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Gates Industrial Corp. Plc (GTES)

Barclays Industrial Select Conference

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MANAGEMENT DISCUSSION SECTION

Lee Sandquist
Analyst, Barclays Capital, Inc.

My name is Lee Sandquist. I'm on for Julian Mitchell's here at Barclays. Big thank you for David and Ivo joining us from Gates Corporation.

QUESTION AND ANSWER SECTION

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Maybe just starting off. Can you talk about the current demand environment, walk us around the world and what are you seeing from a regional perspective?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. Well thank you for inviting us and we're delighted to be here and to share some thoughts with you. So, we just announced our Q4 and I think that we've been quite specific about the demand profile or the demand environment on that call. And so, nothing's really changed since our call last week.

And, look, we've seen a slowdown in some markets. I think none of those were a surprise to most people. Certainly, we've talked about China quite a bit. We've seen a significant slowdown in automotive first-fit. We've actually talked a little bit about that slowdown at the end of Q3, but that was primarily driven by very high comps that we have had from prior two years Q4. We did see a greater impact on auto first fit business in China at that point in time.

We've also seen some slowdown in some industrial applications in China, particularly with products that are directed towards importers. So, folks that manufacture equipment and import/export it, I guess, to U.S. and Canada, Japan and Europe, and so and so forth. And those folks were much more cautious about taking on inventory for the projects that they've had. So, that's something that we anticipate is going to filter (sic) [continue] through Q1 and Q2. So we certainly see, expect and anticipate that the slowdown is going to continue in China throughout the first half.

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We did see a slowdown in Europe in automotive first fit business, but in a similar fashion, we have signaled and we've accounted for about half of the slowdown that we have seen in Q4 through roll off of programs and projects, and we have seen about half incrementally primarily associated with the new emission testing standards in Europe that I think folks are still working through and, again, we anticipate similarly that we will see continuation of weakness in that end market in Europe throughout the first half.

Outside of those couple of specific areas we have seen a very solid environment in industrial applications and industrials have given us the opportunity to offset our automotive first fit business. We have delivered nearly 4% of core growth in Q4, offsetting a significant weakness in the auto first fit business.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

And within China how much of this temporary weakness do you think is related to the tariffs and if we see some resolution on the tariff front, how quickly can that step back?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Yeah. I think that's a good question that all of us are thinking and spending lots of time figuring out. My sense is that there was a generally slower growth environment in China, it's a maturing economy. But my sense is that the trade conflict extenuated the problems and my sense as well is that as we get closer to some degree of resolution, I believe that China is going to take proactive steps to reverse the negative effects of growth, and we should start seeing – we expect sometime in the second half of 2018 – more positive behavior of that economy.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Since you brought it up, could you just. I think it is important to distinguish your auto exposure and the delta between aftermarket and OE, so can you just talk about that difference a little bit and inform the crowd?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. Gates got a reasonably small amount of revenue targeted towards the automotive first fit markets. About 17% of our revenue in 2019 was directed toward that market; about 26% into automotive replacement market. And the dynamics between those two markets are quite different. The automotive aftermarket is primarily driven by the aging car fleet. For us, it's 7- to 12-year-old car fleet that is pertinent to us and the market dynamics for that market segment are frankly quite positive.

In the emerging world – in the advanced world, in the advanced economies, we have finally gotten on the other side of the registration declines from 2009 to 2010. So what was a reasonably good headwind for the automotive aftermarket in the developed world prior four or five years has now turned more towards a tailwind. In emerging economies, the market dynamics are quite good. The market dynamics in the automotive replacement business in China are very good because we are dealing with 30 years of positive car registration growth. So, we expect that we will have a tailwind in that marketplace well into the future.

