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Gates Industrial Corp. Plc (GTES)

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MANAGEMENT DISCUSSION SECTION

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

Good morning, everybody. Welcome to Day 3 of Laguna. Thanks for a great conference so far. We're going to keep it rolling here this morning with Gates. I'm joined on stage by Ivo Jurek, Gates' CEO. Ivo, good to see you in person. Thanks for making the trip out here now that we're back live. I just need to remind all the folks on the webcast in the room before we get started here that if you have any questions about Morgan Stanley's research disclosures, please see the Research Disclosure website or reach out to your salesperson.

With that, Ivo, maybe just kick off with a few thoughts on what you're seeing out there. What you guys are focused on. We'll dive into some questions.

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

Sounds good. Thanks, Josh. Good to see you as well. Look, let me maybe start kind of at a top level that we have done a lot with our business since the IPO to position it for long-term success, adding new modern factories, particularly in Fluid Power, driving innovation, and executing on our focused growth initiatives, which frankly have been paying really nice dividends for us, particularly over the last three to four years.

That focused effort has positioned Gates to deliver a very favorable performance as compared to some of the large multi-industrial comps that we compete with, while we have been dealing with an incredible set of challenges since we have gone public. So we feel very well, how we have positioned the business and our ability to drive additional improvements.

That being said, we are being very mindful of the current challenges that are out there. And that not only we, but others, are dealing with the macro, the geopolitical, supply chain, all the labor issues that all of us have been dealing with. There's been a game of which one of these issues are front and center today versus tomorrow in reality. So, while I indicated over the last couple of quarters that the supply chain issues have been improving in general, it continues to post challenges to, frankly, gaining a great deal of productivity. I think that that's what folks don't necessarily quite realize that the stops and gos are very difficult for you to really get a very strong traction.

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So the demand globally is holding steady and more or less is in line with what we expected. And the supply chain issues and other impediments remain front and center. And – but they're still preventing certainly our company from being able to make a meaningful dent in the backlog that we have accumulated. So the backlog continues to hold very steady at very highly elevated levels. And that's both blessing, but it's also an impediment to be able to deliver – continue to deliver incremental growth.

Our customers remain very optimistic about their levels of demand, but that being said, we are being very realistic about what can happen. Customers tend to be more optimistic perhaps than what may be the underlying realities in the marketplace may be.

And we have not seen meaningful buildup in inventories in our channel. We – I think that is one of the benefits that we have, we have large channel partners that we do business with, and we do a lot of work with them to understand what's happening vis-à-vis demand versus how much inventory they are holding.

Certainly that being said, again, I think what you'll hear from me is that we are being cognizant of potentially entering more choppy waters and we are getting, frankly, ready to that. We are pivoting towards building our plans to drive our cost structure improvements further, reduce complexity as we enter 2023, so we're looking at reducing complexity in the portfolio, and continue to reduce the complexity of our footprint and as a result, to drive productivity well into 2023 and 2024.

So in the broader macro FX, as you know, continues to be a rather large impediment and it continues to deteriorate. And when you have about 50% of your revenue coming outside of United States, it becomes an issue. And we have highlighted on our second quarter earnings call that it's a pretty significant headwind, and that's certainly not getting any better.

And while the demand environment remains quite robust, we recognize that we are heading into uncertainty. Cost versus price is stabilizing perhaps with the exception of the continued impacts that you see in Europe with energy costs. And the impacts, it's not really about offsetting the impacts, it's more about the volatility of the energy inputs that you have to deal with on a month-to-month basis. So there's no shortfall of challenges as we head into 2023 as I think that you hear across the companies from which you have heard. And we certainly continue to anticipate that we will execute a number of footprint projects, as well as continue to drive our focus in the portfolio rationalization.

So we are cognizant of those issues and we are getting ready to be able to embrace those challenges as we move into 2023.

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QUESTION AND ANSWER SECTION

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

Q

Excellent. So that's a helpful overview. And I think very clear-eyed view of maybe what could be lingering in the background even though demand seems solid today. How does that sort of play into your kind of operational planning or [ph] PSYOP (06:35), are you trying to manage down your own inventory? I think we heard from someone yesterday sort of saying, look, I would rather miss a few shipments and sort of steadily walk down my cost base, my inventory, my planning assumptions rather than have to do it all at once if there is a more abrupt drop and then have to deal with maybe price consequences on that. It sounds like you're headed in kind of a similar mindset of I would rather have a glide path, but how does that actually show up in the business for Gates?

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

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Yeah. So you're kind of dealing with two dynamics today, I think, I mean, maybe three dynamics, I would say. One of our biggest dynamic and I mean, we have been reasonably impacted by the scarcity of polymers. And we are a big consumer of polymers. A very significant amount of our portfolio is conversion of polymers into products that we manufacture. And those have been a substantial headwind. So we have been building a raw material position to be able to deal with that because the other side of reducing inventory in a steady manner is you have to make sure that you don't impact your operational efficiencies too much. And that happens also naturally if you're not having your raw material available when you need to convert it, right?

