Gates Industrial Corp.

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Jerry Revich: Good afternoon, everyone. Welcome to this afternoon's session with Gates Industrial Corporation. I'm Jerry Revich and I'm excited to have with me today David Naemura, Chief Financial Officer. Also joining us from Gates is Bill Waelke, Director of Investor Relations. Gentlemen, thank you very much for coming to visit.

Bill Waelke: Thanks for having us here.

Jerry Revich: Dave, maybe as a starting point, what's really interesting about Gates is the business model where you folks have built over 60% of your sales as aftermarket. Can you talk about the company's strategy historically that's enabled that structure for each of your 2 businesses and steps that you're taking today to defend that pretty attractive structure?

David Naemura: Sure. It's a great question. We consider ourselves the aftermarket guys. It's easy to tool up a dozen, 15, 100 SKUs to service OE equipment, but you can only service the number of parts in an aftermarket portfolio having tooled it up over a series of decades really. And Gates as a 100-year old company has kind of built this legacy. That and the combination with the brand loyalty means we don't have to be on original equipment to be the replacement equipment in the aftermarket. So the best example of our aftermarket franchise is probably the automotive aftermarket in North America where we have a 99.99% product coverage. It's really that product coverage that allows us to be a reliable distributor to someone as broadline as say NAPA or O'Reilly. And then we have great brand affinity with the end user which would be an independent mechanic in our case, because our products that we make would get replaced outside of a warranty period, frequently by a wholesale mechanic that uses a wholesale distributor like a NAPA or an O'Reilly as an example. For someone to penetrate that market and to have that SKU count is very difficult and that's one of the moats both on the industrial side and on the automotive side, why it's hard to penetrate and kind of the value proposition for us in the aftermarket.

Jerry Revich: In terms of your leading competitors, from an aftermarket standpoint, who would your number one competitor be in each of your 2 businesses?

David Naemura: It varies by region. So in the United States on power transmission products and automotive applications, you'll see Dayco, you'll see Con-Tech [Hauls], a division of Con-Tech. On the fluid power side, you'll see Eaton, Eaton Hydraulics, you'll see Parker. You'll see more the European brands in Europe so maybe [Menui], ALFAGOMMA, Con-Tech Haul has a bigger presence in Europe. When you get to Asia it's more of the Japanese, MBL, Mitsuboshi, Bondo. On the fluid power side, you'll see more of the Bridgestone, Eaton and Parker are global players, we see them in hydraulics. We tend to be a little bit more competitive in the higher end hydraulics which tends to play a little more in premium applications. But it really varies kind of by region and by product.

Jerry Revich: Any of those competitors that you mentioned that are making new strides towards improving the range of SKUs? Or who do you consider is the most significant threat to you folks?

David Naemura: Good question. I think it varies. The most competitive landscape from a coverage standpoint right now is in China where you've got the largest, most diverse, most complex car parc in the world and you have no aftermarket really. It's developing. And the key to developing the aftermarket is getting the coverage of the parts required in this most complex car parc. And I would say we are by far leading the way. I think we've got coverage at over 90% of the necessary parts of the car parc. We believe the next competitor is probably somewhere sub 80. And that's a number of people, a number of big names competing for that, most of the names I've already said really.

Jerry Revich: In terms of the other part of your strategy in China has been to increase the location count. Can you talk about where we are in those efforts and in terms of the opportunity set, how much larger could your location count in China get from call it 2018 models?

David Naemura: Development of the distribution network in China is very nascent. The larger players haven't emerged. There isn't a NAPA, there isn't a Motion Industries emerging yet. There's 4 or 5 players that look like they're in the mix to emerge and we are competitive with all of them. In this last quarter, I think we grew about 18% in the automotive aftermarket in China and that is just a function of how the car parc has developed over the last number of decades. We see our parts get replaced in kind of the 7 to 11-year timeframe, so we have really a long tailwind of growth associated with that. How will it develop exactly and at what rate is yet to be determined and I would hesitate to speculate because I don't think anyone knows, it's so kind of early stage. But we think we're well positioned, we have relationships with the guys that we believe could emerge as large players. A lot of what we do is we go to cities that we target and we target the end user. We help them understand that we have the catalog necessary to help them know what part goes on what car which is a strategic advantage that Gates brings to the table. And then we help them understand where our products get distributed through and we help create demand to pull through our distribution network.

Jerry Revich: Taking that same question globally as you look at your distribution network today, where are the most meaningful opportunities? Where is the white space in terms of geography or product range that you think your distributors have opportunities to effectively grow the location count and augment the same store sales growth that you would otherwise get?

