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LECO - Q3 2017 Lincoln Electric Holdings Inc Earnings Call

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OVERVIEW:

Co. reported 3Q17 YoverY consolidated sales growth of 17.9%, operating income of $133.1m and diluted EPS of $1.59.

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PRESENTATION

Operator

Greetings, and welcome to Lincoln Electric's 2017 Third Quarter Financial Results Conference Call. (Operator Instructions) And this call is being recorded.

It is now my pleasure to introduce your host, Amanda Butler, Vice President of Investor Relations. You may begin.

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

Thank you, Vince, and good morning, everyone. Welcome to Lincoln Electric's 2017 Third 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 quarter 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 U.S. GAAP. A reconciliation of non-GAAP measures to the most comparable GAAP measure is found in the financial tables in our earnings release, which, again, is available in the Investor Relations section of our website at lincolnelectric.com.

And with that, I'll turn the call over to Chris Mapes.

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

Good morning, everyone.

We achieved solid top line growth in the quarter. Sales increased 17.9%, predominantly driven by good momentum in organic sales and the benefit of our acquisition. Volumes improved 3.8% with growth achieved across all reportable segments across all of our key regions and among most of our end markets. We achieved this growth despite one less shipping day and challenging year-over-year comparisons in portions of our business, especially automation. We generated 1.8% in price in the quarter, substantially up from second and third quarter pricing actions taken in our Welding segments and the consumables category, which were partially offset in our Harris Products Group segment.

I'm pleased to report that we successfully completed the Air Liquide Welding transaction in the quarter and benefited from an 11% increase in sales from the transaction. Our adjusted operating income margin of 13.8% was 60 basis points lower than prior year, reflecting the acquisition. Excluding the acquisition, our adjusted operating income margin was 15.2%, which is an 80 basis point improvement compared with prior year and a record for third quarter operating margins for the company. Our legacy business generated a 27.1% incremental margin on higher volumes, cost management and productivity initiatives.

While we are pleased by our incremental margin performance, raw material inflation has continued to creep higher during the recovery and we expect this trend to continue into 2018. We have announced new pricing actions for the fourth quarter, but we expect inflation to unfavorably affect margin growth near-term. In the interim, we will continue to monitor market conditions, diligently manage costs and leverage productivity initiatives to mitigate the impact.

Cash flow generation was strong in the quarter and free cash flow represented 134% cash conversion ratio of our adjusted net income.

Overall, I am pleased with the team's focus on capitalizing on emerging growth opportunities, mitigating where possible the cost headwinds and working with customers and partners to successfully navigate through this portion of the cycle. All of these actions are critical to achieving success towards our 2020 Vision and Strategy goals of improved profitability and operational excellence.

Looking at end market conditions and performance in more detail on Slide 4, we are seeing ongoing growth in our markets. Not only did all of our reportable segments report growth, but we achieved sales growth across all key regions, including South America. In fact, international region growth and U.S. export serving these markets both increased significantly in the quarter.

By product area, consumable volumes accelerated across all of our segments at consolidated high single-digit percent growth rate, led by the Americas Welding segment. Equipment systems, excluding automation, continued to grow, albeit at a lower rate due to the challenging year-over-year comparisons in our Harris Products Group segment. Automation did decline in the quarter due to a challenging prior year comparison and the choppy order trends which occur in this segment of the market, which we discussed with you before.

Looking at channels and end sectors specifically, we saw solid improvement in our distribution channel and ongoing year-over-year growth among most of our direct channel customer segments.

Moving on to Slide 5. I'm pleased to report that upon completion of our Air Liquide Welding transaction on July 31, we had a successful day one launch and held numerous town hall and staff meetings across our European platform to welcome the Air Liquide Welding employees to our team.

Since that time, we have been progressing quickly on integration initiatives. Our integration and synergy initiatives target various areas of the business where we have identified that we can leverage scale to capitalize on savings and possible in-sourcing opportunities, adopt best practices across our shared network to improve operational productivity and quality, streamline to reduce complexity and improve our efficiencies and to eliminate redundancies. We also feel stronger that we can refine a commercial portfolio of solutions that will ultimately represent a best-in-class portfolio enriching our mix. Our target is to achieve a 10% plus operating income profit margin in the region and we are confident that these efforts will generate those returns.

