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LECO - Q4 2019 Lincoln Electric Holdings Inc Earnings Call

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OVERVIEW:

Co. reported 4Q19 operating income of \$82.7m and diluted EPS of \$1.03.



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PRESENTATION

Operator

Greetings. And welcome to the Lincoln Electric Fourth Quarter and Full Year 2019 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 and Communications. You may begin.

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

Thank you, Carmen, and good morning, everyone. 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 full year results, 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 discussed financial measures that do not conform to U.S. GAAP. And 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. Chris?

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

Thank you, Amanda. Good morning, everyone. Our full year results demonstrate the business resilience in a challenging portion of the cycle. We remain focused on serving customers, executing our strategic initiatives and investing in long-term growth to deliver value to our shareholders. As we celebrate our 125th anniversary in 2020, we are confident that this balanced approach continues to position the business for long-term growth and value generation for all of our stakeholders.



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In 2019, we generated record cash flows, 113% cash conversion, top quartile returns and returned \$411 million to shareholders to \$118 million in dividends and \$293 million of share repurchases. We did this while working to mitigate the impact of decelerating global industrial production trends and weak capital spending.

Our net sales declined 80 basis points to \$3 billion with 3.5% lower organic sales, largely driven by softer demand for consumables and automation systems. We successfully offset the impact of lower volumes in our core business by aligning operations to demand through reduced hours, lower incentive compensation and discretionary spending. Acquisitions unfavorably impacted our consolidated financial results. We reported a 50 basis point decline in our full year adjusted operating income margin to 12.9%, with a 69% decremental margin. If excluding acquisitions, our adjusted operating income margin would have held relatively steady, with a 10 basis point decline to 13.3% in the remainder of our business, which represents an approximate 15% decremental margin.

Moving to Slide 4. Fourth quarter organic sales trends weakened through the quarter, driven by a 5.7% decline in volumes. Two persistent key factors impacted demand. A broad reduction in global industrial production rates across most of our end sectors lowered demand for consumables. And a slowdown in capital spending and project deferrals reduced orders for our automated systems. This has resulted in 4 quarters of an industrial downturn in our sector.

On a global product line basis, we incurred a high single-digit percent volume decline in both consumables and automation systems. Equipment volumes were relatively steady in the quarter. Investments in commercial initiatives to accelerate new product launches, a 100 basis point improvement in our equipment Vitality Index of new products and expansions in our global network of tech centers to 38 are all driving our equipment demand despite challenging market conditions.

Looking at end market trends, the incremental slowdown in global industrial production accelerated decline in demand in key end sectors such as automotive, heavy industries, energy and construction infrastructure in the quarter. General Fabrication and the oil and gas portion of energy were flat to up in the quarter with strongest performance from international customers.

Moving to Slide 5. Given the deceleration in fourth quarter sales and continuing similar year-over-year decline through January, we're cautious on any top line or earnings growth in the first half of the year. We are maintaining the cost reduction measures we implemented last year, given these current macro uncertainties. In addition, headwind from higher expected incentive compensation and a projected higher tax rate in 2020 will reduce earnings. As we have done during previous challenging cycles, we are now freezing senior management wages. We're also implementing additional cost actions across our platform to achieve greater productivity. We expect these actions will contribute approximately \$15 million to \$18 million of annualized cost savings beginning in the second quarter of 2020. But substantially, all of the benefits are expected to be realized in the second half of the year. We will be monitoring conditions through the year and are evaluating additional contingency measures, which we can implement if conditions merit.

In 2020, we'll continue to prioritize capital for both organic and inorganic growth. We expect to invest \$65 million to \$75 million in capital expenditures, in line with our 2019 spend. The board recently increased the dividend payout rate by 4.3%, marking our 24th consecutive increase. We will also continue to execute share repurchases to achieve our 1.75x to 2x gross debt-to-EBITDA target. While a challenging environment, we are well positioned with a strong balance sheet and cash flows to invest in the long-term growth, innovation and productivity improvements to generate value for our stakeholders.

On a final note, on 2019, it was a record year for our safety performance across our company, and we exceeded each of our sustainability goals in the year. This could not be accomplished without the dedication of our employees to building a safe and sustainable company.

And now I will pass the call to Vince to cover the quarter in more detail.

Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Thank you, Chris. Moving to Slide 6. Our consolidated fourth quarter sales declined 1% as a 5.9% benefit from acquisitions was offset by 5.7% lower volumes, an 80 basis point decline in price and a 30 basis point unfavorable impact from foreign exchange. Our fourth quarter gross profit margin



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decreased 100 basis points to 32.7% as positive price costs, including a \$1.8 million LIFO credit was offset by weaker operating leverage and unfavorable mix, primarily from automation systems and acquisitions.

Excluding acquisitions, the gross profit margin would have decreased approximately 10 basis points. Our SG&A expense declined 3.3% in dollar terms as lower incentive compensation expense and lower discretionary spending offset added SG&A from acquisitions.

SG&A as a percent of sales decreased 50 basis points to 20.3%. Reported operating income decreased 12.9% to \$82.7 million or 11.2% of sales. Operating income results included approximately \$8.9 million in special item noncash charges, primarily related to rationalization and asset impairments in our International Welding segment. Excluding special items, adjusted operating income declined 5.3% to \$91.6 million or 12.4% of sales, a 60 basis point decline versus the prior year. Excluding the unfavorable impact from acquisitions, our adjusted operating income margin would have been flat year-over-year at 13%.

Our fourth quarter effective tax rate was 20.6% compared with 8.1% in the prior year period. Excluding special items, our fourth quarter tax rate was 20.4%. This compares with 14.7% in the prior year period. We expect our average full year 2020 effective tax rate to be in the low- to mid-20% range, subject to the future mix of earnings and the timing and extent of discrete tax items.

Fourth quarter diluted earnings per share decreased 23.7% to \$1.03 compared to \$1.35 in the prior year period. Excluding special items, adjusted diluted earnings per share decreased 10.9% to \$1.15, reflecting the impact of lower organic sales.

Now moving to the geographical segments on Slide 7. Americas Welding segment's fourth quarter adjusted EBIT dollars declined 12.7% to \$75 million. The adjusted EBIT margin declined 160 basis points to 16.1% as lower incentive compensation, positive price/cost and cost management actions were offset by lower volumes. Excluding the weakness in our automation business, the segment's adjusted EBIT margins would have held steady versus the prior year with a 17% decremental margin.

Looking at the top line. Americas Welding reported an 8.2% decline in organic sales against a challenging prior year comparison. Americas Welding volumes declined 6.5%, largely due to a high single-digit percent decline in consumables, reflecting a broad decline in industrial production across our primary end market sectors.

Automation demand remained challenged due to weak capital spending, but the rate narrowed to a low double-digit percent decline in the quarter. We achieved modest volume growth in equipment on continued demand for our new solutions. The segment's 1.7% lower price reflects the removal of surcharges in the U.S. business. We expect similar pricing performance through the first half of 2020 until we anniversary the surcharges. Americas welding sales also benefited 4.3% from the fee automation and additive acquisitions.

Moving to Slide 8. The International Welding segment's adjusted EBIT decreased 5.9% to \$11.6 million, and the adjusted EBIT margin declined 30 basis points to 5.2%. Improved European mix and benefits from rationalization and integration activities helped to mitigate the impact of lower volumes. Organic sales decreased 8.1%, primarily volume declines in Europe due to weaker macroeconomic conditions in France and Germany and softness in the Middle East.

Moving to the Harris Products Group. Fourth quarter adjusted EBIT increased 25.3% to \$10.7 million. Adjusted EBIT margin increased 110 basis points to 13.1%, unfavorable mix, accretive acquisitions and productivity improvements. Volumes increased 5.7% on continued solid demand in the OEM channel, and aluminum products and in the retail channel. Harris also recognized a 7% sales improvement from an acquisition in late 2018.

Moving to Slide 10. Cash flows from operations increased 23.3% to \$123 million, reflecting improved working capital and lower tax payments, which helped generate a 150% cash conversion ratio. Our working capital ratio increased due to the lower sales volumes.

Moving to Slide 11 and our capital allocation. We deployed \$118 million in the quarter, paying \$29 million in dividends, reflecting the 21% higher dividend payout rate and we purchased \$71 million in shares. We also invested in the business with \$16 million in capital expenditures. As noted in our press release, our board approved a new share repurchase program, which authorizes the company to repurchase up to \$10 million of



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additional outstanding common stock. This authorization, in addition to the 2.8 million shares remaining from the prior program has no expiration date.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from Saree Boroditsky with Jefferies.

