**Gates Industrial Corporation PLC at Barclays Industrial Select Conference**

Feb 17, 2021 (Thomson StreetEvents) -- Edited Transcript of Gates Industrial Corporation PLC presentation
Wednesday, February 17, 2021 at 7:50:00pm GMT

CORPORATE PARTICIPANTS
Ivo Jurek, Gates Industrial Corporation plc - CEO & Director
CONFERENCE CALL PARTICIPANTS
Julian C.H. Mitchell, Barclays Bank PLC, Research Division - Research Analyst

**PRESENTATION**

**Julian C.H. Mitchell**, Barclays Bank PLC, Research Division - Research Analyst

Great. So welcome, everyone. My name is Julian Mitchell. It's my pleasure to have for our fireside chat now Gates Corporation and Ivo Jurek, CEO. Please, if anyone has question, email me those, and I'll make sure to try and get around to asking them. In the meantime, I'll hand over to Ivo for some prepared remarks before we go into Q&A.

**Ivo Jurek**, Gates Industrial Corporation plc - CEO & Director

Thank you, Julian. Thank you for hosting us today and giving us the opportunity to talk about what we believe are exciting times for Gates. Over the past several years, we have driven fundamental improvements in the business and ultimately reposition it to achieve above-market growth and margin expansion.

We have invested significantly, putting more efficient and flexible capacity in the ground and revitalizing a large portion of our portfolio of mission-critical components and products. We are also starting to see the benefits of our targeted organic growth initiatives, which we have focused on attractive end markets, mainly of which have a positive secular growth dynamics.

Our products play an important role in helping our customers to deliver on their efficiency targets and support the overall drive towards sustainability across industrial ecosystem, resulting in greater demand for our products. In addition to capitalizing on our growth, we are committed to expanding our margins, as we have discussed.

Our restructuring programs remain on track and is expected to deliver full run rate savings later on this year, 2021. Over and above this savings, we expect our new products and productivity initiatives under the Gates production system to continue to contribute incremental margin expansion also. We have emerged from 2019-2020 downturn in a stronger position and demonstrated the resiliency of our business model.

With our ability to generate strong cash flows, we now have a line of sight 2x, 3x net leverage, which we expect to achieve later on this year. As a result, this will provide our business with additional capital allocation optionality and opportunities to drive shareholder value well into the future.

So with that, I'll turn it back over to you, Julian.

**QUESTIONS AND ANSWERS**

---

**Analyst:** Julian C.H. Mitchell, Barclays Bank PLC, Research Division - Research Analyst

**Question – Julian C.H. Mitchell:** Thanks, Ivo. And perhaps it would be helpful to level set us on where we stand in terms of demand expectations, near-term gains albeit a short-cycle business, a very good sort of barometer of industrial spending trends, OE as well as aftermarket, of course. So maybe just give us an update there what you're seeing in Q1 would be a good start.

**Answer – Ivo Jurek:** Look, we have exited 2020 with demonstrating a pretty broad-based growth across our franchise. We have grown across all of our geographies. We have delivered growth across both of our product lines. And I would say, maybe with the exception of oil and gas, most of the demand trends across our portfolio are very positive.

We anticipate that as we progress through 2021, the markets will continue to heal, and we will continue to see positive trends to impact our business. And frankly, we're also now starting to see nice shifts on sustainability, efficiency improvements and equipment uptime. And those offer very attractive growth opportunities for us across just about the entire segment of our portfolio.

©2017, AlphaSense, Inc. All Rights Reserved. AlphaSense is a service mark of AlphaSense, Inc. All other trademarks mentioned belong to their respective owners.

I've talked about some specifics around industrial automation, e-commerce, logistics and warehousing and personal mobility, to name a few. So we feel actually quite positively about 2021, and we believe that the markets are just in very early stages of healing.

**Question – Julian C.H. Mitchell:** Perfect. And that's a good intro. And I suppose looking geographically, the China strength you're seeing, I think, is in common with other companies, but you do have a large presence there. What's your perspective on the sort of how 2021 will play out in your China business? I think you had mid-teens growth exiting '20. So how are you thinking about the slope of that growth this year in China?