I recently returned from Germany in our industry's largest international trade show where both Air Liquide Welding and Lincoln Electric teams were focused as one on using the event to learn from one another and educate their customers on new opportunities available across the expanded portfolio of solutions, whether from Lincoln's proprietary PythonX 3D plasma cutting solution for structural steel or the Air Liquide Welding's premier Oerlikon-branded consumables and plasma welding systems. I'm also pleased to report that our new commercial team has begun to secure quick wins in the market together with new customer relationships across the globe and we will continue to experience greater growth opportunities, leveraging the complementary nature of our expanded portfolio and customer relationships.

Given our assessments, we remain confident in our ability to execute and achieve our synergy target of an incremental $30 million of EBITDA and our near-term EPS accretion goals.

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

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

Thank you, Chris.

Looking at our third quarter income statement highlights on Slide 5, our consolidated sales increased 17.9% compared with the prior year from solid organic sales performance and the completion of our Air Liquide Welding acquisition. Volumes rose 3.8% and price increased 1.8%. Our welding segments generated an average 2.5% higher price in the quarter. The acquisition contributed 11% and we benefited from 1.4% favorable foreign exchange translation.

Our third quarter gross profit margin decreased 240 basis points. The decline reflects the addition of Air Liquide Welding and the $2.3 million charge from the amortization of the step-up in the value of acquired inventories from this transaction. Excluding the acquisition and special items, the gross profit margin was 34.1%, a 110 basis point decline versus the prior year. The decline was substantially caused by lower automation product line margins and the effects of price cost due to rising raw material cost inflation.

We incurred a $2.2 million LIFO charge in our Americas Welding segment in the quarter. We expect similar inflationary trends in the fourth quarter.

Our SG&A expense increased 12.5% to $132.7 million or 19.8% of sales due to the addition of Air Liquide Welding. Excluding the acquisition of special items, the SG&A ratio declined 200 basis points versus the prior year as legacy Lincoln SG&A expenses declined due to lower professional fees and improved sales leverage.

We incurred a $5.3 million noncash pension settlement charge related to lump sum payments taken by Lincoln Electric retirees following the freeze of our defined pension benefit program at the end of 2016. Additionally, we recognized a noncash bargain purchase gain of $52 million from the Air Liquide Welding transaction. The gain represents the difference between the consideration paid to the seller and the fair value of the net assets acquired. The bargain purchase gain is a preliminary estimate until purchase accounting and balance sheet adjustments are finalized.

Reported operating income increased 63% to $133.1 million or 19.9% of sales. Excluding special items in the quarter, adjusted operating income increased 13% to $92.4 million. The adjusted operating income margin was 13.8% of sales, a 60 basis point decline versus the prior year period.

The Air Liquide Welding acquisition had a 140 basis point unfavorable impact to the adjusted operating profit margins. Excluding special items and the acquisition, the adjusted operating income margin would have been 15.2%, an 80 basis point improvement versus prior year and a 27% adjusted incremental operating income margin in the legacy business.

Interest expense was $5.9 million in the quarter compared with the prior year interest expense of $3.8 million. We expect annual interest expense of approximately $24 million in 2017.

Our third quarter effective tax rate was 18.8% and lower than the prior year rate of 25.2% due to the bargain purchase gain associated with the acquisition, which had no tax impact. Excluding special items, the adjusted tax rate was 31.3%, reflecting the geographical mix of earnings and the unfavorable impact of discrete tax items in the quarter.

We expect our fourth quarter 2017 effective tax rate to be in the high 20% range. This estimate is subject to the future mix of earnings, the utilization of U.S. tax credits and the timing and extent of stock option exercises.

Third quarter 2017 diluted earnings per share increased to $1.59. Excluding special items, EPS increased 5% to $0.93 per share, reflecting higher organic sales and cost management.

Now moving to our reportable segments on Slide 6. Our Americas Welding segment adjusted EBIT margin increased 40 basis points to 17.5%, led by high single-digit percent volume growth in consumables. This growth partially offset the impact of lower automation sales and profitability and unfavorable price cost due to raw material inflation. Demand trends continued to improve in this segment, notably in our distribution channel and in key direct end market sectors such as general fabrication and heavy industries. Automotive transportation sales increased and continued to outperform regional auto production. Oil and gas and shipbuilding activity declined in the quarter. Our automation sales declined due to challenging prior year comparisons and the timing of 2017 projects. Backlog order levels remain relatively steady compared with the prior year.