David Naemura: I think there's 2 answers here, Jerry. The first one is, at a very macro level, in developed markets, we're about 70% aftermarket and about 30% -- sorry, yeah, in developed markets about 70% aftermarket, about 30% first-fit applications beyond automotive or industrial. When you get to emerging markets, which is over a third of our total business, that relationship flips. So we're about 70% first-fit applications. And that's how these markets develop. So we would anticipate over time that that balance would continue to shift in emerging market locations which is how you develop these aftermarkets, but it's also an opportunity for us to continue to define growth in the aftermarket. Specific to fluid power, we are very well penetrated in hydraulics in North America and very underpenetrated internationally. And that's both a first-fit and an aftermarket statement. So we would see international aftermarket hydraulic applications as a real big opportunity to further our aftermarket revenues, both through further penetrating products and through expansion of our distribution network.

Jerry Revich: And in terms of the product difference, how meaningful is it in international markets? Or is it converging in terms of the product mix post the move toward Tier 3 in China now, though that's really Tier 4. Does that converge?

David Naemura: There's some convergence. We have a lot of product that can be sold. It can be produced out of any of our plants. It's sold ubiquitously around the world. There are some local standards that we adhere to, but generally speaking, we have products that we sell globally and we manufacture them in 4 regions. We get a lot of questions about China. We manufacture a lot in China but not the United States through China and for Asia. And we have recently added capacity to a host plant that we own in China and we've built a new host plant in Poland. And really, that host plant in Poland is the first meaningful increment of capacity we've had on the European continent. And the capacity that we've put into China allows us to produce for those markets where we're underpenetrated. And then we've introduced new products. Really 2 products. Something we call MXT which is the first kind of large innovation in high end hydraulics we believe in quite a while that allows us to make a lighter, more flexible product which is meaningful if you're routing hose or putting it on mobile machinery and you want to be energy efficient. And also, something we call PRO Series which expands our offering amongst premium hydraulics and addresses spec ranges that we didn't previously address. It opens $1.5 billion to $2 billion of additional market space for us.

Jerry Revich: Can we dig in on the point you made a moment ago, Dave? So you folks are China for China. What about the rest of the industry? What do you view as the impact of the tariff structure? What proportion of the market do you think is impacted that's not China for China?

David Naemura: I hesitate to answer that because I would be speculating to be honest. I don't understand enough about other folks' business model and what they supply out of what plant. But in our case, we have a few specific products that we make in China for the North American market on the power transition side. Frankly they're water pumps. Most of our other products we are in region 4 region, so less tariff impact directly from direct tariffs. I continue to believe that most of us are more impacted by indirect impacts of sales to Chinese customers that export. Machine builders, original equipment folks that are exporting out of China to the United States or other regions that are more dependent on sales into China, maybe Europe, maybe some of the other Asian countries as well.

Jerry Revich: In terms of what proportion of your sales in China would you estimate or guesstimate as the case might be, are actually exported to the west in terms of based on your sense of your end customers?

David Naemura: It would be a smaller percentage. But it would probably be maybe 10%, like that. But still, for China which is about 15% of our total business, 10% being affected in other country sales in I think is something we've seen a pattern with. Our biggest markets there are automotive markets because those have been the fastest growing. And we're quite underpenetrated frankly in industrial, in one of the largest industrial economics. So we continue to grow even regardless of that.

Jerry Revich: Can we talk about water pumps? Not a huge part of your revenue stream, but it will be interesting to hear about your decision tree. Because from what we're hearing, China cost structure post 25% tariffs is not very competitive against producing in other places in Asia or even potentially investing in automating in the US. What does that decision tree look like for you?

David Naemura: I think it's too early for us to make a decision around moving the water pump business. I think we have to see how things develop. We'd do it with a joint venture partner in maybe a little less expensive part of China, but I think we are waiting to see how things develop. I mean the 25% tariffs are just going in, who knows how long these things last. And so I think we would have a wait and see approach to making a decision on something as you point out isn't the biggest fee for us.

Jerry Revich: In terms of the pricing pass through, I think what we've generally seen is companies have pretty good ability to pass through tariffs to the end customer.

David Naemura: I think that's true. Again, our pricing hasn't been as much tariff driven because we haven't been as directly impacted by tariffs. But last year we saw a reasonable amount of raw material inflation which we were, as others, successful in passing through. And I think in our case, a combination of brand and a higher percentage of aftermarket presence probably makes that a little bit easier than it may for some others.

Jerry Revich: And Dave, the other area that you folks really spent a lot of time on at the Analyst Day is talking about the new products. You touched on high end hydraulics. What's that revenue ramp opportunity? On the conference call you spoke about a point or two of total revenue contribution in the back half of this year. How quickly does that ramp into next year and how should we think about the adoption path?

