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LECO.OQ - Q3 2020 Lincoln Electric Holdings Inc Earnings Call

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## OVERVIEW:

Co. reported 3Q20 reported operating income of \$77.8m, diluted EPS of \$0.97 and YoverY consolidated sales decline of 8.5%.

## CORPORATE PARTICIPANTS

**Amanda H. Butler** *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

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

**Gabriel Bruno** *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

## CONFERENCE CALL PARTICIPANTS

**Bryan Francis Blair** *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

**Christopher M. Dankert** *Longbow Research LLC - Research Analyst*

**Dillon Gerard Cumming** *Morgan Stanley, Research Division - Research Associate*

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

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

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

**Saree Emily Boroditsky** *Jefferies LLC, Research Division - Equity Analyst*

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

## PRESENTATION

### Operator

Greetings, and welcome to Lincoln Electric 2020 Third Quarter Financial Results Conference Call. (Operator Instructions) This call is being recorded.

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

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**Amanda H. Butler** - *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

Thank you, Howard, and good morning, everyone. Welcome to Lincoln Electric's 2020 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](http://lincolnelectric.com) in the Investor Relations section.

Joining me on the call today is Chris Mapes, Lincoln's Chairman, President and Chief Executive Officer; and Gabe Bruno, our Chief Financial Officer. Chris will begin the discussion with an overview of our quarterly results and our cost reduction initiatives, and Gabe will cover our third quarter financial results in more detail. Following our prepared remarks, we're happy to take your questions.

But 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](http://lincolnelectric.com).

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

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

Thank you, Amanda. Good morning, everyone. I'm pleased to report strong third quarter results as we continue to navigate the issues associated with the global pandemic. It is important, and I'd like to highlight once again that our organization did an outstanding job operating safely in a challenging environment while servicing our customers and generating long-term value for our stakeholders. I'm very proud of our entire team.

As we move to Slide 4, our third quarter performance exceeded our expectations. Sales declines narrowed to 8.5% due to strong recovery momentum and retail channel strength. We held adjusted operating income margins relatively steady versus prior year at 12.6% on improved operating leverage, price management and \$27 million of cost savings benefits. This resulted in a 12.3% decremental margin in the quarter.

Adjusted earnings per share increased \$0.01 to \$1.10, and we generated top quartile returns on invested capital at 18.4%. Cash flow generation was strong at \$90 million, with 117% free cash flow conversion.

We continue to invest in the business to support our long-term strategic goals and remain focused on growth projects and operational efficiency. We returned \$29 million to shareholders through our dividend. Our balance sheet remains strong with increased liquidity and reduced debt levels and our confidence in the business model allows us to invest in the long-term growth, increase our dividend and resume share repurchases as part of our capital allocation strategy.

Moving to Slide 5. The business saw sequential improvement in demand trends through the third quarter across all reportable segments. While the pace of recovery has differed by geography, all geographies improved in the quarter, led by steady year-over-year performance across the broader Asia Pacific region, mid-single-digit percent declines in Europe and mid-teens percent declines in the Americas.

By products, demand for our standard equipment systems remained the most resilient, declining in a mid- to high single-digit percent rate, while consumable and automation declines improved to a high single-digit percent rate.

By end sector, approximately 45% of our revenue was exposed to growth with general fabrication and infrastructure, construction sector sales up in the quarter. Our automotive declines narrowed substantially as U.S. and Chinese auto production recovered to prior year levels in the quarter, driving higher demand for consumables.

Capital spending in the sector remained challenged. Heavy industry and energy compressed further in the mid-20% range on weak capital investments and low oil prices. Additionally, increased strength in the retail channel was notable in our Harris Products Group segment in the quarter, driven by the DIY sector.

As we approach the fourth quarter, we have ongoing concerns over the reemergence of COVID, OEM activity at the end of the year with their production plans and typical seasonal slowing that we have seen in October across all segments. We expect fourth quarter organic sales to decline at a similar rate as the third quarter.

Turning to Slide 6. Given uncertainty in the shape of the recovery, we maintained stringent temporary cost controls in third quarter and recognize increased permanent cost savings, which resulted in \$27 million in savings in the quarter. This substantially exceeded our initial savings plan of \$10 million to \$15 million. As a result, we now expect to generate \$80 million to \$85 million of cost savings in 2020, with approximately \$20 million of savings in the fourth quarter, split relatively between temporary cost savings and a \$10 million to \$11 million exit run rate in permanent cost savings. We expect this will result in fourth quarter decremental margins of high teens to the low 20% range.

Looking to 2021, we expect to generate \$20 million to \$25 million of incremental permanent cost savings in 2021, substantially in the first half of the year and an incremental \$4 million of temporary cost savings in the first quarter. These actions, combined with improving markets to generate top line growth position us to deliver our normalized 20% to 25% incremental margins in 2021, even with higher wage and incentive compensation costs next year.