In our International Welding segment, which now includes the Air Liquide Welding acquisition, we realized a 5.2% adjusted EBIT margin, a 50 basis point improvement compared with the prior year. If we were to exclude the acquisition, adjusted EBIT margin in the third quarter would have been 7%. Organic sales strengthened broadly in the quarter to 9.6% versus prior year. Volumes increased 6.7% and we achieved 2.9% higher price. Volume growth accelerated due to continuing solid demand in Europe and Asia Pacific.

Turning to Slide 8. The Harris Products Group's third quarter adjusted EBIT margin improved 10 basis points to 12.2% on solid volume growth mitigating the unfavorable impact of raw material trends. Volumes increased 7.2% from demand and consumables predominantly used in general fabrication and HVAC applications. Pricing declined 3.7% on year-over-year metal cost changes, primarily silver.

Moving to Slide 9. Our cash flow from operations was $94 million in the quarter as compared to $113 million in the prior year period, reflecting the impact of increasing sales levels. Our operating working capital ratio is 20.5%. And excluding the acquisition, our operating working capital held relatively steady at 17.6% compared with 17.7% in the prior year. Cash conversion remains strong at 134% in the quarter and 111% in the first 9 months of the year.

Capital expenditures were $11 million in the quarter and $39 million in the first 9 months. We now estimate our full year CapEx spend to be in the $55 million to $60 million range.

During the quarter, we paid a cash dividend to shareholders of $23 million, reflecting the 9% higher dividend payout rate in 2017. The board recently approved an additional 11.4% higher dividend payout rate for 2018, reflecting the ongoing confidence in the company's future cash flow generation capabilities.

And now, I would like to turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Seth Weber of RBC Capital Markets.

Seth Robert Weber - *RBC Capital Markets, LLC, Research Division - Analyst*

I wanted to ask a couple of questions. On the pricing -- the margin commentary with respect to pricing, I guess, I was under the impression that in a rising input cost environment, Lincoln historically has had an ability to raise prices to get in front of that or to benefit from that. So is your commentary around just this impact that you expect in the fourth quarter, is that really just a timing issue? Or is there something else that you're seeing from -- whether it's competitors not matching or private label or something else that's going on there?

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

Yes, Seth. I think it's a little bit of timing. We got ahead of cost increases a little bit in the first and second quarter. The cost inflation did accelerate into the third quarter. We expect the same kind of cost inflation in the fourth quarter. We are in the process of raising prices again in the fourth quarter of 2017 across our global portfolio so we do expect to see a little bit more pricing effectivity in the fourth quarter and into 2018. It is probably worth noting as well that there's a mathematical effect of rising raw material costs that are relatively significant and the impact on the compression in margins as you pass through those costs into your marketplace and the P&L.

At the end of the day, I would tell you that we accomplished most of the inflationary cost increases through pricing management. There's some more to go, we believe, in the fourth quarter and into 2018. But we believe, based on the performance of our gross and operating profit margins and incremental margins of 27%, that we did a very good job of managing price cost in the quarter.

Seth Robert Weber - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay, Vince. And then, I guess, my follow-up is on the automation side, the commentary about -- I think I heard comments about a lower margin on the automation side. Is that a function of just lower volume? Is there some sort of mix issue there? Is it -- is there any color that you could provide to the lower margin comment on the automation side?

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

Sure, Seth. It's both of those things. So our volumes, our top line were down in automation on a year-over-year basis and then, secondly, our mix was weaker. We had a sales mix in the prior year that was a higher margin mix in some of our automation businesses, some of the highest margin products had very strong performance in the third quarter. Those lines of business in automation had lower sales volumes, which hurt us on the mix side. So it was both top line and mix that affected our automation business in the quarter.

Operator

Our next question is from Joe O'Dea of Vertical Research.

Joseph O'Dea - *Vertical Research Partners, LLC - VP*

First question just on the international growth, in particular on the volume side. You called out strength in both Europe and Asia Pac, but just any additional details that you can give on what in particular maybe was driving some of the increased volume growth that you're seeing there?

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

I think the exciting thing for me when I think about starting to see some growth in the international markets for the business is that's been a pretty shallow region for the global welding space over the last several quarters. And the important thing for me is it's really pretty broad-based growth. We're seeing it in a multitude, in the subregional markets within Europe. We're seeing it across several of the segments. It's not any one area or one product category. We're seeing a pretty broad growth, continued strength in the equipment offering that we have for that region.

And Asia Pac certainly has shown the growth for us, but had a very nice quarter. I believe that's part of the improvements we're seeing from the investments we made in the technical centers there in those regions over the last 12, 18 months, a multitude of customers that were getting closer to our solutions and seeing some increased demand in that market as well as the increased presence that we have there is generating some benefits for the region.

