Gates Industrial Corporation PLC at Evercore ISI Industrial Conference (Virtual)

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CORPORATE PARTICIPANTS

Ivo Jurek, Gates Industrial Corporation plc - CEO & Director

CONFERENCE CALL PARTICIPANTS

David Michael Raso, Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team

PRESENTATION

David Michael Raso, Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team

Hi. Thank you, everybody. So we're a couple of minutes late with Gates. A little technical issues, but if that's the worst issue around the pandemic for us and today doing everything virtually, not so bad. But again, apologies, a little late for tech reasons.

Again, I'm David Raso, Head of Industrial Research for Evercore ISI. Very excited to have Gates with us today. We have Bill Waelke from Investor Relations; Ivo Jurek, CEO. So in the interest of time, we'll just go into Q&A and [going on].

Ivo Jurek, Gates Industrial Corporation plc - CEO & Director

Sounds good.

QUESTIONS AND ANSWERS

Answer – David Michael Raso: I was curious, I mean, your cash flow conversion historically has been strong, there's no question about that. When you think of the proper leverage for the company, just so we know, we kind of go from deleveraging to leaning forward, what sort of is that bogey where you start to lean forward? And I guess I'd ask also why? Is it a credit rating issue? Or just your kind of comfort with how you think of the appropriate leverage?

Answer – Ivo Jurek: David, our objective is to get kind of to 2x levered. And it's predominantly because we view ourselves as a premium industrial company. And we certainly recognize that if we want to reside in that neighborhood, that is kind of the leverage that the public investor is comfortable with at that level.

And so as you said, the company generates tremendous amount of free cash flow. We will continue to delever. We have a line of sight to less than 3x levered through the midpoint of our 2021 guidance. So we believe we will make a very good progress as we move forward.

Answer – David Michael Raso: Perfect. And when I think of the growth initiatives that you have, I was curious if you could rank them in the sense of your confidence in achieving them. And it's also not on you, it's also the market adoption and the market growth. Personal mobility, precision motion and industrial chain-to-belt. When you go through these, which are the ones seem to provide the most low-hanging fruit? Not even just the size necessarily, but the very few impediments to make that happen.

Answer – Ivo Jurek: Absolutely. I mean we believe that we are making terrific progress on personal mobility. There's a convergence of really interesting factors. Maybe all the unfortunate issues with pandemic have been some that are helping us out. I also think it is an incredible electrification play here. It is much easier to electrify personal mobility device like a bicycle, e-bicycle, motorcycle versus an automobile. Batteries are less of a problem, charging is very easy and Gates manufactured belts, differentiated carbon reinforced belts are really the right solution for electrified personal mobility devices.

And so we believe that with the content play, which is almost 2x the content that we have on an internal combustion engine, as an example, taking into account the secular trend that we see with this initiative, we believe that we can scale it up to a very nice kind of a $250 million-type opportunity for the company over the very short midterm.

Answer – David Michael Raso: Terrific. I'm curious to go through your end markets. I definitely want to talk to the EV opportunity a little bit later. But going through the end markets, I'm curious, we constantly hear about supply constraints. The market recovery has generally been stronger than most people expected. What are you -- from your customers and the balance between, obviously, your 2/3 replacement, 1/3 first-fit, but at times, when the customer demand is that strong on the first-fit, you sort of acquiesce and maybe pull some product away from replacement to

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first-fit. But just knowing how strong you are in the replacement cycle, I'm curious, how do you balance that? And is that what we're seeing a little bit today? Maybe a little pull away from the replacement because the first-fit's that strong and you want to be there for your customer on the first-fit?

Answer – Ivo Jurek: David, you almost have to go to the second half of 2020. In 2020, we have seen a really nice recovery that was led by a replacement market. Really nice stability and kind of what we've talked about is, "Hey, that's providing the business resiliency." I think it played itself out in 2020.

But as you pointed out, we are getting to 2021, businesses are recovering, people are coming back, there's more demand from some of our first-fit customers and we will balance the customer needs. We want to be a good steward, good partner and we want to support our customers. But I will say that we will always err on the side of not changing the mix. Kind of that 60-40 mix is kind of a right mix for us, and there may be a quarter or 2, that mix gets kind of to 60-40 and then maybe a couple of quarters, that it is more like 65-35. I mean that's kind of the right mix for us, and we believe that the capacity we have put in place, we can continue to balance the needs of our customers, and frankly help all of our clients to support their business.

