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Gates Industrial Corp. Plc (GTES)

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CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Jerry Revich
Analyst, Goldman Sachs

MANAGEMENT DISCUSSION SECTION

Jerry Revich
Analyst, Goldman Sachs

Great. Good afternoon, everyone. And welcome to the fireside with Gates Corporation. I'm Jerry Revich from Goldman Sachs, and I'm delighted to have with us from Gates, Ivo Jurek, Chief Executive Officer. Ivo, thank you so much for joining us today. Nice to see you.

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

Thanks, Jerry. It's truly great to be here with you as well. Good to see you again, and welcome everyone on joining us on this call today.

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QUESTION AND ANSWER SECTION

Jerry Revich
Analyst, Goldman Sachs

Q

Thank you, Ivo, for making time for us. Really strong results for you folks just a day or two ago. And I'm wondering if you could talk about as you folks enter this recovery, how do your strategic priorities stack up heading into this cycle compared to what the strategy looked like two or three years ago?

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

A

So really – a really great question, Jerry. Thank you. Look, maybe I start going back to 2018 when we went public. Look, we knew that this business still needed to – should be improved. I spoke about it during the IPO. There was additional opportunity to rationalize our footprint, revitalize our product portfolio, improve the efficiency of our SG&A. And frankly, we knew that we needed to reduce the amount of debt leverage that we were carrying post-IPO. So, if I go fast forward into 2019

fast forward into 2019, tough challenges in 2019 induced by the China trade war. Then we ran into 2020 and the pandemic. Look, we never stopped really improving our business, and we continued to make investments particularly into our growth initiatives. During that time, we've also strategically – we started to reposition our portfolio of business, and we've taken about $100 million of automotive OEM business out by selectively taking programs that were primarily focused on hybrid vehicles or full EVs.

We've offset this reduction of automotive OEM presence with investments in our industrial markets through programs such as chain [indiscernible] 00:02:57 initiatives that I've talked about quite a bit over the last couple of years. We've put strong emphasis on industrial end markets in particular. And we felt that there are some substantial secular tailwinds that we can capitalize on when we take into account not just the internal focus but also we start seeing the sustainability focus that was coming into it. So this focus on innovation, broader product revitalization, and the new strategy has resulted frankly in above-market growth over the midterm.

We've also paid down over $300 million of debt at the end of 2020. And frankly, now, we expect our leverage to be in the range of 2 to 3 times as I've discussed on the call yesterday by the end of 2021. And this clearly opens up additional opportunities for us

for strategic M&A. So in a nutshell quite a journey since 2018, but I think we stay – we remained focused on our initiatives, and now we can introduce a strategic M&A into it as well.

Q

And, Ivo, part of what's really interesting about the business is you folks are putting up really strong margins this year. And it was nice to hear on the conference call to – and addressing a [indiscernible] 00:04:28 question that you're looking for really strong operating leverage next year as well. Can you just talk about the operating leverage that you expect over the course of the recovery? I think what we've seen in – out of other companies and for your business even in the 2018 once demand really ramps up, it's tougher to deliver continued margin expansion because labor productivity becomes tougher and you face other challenges as the cycle wears on. So

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can you just talk about your ability to manage those headwinds in this cycle and how much visibility do you have on that ability to deliver the types of incremental margins you spoke about on the earnings call?

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

A

Yeah. Jerry, so you're spot on. It always becomes more difficult. But I think that with repositioning our business, becoming more productive, giving ourselves the opportunity to be in regions where we can't find labor and make the labor more productive, the revitalization of our product portfolio, we certainly believe that long-term incremental margins on incremental revenues should be in the 35% to 40%. And we're quite confident with our ability to deliver those type of leverage numbers on incremental revenue beyond 2021.

Q

And can you expand on that point in terms of ramping up your footprint in areas

And can you explain on that point in terms of ramping up your footprint in areas where there's more readily available supply of labor? Can you just talk about the difference in the footprint today versus three years ago?