Joseph O'Dea - *Vertical Research Partners, LLC - VP*

And so it sounds like some outgrowth in Asia Pac for you. Would you also say that in Europe that you're seeing some outgrowth as well?

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

Well, I think it's difficult to know whether it's outgrowth relative to -- probably what you're trying to determine is whether there's actually any share shift going on within the market. We really don't think about share within that narrow of a window. I certainly believe that our teams have been executing well and we like the solutions and strategies that we've been driving into those markets and we appear to be performing well, but I'm not willing to go as far as to say that I believe that there's necessarily any broader share discussions going on for our participation in the market.

Joseph O'Dea - *Vertical Research Partners, LLC - VP*

Okay. And then, on automation and in particular thinking about auto in an environment where global auto builds are flat to maybe up slightly as we move into '18, what is your visibility on automation? Do you have a little bit better line of sight there for some of the plans, in particular related to the automotive industry, to see the opportunity for some outgrowth into '18 on just what you can see on the horizon? Or is that more -- remains more short cycle for you?

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

Well, I would start by reminding you that, look, automation is -- our automotive portion is a significant piece of automation, but our density within that is still probably less than the overall average. So we have a large participation in our automation business in heavy industry and a multitude of other segments that we participate in. We have some visibility. I think that, that visibility -- we're taking a look at our backlog on a continual basis. Our backlog, especially versus prior year, looks very good.

I think the other thing that we can be quick to look at as a data point is the expected light-duty vehicle builds in 2018, but it's also important for us to look at the other model transitions and other activities that are going on within the large OEMs. And we're meeting with those groups and talking to them about platform issues they may be challenged with out 6, 12, 24 months. So visibility to it is there.

Actually, understanding at this point how much of that might materialize into an opportunity for our automation business is still a little bit more short cycle, but we still -- although our automation business struggled a little bit in Q3 from a revenue perspective, I'm still very excited about the automation business, continue to expect to invest in it and, if possible, acquire more companies to bring into our global automation strategy. So we still like the business and want to continue to invest in the business and just view this as a challenge in this particular quarter relative to the mix and the choppiness of the orders that come through our automation business.

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

And I would only that the clients in that automation product line was more focused in markets outside of automotive such as structural. So automotive, as we see in front of us right now, still remains steady and strong and we don't see declines in, at least the near-term, in our automotive segment.

Operator

Our next question is from Mig Dobre of Baird.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

So I want to ask a question about your volumes in the Americas. I'm trying to understand some of the dynamics sequentially as to how you're thinking about growth here. From a pure volume growth, sequentially the quarter was a little bit weaker than what we were guessing just based on what we're seeing broadly in a lot of the key end markets that you're serving. Anyway, my question is as you're looking into the fourth quarter and beyond as comparisons get meaningfully tougher, what's the right expectation for all of us to have in terms of potential growth?

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

So I think we had a good quarter, Mig, in the Americas. The Americas is the segment that has automation concentrated there, so that automation decline year-over-year did have a detrimental impact on what we reported in the Americas of in excess of 1%. We also, as you probably realize, had a day less of billing, which is another 1.5%. So we think we had a strong result in the Americas when considering the number of billing days and the automation impact that we had there. Our consumables business was very strong, which is encouraging because that is a indicator of the underlying growth and opportunities that you have in the business. The automation business did adversely affect the equipment line, but our view is that we expect to see similar or better result in the fourth quarter of this year as we experienced in the third quarter on a year-over-year basis in the Americas segment based on what we see in the order book and sales levels through this date in October as far as the fourth quarter is concerned.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. That's helpful. And the other question -- I was a little bit confused as to the commentary. Are you saying that the backlog in automation is flat or is it up year-over-year in the third quarter? Because I think I've heard both.

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

Stable.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

It's stable. Okay. And then, lastly before I go in the queue, when I'm looking at Slide 4 and the discussion on various end markets, maybe this is parsing it a little bit too finely, but when you're discussing lower demand versus prior year last quarter, you had a couple of end markets that you highlighted this quarter, more like 4. So I'm wondering if you are seeing any shift in momentum, broadly speaking, demand-wise or if it's just me reading too much into this slide?

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

We're not really seeing any momentum shift relative to the segments. So I think we've seen good growth across the segments all year. I'd also share with you that our Air Liquide Welding business, we are not pulling that segment data at this point, so that data would not be included inside the numbers that we're providing to you. I know we had a couple more versus Q2, but Mig, I don't view those as trending severely one way or the other. It's still viewed that we've got very good strength within the business and probably would also call out that the heavy industry segment has shown nice growth for us in the third quarter as we begin to see some of those large OEMs start to recover in their markets.