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

In your slide that you highlighted the improved demand in APAC. Could you provide any color on what you saw by end market there? And any indication if you expect to be impacted by some of the factory shutdowns and supply chain issues occurring in China during the first quarter?

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

Well, certainly, we're watching and concerned about the impact that we may see from the coronavirus, relative to our business as well as our customers' businesses as we're migrating through the first couple of quarters of the year. To provide you with an update on the Lincoln Electric businesses. So our facilities there, we were intending to start our facilities back up on February 10. As you may be aware, that requires not only a governmental approval but also a provincial approval. We have been working with the government to receive those approvals. Although at this time, we've been unable to operate all of our facilities there at this point. We have one facility that's operating, but only at about 25% capacity. So some of those facilities have been closed because of the Chinese New Year for nearly a month. We'll continue to work with the government as in our ability to be able to get those up and operating. And then, I think, we'll have to see what the visibility is to our supply chains, and our ability to continue to operate as well as our customer supply chains and their ability to get their facilities up and operating. So I certainly believe it will be an impact for us in Q1 and probably trend into Q2 as they work through those supply chain issues. But confident that we'll be able to work through those issues.

On a more important note, I'm unaware of any of our employees that have been -- that have contracted the virus, and we did not have any operations in that broad Wuhan area.

As it relates to the demand side in that Southeast Asia area. As you may be aware, we had placed technical centers in that region over the last couple of years. I was actually in our Singapore office in the January window, talking to the team. They just had some very good execution of some customers that came through that particular region. We actually had some nice offshore activity that I know was executed on in that particular marketplace. As well as seeing some benefits from offshore wind that are actually moving through that area of the world. And then we had several equipment wins that occurred there in that marketplace throughout 2019. So it was broad. But I would also say, Saree, that I wouldn't necessarily say that those wins may be representative of those segments on the global market basis. Other than certainly we see offshore wind and wind continuing to be one of those markets, where we think there could be some opportunities for us as we move into 2020.

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

I appreciate the color. Then just in light of the new share repurchase authorization in place. Could you just talk a little bit more about how you're thinking about capital deployment and the cadence of share buybacks? Especially given that, I think with the new authorization, it represents around 20% of your share count?

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Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Right. So I would say that our priorities haven't changed in this market or our experience in 2019, Saree. We're still focused on growing the business, reinvesting in our own capital stock and identifying those opportunities around M&A that, that may be attractive, that fit our strategy and are priced appropriately. And so I would tell you that our outlook for 2020, 2020 is to continue our share buyback activities, at least at a maintenance level, and be opportunistic, depending upon those factors as well as our share price to take our share repurchase activity and drive our total gross debt-to-EBITDA to within the range that we've established for our capital allocation planning.

Operator

Our next question comes from Joe O'Dea with Vertical Research.

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

With respect to the additional cost actions planned for 2020. Just now that we're 4 quarters into volume declines in the Americas segment. And so why the cost actions now? Why not earlier? Is a matter of -- as you assess the outlook, it's more about persistent pressure that you're anticipating? Just sort of timing around some of these additional cost actions?

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

Yes. Look, my perspective on it would be that we're actually accelerating the cost actions. If you take a look at some of our ratios as we migrated through the year, you saw some slight improvements in our SG&A ratios within the business. That was, of the cost actions that we were taking in 2019 as we were trying to understand the extent of the challenges that we were experiencing in the marketplace. And especially in the Americas side of the market, you also had the headwind associated with the acquisitions that were coming in and some of the SG&A associated with that piece. The announcements that we've made today were things that we have been working on for a few months. So it wasn't as if this was just a response to the end of the year. The activities that we're doing here internationally, I have reviewed and seen over the last couple of months. But we wanted to get them in front of the market today, so that they could see the next step of activities. But what I really think of our approach to this, we view that, quite frankly, we made some cost initiatives to try to mitigate some of the volume impacts. Those volume impacts have continued to accelerate some as we move through 2019. And we really went and wanted to bring further forward some other productivity measures to mitigate some of that volume challenge that we're seeing in the marketplace. Expecting to mitigate that and also expecting that we would see a more favorable potential environment as we are migrating through the back half of 2020.