I remain confident in Lincoln's position navigating into 2021 and our ability to capture growth as regions and end markets rebound. This challenging year has demonstrated the strength of our global team, our business model and our ability to invest in long-term value creation through a cycle while returning cash to our shareholders. It is these strengths that are the hallmark of Lincoln's 125-year legacy and brand.

Before I turn the call over to Gabe, I'd like to congratulate Steve Hedlund on his expanded role as President of both Americas Welding and International Welding. Steve has been with the organization for over 12 years. During his tenure, he's been instrumental in the development and growth of our strategy. We've opted to centralize the leadership of the 2 welding segments under Steve to accelerate our higher standard 2025 strategy, which leverages standardized processes, consistent global customer experiences, shared back-office services and product development platforms. After several years of investments to align the regional welding strategies, we felt that we're in an excellent position to leverage a more efficient leadership structure as we execute on our 2025 higher standard strategy.

And now I'll pass the call to Gabe to review third quarter financials in more detail.

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Thank you, Chris. Moving to Slide 7. Our consolidated third quarter sales declined 8.5% as the 1.2% benefit from price was offset by 9.5% lower volumes and 20 basis points of an unfavorable impact from foreign exchange. Our gross profit margin decreased 40 basis points to 32.2% as benefits from cost reduction actions and price management were offset by the unfavorable impact of lower volumes. Price/cost was relatively even in the third quarter.

Our SG&A expense declined 11.4% or \$17 million, reflecting savings from our cost reduction actions and \$2 million in lower incentive compensation. SG&A, as a percentage of sales, decreased 70 basis points to 19.6%. We expect an increase of approximately \$1.5 million in year-over-year incentive compensation expense in the fourth quarter.

Reported operating income decreased 12.1% to \$77.8 million or 11.6% of sales. Operating income results included \$6.3 million of rationalization charges. The quarter also included a \$3.2 million pension settlement charge in the Americas segment. Excluding special items, adjusted operating income declined 8.3% to \$84 million or 12.6% of sales, a 10 basis point increase versus the prior year.

Adjusted operating income benefited from \$27 million in cost savings and \$2 million in lower incentive compensation expenses. Our decremental adjusted operating income margin was 12.3% in the quarter. Our third quarter effective tax rate was 20.2% due to our mix of earnings and discrete items. This compares with 21.1% in the prior year period. We now expect our full year 2020 effective tax rate to be in the low 20% range, subject to the mix of earnings and anticipated extent of discrete tax items.

Third quarter diluted earnings per share decreased 17.1% to \$0.97 compared to \$1.17 in the prior year. Excluding \$0.13 of EPS from special items, adjusted diluted earnings per share increased \$0.01 from the prior year period to \$1.10.

Now moving to our reportable segments on Slide 8. Americas Welding segment's third quarter adjusted EBIT declined 20.2% to \$59.1 million. The adjusted EBIT margin declined 90 basis points to 14.7% as benefits from cost reduction activities, lower discretionary spending and lower incentive compensation expense were offset by the impact of lower volumes.

Looking at the top line, Americas Welding reported a 16.2% decline in organic sales, reflecting growth in general industries, construction and infrastructure as well as improving demand trends in automotive. The segment's price performance was reasonably steady with a 20 basis point decline in price.

Moving to Slide 9. The International Welding segment's adjusted EBIT increased 31.9% to \$13.4 million and the adjusted EBIT margin increased 180 basis points to 6.7%. Benefits from cost reduction activities, lower discretionary spending helped mitigate the impact of lower volumes.

Organic sales decreased 5.3%, reflecting ongoing recovery in key European end sectors and relatively steady organic sales performance in Asia Pacific compared with the prior year.

Moving to the Harris Products Group on Slide 10. Third quarter adjusted EBIT increased 59.3% to \$17.6 million. Adjusted EBIT margin increased 400 basis points to 17.2%. Strong growth in the retail channel, price management and cost reduction actions drove record margin performance.

Growth in the North American retail channel and broad improvement in Harris' other end markets resulted in a 12.8% increase in volumes. Price increased 11.6% on rising commodity costs, notably in silver and copper.

Moving to Slide 11. We generated \$90 million in cash flow from operations and a 117% cash conversion ratio from strong free cash flow. Working capital remained intentionally elevated but improved sequentially as we continue to leverage previously built inventory established to support the recovery. We expect our working capital ratio to improve sequentially in the fourth quarter.

We strengthened our liquidity position and maintained a strong balance sheet profile in the third quarter. As highlighted on Slide 12, we have maintained an investment-grade profile balance sheet with no near-term debt maturities. We further reduced our short-term debt by \$48 million in the quarter, which increased liquidity to \$602 million. Our strong cash flow generation and lower use of working capital in the fourth quarter is expected to deliver continued strong cash conversion performance.

Moving to Slide 13. We are continuing to maintain our disciplined capital allocation strategy. We invested \$12 million in capital spending and now expect full year capital spending to be in the range of \$50 million to \$60 million. We returned \$29 million to shareholders during the third quarter through our dividend program. And last week, we announced our 25th consecutive annual dividend increase by 4.1%.