**Answer – Ivo Jurek:** Look, I think I spoke on my earnings call about our performance in China in 2020 exiting very strong organic growth. 2020, the growth was led by industrial end markets, particularly on the first fit side of the business or the OEM side of the business. Look, many occasions, I have spoken about our focus on developing our automotive replacement side of our business. And we see some very strong underlying market fundamentals there as well given the very high level of auto productions over the past decade. Our AR business nearly doubled just over the last 3 years, and we are very confident that we're going to continue to see that level of growth, certainly, over the midterm future for us.

Look, the overall market demand continues to be a very bright spot for our performance overall. And we clearly believe that we are a clear leader in Asia, in China in the AR side of the market. And I think that we are really well positioned. And so overall, we are very constructive on China, and we expect that 2021 will be another year of solid growth for us, especially taking into an account where we exited the year in Q4 of '20.

**Question – Julian C.H. Mitchell:** And then if I switch to maybe North America, it's a part of the world that's seen quite sluggish industrial spending trends versus other regions even in the last few months. Gates, an exception to that, very good growth exiting last year in North America, much better trends than most of the motion control peers, for example, leaving aside automotive. What do you think is driving that uplift in Gates in North America? What's driving those share gains?

**Answer – Ivo Jurek:** Yes. So look, I mean, I think, again, in North America, in particular, we have seen reasonably broad-based strength across all of our markets with the exception of energy, oil and gas. Despite the fact that it is a reasonably small amount of business for us, we are predominantly focused on land extraction. All the other markets were very, very solid for us.

And I think that demonstrate our ability to take market share away. We have spoken quite substantially over the innovation cycle, launching new products. And I think that you are finally starting to see the design wins turn into revenue. That is driving above-market growth rate. And frankly, that is driving above-market level of profitability as well.

So I think I can, in general, speak about similar trends, right? The ESG drivers are pulling our products as people become -- this is becoming much more important topic for all manufacturers. It doesn't really matter where you reside in the universe of industrial manufacturing. Whether or not it is a noise pollution reduction or it is energy efficiency or energy conservation, reduction of potential incidents from HSE perspective, our components facilitate general improvement in all of those metrics in your industrial equipment. And so I would say that our point to that as probably the biggest driver for us in Q4 and I believe in 2021.

**Question – Julian C.H. Mitchell:** And when you look more broadly on a global basis, and either you have seen at different companies many different industrial cycles and ups and downs, when you're looking at this upturn beyond just this year, how do you think it will play out? What does it remind you of? How does it differ from some of those industrial recoveries we saw 4 years ago, 10 years ago? Any context -- understanding that it's very early recovery.

**Answer – Ivo Jurek:** Look, I think that's a really good question, Julian. And when I take a look at 2019 and 2020, in particular -- maybe folks will cringe when I say this. But to me, it looks very much analogous to 2008 and 2009. If I take a look at the integral under the curve, we see almost duplicate copy of that 2008 and 2009 behavior in '19 and '20. So if I say, hey, look, '19, '20 look like '08, '09, and then I take a look at what happened in '10, '11, '12, '13 and '14, despite popular belief that these cycles go very quickly down and then very quickly up and then they peter out, '10 to '14 was very good time for Gates. 2010 was a very solid year. I believe that our guidance indicates that 2021 is going to be a very solid year for Gates.

And so although it is very early, as you've indicated, I do look towards maybe some more sustainable level-loaded growth rather than necessarily seeing this large recoveries and then the large impacts that we see from this external shock. So I'm very hopeful. We are early in the recovery. We are very optimistic about 2021. And I believe that the work we have done from '18 to '20 in terms of the transformation of the company, not just in operating cadence and restructuring, but frankly, more on the side of innovation, revitalization of our product portfolio, I believe that we can be real beneficiary of some of these positive trends that open opportunities that are more secular in nature, not just cyclical in nature.

©2017, AlphaSense, Inc. All Rights Reserved. AlphaSense is a service mark of AlphaSense, Inc. All other trademarks mentioned belong to their respective owners.

**Question – Julian C.H. Mitchell:** And if we look at the very short -- there's a healthy discussion around how much restocking might be needed in the industrial world, whether it's selling into OEMs or distributor and channel partners. Inventories seem low, but perhaps that's a secular phenomenon. And each upcycle now, you see less and less sort of restock. What's your assessment of that? Inventories are low, do you think we get a big whip upwards in the next 6 months or perhaps not?

