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PRESENTATION

Operator

Good morning. My name is Tasha, and I'll be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation First Quarter Release Conference Call. (Operator Instructions) Also, this telephone conference presentation and accompanying webcast made on behalf of Harsco Corporation are subject copyright by Harsco Corporation, and all rights are reserved.

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I would now like to introduce Mr. Dave Martin of Harsco. Mr. Martin, you may begin your call.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you, Tasha, and welcome to everyone joining us this morning. I'm Dave Martin, Director of Investor Relations for Harsco.

With me today is Nick Grasberger, our President and Chief Executive Officer; and Pete Minan, Harsco's Senior Vice President and Chief Financial Officer.

This morning, we will discuss our results for the first quarter of 2018 and our updated outlook for the year. We'll then take your questions.

Before our presentation, however, let me cover a few administrative items.

First, a PDF of our quarterly earnings release as well as a slide presentation for this call have been posted to our website.

Second, this call is being recorded and webcast. A replay will be available on our website later today.

Third, we will make statements today that are considered forward looking within the meaning of the federal securities laws. These statements are based on our current knowledge and expectations and are subject to certain risks and uncertainties that may cause actual results to differ materially from these forward-looking statements. For a discussion of such risks and uncertainties, see the Risk Factors section in our most recent 10-K. The company undertakes no obligation to revise or update any forward-looking statement.

Fourth, on this call, we will refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to U.S. GAAP results is included in our earnings release as well as the slide presentation.

And lastly, note that all prior year operating figures are now restated to reflect the new pension accounting standard. The quarterly impact of these changes for 2017 can be found in the Appendix of our earnings release.

Now I'll turn the call over to Nick to begin his remarks.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Thank you, Dave. Good morning, everyone, and thank you for joining us.

Let me start by saying that I am once again quite pleased with Harsco's continued strong performance, especially in our Metals & Minerals and Industrial segments.

Our positive momentum began 2 years ago, and we fully expect this trend to continue. In fact, we are raising our outlook for the balance of 2018 based on supportive end markets and disciplined execution of our growth and productivity programs.

We are also initiating a share repurchase program, the first such program in many years, reflecting the confidence in our outlook and the health of our balance sheet. While we are committed to making investments to grow our business, we believe this should be balanced against returning capital to shareholders when appropriate.

I'll make a few brief comments on each segment.

M&M delivered yet another strong quarter, and we are confident the opportunity for growth has never been greater. The opportunities will continue to be sourced from 3 areas. First, the core services business of M&M is pursuing new relationships at a pace not seen in the past. We are adding commercial resources to these efforts and expanding our investments in innovation, mostly around solving customers' environmental challenges and improving productivity. While these efforts are consistent across our 35 countries, the opportunities in China and India are most significant, both due to our competitive position and to the low rate of penetration of outsourced mill services.

Second, our Applied Products business, which is focused on the trend of creating value from waste, has also received stepped-up investment. Each region has added dedicated resources to support Applied Products development, as have the central R&D and engineering functions. The ever-increasing regulation around the environmental impact of our customers' operations is a primary driver of this opportunity.

Finally, we believe there is a significant opportunity to transform M&M into a global leader in providing environmental solutions to basic industries beyond the steel industry. Our reputation, our global footprint and our technical knowledge provide a strong foundation to pursue such a strategy. We continue to actively evaluate a number of these opportunities and anticipate sharing details in the near future.

For M&M, the focus on investing for growth would not be possible without the stable, profitable and long-term nature of the contracts underlying the business. This was not the case a few years ago. Above all, our unrelenting effort to provide value to our customers has been the key to success.

Our Industrial segment recorded its highest revenue and operating income since 2015. Revenues increased over 25%, and operating income was about 4x higher compared to Q1 of last year. This past quarter was also the first quarter in many years where each of the 3 Industrial businesses both grew year-over-year and exceeded their respective operating plans. In general, improving energy markets, competitive dynamics and operational productivity led to this performance. We also believe the leadership team in our Industrial segment is performing at a very high level.

The results in our Rail segment were in line with our plan. We believe our core North American market has troughed, and the story here continues to stem from new products and technologies and expansion outside of the U.S. Greater manufacturing productivity and aftermarket focus will also begin to drive growth in Rail in the coming quarters.

So in sum, I think we are off to a very strong start this year. Our key financial metrics continue to improve, and the volatility of our businesses is much reduced from that of a few years ago.