A

Yeah. So look, we have made a great deal of progress with restructuring. We've talked about the restructuring basically since we came out from the IPO. We are focused predominantly on North America. We are focused on Korea and we are focused on Europe. We have built our three large facilities, one in Mexico, one in Poland and one in China. We have increased our size and presence in China. And it goes down for two reasons.

Number one, we wanted to have a greater ability to support our into region for region strategy which we have accomplished with that investment. And then, by the way, getting into areas like Mexico and Poland where people still, there's a very large available pool of employees, potential employees that you can go and hire that are eager to get good quality, well-paying jobs like we are providing. And frankly, that's given us the ability frankly to get that access to labor which is much more difficult in places like United States. And I think today again, we are all dealing with that as well as Western Europe. Not that easy either. So the transformation, that footprint transformation has given us the opportunity and put us in a position to be able to be much better off than we were in 2019.

Q

And Ivo, based on the performance that you folks are delivering this year. You're not that far off from your Analyst Day target of 24% EBITDA margins at like a sales level that's lower than.

what you had contemplated would take to get there. So can you talk about what has gone better than planned? As you have mentioned restructuring was always in the plan. And so it feels like based on the market performance things are cracking. But I have the long-term targets if – I would love to get your views on what elements of the plan have been [indiscernible] 00:08:23 outside.

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A

Yeah. And, Jerry, thanks for the question. I think this is a great question. And I know that you participate on all of our earnings calls since the IPO. And I think during the depths of the recession, I think we have been asked many times, hey, what about your mid-term vision of the $4 billion of revenue and 24% EBITDA. Do you believe that you can deliver it or do you – are you – what is the status of those, right? And for a long period of time, [indiscernible] 00:08:51, look, we are not de-committing. And one of the reasons that we are not de-committing is because we had the line of sight on our organic initiatives. And we put a very significant amount of work and effort into those. And certainly those are now starting to layer into our resources as you've outlined.

I think terrific set of results that we have demonstrated yesterday. But we have had terrific results in Q4 of last year as well starting to demonstrate the outperformance and the market share gains that we believe we are now taking away from our main competitors that are kind of in that low-single-digit level. And that's quite substantial. And when you layer on top of that, the fact that we are in the very early stages of the market recovery, we have a very constructive view on the overall macroeconomic backdrop. Look, our balance sheet is in a very good shape with line of sight midterm target of 2 to 3 times leverage that I've outlined a couple of minutes ago. And I believe that that gives us optionality to go through M&A on top of that organic set of grade initiatives that we have.

On the margin side, ongoing restructuring, product and process innovation and our Gates Production System deployment is positioning us truly in an excellent position to expand our margins over the midterm toward that 24% target. And if I can remind everybody, our midpoint of our EBITA guide for this year has been raised by 90 bps to about 22.7%. So, I think we have – we feel pretty good about where we sit. And then, again, I just think that we have a great backdrop from both macroeconomics as well as from our initiatives that give us the opportunity to or give us the confidence that we can get back on track and meet or exceed those midterm objectives that we laid out in 2019.

Q

And Ivo, can we expand on the M&A part of the conversation? What types of businesses would be a good fit for you? How does the pipeline look? What sort of sizes businesses are you comfortable with?

A

Yeah. Jerry, look, we have a great deal of interest in broadening our strategic positioning. We participate in a very large marketplace that is highly fragmented. So, we see lots of opportunity for further market consolidation. But we don't have just an interest in market consolidation.

market consolidation. But we don't have just an interest in market consolidation. My interest is to strategically advance our key priorities, which is continue to scale up in faster-growing economies and those economies, as we discussed are some of Eastern European economies, Asia, Latin America, I think those are great places to be. And/or add technology to our portfolio, but we see that there is a great deal of transformation that is happening with propulsion and electrification of passenger cars as well as heavy-duty truck. And we think that there are opportunities out there to add to our portfolio of continuing to leverage and build out on that opportunity that we believe is out there for us for many, many decades to come.

