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Call Participants

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Ivo Jurek
CEO & Director

ANALYSTS

Jerry David Revich
Goldman Sachs Group Inc., Research Division

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Presentation

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Good afternoon. Welcome, everyone, to this afternoon's [fireless] chat with Gates Corporation. I'm Jerry Revich, and with us today from Gates is Ivo Jurek, Chief Executive Officer. Ivo, thank you so much for joining us.

Ivo Jurek
CEO & Director
Thank you, Jerry.

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Question and Answer

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Ivo, to start the discussion for folks that are newer to your business, can you just talk about the Gates business model and how it compares to your competitors? Your aftermarket business is 60% of sales, obviously, much bigger than a lot of the companies you're up against that are more OEM-driven. So if you could talk about the company's strategy historically that's enabled that attractive structure across the few businesses and steps that you're taking to defend or build on that aftermarket position?

Ivo Jurek
CEO & Director

Sure. Look, the leadership position that we have built in our replacement channels is, first of all, it's real differentiator for us and has been built over decades, frankly, on providing the highest quality products and reliable service to customers around the globe with a very complex portfolio. We have certainly moved in very early on internationally. We've been focused on continuing to build on this leadership presence in emerging markets. Look, China and India continue to represent significant opportunities for us in both the automotive as well as the industrial replacement channels, and we are very constructive on both of those.

And I spent a tremendous amount of time talking about innovation over the last 5 or 6 quarters. And so our innovation is going to be a real differentiator for us, and it is focused primarily to stay selectively at a forefront in first-fit applications that ultimately drive our replacement cycles, especially in the developing economies. So yes, very much so focused on the replacement business. We believe that, that's a real differentiating facet about the Gates business and it's also been one that, frankly, has driven the level of profitability that this -- the company has been able to demonstrate over decades of operations.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And Ivo, can you talk about your strategic priorities for the business today and how that's evolved from the time of the IPO?

Ivo Jurek
CEO & Director

Well, sure. Look, our strategic priorities remain the same. Despite the current environment, which I think everybody is very concerned about today, we are focused on our organic growth. We are focused on optimizing our cost base. And now, it isn't just in response to what we are seeing in terms of the COVID-19. We've talked about the opportunities to drive a nice optimization across our business even at the time of the IPO, and as I said earlier, focus on investing in innovation.

Organic growth, probably an opportunity that's even bigger than what we thought originally. And the key initiatives that we have put in play, some that are more secure in nature like chain-to-belt, are certainly opportunities that we believe that can be very substantial in our ability to continue to drive growth well into the future. So on power transmission, as I mentioned, chain-to-belt, very good initiative for us. We're making tremendous progress, particularly in mobility, personal mobility side. I've talked about that a little bit on my last call last week. So those initiatives are proceeding well.

And on Fluid Power, look, we have been spending quite a bit of time and resources in broadening our product lines. We have been spending quite a bit of time and capital resources to broadening our geographic expansion. We talked about that during in 2019 with the 3 factories that we have built in Mexico, Poland and China to give ourselves a much greater opportunity to support our customers in region demand, within the region that they are consuming the demand.

And the performance is going to be further enhanced by the new product platforms that we are launching that are quite significant and have a quite significant IP coverage. Our new plans certainly give us

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an opportunity to accelerate our restructuring plan and reduce our cost structure that we've talked about quite substantially since second half of 2019. And the new product launches, they certainly have gained traction. And we believe that they will continue to gain traction and give us a very competitive differentiation in this global marketplace.

And I think that those are tenets that we spoke about at the IPO, and we have been pretty consistent in outlining to our shareholders and to the analyst community, and we believe that those are still tenets that are very important today.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And Ivo, can we expand more on the market share discussion by talking about the automotive original equipment platform? So essentially, you had prior models roll off in '18 and '19. Can you talk about how we should be thinking about your market share from here? Or are there meaningful new platforms coming online as we head into '21 that could allow your auto OE business to outgrow end demand?

Ivo Jurek
CEO & Director

Sure. Look, on the auto OE side, look, we had a period of -- we had a gap period that we have talked about. And we've talked about walking away from some programs that rolled off and, to a degree, are still somewhat rolling off. And certainly, several key design wins with substantial number of OEs that have not ramped up yet during 2019 and will ramp up during '20 and '21, in particular. We've always talked about being focused on selective participation in the automotive OEM side, automotive OEM business. And look, we don't necessarily require being present with the other OEs to maintain our leading presence in the replacement channels. So there's a dichotomy in here a little bit. It's not as essential, as I said. We have focused on programs where we can differentiate ourselves with technology.