Given the strength and confidence of our cash flow generation, balance sheet and top quartile return performance, we are maintaining M&A activity as part of our growth strategy, and we are now resuming share repurchases on an opportunistic basis.

With that, I would like to turn the call over for questions.

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**Amanda H. Butler** - *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

Howard, could you lead us into the queue of questions?

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question or comment comes from the line of Saree Boroditsky from Jefferies.

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**Saree Emily Boroditsky** - *Jefferies LLC, Research Division - Equity Analyst*

So volumes came in better than expected, and you noted that you're building some inventory and resuming share repurchases, but it also looks like you initiated a voluntary separation program, which potentially points to continuation of lower volumes. So could you just talk about how you're thinking about a recovery at this point? I know there's a lot of uncertainty, but maybe how it differs by region?

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

Well, Saree, this is Chris. Look, I think that when we think about the business and the recovery, to your point, the recovery still looks very choppy. I mean as you saw from our results, our Harris Products business segment had an outstanding quarter, and their business really positioned towards the HVAC market as well as the retail do-it-yourself marketplace. And we saw very strong demand from that particular area of the business.

Our Americas business continued to improve through the quarter, but it's trailing a little bit some of the recoveries that we're seeing in other areas of the world. And Southeast Asia has started to recover more quickly, and we were very pleased with our performance in the international space, especially in Europe. But I believe that's really a follow-up to the conversations we've been having with you relative to putting the inventories in place and ensuring that our customer service models could support our customers during this recovery. And I believe we're benefiting from that in that particular marketplace.

As we shared with you by segment, it's still also a little bit choppy. We saw some improvements. And now we've got 45% of that revenue exposed to what we believe are growing in sectors. But we still see some of the challenges associated with the oil and gas markets as well as some of the heavy industry markets that are out there, although we certainly believe that, that could be an opportunity for us as we're migrating through 2021, especially the latter parts of 2021. So still a very choppy demand marketplace, but very happy with the way our teams executed in managing the business in the quarter. And still very opportunistic about believing that we're going to continue to see improvements in the business moving into 2021.

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**Saree Emily Boroditsky** - *Jefferies LLC, Research Division - Equity Analyst*

And then Harris obviously had a very strong volume growth in this quarter. Could you talk about what you're seeing in retail demand versus -- your sell-in versus your actual customer demand? Was any of this related to restocking? And then maybe any guidance on how we should think about pricing in Harris in the fourth quarter and 2021?

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

Well, I'll let Gabe talk a minute about the pricing with Harris. But as it relates to the demand, look, we worked very closely with those channels. And at the end of the day, there wasn't anything that was unique other than the uniqueness that's driven by the demand model from consumer behavior centered around the pandemic. And obviously, I wouldn't expect it to repeat at that level next year nor do I expect it to necessarily repeat at that level as we're migrating into Q4. But great execution by the team in being able to meet that surge in demand that we saw in Q3. We still think that this is a very good business for us, and we're very happy with the continued improvements we've made at the Harris business. But I wouldn't expect necessarily that, that demand that we've seen in Q3 in that particular channel would replicate in -- would necessarily replicate at that level in Q4, although we would expect it would be above Q4 of 2019.

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. Saree, just to add a comment on pricing, as Chris mentioned. So we have a very disciplined pricing mechanism in place as commodity prices change. So the pricing changes that you saw in the third quarter were driven by the escalation in silver and copper prices, which we can't predict where that will head. But in general, as prices move on those commodities, we also have the discipline to adjust pricing as appropriate.

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**Saree Emily Boroditsky** - *Jefferies LLC, Research Division - Equity Analyst*

Congratulations on the quarter.

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**Operator**

Our next question or comment comes from the line of Nathan Jones from Stifel.

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

I just have a follow-up on Saree's question there on Harris, particularly on pricing. Copper is certainly up, but it's been very recent that copper has really shown any inflation here. And the story I've always got from you guys is that it's fairly difficult to push pricing through the DIY channel. The customers there have got some pretty good pricing power. Is this a little bit of taking advantage of some of the strong volume to be able to push pricing through there? And given that the pricing in the first half for Harris was pretty flat, should we expect, if commodities maintain where they are, to see this kind of pricing leverage through 4Q and the first half of next year as well?

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Well, Nathan, just to be clear, the retail channel, you're right, has a different dynamic in terms of its product mix and the commodity cost component within that sector. We're talking about largely the other portions of our Harris business that's tied into brazing and HVAC and the like. So that's the portion of business that really has the more significant exposure to the silver and copper content. And you're right, we did see more of the escalation in commodity costs on the silver side of our business during the third quarter. So that's a dynamic that will be different as copper prices change further.

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

Okay. So that doesn't sound like there should be much change in pricing outside of further changes in the commodity pricing. So is it reasonable for us to expect double-digit price increases for Harris over the next 3 quarters? Just -- I mean if you're just maintaining pricing where it is, the comparisons would imply that.