And as an example, as our sales into the first fit market in China declined by mid-double digits we have actually grown our revenue in China aftermarket by mid- to high double-digits in the same quarter as well. So there's a dichotomy that we're talking about. So, we feel that we have lots of opportunity and supported markets in the

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aftermarket which is – in the automotive aftermarket which is by far more important piece of our revenue generation.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

And outside of automotive, which end markets are you most excited about heading into 2019?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Look, I mean, we're quite excited by the exposure that we have to the industrial market space. We have a very broad exposure to the industrial complex. We do everything from supporting high pressure hydraulics and machinery from machinery builders like Caterpillar and John Deere to industrial applications and light industrial distribution centers in a sense powering the fleet – the power of conveyance or movement of goods in distribution centers and everything in between.

So we touch frankly every corner of industrial economy, and we're quite excited about the prospects that we have in our business to continue to expand our presence in those markets. And we've talked about a number of growth initiatives that we have that are associated with expansion into the industrial space further, and we firmly believe that the market dynamics for delivering that growth through the innovation that we're putting forward are still very, very positive.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Aside from broader economic factors, one internal factor, if you will, that has been limiting growth has been capacity constraints. Where are the utilization rates today? You guys have been taking proactive measures to make sure that you have the capacity available. So, can you just talk about the time line from here?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Sure. We saw capacity constraints in really hydraulics which is about 65% or 70% of our Fluid Power segment. We play at kind of the premium end of hydraulics, into the higher pressure applications, and that globally was a reasonably constrained supply chain. We had begun in 2016, really before the recovery of the industrial end markets, to build out additional capacity really associated with our broadening of our addressable markets through new products and through new innovations that we're bringing forward.

So we were already midway when the market snapped back. We began to bring up basically two-and-a-half new plants this year, a brand new footprint in Mexico at our campus there, right next to a sister plant, and that began coming online here in the third and fourth quarter. We had completed outfitting a plant that we had kind of half-fold in China. We built up the other half, if you will, and that began towards the end of Q3. And then most recently here, coming out of the year-end, we began commercial shipments out of the plant in Poland.

This should give us capacity for about $150 million to $200 million of additional annual revenues so it will allow us to continue to grow with the hydraulics markets. We're very well-penetrated in North America, but really underpenetrated in the premium hydraulics internationally, and putting the plant in Poland will be the first of scale plant we have to service the European market and additional capacity in China will help us serve the emerging markets in Asia Pacific. So that's a couple of years' worth of growth, at least probably, but it allows us to continue to grow with what is really pretty healthy end markets.

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Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

And as you've gone through this process, what are some lessons learned about that transition? What are some of the negative externalities that you've seen along the way?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Sorry, I don't – I didn't quite understand the question.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

The externalities in terms of unexpected costs, unexpected plans...

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

So, in the second half of the year we had start-up costs associated with the new plants, but really it was almost overshadowed by costs associated with running at full utilization on our existing footprint. So examples of that would be expediting freight, running at a high cost temporary labor. We were making moves to get every ounce of production we could out of our existing footprint. And, accordingly, we were doing some things that were reasonably costly in the near-term to get production move from place to place in, honestly, in a little bit of a too fast fashion, but to allow us to get maximum production.

We service a lot of global OEs and we can't shut those guys down. So we were doing everything we could. Those costs will abate as we get into the new year. We'll still have some start-up costs particularly in the first half of the year, but I think in the second half of next year some of those costs should be favorable on the compare side. We're talking maybe $8 million to $10 million year-over-year, so not the biggest number, but we can get back to a more normalized growth.

We're seeing supply and demand normalized in the marketplace. We're seeing a little more normal activity which is good, still good environment, still robust growth, but a lot of the pent-up demand is normalized.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Now, it's medium-term chain to belt conversion pretty exciting topic for you guys. I know you've talked about quite a bit. Just wondering if you could just provide a little bit of background, maybe give some examples of where you had initial success there, and then quantify any opportunities?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. I think that's a large secular opportunity for our company. We're very excited about it. We have identified an opportunity of potential available market of about $8 billion. So it's very, very sizable. It's an area where we will not be competing with our traditional competitors; we're going to be competing against a competitive technology called roller chain. And so we feel that we're in a very good position to be able to go and penetrate those markets with very advanced products that we are developing and we have developed in the past.