Pete, Dave and I look forward to seeing many of you in the coming weeks as we communicate further details on our strategy and on our long-range outlook.

To take a closer look at our results, I will now turn the call over to Pete.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Thanks, Nick, and good morning, everybody. So let me start off on Slide 4.

Our operating income in the first quarter was $37 million, which exceeded our guidance range for the quarter of $30 million to $35 million. Our Industrial segment was the largest contributor to our better quarterly result. Demand for our heat exchangers continues to accelerate, and we benefited from sales mix in this business during the quarter as well.

As Nick mentioned, our Industrial grating business, IKG and commercial boiler business, Patterson-Kelley, also had better quarters. In the case of IKG, we benefited from timing related to the acceleration of some customer orders in anticipation of higher product prices.

The Metals segment also performed better than anticipated. Higher services demand and commodity prices, along with strong site-level execution, helped us in a few regions, including North America, Latin America and China. Also, our Corporate spending was somewhat lower than we forecasted due to the timing of some spending for professional services.

Revenues in the first quarter totaled $408 million, an increase of 10% compared with the prior year quarter. Our growth was led by the Industrial segment, where sales increased an impressive 27%, and sales in each of our Industrial businesses rose year-on-year. This top line growth led Harsco to a 28% increase in operating income.

Our operating income of $37 million compared with $29 million in the first quarter of 2017. And again, the Industrial and M&M segments, along with lower Corporate spending, accounted for this improvement compared with the last year.

There were no adjustments for unusual items in either quarter.

Diluted earnings per share was $0.22, which was above our guidance range of $0.16 to $0.21. This earnings per share outcome also compares to earnings per share of $0.11 in the first quarter of 2017. And this comparison is helped by a $2 million decrease in interest costs and the lower effective tax rate, which was 29% in the first quarter this year versus 37% in the prior year.

Free cash flow was negative in the quarter, as expected, and is traditionally the case in the March quarter. The change in our cash flows versus the prior year can largely be attributed to higher capital spending, including capital spending for growth. Our growth-related CapEx totaled roughly $8 million in the quarter. And as indicated in our updated guidance for the year, we expect that our free cash flow will improve meaningfully for the remainder of the year.

Let's move over to Slide 5.

In the first quarter, revenues in the Metals segment increased 7%, and our operating income increased to $28 million from $26 million. This earnings increase is attributable to higher steel output, services demand, new sites and foreign exchange benefits.

Steel output, or LST, at customer sites rose approximately 2% in the quarter. And these positives were then partially offset by growth-related investments, which totaled more than $2 million in the quarter. The other offset were lower nickel volumes -- I'm sorry, lower volumes at our nickel or stainless steel-related sites, which resulted from production schedule changes by our customers, mainly in the United States, and which had been anticipated.

Lastly, on metals, free cash flow for the quarter was a net usage of $7 million. This reflects higher capital spending and some working capital investments, which we had expected.

Our focus on cash generation is unchanged. And for the balance of the year, as I said earlier, our cash flows in M&M should improve meaningfully, as was the case in 2017.

Turning to Industrial on Slide 6.

As mentioned earlier, revenues increased 27% for the Industrial segment versus the comparable period in 2017. This $18 million increase in sales translated to a $9 million increase in operating income, which totaled $12 million in the quarter. Also, our segment operating income margin increased to nearly 15% from 4% in the prior year period.

These changes are the result of higher volumes, manufacturing improvements and a more favorable product mix in the quarter. The manufacturing and efficiency improvements are most directly linked to our Air-X-Changer operations, where we are now reaping the benefits of our facility consolidation project, other continuous improvement initiatives and a continued push for more automation.

Also, the momentum in this segment was evident from our customer activity in the quarter. Segment bookings increased nearly 40% quarter-on-quarter and more than 30% year-on-year. As a result, backlogs across our Industrial businesses now exceed $100 million and are 50% higher than a year ago and at levels last seen in early 2015. Most of the order book and backlog improvements can be attributed to Air-X-Changers, where backlogs at the end of the quarter were essentially double our backlog at the end of the first quarter in 2017.

Turning to the Rail segment on Slide 7.

Revenues in the first quarter were essentially unchanged from the prior year quarter. Meanwhile, operating income totaled $2 million versus $6 million in Q1 2017. This change resulted primarily from a less favorable equipment mix, lower services contributions and innovation investments, which have been expected. These factors fully offset the positive impacts realized in the quarter from our higher contributions from aftermarket parts and continued growth from our safety and diagnostic products. Again, as mentioned earlier, these results in Rail were substantially consistent with our expectations for the quarter, and we anticipate improved results in this segment as the year progresses.