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Q

And in terms of how active the portfolio is now, how much of your time do you personally spend evaluating M&A or is this something that you're going to look at once you were to leverage lower over the course of this year?

A

Yeah. Look, we have a small team that is dedicated to M&A, our business development team. We have a number of folks in that organization and we've never really stopped developing the opportunities and the relationships with the potential target companies out there. And so that continues to happen. I spend a good amount of time every month on reviewing those targets, going through the industrial logic and looking at the opportunities that are out there. But I would also say, Jerry, look, the valuations are pretty frothy, to say the least. And we want to make sure that when we do a deal, that we don't dilute our financial performance and that we see it – we have a good line of sight to generate strong returns for our shareholders and for Gates as well. So, we're going to be very disciplined. We have terrific, terrific set of organic opportunities ahead of us. And so we are not starved for growth. We will continue to deliver nice growth above market. But we feel that M&A gives us the opportunity to further accelerate that growth rate and we'll do what makes sense for our company for our shareholders.

Q

And just to shift gears a little bit here. You recently released your sustainability report. I'm wondering if you could talk about what environmentally friendly investment opportunities do you see for Gates or Gates products. Where is the most attractive green ROI if you will for you folks?

A

yeah. Great question Jerry and I want to point out that because we have released the update to our environmental or the ESG report, it isn't just a hey look Gates is just getting onboard with that with this very important direction. I mean we have been working on environmental responsibility and governance and social responsibility for frankly ever since I joined the company.

But as a part of what we are trying to accomplish at Gates we have coined a term internally that we call eco innovation which is an intersection of material science, process engineering and product engineering. Frankly, it is a very integrated approach to innovation that we have taken and to a new product development where we are trying to achieve kind of if you would think about it three things. One, is to drive differentiated performance and that's differentiated performance for our customers and to help them meet their sustainability goals through the use of our products

Our belt drives a good example of that. They are clean, quiet, and generally much more efficient than the alternative technologies that we are trying to replace. On newer fluid power products, those products are lighter in weight than the products that we are traditionally replacing and we have traditionally built which improve energy efficiency, fuel economy if you would and on customer product side also it improves customers' ability to assemble them in their operations. So it dramatically improves the economic factors associated with the satisfaction side.

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Two, we are trying to reduce our environmental footprint for our products. An example in here may be the more environmentally friendly ethylene elastomer materials. That is what we do to make newer belts. It is a new compounding methods that we have developed. And the method frankly is eliminating chlorinated compounds.

And the last, a third if you would, is to improve our processes. And that gives us in general an ability with our new products to be more efficient to make. So in essence we consume less energy. We consume less water. We generate less waste that we sent to a landfill and so on, so forth. So it's kind of a holistic approach to environmental movements

that frankly we are very and we're making great progress across the corporation.

– Jerry Revich

Q

And one element of your opportunity set is within electric vehicles. And in the past, you've spoken about your content opportunity being about 20% higher in electric vehicle platforms versus internal combustion engines. I'm wondering if you could talk about your aftermarket parts strategy related to EVs. How's the stocking of your parts going at your major partners? Can you talk about how that distribution channel is developing?

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

A

Yeah. Sure. I think it's a great question. But let me maybe take it first to kind of what the content opportunities and I'll come back to what we are doing on the aftermarket components, right? And so, Jerry, you're right. When we – in the very early stages when we were starting to get involved, we kind of inhaled it. We got maybe a 20% improved content opportunity. And I got to tell you, we really undershot that and underestimated what actually that content opportunity was as we got more in depth into build out of that portfolio

So let me give you a couple of examples. So if you think look as an example in thermal management system on an ICE versus an electric vehicle, there's a huge difference there. On ICE platform, you might have a mechanical water pump that we are manufacturing today that may sell for kind of $18 to $15 depending upon the size and the vehicle. And that same water pump on any electric vehicle – and by the way, electric vehicle now may have two or three of those water pumps, will range in selling price of kind of $30 to $130 simply because of the power output that's required. And by the way, those water pumps are all electric, so they need to function on demand, not just [indiscernible] 00:19:58 on, [indiscernible] 00:20:01 off.

