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Gates Industrial Corp. Plc (GTES)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Gates Industrial Corporation Q3 2022 Earnings Call. All callers are in a listen-only mode. Following the presentation, there will be a question and answer session. [Operator Instructions] As a reminder, today's conference is being recorded.

It is now my pleasure to turn the call over to Bill Waelke, Head of Investor Relations. Please go ahead, Mr. Waelke.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thank you for joining us this morning on our third quarter 2022 earnings call. I'll briefly cover our non-GAAP and forward-looking language before passing the call over to our CEO, Ivo Jurek, who will be followed by Brooks Mallard, our CFO.

Before the market opened today, we published our second quarter results. A copy of the release is available on our website at investors.gates.com. Our call this morning is being webcast and is accompanied by a slide presentation. On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. Reconciliations of historical non-GAAP financial measures are included in our earnings release and the slide presentation, each of which is available in the Investor Relations section of our website.

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Please refer now to slide 2 of the presentation, which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed in or implied by such forward-looking statements. These risks include, among others, matters that we have described in our most recent Annual Report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements.

With that, I'll turn things over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good morning, everyone, and thank you for joining our call today. Before we begin, I would like to take this opportunity and thank Bill for his support over the last four-plus years in helping Gates to stand up and operationalize our investment relations structure as a public company. Bill is moving on to a new role at a different company upon completion of this quarter's earnings cycle. And we will be making further announcements about the IR leadership role transition over the next month or so.

With that, I'll begin on slide 3 of the presentation. Our global teams executed well and delivered high single-digit core growth, while facing an operating environment that was incrementally more challenging. The underlying demand for our products remain positive, with largely stable order rates across most of our markets and a book-to-bill ratio that remained well above 1.

Our backlog stayed elevated, primarily as a result of incremental raw material availability challenges and labor disruptions, as well as stable order rates. Our profitability improved sequentially in the quarter. While inflation moderated in certain areas, it remained elevated overall. And we saw notable acceleration of energy and specific petrochemical input costs. The inflation in the quarter was higher than our expectations. However, the pricing actions we have implemented allowed us to exit the quarter in a margin-neutral price cost position.

While the availability of some supply chain inputs improved, we continued to face supply disruptions associated with highly engineered polymers, in particular. And we anticipate this situation continuing in the fourth quarter. While we expect these disruptions to moderate next year, we are updating our outlook for 2022 to reflect their impact as well as that of the incremental inflation and additional FX. Although-end market demand remains largely supportive, in light of the current macro uncertainty, we are initiating the next phase of our footprint optimization plan, the details of which, Brooks will cover later in the presentation.

As we prepare to enter 2023, we believe our business is well-positioned. We anticipate starting the year with a robust backlog that will supplement the prevailing demand levels of our mission-critical products. We also are in a positive price/cost position with expected carryover benefits and incremental pricing actions that we believe will offset the elevated levels of inflation we have seen. Finally, any easing of the supply chain impediments will reduce the substantial headwinds we have experienced in 2022.

Moving now to slide 4, our total revenue was $861 million, with core growth of 7.6%, offset by FX headwinds of approximately 8%. We saw core growth in all of our end markets, with the highest growth rates in industrial. Our mobility business delivered another quarter of solid growth. And the energy end market continued to benefit from increased activity in the field. Ag and construction applications included in our off-highway end market also remained robust.

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Third quarter adjusted EBITDA was $178 million or a margin of 20.6%, representing sequential improvement of 70 basis points. Incremental negative FX impact, supply chain disruptions and escalation in material and energy input costs were offset by solid pricing performance and cost controls globally. Adjusted earnings per share were $0.31, flat to the prior-year quarter.

Moving now to slide 5 in our segment level results. Our Power Transmission segment has revenue of $523 million in the quarter, including core revenue growth of 5% and negative FX impact of 10%. Excluding the suspension of our business in Russia, which was almost entirely within this segment, core growth was over 8%. The segment was also disproportionately impacted by the shortage of the said petrochemical inputs. All regions had all regions had positive core growth, led by the industrial end market, with energy, off-highway and mobility showing the strongest growth.