Operator

Our next question is from Rob Wertheimer of Melius Research.

Robert Wertheimer

So, I guess, I have 2 questions. I apologize, I jumped on a couple of minutes late if you addressed it. But I just wanted your feel for the markets from sort of short cycle, consumables or whatever, versus longer cycle, whether you feel like the apparent hotness of the stock market pricing is accelerating, again, whether short cycle is better than long cycle.

And second, and I'll hangup after this. Your second or third slides where it says your volumes were up versus a tough compare, and I heard that in a couple of specifics you discussed, but maybe you could talk generally about which of your end markets -- which of your end segments where you see yourself as still depressed or see sales as still depressed versus ones that are mid-cycle or above. And that's it.

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

Okay. Rob, I'll start by talking about the lines of -- the product lines of business. Certainly, in this quarter, our consumables' pure volumes were stronger than equipment. Equipment was, I pointed out earlier, a little weaker year-over-year primarily because of our automation line that had a very strong performance in the third quarter of 2016. So -- and from our perspective, equipment can be a little bit choppier. Consumables seeing this steady growth and acceleration, I think, bodes well for the outlook as we sit here today.

And from a end market perspective, I think we started to see some additional acceleration in heavy industries. We're still seeing a continuing weakness in areas like shipbuilding and a little bit of choppiness in the energy oil and gas space. We did see a couple of 2, 3 quarters of stabilization in oil and gas and some growth in the last quarter, but we've fallen back a little bit in that area in the third quarter of 2017, but those are generalists, I would say. It continues to be a bright spot. It's one of our largest catch-all segments, if you will, from an end market perspective. And seeing a continual growth in that area and acceleration is promising because that tells us that the broad industrial economy has been gaining in health and broadening as far as Lincoln's participation in those markets.

So I'd say, all in all, a little bit better outlook today than the last couple of quarters, but still some choppiness and some depression in other markets that we've relied on in the past.

Operator

Our next question is from Saree Boroditsky of Deutsche Bank.

Saree Emily Boroditsky - *Deutsche Bank AG, Research Division - Research Analyst*

I'll start by going over any impact you saw on the quarter from the hurricane and any expectations as we think about the rebuilding process?

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

We didn't call out any impact from the hurricane. It's very difficult for us to actually identify all of the impact that there might be. Obviously, we realize there will be a rebuilding process. That rebuilding process should have some favorability for us that should actually -- we should see across a couple of our businesses. We should see that rebuild process affect -- impact the HVAC and wholesaling markets that our Harris business serves as well as some opportunities for us in other portions of the rebuild, in structural and some other segments, even potentially a slight improvement in automotive as some of those vehicles are replaced in that space, but I don't think that we'll be necessarily identifying it as being material enough to be impactful for us as we move forward. It should provide a slight lift, but I doubt that we'll be identifying it as a catalyst as we're moving forward.

Saree Emily Boroditsky - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Appreciate that. And then, can you talk about what you're seeing in Harris as far as online demand because I believe you are starting -- you lacked some challenging comps in the third quarter last year?

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

Yes, Saree. So the third quarter last year, we had a very strong and exceptional product line improvement through equipment and the retail channel, restocking that we had identified in the prior year. So the equipment side of the business was weaker this year because of those difficult comparisons.

On the other side of the product portfolio though, we had a particularly strong consumable performance in that segment that was led by export in international markets as well as more rapid growth trajectory in the HVAC and -- area of the marketplace.

So overall, consumables stronger, equipment facing headwinds from the prior year, retail channel stocking and -- but all in all, a very good top line performance from the Harris Products Group.

Operator

Our next question is from Nathan Jones with Stifel.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Just going back a little bit to the volume question on North America Welding. You talked about 100 basis points from lower volume on automation, tough compare there, and 1.5% on one less billing day. Do you have any difficult comparisons, more or less billing days in the fourth quarter, that we should be aware of when thinking about likely volume growth there?

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

No. We should be fine. We won't be short in the fourth quarter.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Okay. And then, on the pricing in Harris, I think you called out silver prices. I pulled up those while being on the call and while they've been volatile lately, the average price hasn't really changed a lot over the last 12 months. I'm wondering if you could give a little bit more color on what's driving that pricing decline there?