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Well, it would depend on where silver and copper prices go. So we tie our pricing mechanism to the change in those commodities. So if silver and copper continued to increase, then we'll adjust pricing as appropriate.

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

Okay. Got it. Some very good improvement on the international side on volume. Revenue only down mid-single digits there. Have you started to see, with the increase in COVID cases in certain parts of Europe, any changes in customer buying patterns over there as maybe they're getting concerned about lockdowns coming over again?

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

Yes. Nathan, not at this point. But I'm sure, you, like us, have been following some of the reports coming out of the media with the increases that they've had in some COVID cases across broad Europe. It's one of the reasons why we're still cautious as it relates to thinking about how the business will perform as we're migrating through Q4 and into Q1, just the uncertainty associated with that. But I can share with you that at this point in time I'm unaware of any changes in the customer demand dynamic driven by COVID across our European businesses.

**Operator**

Our next question or comment comes from the line of Bryan Blair from Oppenheimer.

**Bryan Francis Blair** - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Gabe, just a level set. What's the breakout of expected structural cost savings as you ramp to the \$10 million, \$11 million quarter level?

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. So when you think about the structural changes, we're looking at \$10 million to \$1 million types of savings exiting the fourth quarter. And so as we progress into 2021, we'll see most of that have a real impact in the first half of the year and then we'll anniversary that. So think about it, \$10 million to \$11 million trajectory into 2021.

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**Bryan Francis Blair** - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Got it. Understood. I should have clarified. I meant by segment, if we think about modeling the upcoming quarters?

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Okay. So about 3 quarters of our structural actions have been on the Americas side. So I would estimate 3 quarters Americas Welding, 1 quarter international welding.

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**Bryan Francis Blair** - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Got it. Okay. And then a higher level one. I was hoping you could offer a little more color on how the pandemic's impacted customer engagements, overall interest on the automation side? And we know capital spending is pressured pretty much across the board at this point for obvious reasons. I would assume that your value proposition and the longer-term role of automation and additive has only been enhanced though. Just curious if you can comment on that.

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

Yes. Bryan, look, I am aligned with your perspective on the longer-term structural dynamics of seeing that potential behaviors from the pandemic, whether that's associated with restoring of activities, whether that's associated with driving automation, to be able to ensure a work environment that maybe either requires fewer individuals or allows you to have individuals in a cell to be able to complete a productive process more effectively. I believe that all of the structural drivers for automation are actually probably amplified from the pandemic. But I'll also share that we know that our automation business is going to have some challenges associated into Q4. And we're expecting that as we're migrating into 2021, we'll start to see some of those improvements. But most of that automation, many times, is an interactive process, a collaborative process with our customers in driving and developing and engineering and installing that automation. And that is a more difficult process in the pandemic.

An example would be some of our new technologies that we have on our equipment side of our business, our new HyperFill product. So we're very excited about that technology on the equipment side. But we can actually develop a webinar and provide that webinar globally to industries and customers and individuals who, we believe, could be interested in that particular technology for their applications. So we can still create customer engagement. Sometimes it's difficult to create that customer engagement on pieces of the automation side because those are individualized specific solutions built for those customers. So we really need to see some of the ability for that collaboration to occur more easily.

We still have opportunities. We still have customer meetings that are occurring. But they're not occurring at the pace that they otherwise would. So I completely align with, I believe, the long-term structural improvements in the automation opportunity. And we just need to migrate through the rest of the portion of the pandemic for us to be able to mitigate some of the impact of an inability to as easily have that collaboration as we would like.

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**Operator**

Our next question or comment comes from the line of Mig Dobre from Baird.



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

Gabe, I apologize. I missed your comments on incentive comp, and I'm wondering if you wouldn't mind going back over that. Where was incentive comp in the third quarter year-over-year? And what is your expectation for the full year now in terms of the decline in incentive comp?

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. So Mig, we mentioned that incentive comp in the third quarter was down \$2 million year-over-year, and we do anticipate an increase year-over-year in the fourth quarter by about \$1.5 million at this point.

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

And for the full year, where do you shake out the full amount?

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

We were at \$13 million -- \$15 million -- it's about \$13 million to \$14 million type overall change.

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

Okay. Okay. That's helpful. So then as we're kind of looking at the temporary savings that you have this year, the, call it, \$55 million to \$60 million incentive comp, I'm presuming that's part of that into 2021, is there a sense for how these temporary savings might be becoming perhaps headwinds with the relationship with volume or anything else that we kind of need to be aware of or think about?

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. So Mig, just to make sure we're clear, I mean, the incentive comp change is separate from the temporary cost savings, right? Just want to make sure that you've got that right. And then when you think about -- so temporary savings then, and right now, we're anticipating continuing to operate in this pandemic environment into the first quarter. And that's why we mentioned that we do expect a favorable impact still on temporary savings into the first quarter. So -- and then the run rate is about \$10 million. So last year's first quarter, we saved about \$6 million in temporary type costs. So year-over-year, it will be about \$4 million during that first quarter of 2021. That's what we anticipate right now.