Our Fluid Power segment had revenue of $338 million in the quarter, including core growth of 12% and negative FX impact of 4%. We saw solid performance across all end markets, with the strongest growth coming in energy, on-highway and automotive replacement. The industrial first-fit business also performed well, with growth in the high teens and the key design wins in off-highway and on-highway applications. Prior investments in innovation continue to pay off with core growth from new products of over 20% in the quarter.

With respect to profitability, our Power Transmission segment was impacted primarily by operating inefficiencies related to raw material shortages, the startup of new production capacity and incremental negative effects, as well as the escalation of petrochemical input costs. Despite these challenges, the segment saw sequential margin expansion of 60 basis points.

Our Fluid Power segment generated strong margins in the quarter with much less exposure to material availability challenges and those startup inefficiencies. The segment delivered year-over-year margin expansion of 300 basis points.

I will now turn the call over to Brooks for additional color on our results. Brooks?

L. Brooks Mallard

Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

Thank you, Ivo.

Moving now to slide 6 and the regional breakdown of our core revenue performance. Underlying demand remained broadly stable, and we delivered core growth in all regions. We are tracking to deliver solid full-year core growth despite the polymer supply headwinds, COVID shutdowns in China and suspension of our business in Russia. In North America, we had double-digit core growth in nearly all industrial end markets led by energy, on-highway and off-highway.

From a channel perspective, we saw the largest growth in sales to OEM customers. Backlog in North America remains elevated due to engineered polymer supply issues and labor availability challenges that resulted in operational disruptions and impacted our ability to drive the anticipated reduction to our past dues within the quarter.

Demand trends in EMEA have also remained supportive, and we delivered solid 6% core growth in the quarter. We saw double-digit core growth in all industrial end markets led by energy, mobility and off-highway, as well as in the automotive replacement business ex Russia. Our business in China had positive core growth, representing

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a significant acceleration across all end markets from the large COVID-driven decline in Q2. Underlying demand in the automotive first-fit market remains solid, which is where we saw the highest growth rate in the quarter.

Lastly, our businesses in South America and East Asia and India had varied results in the quarter. South America delivered another strong performance with core growth of 18%. We saw double-digit core growth across all end markets led by energy, diversified industrial and off-highway. In East Asia and India, we saw modest growth as the region continues to see supply chain disruptions and longer lead times. We are pleased with our performance overall, as we continue to execute in the face of ongoing operational disruptions.

Moving now to slide 7 and some details on key balance sheet and cash flow items. Our free cash flow in the quarter was $73 million, representing a conversion rate of 82%, a significant increase from the second quarter as working capital investments began to stabilize even as we continue to deal with supply chain challenges. Net leverage declined from 3.3 times in Q2 to 3.2 times in Q3. And we continue to expect to see net leverage at or below 3 times at the end of the year.

Moving now to slide 8 and our full-year guidance. While the overall demand environment remains largely constructive, we have not seen the anticipated improvement in our supply chain situation, which has negatively impacted our production volumes. Accordingly, we are modifying our outlook for core revenue growth, which we now expect to be in the range of 5.5% to 8%. We are also updating our adjusted EBITDA and adjusted earnings per share outlook to reflect the impact of lower production volumes, as well as incrementally negative FX, higher inflation and greater than anticipated operational inefficiencies.

Our expectation is for adjusted EBITDA to now be in the range of $660 million to $690 million, with adjusted earnings per share expected in the range of $1.07 to $1.15 per share. While we are pleased with how we were executing through these external issues, and believe they are largely temporary in nature, we do expect it to take longer than originally anticipated to see them normalize. With respect to free cash flow, we anticipate our conversion to be approximately 50% of adjusted net income due to the continued supply chain issues.

Moving now to slide 9 and the footprint optimization plan Ivo mentioned earlier. As we have stated before, we continually look for opportunities to simplify and strengthen our operating model in addition to reducing costs. This phase of the plan involves spending approximately $45 million in restructuring costs in the balance of 2022 and in 2023 to achieve approximately $25 million in annual savings. We expect to hit the full run rate of savings in the first half of 2024 and ultimately see a total cash payback of less than two years.