**Answer – Ivo Jurek:** Look, I certainly hope we don't, to be completely honest with you, because the inventory stocking and restocking and destocking is creating havoc in, I think, industrial companies such as ours. And I think that all of our customers are becoming much more efficient operators as well. And I think that they rely more on companies like Gates to be able to manage their demand without necessarily having huge amount of stock.

That being said, my sense is that you will see some restocking because I believe that the inventories, as you said, are very, very low. And in order for these distributors and channel partners to be able to effectively service their customers, I think it's going to be tough for them to do that from the level of inventory position that they all have today.

Now the complication is going to be that there have been a pretty significant supply chain disruption that we all have lived through from second quarter of 2020 onwards. And it's going to be interesting to see how supply chain start healing. But my sense is that we'll probably see some rebalancing of inventories as we see continuation of the market healing.

**Question – Julian C.H. Mitchell:** Maybe looking at thematic point in the automotive world. Every day, it feels like we're getting headlines around this or that OEM accelerating EV investments, scaling back the ICE investments. And COVID perhaps accelerated that. Remind us how does Gates view that transition affecting the company itself, what's the content per vehicle like. But also, I suppose, with those OEMs in that transition, is Gates confident it can get its fair share within the various OEMs on the EV-based platforms?

**Answer – Ivo Jurek:** Yes. I think this is a great question. Look, I will be the first one that I will admit that we have been doing quite a bit of work under the skin to prepare our company for this transition. We haven't been very vocal about the technology that we have developed. And I think that you will hear us hear a lot more speaking about that as we transition to 2021.

I think on my last call, I stated that, look, we will start talking about more design wins. We have spoken a little bit about the design win that we have secured in Q4, a heavy-duty truck. That, we believe, is a really good design win for us, and it will start our more broad participation in the electrification.

You're right. Almost every day, you hear somebody talking about their desire to accelerate the transition into full electric vehicles. Look, we participate today in the auto and heavy-duty truck markets with more traditional components. Our components go beyond just the power transmission side. Our components that we participate is -- are also thermal management products like engine cooling -- hoses that provide aging cooling and water pumps.

Now on these platforms, these products as they transition into full electric, they have also -- they also cause a transition in technology. So on a passenger vehicle, on an ICE passenger vehicle, you may have a couple of mechanical water pumps that are kind of in the 50 to 75 watts of output that are single directional, really purely mechanical, reasonably low cost, kind of, call it, $7 to $10 of content, at times maybe $2 or $3. Those water pumps go up in output. They go to kind of 200, 400 watts to 1.2 kilowatts.

So you're getting an increase in complexity from the output of power. You're getting complexity to -- these pumps now become bidirectional, on/off-type pumps, and they are electric. And the content goes maybe from $7 to $10 to anywhere from $25 to $100 in content. This is the top of the content where we talk about the opportunity for us. That's the top of the content that we are very excited about.

On the thermal management side, on the kind of what traditionally was engine cooling, we no longer are going to have an engine coolant. But what we have is we have much more complex cooling of the inverter and of the batteries. And so the content for us versus the traditional ICE on the inverter and battery cooling goes up exponentially as well. And so we believe -- that is why we believe we have a tremendous opportunity with electric vehicles. And again, I think that you will start hearing us talk more about participation on OEM side of the electrification more intently in '21 and beyond.

Now at the same time, I want to remind everybody that we are primarily focused on replacement business. And the replacement side of the business is going to take quite a time until the propulsion technologies transition until they age to 7 to kind of 14-year-old car park that is a sweet spot for our company.

But that being said, we are not really waiting until we build out that SKU count for that existing car park that we see today. And I spoke, I think, on my last -- our last quarterly update that we have launched over 30 SKUs for existing EVs that we will continue to build up and we will get ready. So that by the time that this becomes a more significant part of the car park, we'll be in a situation that just like we are in ICE, we are the reliable partner for people to go to, to get their automobiles repaired and go for the components that they need to do so.

©2017, AlphaSense, Inc. All Rights Reserved. AlphaSense is a service mark of AlphaSense, Inc. All other trademarks mentioned belong to their respective owners.