Again, I keep talking about innovation, technology, new products, particularly in the emerging markets, where it will ultimately contribute to our replacement channel presence. And I would remiss if I did not remind everybody that, look, we do earn respectable margins with our automotive OE business globally, and we certainly would expect that at least we will be able to maintain, if not increase, with the selective focus that I have outlined here.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Okay. And Ivo, in terms of the aftermarket market share standpoint, can you talk about where it stands today compared to 3 to 5 years ago for automotive and separately for industrial replacement? Any notable trends?

Ivo Jurek
CEO & Director

Look, so I don't think that there have been any significant shifts in marketplace, getting some puts and takes, not really massive tremors that I would say. Look, again, coming back to launching the new products, they are tracking -- that are certainly tracking ahead of -- or certainly on schedule that we have anticipated. We believe that we are well positioned to come out of this COVID-19 crisis with a number of opportunities to take market share as we see that there are certainly in the automotive space, suppliers that probably will struggle to get back on their feet. And we believe that that's going to translate all the way, not just in the replacement channels, but it's also going to give us opportunities to selectively pick up some business on the OE side if we so desire.

On the industrial side, I wouldn't say that this is dissimilar. I think that I would probably point to the innovation playing even more critical part in our ability to stay competitive. We've made pretty early on determination that there are some real opportunities to offer some real value to the OEMs, whether or not it is in Fluid Power by offering significant weight reduction with our new products and giving folks opportunity to either improve fuel efficiency or reduce the ergonomics in assembling their machines. So

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kind of what we have done most recently with our EE-banded V-force belt that we've just announced a couple of weeks ago with technology that's reducing chloroprenes and is much more environmentally friendly than the prior constructions of those belts, and by the way, also happen to be much more capable in terms of performance life and performance on the temperature.

So I believe that the tenets of innovation give us the opportunities to be very, very well positioned for future market share gains as we exit the present tentative situation with other constraints brought in by COVID-19.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And we're hearing from manufacturers that are increasingly focused on growing their aftermarket business, and they want to own the IP for key components that go in their products, particularly Fluid Power-type applications. Can you talk about how that plays into your business? Are there any implications for your margin structure on -- in areas, where you allow the customer to own the IP? How does that factor into your business?

Ivo Jurek
CEO & Director

Yes. I think, Jerry, that is certainly something that we -- you hear a lot about, right? I mean I think everybody is waking up to the fact that you can certainly make a little more money in servicing your existing equipment that's been in use, that needs to be serviced. But I'll tell you that Gates has been a replacement-focused company over our history over the last 100 years plus, almost 110 years this year.

And I also will come back to the innovation piece that certainly differentiates us. Because you want to switch into a replacement model doesn't necessarily mean that you can. You've got to have a very broad portfolio of products that we have built over decades. You've got to have the ability to support many of your customers. Not every customer has the opportunity to go to your dealer. And I think that, that's certainly something that differentiates Gates, as we've discussed on some calls. Historically, Jerry, on some of our earnings calls, I always try to not remiss and remind people when I talk about my AR channel performance that sometimes, your O'Reilly's and your local NAPA store in the middle of America, where it is difficult to find a major OEM dealer, serves as your industrial replacement channel partner that helps you to repair your combine harvester or your earthmoving equipment and so on, so forth. So I think that the objective, although it's desirable, I'm sure by these OEMs, it is not as easy as flipping a switch.

And frankly, we believe that the innovation differentiate us. We also believe that the large portfolio with the intellectual property that we have that protects us and is kind of a moat against some of these other OEMs' desires. And look, we produce consumable products, and I believe that it is much more difficult for the OEMs to control IP on consumable products like we make because we simply are out innovating everybody that's out there, and it is very difficult to keep up with our innovation machine.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Okay. And Ivo, in terms of the overall demand environment, based on the information you shared on the conference call, looks like in the second quarter, sales are going to be down about a 35% on a 2-year period, 30% in a 1-year period. But that compares to a 21% decline, peak to trough in 2009. So I'm wondering if you could talk about which of the verticals are seeing the more dramatic decline in this cycle? And if you could talk about channel inventories within that context, that would be helpful as well.

Ivo Jurek
CEO & Director

Sure. So let me start with this. Look, I think that we need to remind ourselves that from a pragmatic perspective, the economy and the health of the economy entering the COVID-19 crisis was much better than what we have seen in 2009, right? I recognize that, that does not mean a lot to anybody today on

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kind of 13th of May, but the economy is where in a very -- I think in a reasonably good shape. And I think that, that's going to be important as we exit the situation in here.