Answer – David Michael Raso: And when you provided, guidance with the implied pretty healthy incrementals, I assume the mix that's playing out, that strong first-fit demand, was generally contemplated in the guide? Or has it shifted a little more first-fit than you would have thought initially?

Answer – Ivo Jurek: Look, absolutely. When we look at our guide, we wanted to make sure that we are being pragmatic, first and foremost. And obviously, we do have a little bit of a preview of what's playing itself out in a present quarter at that point in time, early in Q1. And so we felt that we have taken our leverage up on incremental revenue into account, taking into account the mix shift that you may see in 2021.

Answer – David Michael Raso: And going through the end markets, the off-highway, the ag, the construction, those feel like some of the hotter markets right now. What are you seeing in that channel in the sense of accepting and they're not usually that accepting, but price increases given you have to believe some of the input costs related to oil are starting to flow through to you. How does that mechanism work with those larger first-fit customers? And then at the same time, have you already put through a pass-through on the replacement channel?

Answer – Ivo Jurek: Well, there are a couple of different facets in here. Number one, on the replacement side, we've played offense and we've put incremental price increases in as we exited 2020. Generally speaking, we kind of have a 90-day window, so we anticipated those will [further through] in -- as we exit Q1 into Q2. So I think we're in a good shape there.

On the first-fit side, you kind of have to bifurcate it. There are customers where we have material escalation clauses. And they work both ways, right? They work -- they have pro customer when there is deflationary environment, and they play themselves up right side up for supplier when there is an inflation coming in.

That being said, not all of our first-fit contracts do have material escalation clauses. So for the ones that we don't have material escalation clauses, we have spoken a lot about the innovation that we are putting forward. And it's that innovation that we believe and the adoption of these newer products that give us an opportunity to stay above inflation and continue, frankly, our journey to drive margin expansion regardless of what's happening there with inflation. So we believe that we can balance both inflation and price in a way that we have demonstrated over the last 5 years has been right side up for Gates and our shareholders.

Answer – David Michael Raso: The material escalator, are those 20%, 1/4, 1/3 of your first-fit business? I'm just curious how much exposure on noncontracted escalators.

Answer – Ivo Jurek: I think that you should think about it at about 40% of our customers in the first-fit side have material escalation clauses in there. And we have been pretty proactive as this contract came for renewals, we wanted to make sure that we have a fair and equitable treatment there. And that if customers want to get more competitive prices, it is not just a one-way street.

So I mean, I believe that over next cycle, so we will have the entire portfolio of first-fit customers on material escalation clauses as well.

Answer – David Michael Raso: The auto opportunity in China, given you're still relatively early in that process, and there's also just a major growth of the fleet. On a first-fit basis though, just given it's -- the replacement cycle is still developing, right? So it's a little more first-fit for you in China than North America, let's say. That market, looks like the comps are pretty easy for the next few months, and then it gets harder. I'm just trying to balance where you are in the market, like you're not that big so maybe you can grow through a slower period. Is your order book suggesting you can grow throughout the year in China? Or some of the maybe tougher comps and slower industry growth, you're already big enough, you'll feel some of that in the second half?

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Answer – Ivo Jurek: Yes. Look, the way that I look at this and the way that my team is managing in China, first of all, we have a China for China team. It's terrific set of individuals in there. China is the biggest industrial economy in the world. And so my view is that we have many decades to be able to deliver terrific growth in China.

When I take a look at our automotive replacement side of the business, as an example, that business has been growing in high teens for 4, 5 years since I got to Gates. And I believe that we have a long period of time ahead of us that we can continue to drive that level of growth.

On the automotive first-fit side, we have started to defocus that. We don't need that first-fit in auto in China, just like we don't need it in a developed world. I think that we are the biggest brand in the aftermarket in China for the products that we manufacture. And frankly, I feel quite good about our ability to grow.

And then on the industrial side, despite the fact that I want to think that our business in China is good scale, I believe that it is still reasonably small, and we will be able to grow through some of the challenges that comps will provide us in the second half of the year. So my view, our view on China for 2021 is actually quite constructive. And we believe that we should be able to grow high single digits throughout '21.

Answer – David Michael Raso: I'm not sure if you can answer this perfectly. But if I gave you the same volume in FP, in the Fluid Power segment, with your 3 new factories, I won't say fully loaded, but appropriately loaded versus the business before those 3 factories. What kind of margin impact do those 3 factories alone make on FP's margins? Is it 100 bps, 50 bps? I'm just -- I don't know the scope of those 3 factories, how large they are and what kind of reduced cost they bring you. Of course, they also give you the needed capacity, but more on the margin side.