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

Can you just talk about how the 15% to 18% flows through at the segment level? And are these costs that come back if volumes get better?

Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

I could start by saying, Joe, that the split is relatively equal between the Americas and the International segment. So our expectation is that it would be well balanced between those two. And then Harris has very modest amounts associated with it. So it will be fairly equally distributed between Americas and International.

And then as far as the restoration of these costs. Yes, certainly if volume turns at that point in time, some of these cost reductions will be restored. But I will stress that, particularly, in the International segment, these actions are -- some of them related to improving our manufacturing utilization and compressing some of our people and facilities that will likely be more permanent. So I'd say the Americas could be restored with improved volumes. Much of the International improvements are likely part of our permanent cost structure going forward.



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Operator

And our next question comes from Mig Dobre with R.W. Baird.

Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Associate*

It's Joe Grabowski on for Mig this morning. So last quarter, you mentioned an acceleration in the volume compression within automotive. I think it was partly due to the GM strike but also from just broad global weakness. How did the automotive end market trend in the fourth quarter?

Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

I would tell you, Joe, it's similar to what we experienced in the previous quarter. We have mid-teens type of volume decline compressions across the automotive and transportation segment. So on its own, automotive is one of the most significant year-over-year declines in our business, simply because of its size and the magnitude of the year-over-year declines. And then that's followed by heavy industries. But automotive is certainly weak, both in the Americas and internationally.

Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Associate*

Got it. Okay. I guess switching to International. as you guys know, volumes have been down each quarter for the last couple of years. A lot of that has been self-inflicted after the Air Liquide acquisition. As we sit here now and maybe going forward into 2020, are most of the declines now due to the challenging macro? Or are there some still -- still some impacts from rightsizing the business?

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

No. I think that most of the declines that we've been experiencing and will experience if those markets don't become more favorable, moving into 2020, are more market-driven. We put a strong focus on being able to align our business model in Europe to be able to meet customer expectations from a supply chain and a service perspective. Those service metrics have rebounded. And quite frankly, are outstanding for me to look at the business, especially over the last, what I'd say, 4 to 6 months. So thinking about the business as we move into 2020, my concerns with the business are really the underlying economic environment and the challenges that we've seen from some of the industrial production numbers, not only across Europe but from a couple of the specific larger countries. But I believe that the revenue outlook is much more impacted by that versus me thinking about this is furthering for maybe the integration work that we've done.

Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Associate*

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Got it. And if I could just squeeze in one more. You don't get a lot of questions on Harris Products Group. But they had a very strong quarter, both volume and pricing. Maybe just a little more color on what drove the strength there during the quarter?

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

Look, the Harris team had not only a strong quarter but an outstanding 2019, an all-time record for the business. And it just comes from execution. They're very focused on their customers. They've had some new product introductions. We made some investments in that business. Over the last couple of years for them to launch a new product line that was targeted towards the HVAC marketplace in the wholesaling marketplace in the aluminum product category. They conducted an acquisition at the end of 2018 that migrated into 2019, that the team did a very, very good job of



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integrating and then executing on those products into our portfolio. And quite frankly, we expect them to continue to be able to grow and look to make continued investments within that portion of the business.

Operator

Our next question comes from Bryan Blair with Oppenheimer.

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

You just mentioned the continued auto weakness, which, obviously, impacts your automation portfolio. Based on what you can see today and understanding that there are easier comps going forward, is there a realistic chance that the automation and added strategy growth rate reaccelerates during 2020?

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

Well, I'd say a couple of things. One is I don't think about automation and additive when I think about the growth rates as a combined entity. So our additive strategy is a long-term investment strategy that we have. We're certainly investing in that technology. We're excited about that technology, but that's really incubating a new business inside the company. And there are other elements within that strategy that we're working on as I think about additive. As it relates to automation, I certainly expect that our automation business is going to stay challenged in thinking about our performance in Q1. It may have some challenges as we're migrating into Q2. As we think about the backlog that we're looking at and the order activity that we've seen, we're expecting improvements in that business as we move into the rest of 2020. As I look at capital spending dynamics within the industrial space, some of the larger companies have come out and said they're increasing capital spend in their 2020 business plan. I believe part of that will be towards productivity. And productivity in the welding space, certainly, leads you right towards automation. So again, expecting some challenges still in Q1. Expecting us to start to migrate out of those challenges in Q2, and then expecting improvements in that business as we're looking at the back half of the year.