So one side for us has been building our raw material position. And I think we see a greater stability in supply chain. We are still dealing with a couple of these inputs and I've been talking about it for the last couple of quarters. I recognize that maybe investors and shareholders and customers are getting less patient, but the reality is that the polymers are still at scarcity. So you got to stay focused on that. And I think that we will continue to lean on the side of maybe holding a little bit more of the raw materials.

But on the other side, we are balancing what's happening with our backlog. And as I have outlined, backlog is not coming down for us. And that is not something that actually I like, because we are a book-to-bill business and we don't like to hold backlog. So we've got to get to a situation where we can actually work out the backlog and convert it and consume some of the raw materials, so that backlog comes down.

And then the last piece, is the piece that you have outlined. And so, we are very closely monitoring with our customers what is happening in a channel. Over 65% of our revenue comes from the replacement channels where we actually do have a reasonably good visibility what is happening. And so, we are being very pragmatic to ensure that our operating plan and the MR piece reflect what is happening with the underlying market and then you start converting those inventories.

I will note that, when people think about inventory, everybody thinks that inventory is dramatically up in terms of unit volume. But I think that, the complexity of this is that it isn't as simple to look at it that way. Your inventory valuation is up because there's a significant inflation and inflation inflates your cost of goods. So that's a piece of that, right?

The other piece that you're also dealing with in in terms of working capital is when your business grows dramatically, your working capital grow, your receivables and your payables and all of the other attributes in

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addition to inventory go up. And we did have in 2021 the best year on company's history. So our balance sheet and our inventories and our working capital went up along with that, right?

So those are the attributes I think that everybody needs to be focused on and inventory is part of it, a big part of it and our company and our teams are very cognizant that it has to get worked through. Inventory is actually not a bad thing because at the end of the day, it does get converted to cash, and that is what we are focused on. So as we enter the period of time of kind of the next two to six quarters, we believe that we will have a meaningful work down of our finished goods inventories and try to manage that right in line with what is happening with the underlying demand.

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

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Got it. And I want to double click on a couple of things you said there. First on kind of the customer inventory side, you mentioned in the replacement channels, you have good visibility and there doesn't sound like there are any excesses. On the OEM side of the business and maybe not just auto, but kind of broadly thinking about OEM, it seems like there's this dynamic that's been going on for a while where you have these – a lot of 90% finished pieces of equipment.

I would imagine that your lead times are an awful lot shorter than folks who are supplying anything in the electronics world, right? So what's your sense of how that dynamic is flowing through? Do you get the sense that that's the customer situation for products for Gates or are you guys kind of the last man to come in before something gets finished. And how do you think about the sensitivity of maybe that inventory?

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

A

Look, unfortunately, I have learned probably over the last two quarters in particular that we may be the last person standing in preventing somebody from actually be able to finish a very large piece of gear that is ready to go for a full delivery to a customer. So my sense, Josh, that I would probably describe goes like this.

We have not been in a position to be able to supply all of our customers with the goods that they need at unlimited volume. We've actually been working very intensely with customers and across the field from Fluid Power to Power Transmission, where we prioritized what they call hot builds. So what is this really that you need this week that I need to deliver, so I don't hold you from being able to deliver, complete your work and deliver your units to your customers.

So I actually am not that worried about inventory at the OEM channel of our products. It is not the issue. And frankly, that's never been the issue. It's more just in time. And yes, that dynamic, the phenomena happens that they cannot complete their builds. But it's not really a phenomena with my product. My products are still quite constrained to be quite frank,

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

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Got it. Okay, good news, bad news.

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

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Good news, bad news, right. But the bad news is that you're continuously expediting, you're continuously getting those calls. And lastly, I would say that, again, we are very cognizant of that input that we are getting from our customers, but vast majority of particularly on the industrial OEM side customers, they continue to represent to us that they have very strong backlogs. They have a very long visibility for the next 12 to 18 months. And while we do take that into an account, we don't take that as gospel because we all know how quickly that can change.

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

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Got it. Got it. That's helpful. And then you mentioned in some of your opening remarks kind of this broader cost journey that Gates has been on. Maybe just remind us where we're at on that today, sort of what's left to do and what are the priorities underneath it in terms of maybe like four-wall productivity or sourcing or whatever you think folks should pay attention to?