You also have on ICE maybe $20 – maybe $25 an average of thermal management hoses. That is a big product portfolio component for us versus, on EV, that content is kind of $110 to maybe $230, and that's simply because that hose that maybe 1 meter long in an ICE vehicle now has multiple branches and it is ran across the entire platform because the platform is the content of a battery, and the battery needs to be cooled.

Now, you also need to cool that inverter, and you need to cool the motors. So the complexity grows dramatically. The size of that cooling mechanism grows dramatically. And so that ultimately is driving a substantial content improvement for us as well. So I think that, as you can probably agree, we have significantly undershot the original estimate of maybe 20% improvement in content.

Now that being said, in the aftermarket, yes, we continue to build out our catalogue of parts for EV platforms. We today have the content for over 25 vehicles, but it is still very early on as there's very few EV vehicles that are

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being in the traditional sweet spot. And remember, that sweet spot is kind of 7 to 12 years for Gates for the replacement channel.

Now if you combine that with the fact that there's about 1.4 billion vehicles on the road today, less than 1% of those vehicles are EVs. And again if I go back to that sweet spot, that 7 to 12 years – 12-year old EVs, less than 0.1% of that car part is in those aged EVs. So we got some time where it's going to play out. We are getting ready. We are building that coverage. We are very excited about it. But it will take time before it becomes a meaningful part of our playbook, but again, we are ready and we're going to be number one market shareholder just like we are today with traditional technologies.

Q

And, Ivo, are you stocking with the same partners that you're stocking on the ICE components, [indiscernible] 00:22:45, et cetera? Is that – are you able to essentially leverage your relationship to push those products through that channel?

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

A

Absolutely. Jerry, they are frankly spending quite a bit of their own time to figure out how will that ultimately impact their business. And they want to be the same market leaders as these proportions evolve. So we are spending time. We are focusing on how can we help them. And they are trying to all collectively figure out what is the best means to get these devices, these products into the marketplace into the end users' hands to help them repair. Even though that that car park, that H car park is very small, help those

customer to get the products that they need. So, we believe again that we have time. We believe it's going to take some time to evolve, but both of our largest channel partners are certainly focused on that and they also want to be the leaders in the transition as it occurs.

Jerry Revich
Analyst, Goldman Sachs

Q

And on the conventional ICE products, you folks have benefited from lots of platform fragmentation and so with all – with your range of SKUs, how are you seeing that fragmentation playing out in the EV world? Is it a similar dynamic where you have a broad range of architectures and parts that are beneficial for you folks?

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

A

Sure. I think that that technology is still evolving. And if you – I can give you a couple of examples, right? I mean if you take a look at the original Model S and you take a look at Model 3 Tesla as an example, a very dramatic evolution of the battery cooling and the inverted cooling technologies. And I think that we are in the very early stages of getting through what is the most efficient method to actually cool these batteries and these inverters and these motors.

And so, my anticipation, Jerry is that that will continue to evolve. And just like what you have seen with the combustion engines, there will be a fragmentation. There will be different topologies that folks want to do. And I think that ultimately you will see similar type dynamics occur on EVs, where it's all about power output per cubic centimeter or cubic decimeter of space and that will require all of these parts to come together and continue to evolve as the

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temperatures rise, you still have the same impediments associated with NVH, so heat and vibration, and all of these noise attributes that are very destructive to products that we manufacture. And we are looking at range of technologies and developing most importantly organically, developing a differentiated set of technologies that we believe will position us to be a market leader in water pumps – electric water pumps and in battery cooling.