And then, Mig, as we migrate then throughout 2021, then you have the dynamics of anniversarying the impact on volumes in the second quarter and that we've pulled back any discussion at this point on temporary cost savings entering in that environment.

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

Okay. Then if I may switch gears and talk a little bit about segment margin and going to Harris Products, I mean, I'm yet to see a quarter where you had 17% margin in the segment. So you talked about pricing. I'm presuming that pricing hasn't been that much of a contributor to margin, but if it has, I'd love to hear about it. And then what's sort of the right way to think about the cadence of margin going forward, just given how unusual kind of the third quarter seems to be here?

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

Mig, this is Chris. I would tell you that, first of all, just a wonderful work by our Harris Products team in the execution in the quarter. But I would tell you, when I break that quarter down, we actually had 3 or 4 very key strategic pieces that all fell into place all in the quarter. The first is the retail do-it-yourself channel, which we've seen in our portfolio and other portfolios just had very strong demand as the consumers went to that channel and actually were looking for products like the Lincoln product as it relates to bring that back into their garage, their home, that consumer activity. That was very strong for us.

The second piece of the business there that was very strong is that we've all heard about the consumer who is also doing the home remodeling. And guess what, that can come back to our products on the plumbing side. That can come back to our products on the HVAC repair side. And we saw improvements in that portions of our business also. And then we have an HVAC piece of the Harris business that was solid. And all of those things, in the aggregate, were really executed on well by our Harris business in the quarter. I still think about our Harris business, though, Mig, as we've talked about it for a long period of time, which is building a business model that allows our Harris business to be able to perform at where we'd like to see our broader operating margins for Lincoln Electric in total through the cycle. So I will tell you that the 17% performance was much stronger than what I had expected from the business. And I don't believe that our current business has that kind of sustainability in it.

You talk about the pricing. There was this strong movement in copper and very strong movement year-over-year in the silver pricing, which impacts the price component within Harris. So great performance. We believe it's going to continue to be a solid performer for us. But I will tell you that I'm not confident today that we believe it will be a continuing 17% operating profit business for us, at least not in the strategies that we have for that business over the short term.

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. So Mig, just as we've been talking the last few quarters, I think that mid-teens trajectory on EBIT margins is kind of where we are at still.

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

Understood. And then if I may, one last question. International margin, also, quite good, and I understand that volume help. The real question for me here, though, is what sort of revenue do you think you need at this point, given the amount of restructuring that you've done over the years in order to be able to generate double-digit margin in this segment? I'm talking about annual type revenue run rate here.

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

So, Mig, as I spoke at the last call we had, second quarter call, we still believe that we're anchored at some volume increases of the 2019 baseline. So I think we're right on track with our progression in our business. You're right, we've continued to look at opportunities to institute sustainable cost changes in our business model, and we're still confident that some volume increases of 2019 will get us into that double-digit type EBIT margin.

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

I keep asking the question just to see if the answer changes.

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**Operator**

Our next question or comment comes from the line of Mr. Chris Dankert from Longbow Research.

**Christopher M. Dankert** - Longbow Research LLC - Research Analyst

Congrats to Steve. I wonder if we could dig in a little bit. We spent a lot of time in the past on the facility rationalization, but I guess, kind of focusing on the higher standard 2025, where are we with the IT standardization, shared services, some of those investments? And kind of what are the time frame on the softer investments, I suppose?

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

Well, I think the nice thing is that a host of these investments we had been making within the business prior to the pandemic and because of our confidence in the long-term business model, we've been able to continue to invest in those. So one of the foundational elements of that was actually the implementation of a CRM system globally. So we would have better information and data and ability to engage with our customers, and that has been implemented on a global basis.

I would tell you, we're probably 90%, 95% of the way there on that particular tool. We're currently now bringing a new front end to our customer experience. We needed to really change the game in the way that we presented our products from user experience perspective. We have a team of people that are working through that investment. That investment is about an \$8 million to \$10 million investment for us internally. We'll be starting to implement a portion of that probably in Q1 of 2021 with an implementation throughout the year.

I believe it will change the user experience for people that come to Lincoln Electric, want to learn more about our products, learn more about our solutions. And that's another one of those large investments that we have within the business. And then the other one that I'm very excited about is our teams have been very aggressively looking at how we're implementing leverage across shared services within the business. And that's been driven really around the world, but we continue to work on that.

I would tell you that we're in the early innings of that particular work, but that's one of those long-term productivity objectives that we have for the company. And it's certainly there in the process side, the operational excellence side of our higher standard strategy. So I'd see us just continuing to advance those 4 key areas within the higher standard strategy. Obviously, it's a strategy we said we wanted to execute as we're migrating towards 2025, but continuing to make progress. Several of them well into implementation, a handful that we're just starting to invest in now.