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

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Yeah. So I think that when we think about our cost journey, everybody speak to our shareholders and potential investors, what we've talked about is, hey, look, we've done a really big transformation from kind of 2017 to 2019. We've built a bunch of new factories. We have modernized our manufacturing footprint particularly on the Fluid Power side. We have done tremendous amount of work in terms of innovation. So we have developed new products. They are leading class products, highly differentiated, that continue to improve ESG metrics for our own customers and give ourselves an opportunity to be differentiated.

On the Power Transmission side, we've talked about the journey. We're kind of maybe being in a second or third inning of the journey. Many of our investors still state, hey, look, for the size of your business and kind of three-and-a half-plus or minus billion dollar sized company, you've got too many factories. Well, how are you thinking about that? And so the way we think about that is we still have too many factories.

So the journey is accelerating. The good news is we don't have to build anymore factories, which has been the biggest challenge for us when we were trying to do a refresh with fluid power. We couldn't make these moves until new infrastructure was put in place. We have a terrific infrastructure in places where we like to operate that are around large urban areas that have availability of labor. So we will be very in a very near future be announcing certain projects that we believe will continue that journey of driving those improvements.

So that's more on the footprint side. Now we'll talk about that more as we exit 2022 into 2023. We will take the opportunity to give ourselves the opportunity to continue to drive competitive positioning of our business from a cost perspective.

The other side of that equation is that we are seeing a tremendous amount of innovation now taking hold, and it gives us an opportunity to do two things. Again, we are entering new markets, such as what we discuss in personal mobility and chain-to-belt. But those new products in power transmission are also highly applicable for all of the suite of industrial applications that they go to from logistics and distribution, warehousing infrastructure to industrial drives and robotics. And that gives us an opportunity to introduce products that are more competitive. They are a lower cost structure and they are much more manufacturable than maybe some of the products that we have – that we are going to be replacing or that we are replacing today

So we are kind of thinking about those two terms. A big step forward in terms of infrastructure, manufacturing infrastructure, and secondarily, a really nice step forward that we believe will benefit our cost structure by

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obsoleting some of the older generation products and bringing new products in. And we have been very aggressive on that side.

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

Q

Got it. A couple of more things I want to focus on for kind of what you're seeing out there in the near-term. First is on Europe. Everyone, as presented here, is, with maybe a few exceptions of folks in the materials and transport space who have preannounced lately, is – have seen Europe in fairly resilient in the industrial world. It sounds like you guys are seeing something pretty similar. Anything in there either is kind of a yellow flag that you're like, well, demand's still strong but I'm seeing weird signals, or you mentioned it in your own remarks that that energy intensity of your own processes gives you some thought about how that could influence the business. Do you think that there's anything in terms of folks trying to get as much as they can out the door before winter and maybe like gas curtailment becomes a bigger deal? I don't want to ramble too much, but what are you guys seeing in Europe? Do you think there's anything unusual going on?

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

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Well, I think that anybody that doesn't worry about Europe is living maybe in a little environment. We all worry about Europe. We have a terrific business in Europe. We have a good size business in Europe. And I think we worry the most today about the energy situation. The disruptions, the cost impact on industrial facilities that we participate in that we have on our own, I mean, is something that you've got to be very, very cognizant.

That being said, right now, we're really not seeing much impact in Europe vis-à-vis interruptions of energy supply, either in our facilities or with our customers. Again, I'd say that I hear more from the OEMs asking, please don't curtail your output, we still have strong demand, we need your products, please make sure that we get them on time. Don't hold us back. That's still a dialogue that's happening more often than a dialogue that says, hey, look we are unsure what's going to happen over the next three months particularly on the OEM basis, okay?

I will remind you that coming out of European holidays is always a little bit of – it gets more choppy. So the data that comes out in August and in September, you almost need to take a look at these two months and say, okay, what do I think? And I would say that we see a little more volatility on the industrial replacement channel. We have not seen meaningful improvements in automotive OEM business. And as you know, Josh, I've been very negative on it and I don't believe it's going to get any better in Europe on the auto OEM side.

Automotive replacement business remains more robust than I would have anticipated. Taking into account high cost of energy, high cost of fuel and the fact that people somewhat curtailed driving, but I don't know if anybody has visited Europe, I was in Europe maybe two months ago. I don't see curtailment in driving to be honest with you. It almost looks like freeways in the United States when you get on the Autobahn and you're trying to drive from Vienna to Munich but – so we are reasonably comfortable with what's happening with the AR side.

I will note though that we had a very strong AR presence in Russia. So when people start looking at our comps on AR in Europe and say well, you were saying that you feel comfortable with what's happening with the market but your comps were slightly down. Well, they are because we no longer do business in Russia and so vast majority of that demand has impacted our AR comps. But outside of Russia, demand remains reasonably solid.