David Naemura: Well, stopping sort of giving a number for next year, I'll tell you that I think it's a pretty steady ramp. We're seeing -- we look at the frontend of how the funnel builds, we have assumptions around how quickly we think things move thorough funnels, how quickly things convert, at what rates, and we're seeing a lot of excitement around the new products, both on the MXT side, further penetration of PRO Series, but then also on what we call chain-to-belt which is really resonating with end users. So the pipeline is building well. I think Ivo quoted a large number that's probably $150 million to $200 million of pipeline, which are opportunities, not the orders. But we think those, some percentage of those convert. More importantly, we're seeing velocity in the building of the pipeline. So we're relying on second half revenue contributions higher than first half revenue contributions and of course we'll look for a 2020 contribution much higher than we saw for 2019.

Jerry Revich: Much higher than 2019?

David Naemura: Yeah, we'll get -- yes, we'll continue to grow.

Jerry Revich: And in terms of the end markets trends, can you just take us around the world and talk about areas where you're most optimistic on growth? It sounds like China aftermarket is one, but maybe step us through with the next couple of areas. And then the flip side, which markets or geographies you folks are concerned with end demand?

David Naemura: I'll maybe go back to a few of the things we talked about on the conference call. First of all China. Which before the move to 25%, we think we saw a flattening of China. We saw a growth in March and April and we kind of called it mid-single digit growth on a core basis for the year in China. Which would be different than what we saw in Q4 and Q1. We believe market aside, we continue to have opportunities to further penetrate industrial end markets which we see as generally steady, particularly in North America. Maybe not as high growth as we thought we would see, but growth. Where we definitely saw greater softness, we kind of called out Europe which we saw softer than we had

thought, honestly on all fronts. We were well documented in the automotive first-fit issues. That is something that we knew coming into the year that we think is about consistent with what we had thought. But I think more broadly, we're seeing softening in Europe. And we remain bullish on emerging markets. India has got to get through some elections and other things, but India has been a great growth driver for us for a number of years and we see that continuing. And we look to further penetrate industrial applications in a lot of markets, including places like Japan and Korea, India obviously, as well as further penetration in Europe where we just haven't had the fluid power capacity to properly serve what is a very large industrial market.

Jerry Revich: So now you're at a point in the cycle where you will have capacity, especially with the fluid power capacity in eastern Europe. Can you talk about how you expect that push to play out now that you're getting some pretty quick gratification on new product side? How would you think about the pace of contribution from the new plants and the opportunity to penetrate the market with all of your SKUs?

David Naemura: Well, we always remind people, we decided to build these plants not when we saw a recovery of the industrial end markets in 2017, but really in 2016 when we were still in what we considered a pretty robust industrial recession. We did it not because we anticipated market recovery, but we did it because we had a lot of conviction around these new product initiatives and the ability to take share, particularly internationally. So with the kind of comeback of the markets, we found ourselves in a position where we were tapped out. And we had these new initiatives and so without the plants, we wouldn't be able to produce frankly product to satisfy the initiatives. I think the ramp will happen maybe less, maybe a little less than we had thought a year and a half ago. But the growth that we'll see will be facilitated by the new plants. What will drive it is adoption of the new products. And so we'll see what that rate is kind of as we talked about earlier, we're bullish on that. And we think these plants give us opportunity to play in regions we haven't been able to play as strongly in. You can't support an OE in Europe with hose coming on a boat from China. It's just hard to do.

Jerry Revich: In terms of your first-fit business, I'll break it up in two parts. Can we just touch on auto first-fit opportunities from here? Obviously, you're very focused on only profitable business, so what does that translate in terms of what the pipeline looks like as you have say eventual in terms of platforms rolling off that you folks are on, that others are on, and weave-in opportunities? What's the mix of all that if we're sitting here 5 years from now and the next platforms are at full production rates? What's Gates' market share from first-fit standpoint compared to what it is today?

David Naemura: First of all, our first-fit market share is very low. We frankly don't bid on more business than we bid on. It's about 15% today of our overall business, down from, maybe lower 15%, down from maybe 19% a few years ago. And that's a combination of things. One, we have bid on fewer programs and therefore we have attrited some of our share. Maybe we have tightened the strategic filter around what we bid and why we bid over the last 3 or 4 years as we've had a new management team come into place. So that's been an impact. But also the market just turned out, particularly in the last half of last year. In Europe, it was significantly driven by the new emissions standards and that has probably hurt us a little worse because we play a little more heavily on diesel platforms. So that has reduced the size of the business. And then the lack of incentives in China, a little slowing of the economy over there has seen the automotive first-fit production decline and level out. Decline on a year-over-year basis will probably level out this year.

