourth quarter, last year?

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**Vince Petrella** - Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer

I'm going to have to look that up, Eli. Why don't you give me a minute, and I'll answer that before the end of this call.

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**Eli Lustgarten** - Longbow Research - Analyst

So, we talked a little bit about the seasonality we can expect in revenue and operating margins in the second half of the year versus what we normally -- obviously we're going to have a very different seasonality effect in the third quarter, for the \$35 million number that comes out on a comparative basis; not so much in the fourth. And you always typically -- the big margin step-ups that we begin to see in the fourth quarter, I suspect that that had a lot of LIFO as part of that. Are we expecting the profitability to basically be somewhat -- stay at current levels, as opposed to seeing any expansion or change from where we are today?

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**Vince Petrella** - Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer

Well, I would say continuing expansion of our gross margin and operating profit margin is going to be very challenging as we finish off the second half of the year. The comparisons will be difficult. As you might recollect, we had credits in LIFO and falling raw material prices last year that really accelerated in the second half and then bottomed out in the first quarter of this year.

The first-half LIFO credits last year were about \$3.1 million compared to that \$2 million charge that I talked about earlier this year. My recollection is in the second half of the year, those credits accelerated to a more significant credit last year compared to charges that we'll have this year.

And I don't have, again, the LIFO number in front of me for the fourth quarter last year, but I think it was maybe double what we saw in the first half of 2015. And I believe it was roughly \$6 million of a credit in the fourth quarter of last year.

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**Eli Lustgarten** - Longbow Research - Analyst

All right, thank you. (inaudible) off-line.

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**Operator**

Joe Mondillo, Sidoti & Company.

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**Joe Mondillo** - Sidoti & Company - Analyst

Most of my questions have been answered, but I just wanted to follow up on the Harris Products Group segment. First off, in terms of the second quarter, was the -- largely the margin expansion -- was that related to product mix?

And in regard to the silver prices rising, I know that was asked before; but in the past, we've seen you actually being able to expand your margins on higher silver prices. However, in the past also in those circumstances, we've seen a little higher volume growth than we're seeing right now. So just wondering, do you anticipate to be able to expand the margins in the back half of the year?



**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, a couple of comments. First, let's talk about demand. So the demand, as we stated, is really driven from investments and improvements we've made in our retail channel strategies across large customers with our Harris business. We have also had some new products that we've been driving into that portfolio over the last 12, 18 months. Actually, those are just starting to take hold, primarily in some HVAC applications. I think we will see the benefits of that as we move through the rest of the year.

The higher silver prices can provide us for an opportunity for a very slight margin expansion. Although, as I stated earlier, the Harris business has actually been on the other side of that over the last couple of years, trying to improve upon their margins in a falling silver environment.

So I think the bigger message, as we talk about Harris, is the Harris business has been enormously successful. It's been on a long-term journey for us for improvement. It was a key component of our 2020 Vision and Strategy was to make improvements in the financial performance of our Harris business.

I believe we've been doing a very good job of delivering on that, and would expect to continue to deliver on improved margin improvement in the business, as we have over the last couple of years. There may be a slight portion of that that we get if we have some rising raw material prices in silver; but would expect that improvements in the channel work that were doing with a retail and improvements in the new product initiatives, as well as continuing to drive productivity from lean manufacturing competencies, will continue to drive improvement in the Harris business on a very small incremental level, like we have for the last, really, 12 to 14 quarters.

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**Joe Mondillo** - *Sidoti & Company - Analyst*

Okay. And then just lastly, I was wondering if you could comment on your South American, ex-Venezuela business. Is that continuing to get worse, or are you at all seeing some sort of stabilization there? If you could just comment on your business down there.

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, whenever you start talking about South America, ex-Venezuela, as we have shared with before, the magnitude of that business is Brazil. And Brazil continues to be a very challenging marketplace for all industrial players. We like our positioning down there, from an automation perspective. We had an automation business there. And the recent acquisitions that we brought in also had some slight competencies in automation. We have been combining those under our longer-term strategy there for Brazil.

So I would love to tell you that the Brazilian market has stabilized, but we're not there yet. We are seeing some improvements in some areas, but Brazil really is what drives Latin America for us longer-term. We continue to be committed to that marketplace, but it is still a very challenged environment.

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**Joe Mondillo** - *Sidoti & Company - Analyst*

Okay, great. Thanks.

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**Operator**

Steve Barger, KeyBanc Capital Markets.

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**Ken Newman** - *KeyBanc Capital Markets - Analyst*

It's Ken Newman on for Steve. Just a question -- wanted to go back to the decrements for the second half. I understand that you are looking for the margins to be somewhat pressured versus the 22% you saw this quarter. But just given how you are structured today, I'm curious, where is the lowest you think decrements can get in a trough type environment or a trough market?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

The lowest they can get? That's a difficult question to answer. I would say that we're going to do everything we possibly can to ensure that our decrements don't exceed a 25% to 30% type of range. And we'll take the cost actions that we think are necessary in the type of top-line environment that might face us at any point in the cycle. And we'll manage our pricing as well as can be expected; any inflection points, either up or down, in inputs and other costs. So I would say something north of 30% would be certainly a disappointment to me.

