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Gates Industrial Corp. Plc (GTES)

Barclays Industrial Select Conference

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MANAGEMENT DISCUSSION SECTION

Trish Gorman
Analyst, Barclays Capital, Inc.

Hello and welcome to Day 2 of the Barclays Industrial Select Conference. My name is Trish Gorman, I work with Julian Mitchell on the US multi-industry team. So, we have Ivo from Gates Industrial Corporation. So, thanks for joining us, first of all.

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

Thank you.

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QUESTION AND ANSWER SECTION

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

And so, I guess, just starting out, when we look back at 2019, a major topic was the destocking and I don't know if there's a way to quantify kind of how much of the declines in 2019 were market-related versus customer-related and destocking. And then, if you could just kind of remind us your anticipated timeline for when you think we'll get through that destocking in both Power Transmission and Fluid Power?

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

A

Great. I think good questions in here. So, when I look back at 2019, our core growth in 2019 was about negative 5.6%, and I would say that predominantly driven by quite a negative sentiment that has developed certainly over the second half of the year, particularly with mobile hydraulics. Mobile hydraulics decelerated quite substantially. But coming back to the negative 5.6%, about 200 basis points of our negative core growth was what we would associate is with the destocking. So, the destocking was pretty substantial and it has added pretty significant amount of pressure on our top line in 2019.

Now, that being said, on the fourth quarter call, I have stated that we see that the inventories in the channels have leaned out quite a bit, as we exited 2019. We still feel there is a reasonably negative sentiment particularly on the mobile hydraulic side or mobile equipment side. And we anticipate that we will continue to see a degree of destocking through Q1 and probably bottom out in Q2. And then, in the second half of the year, we anticipate that we will see supply and demand more in balance with the underlying market performance.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Okay. That's very helpful. And then, I guess, in this downturn, you guys have taken a lot of action to reduce your cost base and emerge with a leaner footprint. How are you feeling about your position in capture volumes when growth returns? And maybe any lessons you learned from two years ago with the capacity constraints?

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

A

Yeah. So, look, in 2016, during what most people forget was the last industrial downturn – I've been on board for about five years and I've been dealing with the second industrial downturn in five years. So, it just put things in perspective when people feel that GDP has been growing and everything has been quite okay. Well, actually, the industrial economy has gone through a couple of downturns already.

In 2016, we decided that we needed to build incremental capacity. We saw that the incremental capacity will give us the opportunity to do two things. Number one, expand our presence in some underpenetrated regions like Europe and Asia. And number two, we've now spent lots of time and focus on revitalizing up hydraulics product portfolio, so we felt that with the new product introductions, we will get a good opportunity to expand our market presence and market share with the local presence in manufacturing.

But we also felt that we needed to build and broaden our footprint to execute on our longer-term plan, which was to reduce our less-efficient manufacturing footprint. I think that they've got lost a little bit in the translation when we

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– where we've talked about capacity expansion because everybody was dealing with a very significant supply/demand imbalance. But we continuously stated that the purpose of that expansion was dual; A, drive growth; and two, give us [ph] both (00:04:08) the opportunity to reduce our fixed manufacturing overhead.

And so, end of 2019, we have announced a good sized restructuring program. We've announced that we will be taking about $60 million of charges over the next two years, 2020, 2021, to reduce about four or five rooftops, that should give us about a $40 million improvement in our fixed overhead. Now that being said, we also stated that we are not planning to take any capacity de facto with just collapsing less efficient, smaller sides into larger more efficient sides that give us a greater opportunity to flex up and down with volume.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Helpful. And so, then, I guess, as volumes return, what type of incremental should we expect to see on this growth?

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

A

So, in 2019, we've delivered about 55% decremental margin, which taking into an account our gross margin profile is a little bit worse than what you would anticipate. But conversely, we anticipate a significantly greater incremental margin as we progress through 2020. We anticipate that the fixed overhead realignment will give us an opportunity to deliver better incrementals than what we have seen during the last down-cycle for an intermediate period of time.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

That's helpful. And then, I guess, on everybody's mind has been coronavirus in China. I know it's important market for you, guys. I think as of the last quarter, you guys were expecting production to come back on February 10. Maybe just any commentary on what you think the impact might be and kind of how your expectations have changed there?