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

Actually, it's part of that volatility that sometimes challenges us as we're managing that portion of that metal through the various channels for the Harris business around the world. We do what we can to minimize the impact of that price movement through trying to arbitrage the pricing associated with sales to our customers as well as our purchased components, but that volatility is what causes part of the challenge. And silver was the item that we called out, but we also had some volatility in copper as well as tungsten and a couple of other areas of the Harris Products business that's -- and then developing their products and moving them to the market. So silver, certainly one that we identified, also an element there of copper and tungsten.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Just the outlook for the automation business. You had a challenging comparison here this quarter. Do you still expect that business to continue to grow over the next quarter or 2? And what could potentially create headwinds to that now?

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

Well, we do still -- we think about it from, Nathan, from a longer-term perspective. We expect automation to continue to grow at a high single, low double-digit trajectory over the intermediate-term.

As far as the very short-term, we will have another challenging quarter in the fourth quarter of 2017 as 2016's second half of the year for automation was very strong. So we're likely to have a similar type of conversation at the end of the fourth quarter about year-over-year comparisons, but we don't see there being any kind of structural pullback in automation activity. As we mentioned a couple of times, the backlog still looks stable, but the near-term looks challenging from a top line perspective before we reach 2018.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Okay. So challenging volume comparison in the fourth quarter? That's helpful.

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

That's correct.

Operator

Our next question is from Jason Rodgers of Great Lakes Review.

Jason Andrew Rodgers - *Great Lakes Review - VP*

I just wanted to talk a little bit more about the oil and gas sector. What was your decline in that business in the quarter on a year-over-year basis?

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

It was high single digits and it was primarily focused in midstream activity, which would include pipe mill sales.

Jason Andrew Rodgers - *Great Lakes Review - VP*

And I think you still had some easy comps on a year-over-year basis. Just wondering if there's been any change in the competitive market dynamic there? Or is it just a matter of order timing here?

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

I think it's timing. Look, we're looking at one quarter, one very narrow period of time. I think it's fair to say that we did have some improvement, the low to mid-single digit year-over-year performance the last couple of quarters. This quarter, a little bit less performance in the space. We're not signaling that there's any kind of change in our intermediate or long-term view of the oil and gas and energy space. It's just a little bit of a softer quarter and expectations are, as we move out of this quarter, that we'll continue to see some improvement in oil and gas as we look out into 2018.

Jason Andrew Rodgers - *Great Lakes Review - VP*

And then, just the performance of the exports in the quarter?

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

So exports were up double digits, actually about 14% on a year-over-year basis, roughly $37 million of export sales out of the U.S. compared to about $32 million in the prior year. And that was led by -- the automation business did do well in the international markets outside of the U.S. and our Harris Products Group business had a strong international quarter as well.

Jason Andrew Rodgers - *Great Lakes Review - VP*

All right. And finally, even with the acquisition of Air Liquide, you still have a strong balance sheet. Just wondering if you can make some comments on the M&A environment? What areas or geographic regions you might be seeing opportunities?

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

When we've talked about our 2020 Vision and Strategy, we said that we'd continue -- we've got the willingness to invest in our core business and the Air Liquide Welding was a unique opportunity for us to be able to move forward with that acquisition opportunity. We'd like to continue to build out our global automation business if those opportunities arise for us in the marketplace. And as we've done the last several years, we found opportunities to be able to identify unique products and solutions within the welding space that we think can be additive to our broad portfolio. We continue to look for those opportunities. So we're still very interested in executing on our long-term strategy, which includes continuing to identify and bring in acquisitions that add value to the strategy and value to our shareholders long-term.

Operator

Our next question is from Walter Liptak of Seaport Global.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

I wanted to ask about Air Liquide. The revenue came in a little bit better than we are looking for. Was it in line with your expectation? Are you getting growth out of it?

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

Yes. Well, I think it's too early to say we're getting growth out of it. It has been a very, very solid start. I've been very impressed with the people and the teams beginning to develop our strategies. As you can imagine, it's a very large business across a host of regions there in Europe and with some exports, but we have had a very good start with this acquisition, but I really didn't look at their performance in the quarter other than very good. Not necessarily greater than expected, but a very positive start to the integration and bringing that business into Lincoln Electric.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. And just kind of backing into some of the numbers off of Vince's comments, it looks like it was marginally profitable maybe before purchase accounting. It seemed like -- all in, it looks like you had a loss though or it was a headwind to the profits during the quarter?