Answer – Ivo Jurek: But they also gave you the opportunity to drive some of the consolidation restructuring that we have spoken about. So when we spoke about that $40 million of incremental earnings improvements through restructuring program, frankly, that could not have happened if we didn't have those receiving facilities there. So Dave, I think that the best way to think about it is that we have kind of reconfirmed our midterm targets from 2019, frankly, kind of on the same scale. So we still believe '22, '23 time frame is good time frame for us to kind of target at $4 billion of revenue, kind of 24%-plus in EBITDA margin. And as you look at kind of a baselining debt from where we came from in 2020, that's a pretty spawny improvement that we believe we can deliver kind of over the next 3 years or so.

Answer – David Michael Raso: Can you take us through as quantifiably as possible the shift from internal combustion engine to the opportunity you see? And I think you do a nice job of hybrid, and then -- or the stages to get to, what is the full cooling requirements, EV, obviously, the water pump? Can you help quantify the exact impact? And we always talk content in revenues, but I'd be also curious how you view the profitability of that content versus your margins today in auto?

Answer – Ivo Jurek: It's a great point. Look, let me start with something that goes away so I don't get accused of selectively talking about the opportunities, and I'll talk about some of the things that go away. What goes away is basically belts that are driven from an alternator. So they provide power to the mechanical water pumps, as an example, that are in a car and turbos, right? So that goes away. That content is about, call it, $19.

So let's start with we are $19 in all. If I take a look at what we have in terms of in thermal management or engine cooling, use whatever vernacular you would like to, we have about a kind of a $8 to $15 in mechanical water pumps and we have kind of $15 to $28 in molded coolant hoses on ICE.

So great. Now when I take a look and say, "Okay, what does that mean for my fully electric platform?" On a fully electric platform, let me start with the fact that I need to cool the batteries, the inverter and the motors. And so -- and it's really important, by the way. It's more important on an electric than it is on an ICE because what you want to prevent is a thermal runaway event, also known as fire.

And so what you do there is you have water pumps that they are now electric. And by the way, the reason that they are electric is because they need to be on demand. So if the battery gets hot, you really want to make sure that you have a maximum flow. If the battery is kind of at a reasonable temperature range, you go on and off and you cycle through that power of that water pump so you don't consume actually the power from the battery.

And those water pumps are in the range of kind of $30 to $135, depending on wattage, right? And that wattage goes from 100 watts to kind of 1.2 kilowatts, depending upon application. Now when you go back to kind of the molded coolant hoses, you are starting to look at hoses that runs through the entire platform of that vehicle because the battery runs through the entire platform of the vehicle. So the battery may be 3 meters long versus being 1 meter long inside of an engine -- ICE engine compartment.

Now it's many branches because it runs from center to the right and left. Those branches are now costing somewhere between $110 and $130 per platform. And I've announced on our Q4 earnings call that we've just won another platform in discount on an on-road industrial applications of heavy-duty truck and the content there is $600 in just the module branch hose assemblies. So our content really goes kind of $19 goes away, and kind of a $8, maybe, call it, $15 plus $28 becomes kind of a $65 plus $150.

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So the content scales up quite dramatically. With products that we manufacture today, we have a right to play. And frankly, we are developing technologies that are highly differentiated, and we are winning platforms today that are available for grab.

Answer – David Michael Raso: When do these turn into revenues? How far out before these platforms provide real scale to really show up in the financials?

Answer – Ivo Jurek: So my sense is that we're going to start seeing some meaningful revenue on the engine cooling side, kind of from 2020 to 2023 model years. But one of the things that's misnomer, and we haven't spoken about it a lot, is that we have content today on electric platforms.

It's kind of, I would say, $10 million-or-so that we classify in our out-of-first-fit revenue in electrics, and that's on electric power steering. It is in some branch hose assemblies and it is in electric power braking. It is in soft close. All of these devices basically get powered from an electric motor, and they need to power some actuators. So whether or not it's your steering rack, or it is a parking break or it is soft-closing doors, Gates belts today are powering these electric platforms and making it more convenient or safer to drive these vehicles.

Answer – David Michael Raso: I'm trying to think when I hear hose opportunities and belt opportunities, who out there offers? I mean I know my hose companies, yet who offers the belt and the hose? I'm trying to think who is both offerings? Do you have many...

Answer – Ivo Jurek: I don't know anybody that does that. Gates is very unique in that, [I don't need this].