**Question – Julian C.H. Mitchell:** Is there, on the Gates side, much reinvestment needs, R&D or CapEx alongside that transition that the suppliers and OEMs are doing in automotive? Or is that sort of in your run rate already and you balance it with some scaling down of the ICE-related investment?

**Answer – Ivo Jurek:** Yes. I think it's a great question, Julian. And I would -- the answer that I will provide you is that it is in our run rate. I mean I think that you've noted in your note that you have published after our call that our CapEx is stepping back up to the normalized run rate of 3%. Well, we are doing that because we have ton of growth opportunities, and some of those growth opportunities are in the EV space. And so we will be supporting the CapEx required to be able to get these technologies that I've just described launched.

On the thermal management side of the EVs, we have a predominantly built out capital structure. But there are some incremental additional technologies that we need to be able to develop the latest of technologies that are evolving as these platforms are evolving. And if you take a look at just simply from the Model X Tesla to Model Y Tesla, you really see a clear-cut delineation and evolution of the thermal management system, and frankly, a rising complexity for our products. But it also requires you to stay current and contemporary with the technology and make sure that you have the assets in place to be able to support that.

**Question – Julian C.H. Mitchell:** And on the sort of industrial side away from automotive, I think a lot of companies are ever trying to make their businesses in the industrial world more recurring, less cyclical, less commodity centric, more consumable, all of that type of movement. Where is Gates sitting on that front today? What are the main things Gates is doing to try and push up the sort of stickiness of the customer base in the industrial world.

**Answer – Ivo Jurek:** Yes. So I think it's a really good question. I would point out, Julian, that over 65% of our revenue comes in replacement markets that, frankly, in our view, are highly reoccurring revenue. It isn't a reoccurring revenue kind of like you would think in a software-based business. But if your equipment breaks, you're going to go to Gates and get that product so that you can operate your apparatus whether or not it is a combine harvester or it is a piece of gear, a machining center in a machining operation.

So we believe that the vast majority of our products are mission-critical. They deliver incredible amount of value. And certainly, they have a wear and tear aspect associated with them, and they have a natural reoccurring replacement cycles. So we feel quite well. We feel good about our portfolio. We feel good about the components that we manufacture.

And I think that, that is why you don't really hear us so aggressively going and continue to build the OEM presence. We really want to ensure that our coverage of the apparatus that is installed in the industrial complex is covered. And that's where we are spending our focus and commitment to continue well into the future.

**Question – Julian C.H. Mitchell:** And maybe switching to the profitability side. How soon should we expect that 24%-plus EBITDA margin target to be hit beyond some of the vagaries this year of temporary costs returning, maybe some input cost headwind for a quarter or 2? What kind of operating leverage should Gates deliver medium term?

**Answer – Ivo Jurek:** Yes. So look, let me start with my view and my commitment to the shareholders and The Street has been that during the present period, we will be returning -- as we are returning to growth, we are focused on, frankly, delivering elevated incrementals. And we are committed to 50%. I'm on record, and we are very focused to be able to do that.

Thereafter, if you think about it kind of in the year 2 post-recovery, we would certainly expect to see more typical incremental margins to be in the range of 35% to 40% for both of the segments of our product portfolio driven, frankly, by the transformation that we have undertaken of our business and by the innovation that we are putting into the marketplace.

So we feel good about rightsizing our variable cost base. We feel good about the efficiency improvements that we have driven, the footprint restructuring that we have brought forward. And frankly, that remains to be fully on track. And so despite the trade war and despite the global pandemic, we are really not de-committing our 24% midterm target that I have shared with the investment community in 2019.

**Question – Julian C.H. Mitchell:** And maybe looking at free cash flow. I think the conversion rate is obviously depressed this year a little bit by CapEx and maybe some working capital movements. I think Gates historically has talked about sort of 80%, 90% or so type conversion. But the last 2 years, the company is, I think, 105%, if you take '19 and '20 sort of combined. So as we look out, could we perhaps see better cash conversion, better cash margins than what you've talked about typically since the IPO?