Q

And in terms of the replacement cycle, can you talk about how that prepares for belts versus electric water pumps and cooling systems? Anything we should keep in mind about the cadence once EVs become a greater part of the population?

A

Yeah. So, look, our sense is that it's way too early to be able to have any reasonable sample size of how this is going to play out in terms of replacement rates. But I think a couple of points, okay, first and foremost, we manufacture products that age. So, if you take a look at engine cooling today on – in an ICE vehicle, the products that we manufacture just age, they don't die because there's too much pressure. They don't need to be replaced because somebody broke through that hose. They generally speaking need to get replaced because they age and that impacts your ability to cool.

And so, since we are using similar type engineered chemistries, we know that those chemistries

are going to age as well. We know that the vibration doesn't go away. Vibration is kind of a killer of components. And so, we anticipate that car is a car. And so, the replacement rates will be somewhat similar.

Now, if you take a look at water pumps as an example, electric water pumps, they have more duty cycles. You have more duty cycles. You will, generally speaking, probably run similar replacement rates that you see on water pumps today, maybe even higher replacement rates. So, we take a look at – if we take a look at something that is maybe more similar to a full EV, say, a platform such as a Toyota Prius, that's got a reasonably good population out there that has been on the road for a substantial amount of time.

Some of the bigger, more frequently repaired items are the electric water pumps that drive the cooling for that hybrid inverter. And we believe that that's probably a good indicator of what do you – what we will see in the future with the type of components that are deployed or their similar or identical components that get deployed on full electrics.

Q

Right. And your strategy on internal combustion engines from an automotive way of first-fit standpoint is they're only focused on hybrid or high value-added application. What's your strategy like in EV? Is the first-fit market any more attractive to you for EVs than for [indiscernible] 00:29:24 vehicles?

A

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Yeah. Look, We are participating on EVs. We believe that our investors want the assurance that we can – we have a market participating to the future. And so, we continue to win new business whether or not it is on passenger cars, I think a quarter ago on our earnings call, I spoke about a couple of platforms that we won on highway industrial applications for heavy duty trucks.

So we have a participant there in the content heavy duty trucks or even bigger than the content that I've described for passenger vehicle. So we will do a strong demonstration platforms with the OEMs. But Jerry again our overall philosophy has been that over the long term we are the replacement company and we will continue to function in that matter as long as we demonstrate to the external world that we have the technology and that we have the capability to not only compete but provide the most effective solutions on the electric platforms. So it's going to be a balance.

Q

And in terms of the off highway opportunity set, obviously much earlier in that product lifecycle. But can you talk about what are your opportunities if we're looking at electric let's say scissor lift instead of a diesel what's that content for you folks compared to the hydraulic system that you would sell for those applications now?

A

Yeah. So I would say that primary focus today has been on the on highway applications. I think that those companies and those applications are much further along than I think any of the off-highway applications. And so from where I sitthe content on the On-Highway are about $600 for us, $600 to $700 per platform, which is about 3x or 4x of what it is on the diesel-type application On-Highway. And so we continue to build out that portfolio. We work with customers. We'll talk more, I think, about that set of applications on our next earnings call. But we are very constructive on the On-Highway. And as the Off-Highway technologies continue to develop, we will be there with products that support that as well.

Q

And Ivo, if we just shift gears to talk about your distribution, obviously that's where your business is really differentiated, based on the ability to service, call it, we have the 70,000-plus SKUs within a day or two. And can you talk about how your distribution footprint has evolved over the course of the pandemic. And could you talk about how your logistics systems have evolved? Any increases in online order rates and efficiency gains exiting the pandemic?