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

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Got it. And I think you've kind of answered this on my next question, you mentioned a little bit, but on price cost, and you mentioned you were still in kind of tight supply and polymers are a big part of the business. I would imagine that sort of speaks to not seeing a lot of the deflation. But how do you see that balance of price cost evolving here? Are you seeing enough, I would call it disinflation or flattening out to where you can start to kind of expand margins or establish that framework?

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

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Yeah. Look, our sense is that we are probably entering more of a stable environment. As much as I would like to, I cannot say that we see deflation. We just don't see deflation yet. There are things that are improving, but there are just as many things that are not improving and them maybe getting a little bit worse. So I think that puts and takes on aggregate, I don't think that you will see people that will talk, us included, about, oh, you know, there's a tremendous amount of inflation that continues. But there is an attribute of inflation that's called energy. It's a huge input for industrial companies. Certainly, it's a big input for us. And you do see a very significant volatility.

Now we'll deal with it. We are pricing for it. We are very aggressively moving in terms of not transferring that cost on our operating results. But all of these things, again, as I said they're probably volatile. That's the best way to say. And one month can be up, one month can be down, and you've got to be able to deal with it in a pragmatic manner. So I'm just not ready yet to declare that we are on a verge of seeing a deflationary environment. I just don't see it.

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

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Understood. Maybe pivoting over to kind of the strategy, the market position. If I think about your markets, you guys have very good brands, very well-known in the channel. I would imagine there's some areas that you don't want to participate in. You wouldn't want 100% market share if you could get it. But maybe talk about the areas where you think you're strong or maybe areas where you have an entitlement and are focused on, could be end markets, could be geographies, wherever you think that like kind of the Gates advantage is proving out or where it could be more meaningful based on the value proposition.

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

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Yeah. So I think starting kind of at a top level, right, across our portfolio, about 80% of our products and related to that revenue comes from top three market position globally. So we really like what we do. We have a great portfolio of products. We've got great products and we have a good market position. Strategically, we've decided that we will be a lesser of a market participant on the automotive OEM side, because what we have demonstrated over the history and certainly over the last several years being public, that we don't need to participate in the OEM markets to be able to be a large market participant in replacement markets. So that's played itself out.

So we have actually over the last four years, while we have delivered terrific growth, we have substantially shrunk our automotive OEM presence from about 15% of our revenue to less than 10% and grew revenue.

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

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Right.

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

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So, I would say that strategically, that's where we have a less of an interest. We are developing new products. They are opening new markets where we are actually competing against non-traditional competitors like industrial chain. We've talked a lot about our chain-to-belt initiative. That initiative has done by far better on a strategic and tactical level than what we have anticipated in 2018-2019 when we started talking about it. Frankly, the business has grown so much and so quickly that we are running out of capacity to support it. So we continue to add capacity. We are launching new products where we will be able to add the capacity in a meaningful way. It is a very large market opportunity for us, about $8 billion and I wouldn't say that we are even in the first innings of that evolution.

And when you take a look at what we have done with the personal mobility business, last year, we have grown something like 90-some odd percent in that business. We are an industrial tech company. We continue to see a good growth. But that growth now is being more impacted by our inability to supply again because of capacity constraints that we are rectifying. Our backlog continues to grow on that side of the business. And, frankly, our pipeline of new opportunities and our pipeline of converted opportunities is at an all-time high. So we feel very good about it.

And we believe, I believe that that will become a large, meaningful portion of our company's revenue over the next 5 to 10 years. So, it is playing itself out the way that we anticipated. We are early in this cycle. We are first and the largest market participant. And we are now – I think that our customers are now understanding the value prop of converting from industrial chain or mobility chain to a Gates manufactured high-performance belt.

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

Q

Got it. That's helpful. And then if I just sort of pivot that around to kind of the external market and what you guys see out there maybe in the M&A landscape, I mean, there have been some transactions that have taken place, maybe more in fluid power, but I'll call it broader motion and control. Are you in the markets generally that you want to be in from a product category, or is there kind of a near adjacency that would create kind of this one plus one equals three scenario?

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

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I think those opportunities remain front and center for us. We like where we sit in power transmission in particular. We believe that there are a number of potential transactions that are out there. I think like everybody else, we are looking more at what the multiples look like, and clearly we believe that as these multiples are starting to come more in line with – the valuations come more in line with performance, we will be much more front and center on looking at inorganic growth. But we also feel really good about deploying our capital on organic growth opportunities.

And as I said, particularly on the industrial chain-to-belt and chain-to-belt overall, that's a terrific opportunity where we can spend more money, we can fund more capital, we can fund more capacity to be able to convert all those opportunities and continue at the high growth rates in that new market segment for us.

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

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Excellent. I see we have a little bit of time left. Is there any questions in the room? Happy to field them now. Great. Well, Ivo, pleasure having you on stage. Good to see you in person, as always, and thanks for everybody on the line and in the room for your attention.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you.

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