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**Christopher M. Dankert** - Longbow Research LLC - Research Analyst

Got it. That's very helpful color. And then just to dig in, again, we've already covered how strong international was, but it sounded like some of the inventory investment you've done in the second quarter kind of paid off in the third quarter. We were struggling with (inaudible) over a year ago there. Would you say that the working capital investment was actually a share gain benefit in the quarter here? And does that carry into the fourth quarter for Europe specifically?

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

Yes. It's difficult for me to say that it's a share gain. We've said over and over that I really don't think about share from a quarter perspective. We need to show quarter after quarter after quarter of consistent improvement before I start to think internally that maybe we have created a longer-term structural improvement within share. But I do believe strongly that Lincoln Electric's global decision, back in Q1, to actually build inventory to support our customers was the right decision.

And we did that in Europe. We did that in Southeast Asia. We did it here in the Americas, and we're running at a higher inventory level today than what we traditionally do and probably we'll need to exit the year at a slightly higher average operating working capital ratio than what I've normally seen for the business. But because of the uncertainty and the risks associated with COVID, even though we've shown we can operate in that environment, even though we've shown that our supply chain is pretty resilient and we can work through those challenges, the risks associated with that still lead us to continue to be cautious as it relates to the business, which means we want to make sure we can support our customers.

So we're going to continue to ensure that we have probably slightly more inventory to ensure we can do that moving forward as we're exiting 2020 and moving into 2021. But I'm uncomfortable saying that, quite frankly, it's created a share benefit. But I can tell you that customer service metrics that we're reviewing for that team are just exceptional. Our ability to continue to meet expected demand from our customers across the region are really the best that they've ever been for that particular business.

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**Operator**

Our next question or comment comes from the line of Mr. Walt Liptak from Seaport.

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

I want to ask one about the cadence of the recovery. I think you've talked about this in the past, as you guys -- as we all know, you guys touch a lot of industrial sectors. So Chris, what do you -- with the revenue coming in stronger and the tone seems to be pretty upbeat, is this a V-shaped recovery or is this -- how are you thinking about it maybe, I guess, you're probably looking at your monthly improvement, what are you thinking about with the cadence of the recovery that's happening?

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

Yes. Walt, it's difficult for me to identify the current recovery as a V-shaped recovery. My experience in the past tells me that when those occur, they've got less choppiness associated with them. They've got more certainty as it relates to the speed and the acceleration out. Now there's no question that the business went down very materially like you normally see in a V. But I think the cautiousness associated with COVID and the fact that beyond this, you've also got some challenges associated with oil and gas, which are outside of the challenges associated with the pandemic.

We've really not seen the heavy industry piece of our business start to show some of that V-shaped like recovery. And then yet inside it, we see a change in the retail channel, which is obviously much greater than what any of us expected. So I also would tell you that for me to identify this as more of a V-shaped recovery, then we probably should be expecting to be closer to prior year levels as we're exiting 2020, and we're not going to be able to accomplish that as we're talking about still being at about the run rate we saw in Q3 as we're migrating into Q4 with the risks associated with demand. So solid recovery, expecting a continuing recovery, but I probably don't identify it in the industrial space as a V-like recovery.

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

Okay. Great. And then I appreciate the comments, Chris. In the presentation, you guys broke out -- I think you broke out the consumables versus the equipment. I wonder if we can go over that again, and what are you seeing in the differences between consumables and equipment?

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. (technical difficulty) our core equipment business -- I'm sorry about that, I'm mute here. Well, so just to reemphasize some of the key things. So we have seen continued good progression in our core equipment business, in that mid- to single-digit percent range. And that has continued over quarters, right? So we're pretty pleased in our positioning of our product portfolio, where we introduced as new products and continued positioning there. Consumables has lagged a bit. The equipment side, which we know different cycles is a little bit unusual, but that's really going to progress with how we see factories start to reengage.

And then as you look at automation, automation, while sales-wise were at the high single digit percent, we're still seeing that hesitation in committing capital. So we would expect automation to continue to -- at a softer pace into the fourth quarter. And until we start to see some commitment to capital, and that would change the trajectory of our overall automation business. And keep in mind also that automation follows a 3- to 6-month lag in orders. So that's kind of a big picture view on how we've progressed on the product lines.

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

Okay. Yes. On the consumables lagging, the consumables, are those sold direct to the OEs? And that's where you're seeing them reluctant to add inventory and the reopening slower or is it through the distribution channel that there's more inventory that could refresh?

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

Yes, Walt, this is Chris. It's in both baskets. Obviously, when you got our heavy industry segment, the oil and gas segments that are down, those drive a good bit of consumables. Some of those relationships are direct relationships, but we've also seen some shallowness in the distribution channel also from a consumables perspective. So I'm not -- I don't believe it's necessarily targeted towards only one segment or only one channel. It's broader than that.

**Operator**

(Operator Instructions) Our next question or comment comes from the line of Dillon Cumming from Morgan Stanley.

