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Gates Industrial Corp. Plc (GTES)

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MANAGEMENT DISCUSSION SECTION

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Hi. Good afternoon. I'm Morgan Stanley's electrical equipment and multi-industry analyst, Joshua Pokrzywinski. Thanks for joining us for day 2 of our Laguna Conference Virtual this year. Of course, we'll make it up to you next year, I promise, and it might just be me but I promise that we'll be out there. Joining me for our next fireside chat, Ivo Jurek, CEO of Gates. Ivo, good to see you as always. Thanks for taking the time.

Before we get into Q&A here, though, I do have a quick disclosure statement to read. Just as a reminder, for any questions about our research disclosures, please see our disclosure website at morganstanley.com/researchdisclosures, and for all the questions, please reach out to Morgan Stanley sales coverage.

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QUESTION AND ANSWER SECTION

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

With that, Ivo, thanks for making the time. Good to see you as always. Maybe just to jump right into it, maybe give us an update of what you're seeing out there in the world. I think we'll probably spend a good amount of time on supply chain, certainly been topical this week, but maybe set the table high level of what you're seeing out there in your markets.

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

A

Yeah. Look, nice to see you, Josh. Thank you for the invitation and we're all looking forward to having an opportunity to be together in Laguna next year hopefully. Look the overall environment for our products remains very robust, and not so dissimilar to what we have spoken about in our Q2 earnings call. Last couple of quarters, we have mentioned that our book-to-bill ratio remains well above 1. And I would say that the sentiment remains the same. And as you indicated, the biggest challenges that we're all dealing with presently supply chain disruptions, logistics availability, and frankly, the availability of direct labor in United States in particular. But that I think pretty much sums it – that sums it up of what we all are dealing with today.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. I think certainly common observation around the supply chain side, how would you compare that to the pricing environment and your ability to keep up with that here in the medium term? Is that something that is going to get more acute before it gets better? Or do you feel like the pricing environment has sort of kept pace?

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

A

Yeah. So, look, given our very strong brand the large replacement channel presence, kind of the predominant dynamics for our business and a portfolio of mission-critical products. The businesses generally speaking historically responded well to inflationary environment. We certainly – this year we were very early in bringing price increases to the market, frankly, to offset inflation that we have seen already in early Q1. And we've remained [indiscernible] (03:11) economics positive in the first half of the year.

Maybe coming back to our most recent earnings call, we've indicated that we didn't see or we didn't anticipate inflation to ease. However, we still expect that price cost will be positive for the full year. So based on our track record of delivering price cost every year since we became a public company, we have demonstrated the ability to manage through inflationary pressures and we believe that we'll be able to do that well into the future.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And obviously, every supply chain and timing of purchases looks a little different. Spot prices don't always tell the tale as it were. But are you living at spot rates in the business today? Or will that inflation continue out over the next couple of quarters just as hedges and contracted purchases and things like that reset?

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

A

Yeah. Look, we don't necessarily want to speculate about what input costs will do well into the future. Presently, we're all dealing with reasonably significant inflation out there. But again, the dynamics of our business is such that we have a significant presence in the replacement channel. We have a very well-demonstrated ability to manage through market conditions, inflationary, deflationary. We have an ability to react to economic some kind of 60- to 90-day basis in terms of reacting to inflation or deflation that we see.

And so the biggest issue is again we are seeing is freight. I would say that almost the material attribute of inflation is maybe getting within what we would expect, but the freight inflation is still with us. And I think that we will need to deal with that well into the future.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Maybe pivoting around to the demand side, something that really stands out is the strength in your general industrial markets. I know we talk a lot about auto probably too much on the first fit side, but general industrial has sort of led the way out. And do you think you're gaining share there. If so, what do you think is really driving that? And does it affect how you view investment priorities or M&A and other strategic imperatives going forward just given the success you've had?

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

A

Look, we have been and we remain very focused on growing our diversified industrial business, which frankly is also the maturity where our chain-to-belt initiatives are focused. We are seeing very positive secular momentum in industrial automation, particularly in warehousing and logistics applications with the acceleration of e-commerce, and frankly, precision motion control applications such as robotics. Those are all very nice generally industrial applications that we believe in a long-term opportunity for growth for our products.

The design wins that we have mentioned, so – mentioned over the past couple of years are now turning into revenues resulting in very nice growth that we have been demonstrating. And we are confident that we have been gaining share on that basis.

Lastly, I would say that we have prioritized growth in general industrial applications since we became a public company and we will continue to direct our investment priorities there well into the future as well.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. I know one topic that's come up a lot over the past two to three quarters has been inventory replenishment, which is probably overblown on the way out as is being this massive tailwind. It's probably helped a bit is this sort of my suspicion. But where do you think we are today on overall channel health and inventory levels? Is there still some to go? Have we gone backwards with the recent tightness? What's the state of play there today?

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

A

I think that's a good question, Josh, and I think everybody's got a great deal of interest. But when we talk about inventory levels, specifically, from a company's perspective, we're talking about channels. We are frankly referring

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to the replacement channels of our business. And that's where our largest part of our business participation is at. And that's also where we have the best visibility.