Answer – David Michael Raso: When you go to market, is it a bit of a packaged sale? I mean -- or is it still, no, there's still a distinction between the hose opportunity in the belt? Or do you actually sell them together, so to speak?

Answer – Ivo Jurek: Actually, they are separate, David. They are very different type of devices that go into different type of appliances for a lack of better choice of words. So we're just going to be good at both of these product lines, and I believe that we are quite good at both of them.

Answer – David Michael Raso: And when I think of competitors, the business feels very fragmented, and any work in the channel you can tell your belt is pretty clearly the best out there in the replacement channel.

The hose is a little more debatable, it's definitely a top 2 or 3. On the belt side, when I think of the names, I believe our legit competitors, I think Bando Chemicals, they've got the Bando brand, GMs, ACDelco, Sheplers, Continental. The distinguishing feature between those companies and yourself, would you argue is largely just the technology? Or is there something else about the way you go-to-market? How would you characterize a differentiating feature between you and those players? Or is the market just so fragmented, there's really nobody that's having a buttheads with you necessarily for your market position?

Answer – Ivo Jurek: I think it's our technology, number one. By the way, 1 out of the 3 companies that you have listed uses rebranded Gates belts, just to be clear about that. But I would tell you that the Gates brand is the most solid, best bred in the world in belting, unequivocally. And our technology is just highly differentiated. The investments we continue to make to stay number one, unparalleled, and I believe that some of the growth opportunities, we talked about the personal mobility.

The only reason that we can compete with roller chain is because we have a belt that is by far better than roller chain. You cannot destroy the Gates belt. You can destroy a roller chain. I mean the Gates belt will wear, so it will need replacement which is important. But you will not be -- I mean, it will be very tough for you to take box cutters and cut that belt, it's just almost impossible.

Answer – David Michael Raso: And the water pump on the EV side, I mean, your confidence in the technology there, your competitive dynamic around that, where is that confidence coming from? And where do you stack your -- where you are and where you need to be to really win those EV platforms?

Answer – Ivo Jurek: Yes. So David, it's really actually a very intelligent question and an interesting one because if you think about the water pumps in ICE applications, they have been commoditized over the last 25 years. So the differentiation in technology is actually not that great.

Now when you start attacking the electric problem, you actually start having some opportunities to do some very unique things. And so for us, what we have challenged ourselves is we said, "Hey, look, we want to, as a figure of merit, we want to generate 30% more power output from the same footprint, okay?" And so to be able to do that, you have to challenge yourself on a machine construction, and then frankly, on the electronics side. The electronic side is less of a problem. The machine construction is much more challenging. And so we will be launching midyear this year, a very differentiated electric water pump that is going to offer our customers 1 out of 2 things: number one, you can get 30% of our output from the same footprint of present electric water pump; or we can give you the same power output with 30% smaller packaging. Both of these things are very, very important on any automotive platform, weight

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and power output and power consumption are the 3 things that are really critical when you are talking about consuming electric power that you really want to use to propel your wheels.

Answer – David Michael Raso: And it's my question of just trying to take advantage of your relationships. If the hose is sold fairly distinctly from the belt, can the water pump be sold with the belt? I'm just trying to leverage your belt relationships as much as possible essentially. Or is it still, at the moment, it feels like it's going to be distinct?

Answer – Ivo Jurek: I think that you will marry that water pump more closely with that module branch engine cooling hose or the battery cooling hose. Because now you're going to start -- you are trying to solve a thermal management problem that's getting more complex.

When we started to make our investment 2 or 3 years ago in electric platforms, that technology has undergone almost 2 generations of upgrades. And this battery cooling techniques have gotten more complex because people are trying to pack more power, and they want to make sure that they have much more efficient use of that electric power in that battery. And to be able to do that, they've got to keep these batteries at a very nice temperature level without major intrusions, hot or cold, and that's where we come in. Our products will allow you to give you that capability to do that.

Answer – David Michael Raso: Well, we are out of time. I could spend hours talking to you learning more about where this platform is going on EV and some of the opportunities you have in the traditional belt and hose businesses. But we'll have to stop it there for now, but look forward to speaking with you again. And again, thank you so much for taking the time today. Really appreciate it.

Answer – Ivo Jurek: Thank you, David. Thank you for your time. And as you can imagine, we are quite excited about it as well. And we certainly look forward having the opportunity to speak with you more.

Answer – David Michael Raso: Great. Thank you. Have a great...

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