What we see right now is that the first big channels have been impacted quite significantly in 2020. And that's, frankly, due to the broad and general full customer shutdowns. And also, we really did not have in 2009, so this is the different mechanics that comes in play.

The replacement channels, on the other hand, particularly the automotive ones, I think that they are more significantly impacted today than they were in 2009 and due to the very broad shelter-in-place requirements around the world, not just in the U.S., right? And we have certainly seen that.

I would say that we -- and I said it on the call last week, we have already begun to see recovery in China, in particular, right? And China, to me, is kind of a beacon of light because that's the only actual data that I have access to. Everything else is the various forecasts, and I think everybody is looking at how things are going to work out. But I actually have a real data stream live coming every day associated with what is happening in China and how China was completely shut down and how it is now recovering. And my sense is that all the other regions are going to follow --probably not in identical trajectory, but certainly a similar one. I do want to remind everybody that China is a little bit different because China did go hard down. We have really not seen any economy around the globe to -- maybe with the exception of India, to take a similar step to what we have seen in China, where they just shut everything down fully for a period of time. So I think that that's important to stay focused on what's happening in China.

I will also tell you that I was actually quite surprised when I did not see the Chinese government to go all in on stimulus package. I mean there's some stimulus package that is working its way through China, but I think that they have taken a much more pragmatic approach in letting kind of the demand to settle down and then start rebounding off the bottom and rebounding it is.

With respect to the automotive replacement, particularly in the U.S., the third-party data from April has been already indicating an improving trend in driving activity. And frankly, the data coming from the repair -- independent repair shops have been also quite encouraging. We've definitely seen what I would say the bottom of activities in early April, and we have seen progressive improvements as April moved forward across pretty broad set of indicators for the AR business.

Let's remind ourselves that as a short-cycle business, we tend to see both the downturns and the recoveries earlier. In 2010, we recovered nearly all of our 2008, 2009 declines. And I know that there may have been some other businesses that did something similar, but you really need to be kind of an early indicator to see those rebounds. And I'm confident that we will see this again in -- during this downturn.

Look, we believe in the resilience of our business. We have mission -- we manufacture mission-critical parts. In our focus on the replacement channels, positions us well for the recovery that's to come.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And Ivo, can we expand on that discussion we just had on auto replacement market over the course of April? That was helpful. Can you talk about -- are you seeing a similar trend in industrial aftermarket as well? It seems like on the construction equipment side, the utilization rates looks like bottomed in the first week of April and then recovered exiting April. Did you see that play out in activity levels for your aftermarket business?

Ivo Jurek
CEO & Director

Jerry, we do, but I would caution you, it's early and it's -- what we are seeing is the trend line is more like 3 weeks behind the automotive replacement market. So the answer is yes, but -- and I want to see more data points before I can more affirmatively come and say, "Hello, yes, we definitely have seen that bottomed as well." My sense is it has, and we are now seeing some improvements. But I want a few extra weeks of data points to be able to say that. For our products, we are seeing a very similar trend line as we see on the auto replacement side, which is firm.

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Jerry David Revich
Goldman Sachs Group Inc., Research Division

And in terms of the cadence of activity on the auto side, we have been facing a destock for the products that you folks carry, I think, for the past year. So I'm wondering, for your auto replacement business, could that return to growth by the time we exit '20 based on the cadence, just simply because you're comping against inventory destock periods, particularly as we get to late 3Q and 4Q?

Ivo Jurek
CEO & Director

Look, that would be my sense, Jerry. Again, I mean, pragmatically speaking, we try to stay away from forecasting what's going to happen in the second half of '20 into '21, obviously. But my sense is that as this -- again, if China is an indicator, we should start seeing improvements as the counties and the states and the major cities start reopening. We are seeing activities to pick up even today, as I have just outlined a couple of minutes ago. So it would be reasonable to presume that as you exit '20, you should exit in much better shape than where we stand today. And if I'm correct, then our products are being well received, we also have opportunities to also expand our market share as we exit '20 into '21.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Any -- earlier in the conversation there, you pointed to the historical bounce back that Gates saw coming out of the Great Recession, 20% growth in 2010. How much of that was inventory restocking off of the destocking comps just given the natural early cycle nature of your business, as you alluded to earlier?

