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PRESENTATION

Operator

Good morning. My name is Luke, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation third quarter release conference call. (Operator Instructions)

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

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

Thank you, Luke, 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; as well as Pete Minan, Harsco's Senior Vice President and Chief Financial Officer. This morning, we will discuss our results for the third quarter and our outlook for the remainder of the year. We'll then take your questions.

Before our presentation, however, let me take care of a few administrative items. First, a PDF of our quarterly earnings release as well as the slide presentation for this call have been posted to the IR section of our website. Second, this call is being recorded and webcast. A replay will be available on our website later today.

Next, we will make statements 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 and our most recent 10-K and most recent 10-Q. The company undertakes no obligation to revise or update any forward-looking statement.

Lastly, 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.

I'll now turn the call over to Nick.

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

Good morning, everyone, and thanks for joining us today. I'll offer just a few brief comments and then turn the call over to Pete.

Over the past several quarters, we've consistently met or exceeded our financial forecasts and improved our key metrics versus the prior year period, and this trend continued in the third quarter, and we've again improved our outlook for the full year.

The steel and energy markets have certainly recovered over the past 18 months, although they remain well below prior peak levels. But in that context, we're very pleased that profit margins in the Metals & Minerals and Industrial segments now exceed those realized during the previous peak. Management has worked hard to improve the mix of products and services as well as reduce costs and boost cash flow. And due to these efforts as well as a much-improved process to allocate capital, return on invested capital at Harsco should exceed 10% this year after being stuck in the mid-single digits for many, many years.

In contrast to steel and energy, the maintenance-of-way sector of the rail industry has been slower to recover. But I'm sure our Rail business will rebound strongly when demand returns in much the same way as in our M&M and Industrial segments.

As we look ahead, having just completed our long-range plans for each segment, we're quite enthusiastic about the growth opportunities across our businesses. We're equally confident in our competitive positioning, our balance sheet, our process discipline and in the talent and stability of our leadership team, a team that has successfully managed a broad restructuring during the market trough and a team that could not be more excited to grow the business and create meaningful shareholder value moving forward.

Finally, I'm pleased to announce that Mario Longhi, the recently retired CEO of U.S. Steel Corporation, has joined Harsco's Board of Directors. Mario brings tremendous expertise on the global steel industry, and I'm confident he'll enhance the board's efforts to generate attractive returns for our shareholders.

I'll now turn the call over to Pete.

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

So thanks, Nick. And good morning, everybody. So let's start on Slide 4. Reported operating income in the third quarter was $34 million. This figure included a bad debt expense of $4.6 million related to one of our metal sites that was not anticipated in our guidance for this quarter. The quarter also included an asset sale gain of $3.8 million in our Industrial segment that we had considered and included in our guidance for the quarter and the year. This gain was offset by a number of other items this quarter, including severance charges, some exit costs, some impairment charges and professional fees.

The bad debt item related to a customer in Australia that entered voluntary administration over a year ago, and until recently, we did not have sufficient clarity on the collectability of our receivables and therefore were not able to estimate an appropriate reserve until now. Excluding this bad debt item, operating income was $39 million. This adjusted figure exceeded our guidance range for the quarter of $30 million to $37 million, due mainly to better-than-expected performance within our Metals and Rail segments.

Metals & Minerals benefited from services mix, higher volumes and lower costs in a number of regions and countries, including India, Brazil, Europe and our Rest of World region. M&M was also helped by higher-than-anticipated commodity prices, which was mainly nickel for the quarter.

Meanwhile, operating results in our Rail segment benefited from a better mix of equipment and aftermarket parts and higher contract services work. As was the case last quarter, some of these positive impacts were timing related and originally expected in the fourth quarter of this year.

Revenues in the third quarter increased 5% compared with the prior year quarter to $385 million. Most of this increase can be attributed to higher heat exchanger sales in our Industrial segment and increased volumes within Metals.

Our income, adjusted for the bad debt expense, increased 35% versus the prior year quarter, with the improvement attributable to M&M and Industrial. I'll walk through the segment details in a few minutes. Also, the adjusted margin in the quarter was 10%, which included double-digit adjusted margins for M&M and Industrial.

Reported or GAAP earnings per share was $0.16 in the third quarter. As mentioned earlier, this figure includes the bad debt expense of $3 million or $0.04 per share net of tax.

Adjusted earnings per share in the third quarter was $0.20, which was above our quarterly guidance range of $0.13 to $0.18. Adjusted EPS was $0.14 in the third quarter of 2016, and that was the final quarter that included equity income related to the Brand Energy joint venture.

Free cash flow in the third quarter was $22 million. Our cash performance was consistent with internal forecasts for the quarter, and the cash flow change from the prior quarter is due mainly to swings in customer advances and inventories within the Rail segment, which we had anticipated. We expect free cash flow comparison to be more favorable in the current quarter, and we expect the fourth quarter to be our strongest free cash flow quarter of the year.