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

No. It contributed slightly and tipped us over about $0.01 of EPS when you include Air Liquide. So it was modest, ex-special items and purchase accounting.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Excluding the purchase accounting? Okay.

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

Correct.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. Great. And what are you thinking about for accretion on an annualized basis?

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

So we're still thinking that Air Liquide will not contribute significantly to the fourth quarter, but we expect in 2018 that we ought to start the year in the first quarter at about a $0.03 per share improvement in EPS as we fully fold in the Air Liquide operations in fiscal 2018. And then, second half of next year, probably a little bit of improvement that we'll see from synergies that start to come into the business. But first half of the year, we're looking about -- at about $0.03 per quarter.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. Great. And impressive that you guys took a gain on this. I guess, question is what did you guys get in terms of assets? And are there things that you might be able to sell, take cash in for as you consolidate? How are we thinking about the asset that you acquired?

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

Yes. I don't think there will be any opportunities for asset sales that will bring a substantial amount of cash into the business from our integration of Air Liquide Welding. Simply, the gain is a simple calculation of the fair value of the accounts receivable and inventory and other assets that were acquired being a little different than what the cash purchase price was. At the end of the day, our perspective on that accounting gain is that it's of little import and what's going to be more important to us going forward are the real improvements in cash flows and earnings per share that we are able to achieve off of those assets and not so much a noncash accounting gain that is onetime in nature.

Operator

Our next question is from Liam Burke of FBR Capital Markets.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

Chris, could you talk a bit about new product introductions outside of the automation? I mean, there's been a lot of discussion on the innovation on the automation side. How about the -- just the core welding business?

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

Yes. That's a great question. And one of the things that excites me about the innovation and the new products that we're bringing in is that the acquisition of Air Liquide Welding instantaneously offers a portfolio of some, especially consumable products, that we currently didn't have within the Lincoln global portfolio. So actually accelerating our ability to drive innovation and new products by leveraging some of the competencies and technologies that they had. A great example would be plasma welding, a great example would be some of the consumable technologies within the Oerlikon brand.

Also though within the business, we continue to drive new product introductions. Just recently, at the global Essen show, we showed some new technologies that we have as we continue to build out competencies and capabilities from an IoT perspective within our equipment offering, assisting our customers with being able to better understand and manage their welding competencies, not only individually at the sell, but on a global basis. I think you will continue to see us bring more and more of those types of capabilities to the marketplace with the equipment offering. We also have some new equipment lines that we brought out in the last 6 to 12 months that continue to do well as well as a couple of new equipment offerings that we have scheduled to launch within 2018.

So we've continued to invest throughout the cycle. And I think that, as well as the catalyst of products that are there with Air Liquide, should bode very well for us as we talk about new product introductions not only today, but moving into 2018.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

Great. I'm looking at new product introductions and automation. How does that flow of revenues translate to the margins on the consumables front? Are you getting any better margins as you integrate consumables under these new products and into the automation side?

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

Yes. Well, it's a good question. I'll tell you we probably don't think about it that way. We think about the innovation that we're driving and trying to resolve that challenge that our customer or that segment is having in the industry around welding and cutting solutions. There are pieces of those consumables that are very, very attractive. There's pieces of those equipment offerings that are very attractive. We probably don't identify one product group or the other product group as being a more targeted area. We view that the margin opportunity within each of those areas is good for us to continue to drive within the business.

Operator

Our next question is from Steve Barger of KeyBanc Capital Markets.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

You said the mix was tougher in automation. Given that, that business is bigger now, can you talk about how wide the range of margins is for those product lines? And is mix a function of selling individual components versus systems or big systems versus small?

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

Yes. I would just tell you that last year, the mix in automation resulted in a higher operating profit margin in that product line compared to the consolidated group by a meaningful number. And then, this year, the margin in that probably was lower than the consolidated group operating profit margin. So it's a fairly meaningful shift in mix away from, on one quarter's basis, a very high margin portfolio in the prior year and a lower margin portfolio in the current year.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Is that variance because you sell to a different end market or different types of systems?

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

It was more outside of the automotive and transportation market last year. So the mix shifted towards automotive and transport from a broader end market perspective in the prior year.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

So the more you can sell to broader markets, the better your mix of margin is in automation?

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

That's the case on a year-over-year basis in this particular quarter.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. And my follow-up, just how long would you expect -- or maybe I should say do you expect to get the operating working cap ratio back into the high teens over the next few quarters as you integrate and optimize Liquide? Or is there any reason why working capital would be structurally higher in 2018?