For us, we'll introduce new innovative products in automotive first-fit. We don't see it as

a big growth area for us. We see it as somewhere we want to play to be innovative, remain relevant, help support our aftermarket brand and our aftermarket franchise for decades to come. We've always said we wouldn't mind keeping it flat to make it more profitable, so kind of keeping it around a $500 million-ish type business through the cycle. And as we attrite programs off now, eventually replace some of that with a little more innovative programs, and try to kind of hold the level of business. But again, make it a little more profitable, a little more strategic and value add to our OE partners. And also, that will help support the aftermarket.

Jerry Revich: When we're talking about holding the line at the $500 million run rate, is that an inflation adjusted number in your mind?

David Naemura: Yeah, probably.

Jerry Revich: And in terms of you mentioned the diesel headwind in Europe, are we at the point where all of the platforms that we expect to roll off have rolled off? Or are there any pieces that we should keep in mind? And by that same token, any new platforms coming online that you've already won?

David Naemura: I don't know the answer to that, Jerry, but I suspect there is probably still a little more attrition to come on a net basis.

Jerry Revich: And in terms of your industrial first-fit business, can you talk about the opportunity set there? We spoke about the new products, so maybe weave in what the market share outlook is for that part of the portfolio?

David Naemura: I think over a period of time here, a couple of years, we would anticipate taking share because we're bringing innovative new products and we have a big OE presence internationally. We have some definitely domestically. We think there's more opportunity internationally and we think introducing the innovative new products gives us a competitive advantage. I think we're coming out of a time of constrained supply where the OEs were getting all of the demand they could get, and everyone was working hard to satisfy them of course, and not all of us did a great job of that and now we're going to have hopefully more capacity and demand will normalize and we'll be able to get back to more of a normalized state.

Jerry Revich: And do you think they're destocking in industrial even now after not being able to get their hands on enough last year?

David Naemura: Maybe. I think when we talk destocking, it tends to be more associated with our distribution channel. But I think there was a period of time when everyone was getting their hands on everything they could to avoid getting in the situation where they're maybe having line shutdowns. So I wouldn't be surprised if there was some inventory level reduction there. But as we've talked about destocking as a phenomenon, we've been more focused on the distribution channel and frankly mostly North America.

Jerry Revich: Let me pause there to see if there are any questions in the audience? Yes, the mic is right behind you.

Unidentified Participant: Could you just review where you guys stand within automotive in terms of the shifts to hybrid and electric vehicles? And when you look at your parts SKUs, are there some that are vulnerable? Given that you guys like to innovate, are there places that could be an opportunity? Maybe just recap that? Thanks.

David Naemura: Sure. Thanks, Greg. Cutting with an ax, these propulsion technologies are going to migrate over time. We're the aftermarket guy. So we look at how the percentage of propulsion technologies grow over a period of time. And what we see in the next frankly decade, maybe decade plus, is that 7 to 11-year aged car parc, the largest growth will be from hybrid, full and MYO hybrids. That is an area where we have good technology and good content. Those are highly engineered systems in small compartments which plays well for Gates. ICE or traditional internal combustion will continue to see some share of the hybrid and eventual electric. Electric will become a meaningful part of the car parc someday. But as we look over the time horizon, I think this is directionally correct. Well, I'm not going to quote data other than to say it's probably a mid-single digit component of the aged car parc, still probably 12 or 15 years from now. So it doesn't become that meaningful to the aftermarket for quite a while, but we're very focused on what will in the near term, which is the continued growth of hybrid technologies, if that helps.

Jerry Revich: Dave, from a product standpoint, can you talk about are there any product types that are not within the Gates portfolio that would make sense where you could add value with your distribution or manufacturing footprint?

David Naemura: Well look, as technology, propulsion technologies continue to evolve, we will continue to evolve with it, right? So I would foresee a number of electric water pump applications, heating and cooling, fluid conduit applications for electric vehicles. There will be content, there will be actually a lot of content. It will shift from maybe a little more power transmission to a little more fluid power, but that's going to develop over time. And right now, those are OE products that we make some of each of those, but we don't play very big and we'll continue to advance that as we see the aftermarket developing. So it will be an evolution over coming years.

Jerry Revich: To Barry's question, you folks have done well in innovation. Is there a scenario where your OE market share is higher with some of these products than it has been as you mentioned low market share for power transition standpoint historically on an OE basis?