With that, I will turn it back over to Ivo for some final thoughts.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Brooks.

Moving now to the summary on slide 10. I would like to wrap up by thanking our customers and suppliers for their partnership; and our global Gates associates for their grit, determination and effort as they continue to deliver strong performance in the face of the challenging macro environment.

While significant uncertainty remains, we stay focused on managing what has been in our control and continuing to drive incremental improvements across our enterprise. Given the ongoing challenges associated with raw material, logistics and labor, we are proactively pivoting to the next phase of footprint optimization and business simplification projects to drive the efficiency of our business, well into the future.

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The pace of positive secular industry trends continues to accelerate. And we are well-positioned to capture future demand in these secular opportunities. We will continue to direct investment in innovation and business simplification towards higher-margin NPI and end markets, giving us confidence in executing upon our mid-term growth strategy.

With that, I'll now turn the call back over to the operator to begin the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Thank you. Our first question comes from Andy Kaplowitz from Citigroup. Please go ahead. Your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, everyone.

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

A

Morning, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, you mentioned that book to bill is still significantly over 1. We know you're still significantly constrained by supply chains, but have you seen any bigger demand slowdown in any of your large end markets? I mean, it doesn't seem like you have seen any weakening of demand, for instance, in personal mobility. Maybe give us more color on channel inventories as well.

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

A

Sure. Look as I said in my prepared remarks, we see the demand remain actually quite stable. I'll tell you, maybe even better so than what you would have anticipated, taking into an account the challenges that you see in the markets globally.

Personal mobility is very strong. We continue to be on a pace of substantial additions of revenue to our backlog. It's where we want to be. We have been most impacted with our lack of ability to eat the backlog, as we've perhaps anticipated at the end of Q2. If there's one area that is somewhat more choppy or perhaps a little bit softer, I would say, that's Europe industrial replacement. We do start seeing some choppiness there. But it's, in my mind, less related to channel destocking and more related to some weakness that's flowing in, in the industrial replacement segment of our business. So, outside of that, China is recovering nicely. East Asia is doing fine. I'd say, Latin America is very, very strong and North America is very solid as well.

So it's not an issue of demand for us at this point in time. We certainly recognize that, that can change, but that's not the situation. Channel inventories, I think that everybody would feel that they are elevated. But in my mind, the

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channel inventories remain more or less in line with the underlying end market demand. And so, from a demand perspective, I think, it's reasonably all right.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Got it. Then, Ivo, to the point of supply chains, is it possible to quantify how much production inefficiencies are hurting you in Q3 and/or in Q4, given your new guidance? And you did suggest that supply chain could get better as you go into 2023. Are you getting any more visibility toward polymer availability as you go late here this year?

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

A

Yeah. So, look, I would say, that it's – the inefficiencies and primarily associated with the lack of supply, kind of in the 300, 350 basis points of top line. That's probably a good number to use. And I would say that, I mean, we do see improvements in ability to get – to source raw materials. That is a fact. Particularly on the metal side of our business; metals are really not an issue. And we are seeing lead times shrinking. And the ability to secure those materials is quite all right.

When it comes to polymers, I think that's kind of a bifurcated story. We actually are able to secure the polymers that we need to support our customers' run rate business. The issue is the spottiness of supply. So, you may get the polymer that you need, but you may get it two weeks late than you anticipated or than the supplier has committed and that drives very significant set of issues for you vis-à-vis your ability to not lose production days of output.

And so, I would say that the polymer issues are a big headache for us. We do believe that it is improving somewhat. And we are more cautiously optimistic that into Q1, it could be less of a headwind for us, so 2023 should be less of a headwind for us from the polymer side. But I'll also say – and I know that you didn't ask the question, Andy, but I also say that the polymer – the inflation on polymers is certainly not abating, and so we are taking that into an account. We are pricing for it, and we continue to roll out more price increases to keep up with the inflation that we see in the polymers in particular.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate the color, Ivo. Thanks.