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

A

Yeah. So, first of all, we got a pretty significant amount of head count in China associated with our manufacturing footprint. We have bought five facilities in China. First and foremost, we are worried and concerned about the well-being of our employees. And so far, we have been very fortunate to not have anybody that has been impacted by coronavirus. That is a good thing.

All of our facilities are now up and operational to the tune of about 40% to 50% capacity utilization. The capacity utilization is predominantly impacted by the availability of labor. As you know, it's a migrant workforce, and post-Chinese New Year, most of the employees return from their home provinces into our sites. Number of those employees have been quarantined for two weeks. Good amount of employees are coming off quarantine on Monday of next week. So, we frankly anticipate that we should be kind of up at the 60% to 70% capacity utilization next week. And as we enter into March, get through about full capacity utilization.

So, we anticipated that by February 10, we would start production. We actually started production about three or four days later than what we've anticipated. And the ramp up has taken a couple more weeks than what we have anticipated originally, but not too much different than what we thought when we report in our fourth quarter.

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Trish Gorman
Analyst, Barclays Capital, Inc.

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Okay. And would you expect to see that demand come through in the second quarter or it's kind of just gone [indiscernible] (00:07:52)?

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

A

Yeah. So, in our case, we certainly believe that the demand just got pushed out into second quarter and beyond. We anticipated as this gets worked out, although nobody can really give you a firm answer yet, because I think the Chinese government is dealing with all of those issues presently and I think they're trying to get their arms around that. But we certainly believe that that demand just gets pushed out into Q2 and Q3 and Q4, and we still anticipate that we're going to have a very good year.

As you mentioned earlier, we exited 2019 with lots of positive signatures in our business in China. I think that we've outperformed the market very, very nicely across all of our product categories. And we believe that that's going to carry through once we work out the issues associated with the coronavirus.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Awesome. And then, I guess, looking at end-market trends, I know on the call you've seen some signs of stabilization in industrial. Maybe if you could touch on kind of what trends you're seeing now in your end markets, maybe where you think those are going to come from throughout 2020.

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

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Yeah. So, Gates has about 65% of our revenue derived from the aftermarkets. And so, one of the things that we like a lot about Gates is that aftermarket presence and it makes the quality of this business very high. When you see deceleration in markets, unfortunately, you also see kind of a double whammy with the destocking that you will see through the channel partners. And we anticipate that the destocking as I said earlier is going to work itself through certainly in North America, through the first half of 2019.

We've planned on reasonably negative market environment, particularly in the mobile industry in the first half of the year. And then, in the second half of the year, you will start running against more – much, much easier comps. And so, if you look at what we have taken into an account for our guidance, I mean, we set our guidance at 50 basis points of core growth at the midpoint and we certainly still believe that the market environment is exactly what we have anticipated at the beginning of the year and we are frankly still at the beginning of the year, but we are not seeing anything presently absent of some more significant disruption in China that should change our view on 2020.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Okay. Great. And then, I guess, just shifting to kind of deleveraging, I know you pushed out that target slightly. How do you think about deleveraging now and how does that impact your medium-term capital allocation priorities?

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

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Yeah. So, look, we have terrific year with cash generation in 2019. We've generated nearly $270 million of free cash flow that we've put on the balance sheet, so we exited the year with nearly $600 million of cash flow on balance sheet. That gives us some flexibility on how we think about what we want to do with that cash.

Our primary priority remains deleveraging. My sense is that we will get to our next target of deleveraging to three times of below leverage in 2021. So, we are not really that far out of being able to get to that initial target that we have communicated to our shareholders and the market and we feel pretty well-positioned to be able to deliver that next year.

From capital allocation perspective, look, we are always looking at bolt-on acquisitions. Again, as I said, we have over $600 million of cash on balance sheets, so we do have some flexibility. But we've got to see some good quality assets that can be very additive to our strategy whether or not it is expanding our product portfolio, where we can drive incremental growth, or expanding our geographic presence or giving us an opportunity to get into new, higher growth markets.

So, we continuously to look at those potential acquisition targets. But presently, there isn't anything that we are active on, to be honest with you, and probably repaying some debt is going to be a priority for us.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Understood. And then, on free cash flow, 2019 was very strong, especially Q4. And then, guidance for 2020 is for over 80%. Kind of how should we be thinking about moving pieces within free cash flow this coming year, and then maybe a longer term sustainable run rate?