David Naemura: I think there are those opportunities. Whether they develop that way, we need to see. There are some new technologies we're working on. And actually, I think it was in Q1, might have been in the fall, either the fall or Q1, we put out a press release that talked about a number of new products that we're putting into amongst all propulsion types. So we're putting into the market currently. So without going into anything specific about products to come that haven't been announced, I would say yes, that's obviously an opportunity. And too you'll see us bring out some new innovative products that could influence the first-fit market.

Jerry Revich: In terms of acquisitions, you've made a couple of deals at attractive multiples and expanded the customer base. How would you characterize the M&A pipeline now and what's your appetite if you were to find an interesting fit to lever up towards the high end of your target range at this point in the cycle?

David Naemura: The deals have gone okay. Rapro is a good example. We talked about one of the things we pick up with Rapro is we pick up more capability in automotive fluid power which goes directly to particularly engine hose and the new advanced kind of modular engine hose technologies. Also, we pick up SKUs for that product line for the aftermarket. It's hard to tool up thousands of SKUs and with Rapro we get the European SKUs for something we already do well in North America. Our appetite remains good, remains opportunistic. We are focused on growing the business and doing what's right for the

business while being mindful of de-leveraging. And having said that, when the right deal comes along, we'll do the right deal. There's nothing imminent, nothing in the pipeline today. But we believe that we get more optionality over time as we continue to de-lever. We play in large, highly fragmented markets that are attractive for acquisition frankly. We think we can get attractive returns, we think it's an attractive target base. And over time, our optionality will increase and we anticipate taking advantage of that.

Jerry Revich: In terms of your M&A framework, so let's say an opportunity emerges and we see Gates acquiring the business, what are the thresholds that that business will have to meet?

David Naemura: Well, it honestly depends. I think if it's a classic bolt-on, we're looking for double digit ROIC by the second year. If it's truly a bolt-on. And that means it really does accelerate strategy and we're able to go in and tear out costs and integrate it at the rate we should be able to integrate it. If it's not a bolt-on, the returns would be less than that. ROIC of double digit third or fourth year I would say.

Jerry Revich: And that's not on tangible capital, that's all-in?

David Naemura: All-in. Yeah, all-in price. But each deal is a little different. I think we look at what helps us extend our aftermarket portfolio, what gives us new technology, what gives us capacities from maybe a commercial or a product or engineering standpoint. And we're always kind of looking at all those things. Look, there's a good pipeline of opportunities out there and we continue to be active. But in our situation now, we'll continue to be very disciplined when it comes to acquisition.

Jerry Revich: Dave, from an R&D standpoint, can you talk about the mix of projects today, how that's different from 2 years ago? Are you spending more on product costs over some new product introductions? Can you give us a flavor of how you're allocating the budget?

David Naemura: Yeah, so R&D as a percent of sales, pretty low. We're at about 2%, 2.2% over time. And our objective over the last 3 or 4 years has not been to grow or reduce that, but it's been to get something different for it. So what you see us doing is working on far, far, far fewer but far larger opportunities. So MXT is an example of that. MXT is a new product, but it's also a product that helps us take costs out of the products. So new product and VA/VE, reenergizing both of those bases and really just frankly, that's why I said, looking to get more out of our R&D spend by focusing on larger, more meaningful opportunities.

Jerry Revich: Dave, you mentioned you had a couple of new plants that have come online. Can you talk about the technology capability that you're able to deliver in the new plants? And the opportunities for efficiencies to ramp over time with the new generation technology versus what part of the footprint that was built 20, 30 years ago looks like?

David Naemura: Yeah, great. First of all, all the new plants are built with globally homogenous equipment and process. So as opposed to we use this brand of machine over here and this brand of machine over there, we have harmonized on one set of equipment, we have harmonized on one set of manufacturing processes, and those are all capable of making our newest products as applicable as well as are appropriate. I used the word legacy, but kind of trip products is probably a better word. We are outfitting about a third of our plant in Mexico and about a third of our plant in Poland and then we finished completing capitalization of a full plant in China that was already about 1/2 to 2/3 full. And the most important thing is we're able to make in a consistent manner the same product anywhere in the world of our newest generation products.

Jerry Revich: Good. Time for one last question. As you think about some of the new technologies that have come out from a process standpoint, or predictive maintenance, anything along those lines that could really move the needle from a Gates standpoint?

David Naemura: We haven't introduced anything. I will tell you, given our material science background and the material science work we're doing today, we continue to look at those opportunities. We understand the push in that direction. We think there's opportunity. We haven't introduced anything yet, Jerry, but I will tell you we continue to look down those lines.

Jerry Revich: Good. Well please join me in thanking Dave and Bill for coming out and visiting with us. Gentlemen, thank you.

David Naemura: Thank you.