Lastly, free cash flow in Rail improved roughly $9 million versus the prior year quarter due to working capital changes.

So turning to our updated 2018 outlook on Slide 8.

Here, let me highlight a few things. First, our full year operating income guidance is increased to a range of $165 million to $180 million. This compares to $150 million to $170 million previously. Likewise, our forecasted earnings per share now will be between $1.11 and $1.24 per share as compared to our prior range of $0.97 to $1.14. These outlook changes are being driven by our Metals and Industrial segments roughly in equal proportions.

Our underlying confidence in the demand for mill services and our expectations regarding mix are improved in M&M. Very little of the metals outlook change can be attributed to recent trade policy actions and discussions in the United States and elsewhere.

Also, our assumptions for commodity prices have also increased modestly, and foreign exchange is a slight positive versus our original guidance for the year.

We are clearly pleased with the momentum within Metals & Minerals. We're pursuing a pipeline of potential growth investments, and we continue to make P&L investments in commercial and innovation linked to our growth strategy.

In Industrial, our expectations for each of the underlying businesses have improved, although our projections for Air-X-Changers, as you would expect, have increased more than the others. Our sale of the heat exchangers are now expected to grow more than 30% for the year.

Our outlook for Rail and Corporate costs are unchanged.

And finally, we don't expect any material impact within our manufacturing businesses from commodity price or input cost inflation.

The low end of our free cash flow guidance has increased $5 million, with our capital spending outlook unchanged.

A summary outlook for each of our business units is included in the presentation appendix.

And lastly, before I discuss guidance for Q2, let me comment briefly on our other announcement this morning.

We are pleased that Harsco's board authorized the implementation of a $75 million share repurchase program. Our share buyback activity has been very limited during the past few years, and, as Nick said, this decision is a positive reflection on our strong balance sheet and our confidence in the business. We plan to be prudent with any repurchase activity, and it's important to note that this will not impact our growth plans.

Let me conclude with some comments on the second quarter on Slide 9.

In Q2, we expect operating income to be between $45 million and $50 million as compared to operating income of $43 million in the second quarter of 2017. Also, diluted earnings per share is projected to between $0.30 and $0.35 as compared with $0.22 in the prior year quarter. As was the case in the first quarter, the improvement in our financial results year-over-year is projected to be driven by both the metals and Industrial segments. We expect M&M to benefit from higher service levels and commodities as well as new contracts. And Industrial results should strengthen from prior year quarter due to improved demand and a more favorable product mix. Rail earnings are likely to decline somewhat, and Corporate costs should be modestly above the year-ago period.

So that concludes our prepared remarks. And at this point, we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jeff Hammond from KeyBanc Capital Markets.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

So just on M&M, can you talk -- seems like you have a little more confidence on a go-forward basis in incremental margins. So can you just talk about that? And maybe just speak within that to what you're expecting for Applied Products in the out quarters.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

So in general, within M&M, I think the confidence stems from, first of all, what we've accomplished the last couple years in terms of stabilizing the business and improving its underlying core processes, in large part how we allocate capital. So you've seen the core metrics around the contracts increase -- improve significantly. If you look at the -- as we look at the pipeline of new opportunities, and we said in the last few quarters that, that pipeline has, for some time, not been as robust as it is now, we think we'll continue to see on the growth those strong metrics that we see on the existing contracts. So a lot of confidence there. Also, of course, on existing sites, the ability to add on new services and provide more support around transitioning their waste streams to value. All those things, I think, together really speak to the opportunity and the confidence that we have in M&M. In terms of Applied Products growth, certainly we expect that to be higher than that in the core services business. Now Pete, if you have a specific figure for the full year on Applied Products.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