We have frankly not seen any signs of tangible inventory restock in our replacement channels today. Based on the point of sale data that I referred to when I speak about inventory rebalancing and the end user demand, which is very broadly supportive, the channel inventories remain quite low when compared to the demand levels that our distribution channel partners see. On our last two earnings calls, we've talked about our book-to-bill ratio as I mentioned earlier on this call. And our book-to-bill remains nicely above 1.

And that's an indication of the demand outstripping our ability to supply, especially for a business like ours that does not typically build backlog. So if and when a meaningful restocking happens in the future, frankly, we will have to stay focused on supporting our customers' needs just as we are doing today. But it is hard for me to see that that's going to occur any time before 2022.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And I want to pick up on something you just mentioned on chain-to-belt earlier when discussing diversified industrial. What do you think of the big applications that have yet to convert? I know some of the stuff is specified in over time. And the wins come in advance of the revenue sometimes by quite a bit of time. So how do you think about that over the next couple of years in terms of the incremental growth from what you can see today?

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

A

Yeah, Josh, let me remind everybody that we believe that this is a really nice secular opportunity that's quite sizable. It's over $8 billion market size. And we believe that they are very early stages of capitalizing on the opportunity. We've talked about numerous design wins in chain-to-belt over the past few years. I've been really upfront about where we are winning. And those design wins today are turning into billable revenue, which we have been highlighting over the last couple of quarters.

And we see very strong growth from that initiative. And while we do not anticipate certainly the type of elevated growth rates that we have been reporting over last quarter and every quarter, this is a large steady secular long-term opportunity for our business that will support our growth well into the future. And we are quite focused on particularly diversified industrial applications as we discussed a couple of moments ago, particularly across logistics, distribution and light industrial applications such as food, beverage, pharma to be listing couple of these areas that are of great deal of interest for us.

We're targeting applications where frankly uptime, cleanliness are key priorities for the end users with our belts offering the biggest set of value proposition benefits when compared to those chains. We are also discussing the – we have discussed the expectation that over $200 million of revenue is the target that we believe we can deliver in our diversified industrial end markets. And a large portion of that is going to come from this chain-to-belt initiative that we spoke about. So again, as I said, frankly considering the size of that market opportunity, we are just getting started and very, very excited about it.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Now, the real question is when is my road bike going to have a belt on it rather than having to deal with this chain?

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

A

Road bike, that may be a little while, but I'm hoping that maybe you can buy yourself a nice e-bike to help pedaling uphill and that you can get a good one with the Gates Carbon Drive support.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

I'll keep that in mind. I only got seven years' worth of the knees left, so I don't have infinite runway to wait for that.

Shifting over to the auto side, so you've sort been deliberately migrating or managing down some of the OEE exposure over the past couple of years here, being much more selective in the bidding process. I think, at the same time, though, you've also seen OEMs really shift their own focus to the EV side. How has that selectivity and OEM reprioritization gone? Are you finding more content on the EVs? Is it just sort of a lack of interest and the broader OEE doesn't matter what technology they're using? Talk about your own strategy and what you see on the customer side and how you think that plays out here.

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

A

Yes. Lots of really good points in there, Josh. So let me start with reminding everybody that we are predominantly focused on the replacement channel in automotive. And so we are focused on build-out of our EV product coverage on vehicles that are in operation. But before it becomes a meaningful portion of the 7- to 12-year-old fleet, that certainly is going to take some time.

We have been very intentionally, as you said, reducing our automotive OEM participation from about 15% to 10% since our IPO, and the 10% was in the first half of 2021 that was the most recent quarter that we had recorded. And we certainly demonstrated that we don't need the OEM business to drive growth in that replacement portion of our franchise. So generally speaking, we are seeing much larger content opportunities on the electric vehicles with the emphasis for us being in a thermal management system.

This shift from ICE to EV is frankly a substantially net positive for Gates as it relates to the total dollar content. For example, mechanical water pump on an ICE car is selling for about $10 to $15 a unit while the electric water pump on the electric application runs north of $100, so a very substantial growth there. It is a similar situation on the thermal management house assemblies with content growing from kind of $15 to $30 on ICE towards trending towards $100 to $200 on an EV application.

So, kind of put a point to it, a couple of quarters ago, I've highlighted a design win on an electric platform with roughly $600 of content per vehicle. And that is a really good example of the potential we have with the electrification on a fast car or heavy duty application. So as you can see, we are quite excited about electrification, but it is still for us a much longer-term opportunity as we want to be truly a large player as we are today in the aftermarket part of that business.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Understood. And just for comparison for folks on the line, what is that $600 – what would that translate to in a more typical ICE application for you?

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

It would typically trend somewhere between $50 to $100.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Got it. So order of magnitude, more than more than 10x?

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

Absolutely. And I think that that's what we've tried to demonstrate to our shareholder base and potential shareholder base. We're really quite excited about the opportunity. And we're in that business today. So it isn't like we've got across some of the technology schism to be able to participate here.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Got it. Maybe just shifting over to the fluid power strategy. Chain-to-belt is sort of a pretty clear differentiator on the PT side. What do you see as driving margins and growth once IP returns to normalized levels for the fluid power side of the house? Anything that you're doing specifically or anything – in some of those markets that you're particularly focused on?