So let's move to Slide 5. In the third quarter, Metals & Minerals had reported operating income of $24 million, and adjusted operating income was $29 million. Revenues increased 3% compared to the third quarter of 2016, and adjusted operating income rose 20%. This increase in operating income is attributable mainly to higher steel production and service levels and a more favorable services mix. Also, higher income at Reed Minerals, which was due to improved demand for roofing and blasting materials, helped the quarter. The net impact of new and exited sites was minimal this quarter, as anticipated.

Customer steel output increased 6% year-over-year in absolute terms, and on a continuing site basis, customer production increased 3%, which was consistent with our expectation for the third quarter.

Lastly on Metals. Free cash flow has totaled $83 million year-to-date. This figure compares with $108 million in the comparable period of 2016. The year-over-year change in free cash flow, as I mentioned in August, is the result of higher capital investment and anticipated changes in working capital.

So turning to Industrial on Slide 6. Revenues rose 23% as a result of increased demand for heat exchangers within the U.S. energy market. Operating income increased from $6 million to $13 million in the recently completed quarter, with the drivers here being higher shipments of heat exchangers and improved mix and a gain on the asset sale I discussed earlier.

The asset sale gain resulted from our decision to monetize and ultimately relocate our facility used in manufacturing metal grating and fencing within the city of Queretaro, Mexico. This transaction had been contemplated within our annual plan and guidance, and we expect that a portion of these proceeds will be used to relocate the facility in the near future.

This gain is captured within the other category on the bridge. The slide shows that this gain was mostly offset in the quarter by some exit and severance costs not related to the Mexico operation as well as higher incentive compensation.

Industrial's operating margin was 16.4% in total and 11.6% if you exclude this gain, both of which are up meaningfully versus the prior year quarter. Also as a result of growth in cash earnings, free cash flow for this business unit has increased year-to-date. We also continue to be encouraged by energy market trends and the outlook for our Air-X-Changers business as a result.

Bookings were again strong in the third quarter and have been steady for much of the year despite some commodities market volatility. Year-to-date, our Industrial bookings have increased more than 40%, and our backlogs have risen by more than 60% since the beginning of the year.

So let's move to Rail on Slide 7. In Rail, revenues and operating income both decreased 10% from the prior year. The revenue change resulted from lower equipment sales, which had been expected. At the operating income level, the impacts of lower equipment shipments and added administrative costs linked mainly to compensation and professional fees were largely offset by product mix and the higher contributions from aftermarket parts and contract services. As a result, the segment's operating income margin was consistent with the prior year at just over 8%.

Lastly on Rail. Free cash flow was unchanged year-to-date, and we expect Rail's free cash flow to improve in the fourth quarter due to anticipated customer advances and working capital changes.

So now for our outlook on Slide 8. Here, let me mention the highlights and key changes. First, our adjusted operating income guidance has increased to a range of $137 million to $142 million as compared with $125 million to $140 million previously. This change can be entirely attributed to our Metals & Minerals segment. Compared to our prior forecast, higher commodity prices, a better services mix and a weaker U.S. dollar support the improved outlook. Otherwise, our expectations were largely unchanged.

Likewise, our adjusted earnings per share for the year is now expected to be between $0.65 and $0.69 per share as compared with $0.55 to $0.69 per share previously. Our anticipated net capital expenditures are unchanged for the year, and as a result, our free cash flow outlook is tightened to a range of $85 million to $95 million.

So let's move to Slide 9. Regarding our fourth quarter outlook, we expect operating income to be between $28 million and $33 million as compared to adjusted operating income of $28 million in the fourth quarter of 2016. A summary of the major moving parts by segment are included on the slide.

In total, we expect that our performance will improve year-over-year in M&M and Industrial. Higher commodity prices, higher Applied Products earnings and foreign exchange support the increase in M&M results, while Air-X-Changer volumes and mix will mainly drive the improvement in Industrial.

And note that corporate costs are expected to be similar to the just completed quarter and therefore are likely to be $3 million or so above the prior year quarter. The year-over-year increase in the current quarter is mainly attributable to incentive compensation and pension expense.

Relative to the third quarter of this year, adjusted earnings are expected to fall, as is traditionally the case for Harsco's fourth quarter. Seasonality within M&M and the steel industry will be the primary driver for the sequential change in results.

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

QUESTIONS AND ANSWERS

Operator

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

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

So Metals & Minerals, the quarter was a little bit lighter than I thought if you back out FX, just given kind of production rates. Are you still -- and I think you mentioned in 4Q running off some contracts. So can you just talk about kind of run rate for exiting contracts that would have impacted 3Q, 4Q?

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

Sure, Jeff. It's Pete. So the revenue impact of the exits was about $7 million in the third quarter compared to prior year. But there was really no impact on operating income. And for the full year, we're looking at the impact to be about $15 million at the revenue line. And similarly, there should be very little to no operating income impact associated with that.

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

Okay, great. And then you mentioned the backlog in Industrial being up 60%. Is that as of the end of third quarter?

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

Yes, that's at the end of the third quarter. We're -- our Industrial backlogs are just under $90 million, which is up year-on-year about 60% and sequentially up about 5%.