Operator: Our next question comes from Jamie Cook from Credit Suisse. Please go ahead. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. I guess, two questions. One, I'm just trying to understand the fourth quarter margins. It looks like you expect core growth to be better than the third quarter and the revenues are comparable, but the margins are down considerably from the fourth quarter relative to the third quarter, so just trying to understand the cadence there. And then my second question to Andy's Q&A. You said the European industrial replacement business was weaker. Can you just help us understand how big that is for your business? What were the declines like in that? Did that continue into this quarter? Thanks.

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L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc
A

Hey, Jamie. Let me take the first part of that question. So, from a margin perspective, there's really a couple things, right. One is, as we talked about, there's more inflation rolling through, particularly on the polymers side. And we've seen polymers continue to go up, quarter-on-quarter, kind of in the low double-digit range. I think, around 10%. And the pricing for that tends to lag a little bit, so we'll price for that. As we get into the first quarter, we roll out our New Year's price increases.

I think the second piece is a combination of additional operational efficiencies that we've talked about. Q4 is always going to be a little bit tougher from a seasonality perspective. And then, you roll in the additional operational inefficiencies which are really costing us kind of in this 250 bps range of cost, both from an external and then kind of an internal perspective. So, it's not insignificant, but those are the two primary drivers of the decelerating and profitability from one quarter to the next.

I'll let Ivo pick up the second part.

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

Yeah, so Jamie, on the industrial replacement in Europe, I said that we saw choppiness, that's different than decline. I mean, the business still grew mid-single digits in the quarter. So, I want to say that the business is flowing off, a trajectory of growth. But we just see kind of softness in certain areas, and it represents about 8% of revenue.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Thank you.

Operator: Our next question comes from Deane Dray from RBC Capital Markets. Please go ahead. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thank you. Good morning, everyone. And I want to thank Bill for all his help and wish him all the best.

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

Morning, Deane.

Bill Waelke
Vice President-Investor Relations, Gates Industrial Corp. Plc
A

Thanks, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

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Hey. Can we start with free cash flow? Cutting the guide, this has been a sector-wide phenomenon. It's not a Gates issue singularly. It's everyone. Can you give us a sense of your line of sight on free cash flow conversion for 4Q? It looks like it's about a 300% conversion, which is only a little bit above your historical average, so it does not look like it's heroic. But maybe just your line of sight, what has to happen, right, in terms of receivables, backlog conversion and so forth?

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, Deane. So, look, if you looked at our Q3 kind of cash conversion, it was above 80%. So, we're starting to get back in the area of where we want to be, not there yet in Q3, but getting closer. And then Q4 is going to be one of the better cash conversion quarters that we've had in the company since we've been public.

Now, remember, we've also got the bad receivables rolling in that I talked about last quarter. And so that's giving us kind of, I think, we talked about a $40 million favorable tailwind, which to your point, makes the numbers for Q4 look a little bit better. So, when you look at the back half of the year, we feel like we're starting to get more stable and more normalized. And so, as we start to move forward, we'll be back to less on this big kind of working capital investment with all the inflation and the inventory, the supply chain issues, and as we head into 2023, be in a much more stable position.

So, we like where we are in the second half of the year. Obviously, changing the guidance is not great, but we really like where we are in the second half of the year from a cash conversion perspective.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good, appreciate that color. And then for Ivo, to the extent that you can, can you flesh out the plans for the footprint optimization; maybe the timing, the regions, the number of plants? If I look at the payback it's just under two years, so it really does look like all real estate, not people, because that would be a quicker payback. So, just some context and color; any specifics you could provide would be helpful?

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

A

Yes, Deane. Thank you for the question. We will provide greater color on our next call, Deane. We are still working through some regulatory approvals and announcements within Gates here, within our four walls. So, we would like to get to that before we give you a real breakdown on the number of facilities, where those facilities are located.