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**Ken Newman** - *KeyBanc Capital Markets - Analyst*

Understood. And then moving on, you mentioned some stability in the second half in terms of easier comps. I was curious if we could go at it at a different way, looking at the performance by end market. Are you seeing the easiest comps within the highly pressured oil and gas market, heavy fab? Or is there another end market where we're really seeing those easier comps come through?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Well, certainly oil and gas is at the top of that list. And I would say heavy fabrication is also right there in the mix. Those two end market segments have been hit the hardest and for the longest period of time that we could identify our end market segments in. So I would certainly put those two at the top of the list of the easiest comparisons for the second half of the year.

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**Ken Newman** - *KeyBanc Capital Markets - Analyst*

Thanks.

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**Operator**

Justin Bergner, Gabelli & Company.

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**Justin Bergner** - *Gabelli & Co. - Analyst*

First question was just a quick follow-up on Venezuela: can we expect any sort of EBITDA loss or cash loss going forward, given what you've said about recent trends, given that we won't be seeing the financial impact of that in your P&L?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

No, there should be no significant impact from an earnings or cash flow perspective going forward in the foreseeable future. The last four quarters of Venezuelan reported results have not resulted in any meaningful income or loss reported in the Company's consolidated financial statements. We've been operating under a variety of regulatory requirements for pricing, and have had challenges in running our Venezuelan business in a profitable or meaningful fashion in the last four quarters. So, we wouldn't expect that to change, at least in the near and foreseeable future. Again, no significant impact from a profitability or cash flow perspective from Venezuela going forward.





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**Justin Bergner** - *Gabelli & Co. - Analyst*

Okay, great. So I guess the profitability was also pretty close to breakeven in the second half of 2015, then, in addition to the first half of 2016?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

It was. The second half of 2015 was a breakeven business from an EBIT perspective.

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**Justin Bergner** - *Gabelli & Co. - Analyst*

Okay. Great. One other question, which is on the international margins, which were quite strong this quarter, and great work there. Is there anything unusual that is boosting the international margins? Because you actually improved margins on a heavier price mix headwind this quarter vis-a-vis last quarter. Are materials a more notable tailwind in the international segment? Or how should we think about the profitability going forward versus the strong level of 2Q?

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**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

Well, look, I think we -- as we mentioned, we saw some improvements in our international business, specifically improvements in Southeast Asia. We have also continued to try to make improvements in our core European business. We saw some improvements in the demand profile in many of those countries. As part of our 2020 Vision and Strategy, though, our expectation is to continue to drive improvements in the margin profile for that business.

And we have been continuing to work on our talent, on our resources, and in driving those solutions into that marketplace. It's a challenging market to be able to accomplish that, but would be expecting that we continue to see incremental improvements in our margin profile in our international business.

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**Justin Bergner** - *Gabelli & Co. - Analyst*

Okay, great. Thank you for taking my questions.

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**Operator**

Schon Williams, BB&T Capital.

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**Schon Williams** - *BB&T Capital Markets - Analyst*

Vince, could you give the actual export dollar amounts for Q2, and then Q1 if you have it as well, of this year?

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**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

I have the second quarter, which is about \$35 million this quarter versus \$47 million in the prior year.



**Schon Williams** - *BB&T Capital Markets - Analyst*

Okay, that's helpful. And then just any comments on the automotive end markets? There still some concern out there that we may see some deceleration. Just wondering if you are seeing any early cycle turns there.

**Chris Mapes** - *Lincoln Electric Holdings, Inc. - Chairman, President and CEO*

We are seeing a slight deceleration as it relates to the automotive space. But I also have to caution that, look, it's off of very peak volumes off of 2015. It's still a -- relative to a multitude of other global segments -- it's still a real strong demand profile, if you want to talk about it from a historical perspective.

We have also got some new solutions and some competencies that we are trying to drive into the space. So we're excited about the automotive segment, longer term, but we are seeing a slight deceleration on a year-over-year basis.

**Schon Williams** - *BB&T Capital Markets - Analyst*

All right. That's helpful, guys. Thanks a lot.

**Operator**

This concludes our question-and-answer session.

I would like to turn the call back to Vincent Petrella for any closing remarks.

**Vince Petrella** - *Lincoln Electric Holdings, Inc. - EVP, CFO and Treasurer*

Thank you, Andrea. And thank everyone for joining us today on the call, and for your continued interest in Lincoln Electric. We look forward to discussing the progression of our strategic programs and our 2020 strategy as we enter the third quarter. Again, thank you very much.

**Operator**

This concludes today's teleconference. You may now disconnect your lines at this time, and thank you for your participation.

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