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

Okay. So I imagine -- maybe just talk about the funnel and order activity in Air-X-Changers into 2018 and how that kind of frames how you might be looking at the out year.

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

So the order book is continuing to be strong. I will tell you in Air-X-Changers the backlog increase sequentially is about 15%. So we're not growing the backlog sequentially as much as some of the other businesses in Industrial. But nonetheless, we've got pretty good visibility for the next 6 to 9 months, and we feel pretty optimistic about 2018.

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

Okay, great. And then just final question, you mentioned in the Q an issue with FCPA in China. Can you just speak to that and maybe the range of outcomes? And is there any risk of future lost business as a result?

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

Jeff, it's Nick. Really can't comment much beyond what was disclosed in the 10-Q. It's an ongoing investigation, something we have self-disclosed to the DOJ and the SEC. In thinking about the range of outcomes, it's difficult to envision an outcome that would be materially negative to our financial condition. But it is ongoing. And beyond that, there's really not much to comment on.

Operator

Your next question comes from the line of Rob Brown with Lake Street Capital Markets.

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

Industrial, the heat exchanger business or really the Industrial segment in general, what's sort of the margin kind of target there? How do you see that playing out as this business recovers? And sort of where can you get to?

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

So we're having pretty good margins in the Industrial segment as a whole. We're starting to see, particularly in Air-X-Changers, margin levels that are what we saw at the peak of the cycle, and we're only roughly 50% of the cycle. So we attribute that a lot to the efforts that we put in taking cost out of the production process and moving our manufacturing facility into a very state-of-the-art consolidated facility. So what we had for the quarter, we saw margins in the neighborhood of 16%. We -- now that included -- an element of those margins included the gain on the asset sale, which I mentioned earlier. So if you take that out, the margins were about 12%. And we're targeting about that for the full year.

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

Okay. Okay, good. And then maybe just turning to kind of your growth thoughts in the M&M business. That was doing well. But sort of what -- going forward, how do you view the market and opportunities to grow that business?

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

Yes. I think the opportunities to grow M&M are -- will likely be more driven by focused investments that we make in new contracts and new initiatives as opposed to underlying growth in the sites that we serve today. Most estimates for LST growth are in the low single digits. I would say that's roughly consistent with what we expect on our sites over the coming few years. But as we look at opportunities in developing markets in M&M, India, China, Middle East, Brazil, we've actually never had a healthier pipeline of growth opportunities. And as you know, we're quite well positioned in those markets relative to any global competitor. So we feel quite good about the opportunity to grow the core business organically. But beyond that, there are a number of opportunities in adjacent industries where we can apply our technology and perform similar services and generate similar products. So I would say there's a relatively equal balance in our growth projections for M&M between penetrating further existing developing markets and investing in adjacent markets and new technologies.

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

Okay. And then my last question is really on Rail. I think you talked a little bit about some pull-forward from Q4. And maybe just give us further color there? And also, as the quarter step forward here, maybe how do you see that growth trending in that business?

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

You broke up a little bit. I think I caught the gist. This is Pete. I think I caught the gist of it. Maybe I'll start, and then Nick can talk about the outlook for 2018. But in terms of the estimated operating income of what was kind of budgeted for the fourth quarter that ended up in the third quarter, it was similar -- just under $1 million in terms of operating income impact. So for the full year, our guidance really is unchanged relative to Rail. So year-on-year, it'll be slightly down but consistent with what we expected earlier in the year.

Operator

(Operator Instructions) We have another question from the line of Jeff Hammond with KeyBanc Capital Markets.

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

Just to follow on Rail. Can you just talk about the -- I know it's no-profit revenue, but just talk about the top line ramp expectation for the SBB contract into 4Q and into '18. And then maybe just talk about how the North American Rail market is shaping up as we move into '18.

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

Yes, so I'll -- this is Pete, Jeff. I'll comment on the SBB. So we're -- right now, we're looking at as much as $50 million of revenue in Q4 from SBB sales. And as you correctly point out, those are 0-margin sales. So that has a little bit of a drag on our margin for the whole year, as you should expect. And a similar amount in 2018, and that'll continue on to 2019 and probably won't be finished both contracts deliveries until 2021, '22.

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

And Jeff, in terms of the outlook for the North America maintenance-of-way market in 2018, most of the Class I's have established their capital spending plans, budgets for next year, and they're largely flat. So we're not expecting significant growth in the core North American equipment market. Now as you know, we're further penetrating the aftermarket space in the Protran-type Technology, so we expect some growth there, not so much driven by the market but driven by our further penetration into that segment of the market. But even though car loadings are up, traffic is up, the Class I's have not yet indicated an expectation to increase their capital spending.

Operator

There are no further questions at this time. I turn the call back over to the presenters.

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

Thank you, Luke, and to those that listened to our call this morning. A replay of the call will be available later today through November 22, and the replay details are included in our earnings release.

Also, if you have any follow-up questions, please contact me. And my contact details are included at the top of today's release. And then lastly, again, we appreciate your interest in Harsco, and have a great day.

Operator

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