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Now, one of the misnomers is that we are starting from ground zero and that's really not the case. We actually have over $200 million of revenue today that we derive from what we call or what we've coined the chain developed conversion opportunity for us. We have a tremendous amount of pipeline that we have built, identified opportunities and frankly we've added a nice double-digit amount of growth that turned into revenue in 2018 into that revenue as well.

Now that being said, our sense is that the highest growth rate – the higher growth rates that we will see from adding to that revenue are going to occur kind of in the 2020, 2021 timeframe, as we launch some of the new technologies that we are putting in place. But when we think about this opportunity, we think of this opportunity kind of in three different work streams.

One work stream is primarily focused on industrial applications, which would be, think kind of lumber mills, think aggregate manufacturing facilities. The second work stream that we have put together is in personal mobility. Personal mobility is anything from bicycles to motorcycles in the developed world to [indiscernible] (00:14:08) in the developing economies, and that market itself is about $1 billion in size plus or minus. We have about $50 million of baseline revenue there. So, again, very nice base to build upon and a highly differentiated technology that we believe is positioning us towards continue to drive the trajectory of growth there.

And the third stream, it's quite interesting and we have really not talked a lot about that in the past. It's a stream of adjacent technology that we have in our portfolio. We have, again, about $40 million, $50 million revenue base in that technology and that technology called TPU, so thermal polyurethane based belts, and that market is again quite a sizable market, a multibillion dollars market opportunity, and the applications there are in the pharma, food, light industrial distribution markets and so and so forth.

So we feel like we're very well-positioned. We have, actually, quite a sizable presence in that space already and we feel very constructive about what it means for the future for our company.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

And taking a step back, how satisfied are you with the level of innovation at Gates? It seems like last year you had some pretty good success with MXT launch in premium hydraulics but any other examples would be great.

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Yeah. So, most recently, if you go on our website we have made an announcement actually into automotive first fit business technology that's targeted towards mild, full hybrids, and electric vehicles. We've launched about five new technologies that are nicely differentiated that we are quite excited about, what they will deliver for us over the mid- to long-term particularly in the after markets.

We are frankly working across our entire portfolio on full revitalization of our product lines. And as we move forward, I think that there are lots of exciting announcements that are pending across our product portfolio. So I would encourage everybody to keep on watch for these announcement coming forward.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

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Okay. And based on your growth rates and these comments, it seems like, obviously, the result has been market share gains. Can you talk about your market share presence across the business right now and if there's scope to continue increase in share?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. So one of the things that we probably haven't gotten across to most of our potential and future investors is that Gates competes for number one, number two, and number three market position across about 80% of all of the products that we manufacture. And if you think about it, that's a pretty staggering statistic. There are not too many industrial companies that can make that statement. So we are starting from a position of strength across a pretty significant parts of our technology, and we believe that continuing on the trajectory of innovation, we can frankly take additional market share.

And despite the fact that we have such a strong market positioning, we're playing in very large markets where if you aggregate the top four players, as an example, in hydraulics, if you aggregate top four or five market players, we all combined would have less than 45% market share. So, what this means is that we are all large players with reasonably good market share, but we are playing in a very fractured market with great set of opportunities for a player that continues to innovate and continues to expand its capabilities whether or not it is production capacity that we've put in place or new products that are differentiated and solve some specific problems that our customers are looking to have solved, we believe that we can continue to take a good amount of market share well into the future.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

One more on growth, can you just discuss the EVs and how it impacts Gates' dollar per vehicle content?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. That's a great question. When it comes to electric vehicles, I'll give maybe a little more complex answer than you may be looking for. But when we think about propulsion, and EV is just a different type of propulsion of an automobile, we think about automotive propulsion in four different segments, if you would. Starting with ICE on the one side of the book and the other book end book is full EV. The middle is mild and full hybrid.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Right.