Ivo Jurek
CEO & Director

Yes. That's a really good question, right? I mean, I wish that I was here, but let me just give you my sense. So my sense is that there was certainly some element of restocking in 2010. I mean, that would be natural to look in hindsight. But there was also a fundamental improvement in demand for our products. I want to remind everybody that we make mission critical products, right? So it isn't something that is nice to have. I mean if your belt in your automobile or your water pump in your automobile breaks, you will not get an [AED] light. I mean, your car will not drive. If a hose breaks in a combine harvester, you're not going to go and harvest wheat, you have to replace that hose. And so my sense is that a combination of the mission criticality and the improving market fundamentals and the market dynamics exiting 2009 added to restocking, right?

The end users also, generally speaking, the fair purchases of new equipment when there is a high degree of market uncertainty, and they are much more focused on better maintenance of the existing equipment that they have. And I'm sure that played into the recovery where people maybe wait another year before they buy a new piece of gear, but they'll make sure that the gear that they have is operating correctly. So if this repeats, in my sense, is that there's no reason to think that it wouldn't. And the large installed base of the aging equipment that's out there will need to be maintained. Frankly, I also believe that, as I said earlier, the economy was in a reasonably good shape. There may be even a larger base of installed equipment out there than there was in 2010, which should represent good opportunity for us to help those operators to maintain that equipment and get ready to restart. But I don't think that there's anything that should limit our ability to grow as those markets recover. And we have the capacity in place, as I said, in all the regions. We have much more flexible supply of labor that we didn't really have available during 2017 and 2018. And we have launched a ton of new products. And so I feel pretty good across both of our product line segments that we ought to be able to benefit as the markets become more constructive as people need to maintain that critical set of consumable products to operate their equipment. So I feel pretty good about that.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

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And Ivo, in China, on the new equipment side, we're seeing really significant growth for excavator demand based on numbers that just came out overnight for the month of April. I'm wondering, for your replacement markets in China, are you now in a position where the business is growing year-over-year in replacement markets? Or is it lagging the ramp-up that we're seeing on the new equipment side?

Ivo Jurek
CEO & Director

The replacement side of our business in Greater China has grown nicely in April. So I would say that we have seen that trend that you have outlined, Jerry. And by the way, we also see the growth in the excavators demand.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

That's really nice to hear. And in terms of coming back to a comment, Ivo, that you made at early on in the conversation with the manufacturing footprint investments that you folks have made in lower cost areas, are there opportunities to structurally consolidate the manufacturing footprint so we come out of the cycle with a higher-margin structure than heading into the downturn?

Ivo Jurek
CEO & Director

Yes. I think that's a really good point. And look, we've talked about facility consolidation, and it was always envisaged as a part of our plan. That is, frankly, why we've built the 3 new plants during '17 and 18. And I've talked about it during the IPO by the by, right? And today, we are really well positioned to support all of our customers within the regions and having that flexibility. And I believe, in May of 2019, I've officially announced on my earnings call, a restructuring plan and then we have upsized that restructuring plan in August of 2019 to address $40 million of structural cost.

Look, amongst the actions, we've planned to consolidate certain other facilities. And we wanted to do that not only to lower our cost, but frankly, give us an ability to put it in -- consolidate it into locations where we have much greater flexibility and more efficient plants that we operate. Those newer plants that I've talked about, they are located in much larger population centers that provide us with much greater flexibility for labor supply. And that enhances our ability to be able to fluctuate labor as the demand goes up but also be more efficient when demand goes down, ultimately, significantly improving the structural quality of our operating model that we are very much focused on.

And look, maybe that wasn't part of your question that you have asked, but I said that on my earnings call, if we need to be prepared for some negative turn and if the things are not going to play out the way that I think everybody is anticipating that they're going to play out and things become worse, we have a contingency plan in place that we could accelerate some incremental restructuring. And we are certainly ready to take that on. We got the management capacity, and we are not going to shy away from continuing to structurally improve the quality of our franchise.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And Ivo, on the flip side, the industry really struggled to keep up with peak demand in the last cycle and essentially ran out of supply. Can you talk about the lessons learned and any opportunities for you folks to potentially get the higher peak margins, if you will, in the next cycle based on labor efficiency gains or other initiatives? How should we think about what's going to be different whenever we're in that high-class problem or industry is out of supply?