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

A

Yeah. So, [ph] I understand over the (00:12:37) longer term first that I think is pretty straightforward answer there. Look, we have outlined during our last year's investor analyst day that our overall target is to convert adjusted net income at about a 95% rate and we believe that that remains to be our intermediate target to get to. Over the last two years, we have had more expensive CapEx requirements, where we were building three new facilities. We finished those projects frankly in the first quarter of last year. And we anticipate that our capital investment is going to normalize around 3% of sales. That also was our longer term stated objective.

And so, as the growth returns, we believe that the pieces between inventory reductions and accounts payable and CapEx at 3%, frankly, should give us the opportunity to continue to deliver at that 90%, 95% cash conversion to adjusted net income. We don't see any reasons that we could not deliver that over the long term and that is our primary objective to go and execute on.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Okay. And then maybe just specifically on 2021 with the guidance for over 80%, so what are the moving pieces within that, kind of what's changing from 2019?

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

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We will require to rebuild some working capital on the back half of the year. The way that the math works, there's actually a reasonably good amount of growth that will occur in the second half of the year. And so, early in the year, we just provide a guidance that we believe is reasonable for our shareholders to build their own plans around how we view cash generation. And we certainly anticipate that we have to be able to do at least 80% or better in 2020. There isn't anything that is lurking out there like an incrementally large amount of CapEx that we want to invest. I think we've guided about $100 million of CapEx for 2020 and we still believe that those are good projects that we want to invest in and that's about the rate that we foresee to go and execute on at this point in time in the year.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Okay, that's very helpful. And then you touched on a little bit, but I guess on the acquisition front, if you were thinking about expanding in geography with Fluid Power being around 70% North America. What other geographies are attractive to you and where do you look towards expanding into?

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

A

Look, I think that our big priority today is to expand much more significantly in Europe. Our Fluid Power business overall is heavily weighted to North America. And we like that, we are big player in North America. By the way, we are launching a ton of innovation. So, we believe that we still have an opportunity in North America as much as everywhere else around the globe.

But we have underserved the European market. We have a great brand in Europe. We have right to play in Europe. But historically, Gates has not had a manufacturing presence in Europe and we have built a nice business in Europe in hydraulics over the last 20, 30-some-odd years without having a large-scale facility. Well, we've built this facility in Poland over the last two-and-half years or so and we have a ton of innovation that's coming into the market as we speak. So, we believe that we are in a very good position to very nicely scale up our business in Europe in particular.

Now, we also scaled up our facility in China. We have two factories in India. So, we believe that there are great opportunities to continue to drive growth in China and India, in particular. Again, on the back of the investment that we have done in China in capacity expansion, we have a very nice size, very large factory, and the new innovation that is coming forward with the products that we have launched in 2019 and frankly, that we are launching, that we'll continue to launch in 2020.

So, we feel that we are very well-positioned to be able to take market share in global hydraulics, not necessarily just in one region or another, but we feel that we have an opportunity around the globe to be able to do that.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Great. And then, I guess on that end, with new product development, I don't know if there is – if you can quantify, but what percentage of sales comes from those new products right now or do you have a longer-term target? Yeah.

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

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Great question. Again, I'll come back to what I said last year at our Investor Day and during that meeting, I stated that about 2016 timeframe, we were generating about 5% of our revenue from new products that were younger than five years. Our long-term target is to get that number to 20%. And we believe that we will get to that 20% of NPI vitality index by 2023. You know we feel that all the activities that we are working on are going to support that objective. And as I said, I feel that we have done already a very significant amount of work in Fluid Power. And our Power Transmission business and product line is now ready to receive the same level of attention and we believe that we will start introducing a ton of new products from 2020 and beyond.

So, by the time that we are done maybe by 2021, we are thinking that we will be, more or less, done with revitalizing most of our core product lines across Fluid Power and Power Transmission. And as you know, the industrial companies are not terrific in re-launching new products. And so, this is a very complex set of projects that we are working on. More importantly, we've got to demonstrate that we can actually take that innovation and offer it to all of our customers and give them the incentive that they – certainly they should see with that innovation that it's important and essential for them to adapt into their machinery.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

That's great. I don't know if anybody in the audience has any questions you want to ask. Okay, another one from me. On chain-to-belt, are there any updates you can give us there in terms of where you think you are in that journey and what it kind of looks like maybe in the near to medium term?