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

Got it. Appreciate the color there. Obviously, good contribution this year from your new products helped to offset some of the underlying market weakness on the equipment side. I was wondering if you could parse that out for us? And maybe the expected impact to continued run rate weakness on a market level in the first half?

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

Well, I think it's awfully difficult for us to parse it out because when I look at our new product introductions, there were a host of them. And we saw that come across our Vitality Index across the equipment portfolio. So it's not any one application, it's a multitude of applications. However, I will bring up our new HyperFill technology, which is growing globally. And it's a technology that, quite frankly, allows users to be able to take twin wire technology to improve deposition rates and improve the productivity in the welding process. During my travels in the first part of the year, I saw that application in a couple of international applications, and believe that it can continue to provide a nice growth vector for us as we're moving into 2020. But even that application can be utilized across the multitude of the segments. So it's very difficult for us to point towards that, towards any one segment. I've got confidence in the investments that we've made and the new products that we've launched, even in late 2019. And what we have coming in our portfolio in 2020, that we should be able to continue to drive improvements in our equipment portfolio across those segments as we're moving through the year.



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

Okay. And then one last one. Vince, you touched on capital deployment strategy, how that's unchanged at a high level. If you had the right opportunities come along, particularly, on the M&A side. What do you see as deployment of capacity over the near term?

Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

We could, certainly, for the right acquisition that we'd be comfortable taking our debt-to-EBITDA up to 3 and above. Up to -- between 3 and 4x for the right transaction.

Operator

Our next question comes from Steve Barger with KeyBanc Capital.

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

Chris, you made a comment about how end market conditions and a higher tax rate are going to bring earnings down in 2020. Does that comment from 1Q, 1 half or full year?

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

Yes. Look, I would tell you that, that's a full year. But certainly, the first half of the year is where we're focused that, that we have our best visibility of the headwinds facing us. But I think even if we do have a turn, Steve, in the second half of the year, we're going to be very challenged based on sort of the run rates that we're experiencing in the early part of the first quarter. And knowing that our tax rate will likely be higher than what we experienced in 2019. So I would tell you that those comments apply to the full year. So really, the first half being the most challenging.

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

Got it. And so just thinking about organic decline rates in 1Q, will that mirror what you saw in 4Q? It wend kind of down high single-digit in Americas and international? Or is that -- will it get kind of sequentially better on a year-over-year rate?

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

No. That's what we see right now. Based on our order trends and our experience in sales for the first month of the year, we're tracking at that mid-single-digit year-over-year decline that we experienced in the fourth quarter. So no, our expectations are with what's going on in in China and the knock-on effect that, that might have on global economies that the first and probably the second quarter of the year will likely be tracking at those kinds of year-over-year declines. And second half of the year, it's a little too early to make those kinds of predictions. But certainly, first half similar kind of performance from a top line perspective.

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

Okay. And then just one more, I guess. If the Americas is running down at that level or at that similar level, how sustainable are margins versus where we came in at 4Q? Or how should we think about decremental margin in that segment given the headwinds?



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

Yes. So I think we're -- we've got the -- not only those headwinds from the year-over-year declines in the top line, but we have incentive pay headwinds as we reset our objectives for the year. And part of the need for these cost savings initiatives that we're driving through our Americas segment as well as International is to hope to offset those costs that we will incur from incentive management systems. We're also seeing a little bit of input cost inflation as we enter 2020. We did have some declines as we finish 2019, that will likely be another headwind we will have in the first quarter and perhaps first half of the year. So we believe that the cost savings initiatives should largely mitigate some of these headwinds that we know are in front of us. But we do have, I believe, at this point, some downside risk to maintaining those types of margins in the -- certainly in the first quarter and the first half of the year.

Operator

And this concludes our Q&A session. I would like to turn the call back to Vincent

Petrella for his closing remarks.

Vincent K. Petrella - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Thanks, Carmen, and thanks, everyone, for joining us today on the call and for your continued interest in Lincoln Electric. We look forward to discussing our progression of our results as we move into the first quarter of 2020. Thank you, again.

Operator

And with that, ladies and gentlemen, we thank you for participating. And you may now disconnect.

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