**Dillon Gerard Cumming** - *Morgan Stanley, Research Division - Research Associate*

A couple of questions on the end market backdrop. I want to start with infrastructure, kind of curious on what you're seeing there. That business is clearly kind of holding in better than the rest of the business. But I guess, given the broader pressure on state and local budgets, given that we're working off of a fast extension and not kind of a larger transportation bill, do you feel like some of that sequential recovery and some of the strength you've been seeing there is kind of sustainable heading into next year?

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

Well, as I stated, I think the Harris team did an exceptional job of executing in Q2. There's certainly an element of demand that's there for Harris that was an outcome of some of the consumer behavior relative to the pandemic. And so we know that that's a piece of that demand driver that probably will not replicate itself, certainly not at this time next year. We would still expect Q4 to be better for them in that channel, but I'm not sure that we feel comfortable saying that, that demand level would be what it was in Q3. The rest of the demand profile for the Harris business, though, really comes from some strategic investments and some new products that we've been making in that area that actually support the brazing alloy side and some products for the broad HVAC industry. So quite frankly, those should be able to continue to show growth as we're exiting the year and moving into 2021. So very solid performance. But at the end of the day, I don't know that I can say that the Harris business will perform at that kind of demand level as we're moving into next year.

**Dillon Gerard Cumming** - *Morgan Stanley, Research Division - Research Associate*

Okay. Got it. That's helpful. And then maybe to wrap it up on energy. I think you guys have made a comment that, that business is actually not really seeing the same level of declines versus the rest of your portfolio over the past few quarters. And I guess, it's pretty clear we're kind of in the early stages of a multiyear kind of downturn there, at least an extended downturn. Are you seeing any opportunities in terms of either new geographies or new product lines you kind of haven't historically operated and that might kind of help to offset some of the more structural demand headwinds in that business?

**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Well, the detail and just to kind of reinforce that a bit, we did see an acceleration of weakness in energy, particularly on the oil and gas side. So really, there's nothing we can see short term that's going to change that trajectory, particularly with the price of oil in that low 40s and just south of that. So that's going to be -- continuing to be a challenged environment.

Now within that, we are seeing a good strong positive momentum in renewables. And for example, in wind. So we saw during the quarter a good positive trend. It's a smaller component of our overall energy and industry segment, but we are seeing positive there. And we do expect that to continue into 2021. But in general, the oil and gas markets, as we know, is weak. We did see an acceleration of that in the third quarter, and we continue to see that we'll expect that into 2021.

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**Operator**

Our next question or comment is a follow-up from Mr. Nathan Jones from Stifel.

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

Just looking for a little bit more color on the cadence through the quarter. You guys had previously disclosed the July order rates were down in the high teens and have said August order rates had improved from that level. Organic revenue came in down only about 8.3%. So I'm wondering just how strong September was? And then you did call out in the press release that October order rates had moderated slightly due to seasonality. Can you talk about whether that's in line with normal seasonality or a little bit better, a little bit worse?

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. So Nathan, let me just try to give you a big picture first on the third quarter. So as you mentioned, we did discuss the order trends in July being the high teens. While we didn't provide any color on August except as improvement, we did see a pretty nice step change in August. And it's stuck. So we saw the continuation of the level of business activity in August that also progressed into September with no meaningful difference in the overall trajectory between August and September.

Now that said, as we enter the fourth quarter, I mean, there's a lot of choppiness, as you can imagine, in our business. And there's normal seasonality that we would otherwise expect. I mean the mix of business could evolve. We're pretty confident at this point based on what we see that our trajectory and the overall organic sales to be commensurate to what we saw in the third quarter, but with normal seasonality is what we see.

Now the one thing I would add also, Nathan, is to keep in mind that in the fourth quarter, there is 1 less workday than the third quarter -- year-over-year, I'm sorry. And then there was 1 more workday in the third quarter year-over-year. So at this point, we would expect that it's normal seasonality. But based on what we see with -- in our business, that organic sales level in the fourth quarter, that would be commensurate with third quarter is kind of what we see.

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

So you're saying that the 4Q organic revenue number should be roughly about the same. If we adjust those for the extra day in 3Q and the 1 last day in 4Q, that implies the underlying kind of daily sales rate is continuing to improve, 4Q versus 3Q?

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**Gabriel Bruno** - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

I would say, Nathan, to hold steady. I mean I think if we're thinking about overall, just holding steady at this point. Still got a long ways to go in the quarter, but right now, we would say we're holding steady.

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**Operator**

Our next question or comment comes from the line of Steve Barger from KeyBanc Capital Markets.

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

I'm going to ask a similar question around 1Q next year. You've got a negative 7.5% revenue comp. Is that weak enough relative to how you're seeing end markets trends that 1Q can be up year-over-year? Or do you think some of the challenged end markets mean another quarter of negative revenue growth in 1Q of '20 -- 1Q '21?