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

Well, it likely will be. You saw that we had disclosed, just for the 2-month period with Air Liquide, a 20.5% average operating working capital to sales ratio. We view this as another opportunity that we have to take cash out of, now, the combined balance sheet. So we're excited with the opportunity to improve our average operating working capital and generate more cash for our shareholders and through our cash flow from operations.

So it will take us some time as we integrate the business, but I would expect, with having -- knowing that Air Liquide's business has a higher working capital requirement, it will be a multiyear effort. I don't expect this to happen in the first half of 2018. So we will run with a slightly higher average operating working capital until we drive efficiencies and improvements and integrate our operations with Air Liquide through our business.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Is this just them carrying more inventory and having longer receivable terms? Or is there something else?

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

Yes and yes.

Operator

Our next question is from Matthew Trusz of Gabelli & Company.

Matthew A. Trusz - *G. Research, LLC - Research Analyst*

Just a follow-up on heavy industries, just to elaborate a bit. So it's up overall, but ship and rail are both down. What is the story on strength other than resource industries and mining? Or is it all just mining?

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

Well, I think the story is that. It's that, quite frankly, look, resource industries and mining seem to have a very strong improvement as we were looking at the third quarter, especially accelerating as we were exiting the quarter. So that was a very good sign for us. Mining has -- is one of those segments that we have as a critical segment for Lincoln Electric. It's been in a challenged environment over the last several years. And we started to see that portion of the segment really start to expand and expand with consumption of consumables, specifically as we were moving through the quarter.

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

And that heavy fabrication, heavy industries would include construction equipment makers as well, Matthew.

Matthew A. Trusz - *G. Research, LLC - Research Analyst*

That's great. And then also, just to go back on the cost inflation, could you compare and contrast the experience in equipment versus consumables with respect to the extent that you feel the inflation and also the challenge of passing on price?

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

Well, clearly, Matthew, the greatest inflationary impact that we have to our business is in consumables. So steel costs have risen by a double-digit pace on a year-over-year basis and so that's where we're feeling it the most. The bulk of the cost of goods sold in consumables is, frankly, steel purchases and so it has a material impact on our costs in that product line. So price increases have been much more substantial in consumables than equipment because of that impact through cost of goods sold.

Operator

Our last question is from Mig Dobre of Baird.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Yes. Vince, just looking to clarify here, when you talk about volume sequentially into the fourth quarter, we had the one fewer selling day. Like you said, that's 1.5% hit. Are you essentially saying that because you won't have the same headwind in the fourth quarter, we should be expecting flat volume? Or are you saying that volume can actually pick up a little bit because you end up with one extra selling day?

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

Yes. I'm glad you asked for the clarification. So in the Americas segment than we are focused on, we had a 2.2% volume improvement year-over-year in the third quarter. My expectation is because of that one less selling day in the third quarter and the trends that we're seeing in our order book and sales through this day in October that we should see something at least as good year-over-year as that performance in the third quarter. So baseline, third quarter year-over-year, 2.2% or higher.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Perfect. Perfect. That's clear. And then, I wanted to ask a little bit about incremental margin. And I don't know if I missed this in your earlier commentary as to how we should think about it going forward, given the price cost dynamics. And also related to this, if I recall correctly, coming out of the second quarter, your bonus comp accrual was up something to the tune of $4 million year-over-year. I'm wondering if this builds further in the third quarter? And how we should be thinking about this if you perform according to plan for the full year?

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

Yes. So as far as incrementals are concerned, my expectation is that the fourth quarter will be somewhere in the range of 20% to 25% in the legacy business ex-Air Liquide Welding. Our reported incrementals, I believe, are around 10%, including Air Liquide Welding. And I expect that to be perhaps even a little bit less as we combine 3 months of Air Liquide Welding in the fourth quarter as compared to 2 months in the third quarter. So Air Liquide will to continue to be a drag on our reported incrementals into the fourth quarter. And I would peg our overall legacy business ex-acquisition at somewhere in the 20% to 25% range based on what we see in front of us today.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And on the bonus question?

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

As far as the bonus, we continue to accrue according to formula and that formula is roughly 26% of our operating profit ex the bonus. So no significant variances expected at this point in time as compared with previous accruals based on our formulas.

Operator

This concludes our question-and-answer session.

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

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

Thank you, Vince, and thank everyone for joining us on the call today. And we very much look forward to talking to you in February about our progression in the fourth quarter of 2017 towards 2018. Again, thanks again and have a nice day.

Operator

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