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Okay. On internal combustion engine, we have about $175 of potential available content per vehicle. If you take a look at the other book end, we have about $225 of potential available content on full electric. So, things get better for us as we move from ICE to full electric. And in the middle, we have also about $225 of potential available content. So as the technology gets more complex, the opportunity for Gates gets bigger. But what we are trying to get across to our investors is that frankly we are ubiquitous in the opportunity. We don't really necessarily care about what propulsion is used and we just like to see the advanced propulsions to scale up more rapidly.

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Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Right. Now shifting gears to efficiency and profitability. Can you discuss the Gates Operating System, how it's differentiated versus the operating systems of your peers?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Sure. I'll let you take those.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Sure. I spent seven or eight years with Danaher prior to coming here and I think it's good, maybe a good comparison. I get asked all the time how's the Gates Operating System similar to Danaher and do you guys design it based on some of your roots in terms of the businesses. And the honest answer is no. It could be almost a little more different. In the case of Danaher, the Danaher Business System, my experience from my tenure there was that, it's first and foremost founded in culture and has developed over multi-decade period of time; whereas with the Gates Operating System, it was of a much more tactical design.

We had a very fragmented business that had disparity of process and we really use the Gates Operating System as a way to define what we think is best-in-class global process and to orient an entire business very tactically around that. And it's how we drove 300 basis points of margin expansion, gross margin expansion and EBITDA margin expansion from 2014 to 2017, by basically coming to our plant footprint first of 39 plants and saying, okay, if they have 39 different ways of doing things, we're going to apply the best operating system we could.

And in our case, it was taking the focus away from labor productivity, which is only 7% or 8% of our bill of materials, and moving it into overall equipment productivity which had a dramatic effect and then doing that consistently across our global footprint. Similarly, in product development, in the way we run the back office and the way the relationship between R&D, the product lines, the commercial workforce, we've defined those things and those processes well. So, a lot more tactical and a lot more designed at getting our entire business centered around kind of best-in class process. That helps.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Now, one similarity with Danaher is a high degree of aftermarket revenue.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Can you just talk about what is the ideal level of aftermarket as a share of sales? And if there's any large differential in margin profile between aftermarket and OE.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

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Sure. So, look, we're the aftermarket guys, right. I mean, 65% of our revenues are from aftermarket applications, and our aftermarket goes through aftermarket channels. What's the right number, it's not 100%, but it's probably somewhere between 60% and 70% on a consistent basis. A little appreciated fact about Gates is that we do not need to be on the OE application to win the aftermarket business. That's why we're not so concerned about automotive first fit, we're not worried about that in-warranty repair, we're happy to be the off-warranty repair on the car that's 7- to 11-years-old.

Similarly on high horsepower mobile machinery or construction equipment, the aftermarket user is perfectly happy to put Gates hydraulic hose, in fact probably prefers to put Gates hydraulic hose when they refit, go through the one of the four or five lifetime refits of hydraulics on a combined harvester or something like that. Ultimately, it's our brand reputation that we sell up time, but we sell up time in a situation where the cost of the product is de minimis in relation to the cost of down time.

So, we like being on the OE and admittedly those margins are lower than the aftermarket, but we also don't take very low OE business because we don't have to. The margins vary product by product, region by region, but if we don't have to be – we're not trying to buy aftermarket business because we don't have to be on the OE to get the aftermarket business.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

In terms of pricing, it's been very strong recently. Obviously, a portion of that is to combat the inflationary environment. Can you just discuss price cost heading into the 2019 and how you think about the phasing of that margin?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, we anticipate – first of all, price cost is, I'll say, very favorable in 2018. I think we led the market up appropriately. We did experience raw material inflation and we priced it ahead and above that. We even anticipate – it's a little bit our philosophy of pricing that our brand and aftermarket position, positions us well to price, but we believe we should price to offset raw material inflation and we would anticipate doing that again in 2019. We don't think it's as inflationary of an environment and we don't and, likewise, it won't be as rich of a price environment that we saw in 2018 but will be price cost favorable.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Shifting to balance sheet and cash flow. Cash flow conversion you've guided above 80% this year.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Step up year-over-year. What are the big drivers of that improvement?