Ivo Jurek
CEO & Director

Yes. So you're right. I mean we didn't take any fixed capacity offline, Jerry, if I can remind ourselves that we did see the industrial downturn in 2015, 2016, as I think everybody has forgotten about. But during the downturn, we did not take any fixed capacity offline. We -- what we did is we've taken some labor

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capacity offline during that -- during the downturn. And then unfortunately, we end up struggling during the demand rebound, and it was predominantly driven by the supply of labor, a supply of labor of being in these less populous locations that, frankly, has been resolved by building these 3 new plants, as I said, in areas where we believe that we have much greater ability to access to direct and indirect labor. We've spent a large part of the year addressing a compressible cost in 2009 and -- in 2019 and to address our compressible costs, and I felt really good about where we exited.

And so as we exit this downturn, when we compare that to kind of the situation in 2017 and '18, where we have been all labor constrained and capacity constrained, what are the things that are different about Gates? Well, first of all, we have reduced compressible cost base, which is really good for us. We have fully in region, for region manufacturing presence, which was not the case during '17 and '18. And we still were putting big, bulky hydraulics on planes and boats and shipping them over the world to support our global customer base. We have much more capacity available with the more efficient plans that we've put in place, and we have much more labor flexibility.

We also have fully revitalized product portfolio that gives us an ability to get more out of the fixed base capacity, and it's much more cost competitive construction. So I believe that we are in a much better position to take advantage of that eventual recovery that we all believe will come. We don't know when it will come, but it will come in a minute here. We are well positioned to take advantage of that.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

And Ivo, can we talk about the distribution part of the Gates story? So you folks have over 370,000 SKUs that -- delivering within 48 hours to your distributors. Can you talk to us about logistics system structure today and any opportunities that you see to drive further efficiency gains and potentially market share on the aftermarket side?

Ivo Jurek
CEO & Director

Yes. For sure. Look, you said it, we have a very broad product line coverage and we have in region, for region that gives us the ability to supply in very short lead time, right? And that's really essential because if your combine harvester is down and you need to go harvest, you need to get that hydraulic hose or coupling ready to be replaced. Look, from our system expertise and experiences playing significant role, again, talk about the in region, for region and the importance of it to be able to support the local and regional channels, distribution channels. And our goal -- or the key tenet of our recently introduced new products -- and I haven't spoken about it a lot, but I will well into the future is, the key goal here is also to reduce the product platform complexity while maintaining the same level of application coverage. And that -- as a result of that, we should improve our logistics efficiency, and frankly, improve the logistics efficiency of our channel partners, which I think is going to be very differentiating, right? And so the replacement channels in emerging markets will continue to be a very significant opportunity for us. China, right? Automotive replacement channel should continue to provide very significant growth for us on a back of very strong production rates that we have seen over the last 25 years historically. We will continue to expand our presence in the lower-tier cities in China. And we will continue to broaden our portfolio coverage to solidify our -- frankly, what I view as #1 market position in China. So China automotive replacement key have done a great job, and we believe we will continue to get a great deal of opportunity there.

On the industrial side in China, the channel is much less developed, Jerry. As you know, it is very fragmented, but it does also provide us a similar opportunity for future growth as those channels start to consolidate. As the sophisticated amount of equipment is entering service, it will require much higher-quality product portfolio to be able to support those operators. And I feel that we are very well positioned to capitalize on that opportunity as it starts to evolve into the future on the industrial side in China.

The replacement channels in India, they are another very key area of focus for us. Industrial is probably a little more developed than automotive, and I would say that they may be 5 or so years behind China. But we have been in India for a long time. We are investing in product line coverage. We kind of have a really

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good standard work process on building our presence in these developing economies. We have done that in Eastern Europe, then we have done that in Russia, then we have done that in places like Turkey. Now we are demonstrating that machine in China, and we are taking that machine to India and building that capability there with a line of sight on future significant growth in India.

And lastly, I think that you will see an opportunity in places like Africa, but that base of -- that installed base is growing there as well. We don't manufacture anything in there, but we are now starting to build out our commercial presence so that we can start supporting customers that wants to buy Gates products. So I feel very bullish about what lies ahead of Gates in terms of replacement channels. That story has not been written. I think that there's a big set of chapters that are still being written. And I believe that those opportunities are going to be terrific. We make good money in developing economies and replacement channels. And that is our DNA, and we will continue to build on the DNA and the opportunities that we see ahead of us in distribution.

Jerry David Revich
Goldman Sachs Group Inc., Research Division

Good. Ivo, thank you so much for your time. Really nice visiting with you. And hopefully, next time, it won't be in a virtual setting. Thank you so much. Thank you, everyone, for joining us.

Ivo Jurek
CEO & Director
Thank you, Jerry. Appreciate it. And everybody, stay safe.

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