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

Steve, that's a great question. And I'd tell you, it's just really hard for us to get that kind of visibility. I think we'll be at the cusp. I do think that, quite frankly, sometime in that first half, we're going to migrate favorable. Whether we can accomplish that in Q1 or Q2 is just a little bit difficult for us right now. I mean you know this business well. I mean we could see, quite frankly, the large OEM portion of our business actually moderate in Q4 because maybe they're doing inventory work, maybe they've decided that they're not going to push through the rest of Q4. And then we could see some of that demand move into Q1. It could quite frankly move the other way. And still very concerned on a global basis about a reemergence of COVID and what that may mean to the demand model. So I think we're very close to that tipping point, but probably uncomfortable saying whether we'll be able to accomplish that in Q1 versus Q2 as we continue to see the improvements in the business globally.

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

Understood. And so I guess that kind of goes to the next question where I was just going to say, do you expect a more normal revenue cadence, meaning 2Q peak and 4Q kind of flat or trending slightly up sequentially from 3Q? I know part of that depends on the cadence that you just talked about, but it seems like you have enough visibility in some of the end markets to start thinking that you're returning to a normal cadence, is that fair?

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

Look, I think it's fair to say that we should be able to see that as long as, quite frankly, we recognize the challenges associated with the reemergence of COVID or some other issues. Barring any one of those other variables becoming a larger impact, then, I'd say, yes, we can see that cadence. And that's why we've got confidence in believing that we will migrate back to that level in the first half of 2021.

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

Got it. And I'm sorry if I missed this, but given the mix you've talked about in the Americas, should we expect that segment to be down more than international on a year-over-year basis in 4Q? I mean, obviously, it was down a lot more in 3Q.

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

Yes, you should. And -- but I would tell you that it's a couple of things, Steve. There is a mix and a segment level inside of there, which leads me to that. The other thing is, let's not forget that the Americas business, as it relates to the recovery from COVID, has also been trailing that international business. So I would expect that, that would continue, although I am expecting improvements in our Americas business from Q3 to Q4.



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

Got it. And then last one for me. Gabe, year-to-date free cash flow is down versus prior year. Is that the cash cost of restructuring, and then we would expect to see the positive swing of free cash flow conversion to improve in '21? Or can you just talk about the puts and takes of free cash flow this year?

**Gabriel Bruno** - Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer

Yes. So overall, Steve, the free cash flow position is really driven by overall changes in sales, right? So we do have some increased investments intentionally around inventories. You have the timing impacts of the decreases and increases on receivables, but nothing truly different than that. Not a significant impact, as you mentioned, on structural changes, some of the rationalization actions. So I wouldn't see that as a driver. But it truly is driven by top line sales changes and then the investment profile and working capital. We would expect also, Steve, to see an increasing level of spend on capital. So you saw that we were challenged a bit in executing on some projects, but we're very much focused on new product introductions and productivity initiatives within our plans. But I would expect also the capital spending to be increased from what you saw in the third quarter.

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

That comments for '21?

**Gabriel Bruno** - Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer

Yes, into 2021.

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

Got it. And if you have a top line increase, then presumably, you would have working capital build next year as well. So we should think about both those things as factors to free cash flow?

**Gabriel Bruno** - Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer

Yes. Although as we've talked, we've been conservative in our positioning and working capital. And we'll continue to be conservative in our positioning as we're migrating through this pandemic.

**Operator**

Our last question or comment comes from the line of Chris Dankert from Longbow Research.

**Christopher M. Dankert** - Longbow Research LLC - Research Analyst

I heard over a year since that first official launch and the first beta orders in the Additive Manufacturing program, is there anything to highlight there either in terms of program wins or technology development? Just kind of looking for any comments on Additive?

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

Yes, this is Chris. As you would expect, with Additive being a new technology, and it's very individual to what the customer might be looking for from a component perspective, much like our automation business, our ability to drive engagement, the last few months have been a little bit



more challenged. But we do have one new strategy that we're implementing and that we're very excited about. So what we've decided to do is we are going out to global OEMs that we know should have an interest in this technology and talking to their R&D centers as well as other R&D centers at universities and Oak Ridge labs and other individuals like that around the world, and we're going to start looking at placing some of these systems in those R&D labs.

We believe that placing them in the R&D labs will allow those large OEMs to be able to get become more familiar with the technology, see how the technology can be utilized within their business practice. We're doing this because of some of the challenges associated with providing that in the current COVID environment. So I'm excited about that. I think it will continue to advance the technologies across key OEMs and key industries who are looking at ways to utilize Additive, and we still like the business long term. We recognize that we're still incubating this new business. And as I mentioned, certainly COVID has created some challenges for that particular business in the last several months.

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#### Operator

Thank you. Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the call back over to Mr. Gabe Bruno for closing remarks.

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#### Gabriel Bruno - Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer

Thank you. I would like to thank everyone for joining us on the call today and for your continued interest in Lincoln Electric. We look forward to discussing the progression of our strategic initiatives and cost reduction programs in the future. Thank you very much.

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#### Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may now disconnect. Everyone, have a wonderful day.

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