This project's a great project. There's a terrific payback, as you stated. And it's just a continuation of the cycle of productivity improvements that we see we still have available for our franchise. So, we will continue to do that as we see fit. And we are seeing the opening now to be able to start executing on couple of these projects. And so, we feel great about being able to have the opportunity to execute them.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good. Fully appreciate you got to make all those announcements first. And just lastly, I might have missed it, but to the extent, any color on October?

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

Yeah. Look, I think that October has been more or less in line with what we have seen kind of in Q3. So, again, bookings remain stable. I would say, again, kind of what I said about Europe industrial replacement, again, spotty; not falling off the cliff, but spotty. And still dealing with the headaches in the supply chain that we have outlined in Q3.

We are able to keep up with our customer demand, which is really terrific. This is probably, for the first time in a while, that they have been able to do that, so we're servicing. Our service rates are improving, but unfortunately, we're just not able to eat up into our backlog that we anticipated when we set our original guidance in July. So, October, more or less, the run rate that we have seen in the third quarter. And we are working through some of these issues and executing well. And I'm really proud of how our global Gates team is executing so far.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thank you.

Operator: Our next question comes from Jeff Hammond from KeyBanc Capital Markets. Please go ahead. Your line is open.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.
Q

Yeah. Hi. Good morning.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc
A

Good morning.

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

Good morning, Jeff.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.
Q

Hey, best of luck to you, Bill. So, just on the – you talked about the supply chain issues, but I think you mentioned labor as well. I'm just wondering if you're seeing any kind of improvement there, the labor market getting a little looser. And then, just as you think about kind of supply chain and labor, into 2023 like is that 250 to 350 basis point headwind kind of the comp? And how much of that, do you think, kind of goes away into 2023?

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

Yeah. Great input, Jeff. Thank you for your questions. So, look, I would say, that the labor shortages are getting better. I don't think that the labor shortages are – we don't intend to say that the labor shortages are the major impediments. But I would say that labor shortages, particularly in distribution centers in North America, are still

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spotty. We are still having difficulties with ensuring that we have all of our shifts staffed up. And we got all the people at the right set of distribution centers that we need.

And so, I would say that, that's probably the biggest issue on labor, particularly, in North America, as I said. Out of the 350 bps of lost productivity in the second half or in Q4 here, our sense is that we should start seeing that abate as we enter the front end of 2023. I'm not in a position to be able to tell you that it's going to be gone by January 1, but we are seeing improvements. It's just the reliability and predictability of when that supply, generally speaking, lands in your facilities, so that's going to be the area of focus for us.

Logistics is improving, obviously, so the reliability of logistics is getting better. That has been a real issue for us. And so, I would say, that the combination of these things should abate as you start seeing greater stability globally across the outputs as well as across moving goods from point A to point B. So, I would say, first half of the year, it's not unreasonable that in the first half of 2023 you should start seeing this to abate.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay, great. And then, just on – as you think of 2023, and it sounds like there's still inflationary pressure, just talk about pricing your contemplating into 2023? And then any carryover [audio gap] (00:31:35-00:31:42)?

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

You kind of broke up at the end there. Can you repeat the back half of that question?

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. Just I mean, just pricing in the next year what your thoughts are what [Technical Difficulty] (00:31:51-00:31:57)?

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. So, you still kind of broke up at the end, but I assume that what you're asking about is just pricing in the next year. So, look, again, we've done a phenomenal job with pricing. In the third quarter and in the second half of the year, we're going to EBITDA-margin neutrality, as we suggest that and actually a little bit ahead of schedule.

We've got additional price increases that we roll out at the beginning of the year. We're going after all segments, all regions, all customers. In addition, we're looking at some specific areas that have been probably more heavily impacted by some of the polymer and supply chain issues. And we're going to go a little bit more there.

So, we're very confident in our ability to continue to get price to offset inflation as we move forward into 2023. And we really as we think about our issues, as we move forward, we don't really see the pricing as a big issue. We think we've got that kind of square in our sights. And we feel comfortable with where we are.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. Thanks so much, guys.

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Operator: Our next question comes from David Raso from Evercore ISI. Please go ahead. Your line is open.