A

Yeah, look. So, it's kind of a combination of questions both on the – just on the physical distribution centers and then maybe a little bit of a digital in the year, but let me try to tackle both of them on two different attributes. Look, when I take a look at our physical presence, with kind of a brick-and-mortar distribution, we have a very robust network. We are globally deployed, we have strong locations. And they make sense relative to our manufacturing footprint and frankly, our customer locations. So, I think that we are in a very good shape.

When I take a look at

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what some opportunities for us, I think that we have opportunities frankly to advance our distribution in in developing economies. So I take a look at Africa, I take a look at Asia, I take a look at India. Those are opportunities that we believe we can continue to grow further. We continue to build out our channel presence, so people first, location second, products third. And the innovation that we've put in place gives us the opportunity not only to solidify our presence in the developed economies but also in the developing economies. So I feel that we are in a good shape.

Now when I think about digital, on the digital side we've made quite a bit of interest because frankly, Gerri, we are not as contemporary as I would have liked to be coming into the IPL. And we knew that we wanted to do that. And again I spoke a little bit about that during that IPO process. So if I take a look at what we have done and most of that work has been done the latter part of 2019 and throughout the pandemic-induced 2020. Late last year we had launched something would be called Gates Connect. Gatesgonnect. com is a social service portal for existing channel partners and OEMs. They can place orders, they can check the order status, and it facilitate an ease of doing business.

We've spent a ton of money and resources on doing kind of rudimentary things if you would. We have upgraded our EDI tools. We have added a whole bunch of capability in our product configurators price and quoting tools so we can do that faster design tools that make it easier for our customers to take out products and design them into their applications. We have globalized our CRM platforms. We've just tried to make ourselves more contemporary as a business and an easier business to do with.

Now on – How does that impact our kind of e-commerce platforms? Look, we have digitized our catalogs. So not only to make it more customer-friendly and give them the opportunity to have content at their fingerprints, but coming back to ESG, eliminate all the paper. I mean, it is very wasteful to print all these paper catalogs. But most importantly when you print a paper catalog, it's already obsolete, right?

So that platform is now feeding our website and that website is feeding our e-commerce platform. That is our own internal platform as well as our customers' platform. So we're focused on developing a content for all of our products, kind of 360-degree photography, greater application content and infographics that drive much more clearly articulated value proposition.

So when you take a look at it, we're making big investments into digital front end and we believe that we are positioning ourselves not only to take advantage of the shift from maybe simply a brick-and-mortar model and take advantage of that e-channel shift, but frankly make it much easier for our brick-and-mortar channel partners to enable their own digital aspirations that they have.

And I can tell you, they all are investing heavily in becoming much more

digitally-enabled as well. So we spend quite a bit of time. I think we have a very focused effort and I think we are well-positioned to be able to capitalize on that shift.

– Jerry Revich

Q

And in terms of the proportion of your orders today that are shipped digitally or processed digitally without direct human contact, is that a meaningful part of the business today?

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

A

It's about 20% of our business, Jerry, and it is growing very rapidly. And we like to enable ourselves that way because there is nothing more inefficient than actually getting people talking to each other on a telephone when they are trying to figure out what they should buy. So if you can drive more of your customers to the digitally-enabled process, it not only becomes more efficient but it also becomes much more accurate and much more satisfying. And I think that that continues to drive stickiness to our company.

– Jerry Revich

Q

And in terms of processing cost savings to you folks doesn't move the needle in terms of total overhead costs. Obviously, it's more efficient but is it to the point where it's contributing to margins?

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

A

Jerry, we don't look at it that way. The way that we look at the efficiency is by going in and reinvesting the savings into inside sales, into frontend to drive things like chain to belt and more design engineers. So rather than continue to grow the pie of SG&A and R&D, create efficiencies that you can then reinvest in your business.

Jerry Revich
Analyst, Goldman Sachs

Yeah. Very interesting. Well, that's all the time that we have today. Ivo, really appreciate you making time for us. Nice visiting with you. Thank you very much overall for joining us.

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

Thank you, Jerry.

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