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

Okay. So let me start with what I said on the second quarter earnings call. We view our fluid power business as still being a bit later in recovery relative to power transmission. We think the power transmission is a little bit ahead and that also is supported by the growth rate in PT versus FP.

The key part on what we are delivering with our new product innovation is differentiated level of performance to end user that in general translates into share gains. And we have seen a good evidence of that over the last year or so as well. Many of our new products use advanced construction which drives improvement in factory operations. And frankly, it supports our competitive positioning in the game that comes back to that market share gains that we have been reporting.

This innovation also gives us the opportunity to drive product that enables portfolio simplification, which frankly is quite big when you take into account the amount of SKUs that we manufacture that we have been historically speaking about and that frankly drives further operational efficiencies. So, look, as an example, our new fluid power innovation allowing us to cover even broader set of applications with 50% or fewer host SKUs, and that enables growth. That enables ease of doing business, not just for us but also for our channel partners and that builds not only an opportunity to drive revenue generation to take market share, but it also frankly gives us an opportunity to be much easier to do business with. And so that's what I would summarize is the key set of fundamentals around driving growth and perhaps profitability improvements in fluid power.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Got it. And is there a strong interplay today amongst the two businesses where customers truly are purchasers or both? I guess, I'm sort of weaving distribution in the aftermarket aside. The distributor seems like they could

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logically carry both. But OE content-wise, they're showing up with both product lines. Are you finding that gives you an advantage when you've been on these platforms?

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

A

Yeah. Look, it's much easier to talk to the same customer, but let's make no mistake. Generally speaking, it resides in two different purchasing organizations on the power transmission versus fluid power side. But it does help you that you are a credible player with one or the other product portfolio.

But I wouldn't say that it gives you a dramatic advantage, because you have those two product lines and it by some default gives you the rights to get a more market share. I think that you've got to be focused on both. You've got to be focused on driving innovation and out-hustling your competitors. But maybe the benefit just is around the fact that you have a credibility with these large accounts in this pretty critical application sense.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Just shifting over to Asia and maybe diving into the aftermarket model there particularly in China. Obviously, the case count there has gone up. And you've seen more lockdowns. Any evidence of that in your business, whether on demand side or customer response, lead times, anything that would relate back to what you're seeing in the macro or COVID level in Asia?

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

A

Yeah. I think there's a lot that we're all reading about what's happening in Asia. And Asia has been pretty hard hit over the last 18 months with COVID and almost seems like they're just going from one shutdown to another. But we're very fortuitous that all of our operations in Asia have not been impacted certainly in the last 60 days. We are in countries that are open, they are operational. And frankly, the demand that we see remains very much in line with our second half guidance.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Understood. And then, just thinking about the medium-term incremental margin outlook, you guys have seen a nice snapback here thus far in the recovery. Demand certainly seems like it's strong. You're staying on top of price cost generally speaking. How should we think about that migration over the next couple years in that backdrop? Can we still sustain these 30% plus incremental margins or are there other investments or something else that starts to normalize that?

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

A

Josh, we've certainly committed to our shareholder base that we believe we can deliver incremental margins during the upcycle in the mid30s. And nothing is telling us today that we can't do that. We certainly have been doing a solid effort here on the inflation management. And we believe that despite the fact that it is very difficult, it is front and center in everything that we do. We are able to manage through it. And we will continue to remain very vigilant in controlling what's been in our control. But fundamentally, our business is positioned to be able to deliver the mid-30s incrementals over the midterm.

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Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And then, the last question, with the balance sheet improving here quite a bit in recent years, how should we think about the framework for capital allocation? Clearly, two lines of business that are doing fairly well. Do you think about bolt-ons for M&A? Anything else on the allocation that's sort of rising to the top here as that becomes more actionable?

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

A

Yeah. As you know, Josh, you and I had this conversation many times. My priority continues to be de-leveraging of the business from where we came from to where we sit today. And so, we are moving forward towards the long-term target of net leverage below 2 times.

And so, look, the stronger balance sheet that we have today does provide us with additional optionality as you've highlighted with respect to further capital allocation. We remain very excited about opportunities that we have to invest organically. We believe in the organic growth as probably the lowest-cost-highest-return growth. But clearly, M&A now becomes a much better option for us as well. We are participating in highly fragmented end markets. And that gives you the opportunity to go out and do some more bolt-on-type acquisitions that we certainly have a very good pipeline of opportunities with.

And also, we have other means to look at potential deployment of our cash, whether or not it is potentially repurchasing some shares or potentially issuing dividend. All of those attributes on the table for us, and we will review all of them and we will make sure that we do what makes sense for our shareholders and for the business over the long term. But the optionality from where I sit is nice to have at this point in time.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Excellent. Well, thanks for participating today, Ivo. Good to see you as always. Hope to do it in person next year. In the meantime, take care. Be well. Thanks a lot.

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

Thank you very much.

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