David Raso
Analyst, Evercore ISI

Q

Hi. Thank you. I was curious, the pricing that you're seeing now, how much of the fourth quarter organic growth is pricing? And the pricing actions for next year, have they been communicated yet to the channel?

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

A

So, the pricing actions for next year have been communicated to the channel. And we anticipate that we will continue to roll them forward. Again, I would say, Dave, that there are some areas that are more impactful than others. So, we are now being much more selective. And as Brooks said, we've got to margin neutrality price/cost-wise earlier than what we've anticipated. So, we've also seen escalation of inflation, particularly when it comes to energy costs in Europe. And certainly the engineered polymers and petrochemicals continue to be on a trajectory up, not even on a trajectory of flattening. So, I just want to make that clear, and I'll let Brooks to chime in on specific pricing.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. Yeah. So, most of the price – most of the organic growth year-over-year, Q4-to-Q4 is price, right. But let's not forget, we still have the Russia headwinds; we still have material headwinds. Ivo had talked about that being 350 bps. I mean that's kind of the right number, 350 to 400 bps. And then, also, FX is a huge headwind still right as we head into Q4 year-over-year. So, I would say, kind of 80% to 90% of the organic core growth is going to be price. But then also remember that you got that 400 basis points of volume headwind really related to Russia and material supply issues.

David Raso
Analyst, Evercore ISI

Q

And I know you don't want to give margin guidance for 2023, but if you were in our shoes trying to think about what you know today, let's assume no further degradation in the supply chain, the actions you've communicated on pricing for next year, how should we think about incremental margins next year? And one clarification, the fourth quarter does not include any restructuring charge in the guidance, is that correct?

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, I mean, restructuring is an add-back, and so we're still working through the timing of when some things are going to be announced and when we're going to take some of those charges. I think from a cash perspective, it probably will be de minimis, but I don't know that for sure. So, we're really not contemplating that in our guidance right now. Does that answer your question?

David Raso
Analyst, Evercore ISI

Q

On the margin question for – yeah, thank you for the fourth quarter clarification. But I'm thinking about incrementals for next year. And again, incorporating what you're thinking about regarding pricing. Obviously, you have some carryover currency as well to think about. But if you can just give us some framework, because it

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sounds like the savings were highlighted as a 2024 event. So, I wasn't sure if we can think about any savings in 2023.

So, if you can just kind of wrap it all together, just so we can have our own thoughts on the top line, the price carryover. Just trying to get a sense of looking at that fourth quarter margin. And I know it's not a great seasonal quarter for margins, just how to think about incremental margins for 2023. Thank you.

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

Look, David, I think that – I would stress that we are still going through our financial planning for 2023, as you can appreciate, predominantly driven by the volatility that you see, right. I mean, we said – we adjusted our guidance in July, and we have seen a very substantial incremental headwinds associated with FX, and some more disruptions in supply chain and labor and so on so forth that we are all certainly appreciate it and anticipate that will get better. So, I would probably defer a better conversation after our Q4.

Look, we do anticipate we're going to a small amount of savings from the restructuring in the back half of next year. And we will inform you more effectively about what we anticipate vis-à-vis 2023 after our Q4 call?

David Raso
Analyst, Evercore ISI
Q

I appreciate that. Thank you. And Bill, thank you for all your help and best of luck.

Bill Waelke
Vice President-Investor Relations, Gates Industrial Corp. Plc
A

Yeah. Thanks, David.

Operator: Our next question comes from Jerry Revich from Goldman Sachs. Please go ahead. The line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Yes. Hi. Good morning, everyone.

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

Good morning, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Ivo, I'm going to engage. Can you just talk about conceptually nice to see that you folks are pricing to offset but we're not able to offset the higher logistics costs with the current pricing actions based on the third quarter results and guidance. So, conceptually, for business with a strong of a market position that you folks have, what's keeping you folks from taking a more aggressive stance on pricing, so that we're not only offsetting the inflationary impact with commodities, but the operating challenges that you spoke about on the call? And how are you thinking about potentially pricing for those as you think about 2023?