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

A

Yeah. So, we still believe that we are in very early innings of this journey. Along the way, I start speaking about chain-to-belt initiative maybe 18 months ago and we have kind of a couple hundred-million-dollar revenue base that we derive from what we call synchronous belts. A good amount of this revenue is going into elimination of industrial chain and moving towards Gates' belts. And since then, we have split that initiative kind of in three. So. as we think about chain-to-belt today, we are thinking in terms of industrial chain-to-belt, so this is anything heavy machinery, grain silos and aggregate materials and asphalt manufacturing facilities and so on and so forth.

The second kind of a category for us is what we call personal mobility, so think bicycles, motorcycles, e-scooters, e-bikes and any device or electronically controlled skateboards as an example, right, and that initiative is progressing really, really well. I spoke about having about $100 million of design wins with personal mobility alone and we believe that that's a category – it's a product category and set of applications where we have probably the easiest time to drive adoptions because the value prop is not just [ph] green card (00:21:15), but it's very sensible.

And then, the third piece is light industrial automation, so anything associated with distribution and logistics. So, if you go to any large e-commerce company warehouse, you take a look at their goods moving equipment and you start seeing that the chains are being gone from that apparatus and belts are being deployed, so that's a very good area for us, where we believe that we have lots of value that we can bring.

Robotics. In robotics, we – particularly in the heavy duty industrial robots or robots that you would see in car manufacturing facilities and so on and so forth, those robots have something that we called gear-to-gear control. And those robots now switching into belt-driven apparatus because it allows them to have these robots lighter and they have greater motion and they can be more compact. So, lots of value in there.

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So, as you can probably see from my voice, I'm very excited about it. Again, I believe that we are in early stages. This is a secular opportunity that is going to be with us for the next 20, 30, 40 years and we believe that about $6 billion market gives us a lots of runway over the next foreseeable future to ramp up and drive a nice incremental growth for our company.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Great, great. And then, I guess, just one more kind of looking at longer term as well. Your operating margins relative to peers are higher than peers. Even in 2019, they're down slightly. Over time, is there more room to grow operating margins? And if so, kind of where do you see that coming from and how would you address that?

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

A

Yeah. So, again, coming back to that 2019 Analyst Day, we said that our target over the next intermediate period of time is to deliver a kind of 24% EBITDA margins. And despite the fact that we have taken a step back a little bit here in 2018, we still believe that we will be able to deliver that EBITDA margin during the next up-cycle. We have expanded our production capacity in places where we have a lot more flexibility. We have also put the capacity in place where it is a lot cheaper to operate in. And we are resizing our fixed manufacturing overhead. So, we believe that all of these things, plus the level of innovation that we are putting into the marketplace, will give us a high degree of confidence that we should be able to deliver on that mid-term objective of raising our earnings to that level.

Trish Gorman
Analyst, Barclays Capital, Inc.

Q

Great. That's very helpful. So, no more questions from the audience. I guess we'll move on to the audience response questionnaire. So, do you currently under stock? Yes, overweight, marketweight, underweight, or no?

No. [indiscernible] (00:24:47)

Okay. Moving on to the next question. What is your general bias towards the stock right now? Positive, negative or neutral?

Pretty much everybody is neutral. [indiscernible] (00:25:08)

In your opinion through cycle EPS growth for Gates will be: above peers, in line with peers or below peers?

In line with peers looks like most of the answers, which is greater than last year, okay.

In your opinion, what should Gates do with excess cash? M&A either large-scale or bolt-on, share repurchases, dividends, debt paydown or internal investments?

Debt paydown seems to be a clear winner there. In your opinion, on what multiple 2020 earnings should Gates Industrial trade? Less than 10, 10 to 12, 13-15, 16 to 18, 19-21 or above?

So, most seem to think 13 to 15 times or 16 to 18.

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And last question, what do you see as the most significant share price headwind facing Gates, like why don't you own more of the stock or why don't you own it? Is it core growth, margin performance, capital deployment or execution strategy?

Most say core growth and that's similar with 2019.

So, thank you guys very much for coming to our conference and I hope everybody has a great rest of the conference day.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Trish.

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