No, not broken down specifically. But Jeff, let me -- I can at least comment a little bit on the margins expectations. So we expect margins to grow in metals year-on-year, and that's despite the investments that we've been talking about, the P&L-related investments that we're making in commercial innovation and all the other things that are linked to our growth strategy. And a good chunk of that, if not most of it, is going to be driven by new contract and contract turnover. We're -- as we've talked about before, we expect new revenues from contract changes to be roughly additive by $20 million to $25 million, but the margin associated -- the operating income margin associated with that we're expecting to be in excess of $10 million. So I -- that's part of the reason why we see the margin increase. Plus, as Nick mentioned, the growth in some of these Applied Products businesses, which have, as you know, a better-margin portfolio than some of the traditional mill services, are expected to increase as well.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay, great. And then on Rail, it looks like the margin -- the margins were weaker than you were anticipating in that and still a lot of confidence that op income is up slightly. Can you just walk through any more color you have on margin cadence in Rail into the out quarters? And anything we should be aware of on SBB timing that would impact that?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Well, I -- as you know, a big draw -- drag on margins is the revenue associated with SBB, Jeff, and we're anticipating there to be about $30 million of revenue in 2018 associated with SBB with a 0 margin -- with $8 million in this quarter. We may even have a little more than that under the new standard. So that's the biggest draw. Now the offsetting factors to that would be, of course, the increase in aftermarket parts, which have better margin profile. But the real big indicator and what's probably going to be driving most of the changes is equipment mix, and that's really comparing -- the nature of what we sold last year compared to this year is going to be a big component of that change. But all in all, I think we expect margins to be, by and large, consistent for the full year in Rail from what we experienced in 2017.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay, great. And then just final one. A lot of discussion on other calls about price/cost and supply chain issues as things strengthen. Can you maybe just speak to what you're seeing there, if anything? It doesn't seem to be showing up in incrementals but in the manufacturing businesses.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

So as I mentioned in my remarks, we're not seeing any material impact from supply and input cost inflation, Jeff. It's just not noticeable to us. If anything, we experienced a little bit of acceleration and some sales in our grating business as we saw that some customers were looking to purchase things in anticipation of what they thought would be price increases in the outer period. But overall, very, very immaterial.

Operator

(Operator Instructions) Our next question comes from the line of Rob Brown from Lake Street Capital.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Just on the Industrial business, could you give us a sense of what your capacity utilization is at this point? And then I guess generally, you talked about the market growth, but are those trends continuing into this year and into next year? Just sort of an outlook on how the market is developing.

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

I think in terms of the capacity utilization, I'll comment primarily on the Air-X-Changer business. You'll recall that we added significant capacity a few years ago when we consolidated into a much larger facility in Tulsa. So I would estimate now we're kind of at 60%, 60% to 70% of capacity in that business. So we certainly believe we can go well beyond the peak volume of 2014 and '15 in this new facility. And just a related comment, if you look at the margins in the Air-X-Changer business now, they are well above where they were at the previous peak. And in fact, the operating income is above where it was in 2014 and '15 despite the fact that volume is only still 2/3 or 3/4 of what it was. And the outlook continues to be positive. As you know, that's -- the lead times are kind of 3 to 6 months, so we have good visibility there on the rest of the year. And that really underlies our strong outlook for the Air-X-Changer business.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

We've got backlog now, as I mentioned in my comments, that are very, very high. We're looking at backlogs in the Air-X-Changer business of $90 million. We're talking 6 months' backlog. So we have really good visibility for the rest of the year. Our bookings continue to accelerate, so we feel pretty confident about the business for Industrial broadly but Air-X-Changers in particular for the rest of the year.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, good. That's good color. And then in the M&M business, what nickel price are you modeling into your forecast?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes, it's -- right now, it's about $6 per pound, which is slightly less than what it is today. But as you've seen, the volatility over the last couple of months certainly seems to center around that $6 per pound number

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Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, good. And then just more of a broader question on the trade impact and some of the tariff discussions. But how's the M&M business impacted by sort of activity in the tariff and trade discussions?

F. Nicholas Grasberger - *Harsco Corporation - President & CEO*

Our estimate is that it should be a modest net positive. About 25% of the M&M business is in North America. Of course, the tariffs and the quotas would support the U.S. steel industry and, therefore, our customers here in the U.S. But we are, as you know, leveraged to volume, not price, and even a 1%-or-so increase in volume globally is about $2 million of operating income, and North America is 25% of that. We don't -- actually, outside North America, most of our customers do not export to the U.S., so we don't really see a negative impact there. So I would say a modest net-net positive

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Operator

(Operator Instructions) There are no further questions at this time. I'd like to turn the call back over to Mr. Martin.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you for joining us today. A replay of this call will be available later today through May 23 on our website. Also, if you have any follow-up questions, please contact me using the contact details provided at the top of our earnings release. Again, we appreciate your interest in Harsco, and we look forward to speaking with you in a few months. Have a great day.

Operator

This concludes today's conference. You may now disconnect.