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Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Well, first of all, we're just getting back to structurally where the business should run. And I'd say that guidance is greater than 80% which is where the business should run, and our longer-term target of staying at 100% of our adjusted net income aligns with past performance. When we put a lot of capital into the business, a lot of CapEx in the last year, and so we see that stepping down from $180 million in 2018 to about $150 million in 2019, on its way back to a more normalized level that we see it kind of 3% or a little over 3% of sale.

Also, we had core growth in 2018 of 5.9%. We had total growth of 10%. And we run a very high working capital requirement, very little too high, and that working capital requirement is about 25% of sales and that we have to provide a lot of cash associated with that 10% growth. Obviously, the growth rate will moderate a little bit this year, so we won't have that big requirement.

So I think if we're a little more efficient as a working capital as a percent of sales, that will offset the increase of working capital associated with growth. So those should come closer to netting this year versus being a big negative last year and then we have the decline in CapEx which gets us right back towards where we should be running frankly.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Okay. Maybe we can just shift to the automated response questions quickly. So, first question is do you currently own the stock?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Future buyers.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Number two, what is your general bias of the stock today? Okay. No negatives, but no shareholders. And number three, through cycle EPS. Number four, what should Gates do with excess cash on the balance sheet? Bolt-on M&A, dividends, debt pay down number five, for 2019 earnings where should Gates trade on PE multiple? Okay. Number six. If you don't own the stock, as a lot of people in this room do not, what's the biggest barrier? Core growth. Okay. Got it.

And then just a couple of closing questions from me. Sticking with the balance sheet, what's the right – I mean, debt has come down quite a bit, what's the right balance sheet leverage ratio for you guys?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

It is tough to say. Depends on future opportunities, but we see 3 times, net debt at 3 times leverage is an important demarcation point that we will be at in 2019 towards the end. We remind people that we started this journey at 7.25 times leverage at the beginning of the LBO and pre-IPO proceeds were 5.1 times and we've now subsequently delevered at 3.4 times at the end of this last year. So, we feel the trajectory has been very good deleveraging and we have line of sight to that first goal. Beyond that, we'll see. Ivo mentioned we have very

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fragmented markets which gives us an opportunity for structurally attractive M&A probably as we gain more flexibility. So after 3 times, it depends.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Okay. And in terms of capital deployment in the form of M&A, can you just touch on the deals that you guys have done recently, and then where is the pipeline today for future acquisition.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Given our leverage profile, we are really focused on bolt-on M&A that will accelerate organic strategy. And so a good example would be Rapro, a deal that we did recently which was about 8.5 times EBITDA, but net of synergies probably around more like 5.5 times, which gives us good pay back in the second year, and also maybe leverage neutrality in 18 months. It's a deal where we add a lot of value and that's what we look for. There's a good pipeline of opportunities in these highly fragmented markets, but we have to be very selective and very disciplined and we'll continue to do that and our M&A flexibility will continue to increase as leverage comes down.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Q

Okay. And since we have a lot of opportunity for shareholders in the room. What are people missing about Gates today. What's the final sales pitch?

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Well, I think that people underappreciate the diversity of our portfolio. I think that they don't appreciate the presence in the replacement markets and, frankly, the counterintuitive ability to generate and harvest our balance sheet during a downturn. So, we feel that we are a company that has tremendous – not only a tremendous opportunity to grow in the future, but also has a little bit of a downside during a recessionary market environment. We believe that people – as we mature as a public company – we've been public for one year – as we more mature as a public company and people start to appreciate the performance throughout the cycle, I think that we'll get a lot better appreciation for the stock and I think a lot more people will be interested in owning this equity.

Lee Sandquist
Analyst, Barclays Capital, Inc.

Okay. Thank you both very much.

Ivo Jurek
Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

Appreciate it.

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