**Answer – Ivo Jurek:** Right. Look, there is nothing structural that prevents us -- or prevents this business from achieving free cash flow conversion greater than 100%. And as you know, that is my stated goal. Our guide in 2021 contemplates a very significant growth, which does require to fund some working capital needs.

©2017, AlphaSense, Inc. All Rights Reserved. AlphaSense is a service mark of AlphaSense, Inc. All other trademarks mentioned belong to their respective owners.

That being said, it is our initial minimum targets to deliver 80%-plus cash conversion. We believe that the large investments are behind us. We don't believe that we need to make incrementally large investments over the foreseeable future. And look, our CapEx is going to normalize kind of at the 3% of sales, which includes continued funding for the initiatives that we've spoken about earlier, right, whether this electrification opportunity or some of the other secular trends that we see we can capitalize on.

So we are very committed to reduce our gross debt. And as we do that, in addition to converting cash of the adjusted EBITDA, we also believe that our free cash flow margin can improve as we continue to pay down our gross debt. And as you know, I'm hell bent to be able to do that certainly in this year and for the foreseeable future.

**Question – Julian C.H. Mitchell:** And on that point, Ivo, the 3x net leverage at the end of this year looking more likely now, what's the sort of through the cycle leverage range you think Gates should run with? How soon can you start to deploy cash for nondebt reduction uses?

**Answer – Ivo Jurek:** Yes. Look, Julian, we put ourselves certainly in the same category as premium industrial peers. And if we want to be truly put in that excellent environment of peers, we need to also get our leverage to a level that they operate within.

And my sense is that we have taken a pretty significant investment in 2017, '18 and '19. That being complete, we believe that over the midterm, we can get to that 2x to 3x leverage through the cycle. And we believe that that's a really good environment for us to operate within. Again, we have demonstrated -- you have highlighted that we demonstrate we can generate terrific cash flows. We've done that in depressed time frame.

We believe that this business is very capable to generate and turn earnings into cash. And I don't believe that it's going to be 5 years before we need to -- before we operate in the 2 to 3x. I think it's probably a kind of 2- to 3-year time frame when we will be operating in that kind of 2x net leverage environment.

Now that being said, we don't need to get to 2x net leverage to deploy capital to other uses. We are operating in a very fragmented market. We spoke about a very large market that we participate in. There is significant amount of opportunities for consolidation. We have good pipeline of opportunities of potential acquisition targets that give us an opportunity to broaden our portfolio within close adjacencies. We have a very formulated sort of opinions about where we want to grow through some of the secular trends that we see. And we think that those opportunities are out there.

But honestly speaking, first and foremost, I want to get to 3x of below leverage. And then I think we can have a very proactive conversation and productive conversation about where we think that we can grow inorganically. Those targets are there, and they're great.

**Question – Julian C.H. Mitchell:** And would the idea at that point sort of steady acquisition process year in, year out, and that's where most of the cash would go as opposed to sort of buybacks or dividends or kind of the odd large transaction into (inaudible)?

**Answer – Ivo Jurek:** Yes. My focus, Julian, is to actually do something that maybe industrial companies don't do so well. And that is to demonstrate we can grow really well organically. Layer on top of that kind of a 2% to 3% of incremental M&A-driven growth. And if we can accomplish that, we believe that we can kind of grow in that 6% to 10% range every year through the cycle. And that would leave room for other uses of cash. It doesn't necessarily mean that all of that cash will be deployed on M&A.

We believe that the lowest cost growth is an organic growth. And I think that we are really well positioned to do that. And I think that, particularly over the next few years, we're going to demonstrate that we are a really good organic grower.

**Question – Julian C.H. Mitchell:** Perfect. Well, unfortunately, Ivo, I think we're out of time. And I know you have a very busy investor meeting schedule. So really appreciate you participating in this fireside chat. Thanks, everyone, for joining us today, and we look forward to seeing you soon.

**Answer – Ivo Jurek:** Thank you, Julian.

**Question – Julian C.H. Mitchell:** Thanks a lot. Bye-bye.

**Answer – Ivo Jurek:** Bye-bye.

---

StreetEvents transcripts content provided by Refinitiv

REFINITIV

©2017, AlphaSense, Inc. All Rights Reserved. AlphaSense is a service mark of AlphaSense, Inc. All other trademarks mentioned belong to their respective owners.