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L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. So, Jerry, let me kind of correct the framework here. So, we are definitely getting price for the uptick in freight costs from an inflationary perspective. So, we're getting freight, we're getting material. And quite frankly, in fact, we started to incorporate energy into our framework in terms of getting price.

What we haven't fully covered is both the internal and external disruptions that are causing some of our operational inefficiencies, and then also, some of the volume impact that flows through and the causes of margin dilution. So, from an inflation perspective, right, we're getting price and then more to get to EBITDA margin neutrality. What we're not getting is the operational efficiency and volume offset from a pricing perspective. And quite frankly, we think that's kind of the right approach to take.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. So, of course, you and I are saying the same thing. And you said you're offsetting inflation, but this is a really hard operating environment. And everybody's facing what you're facing. And other companies are just being more aggressive in pricing for the logistics challenges. And I'm just wondering, given your market position, how are you folks thinking about, what – we need to push pricing another 2 points to essentially pricing this risk of further inefficiencies from getting the right material to the right place, given COVID zero policies and other supply disruptions.

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

A

So, Jerry, let me let me take it a little different tact. We are fully recovering inflation across all of the inputs. It's not that inflation – price macroeconomics, including energy and logistics is not the issue. Again, our issue has been the disruption that the lack of supply that we see in our manufacturing facilities. And we just don't believe that, that's something that our customers should pay for. This is something that we've got to deal with, and we are dealing with those issues.

We continue to take price, taking into account that we are in a inflationary environment that is not slowing down, perhaps despite popular belief. And we will continue to do that until such time that we see inflation abating across all of our inputs. But that being said, the headwinds that we have highlighted for Q4 are more operationally driven through the availability of raw materials than anything else. And I think that, that's how you should think about it. And for inflation, we will offset inflation.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And even – when do the operational challenge improve? Is there a range of tight components that you're tracking or polymers, et cetera? Can you just give us a sense on what's your best sense today on when that availability might improve?

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

A

Well, Jerry, I thought in July, I thought that the availability is going to improve in August, and September and October. And clearly, that call was not the right call. And I would again, I would probably say that perhaps the availability is getting better, but the reliability and predictability of when it will arrive is not.

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And as I said earlier, Jerry, I think that second half – I mean, sorry, first half of 2023, we should start seeing abatement of these issues. Again, both we are seeing improvement in logistics reliability, which has been a real issue.

Again, we are moving large quantities. We are not moving small boxes of goods. I mean, we are moving tens of thousands of kilograms of polymers to a reasonable amount of facilities globally. So, I think, as we see improvement in logistics reliability, we will be seeing improvements in our performance.

What I'll say is that when you take a look – and you almost have to think about it in vis-à-vis product line segment. So, if you take a look at our FP segment, and we have done a tremendous amount of work in that 2017, 2018, 2019 timeframe, making investments in NPI, making investments in materials science and engineering. And we have engineered lots of these overly dependent, single-source highly constrained polymers out of our supply chain. And you see that, that's been – that's really paid off.

I mean, we have not seen the same level of supply chain issues, we have not seen the same level of disruptions. And lo and behold, we got a terrific core growth and strong level of profitability that is filtering through, because we have limited or almost nonexistent shortages there. You see all of that impact rolling into our Power Transmission segment.

And we are now in process of, frankly, doing the same thing that we have done on PT. We're making investments in incremental, more efficient capacity. We're making significant investment in NPI innovation. We are engineering lots of these highly constrained polymers out, giving ourselves an opportunity to have much broader supply chain and raw material availability to support the production as needed, when needed, where needed. And we are feeling very confident that we will feed sort of coming cycle the same level of benefits in PT that we have delivered domestically.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yeah, I appreciate the discussion. Thank you.

Operator: Our next question comes from Julian Mitchell from Barclays. Please go ahead. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks for squeezing me in, and thanks to Bill for all the help the last few years. Maybe just a first question around the – any color you could give on the segment margins. You have that 200 bps decline in Q4 sequentially firm wide. Any color on how that affects each of the two segments? And I'm just trying to understand the capacity aspect here. So, you're adding capacity in PT, I think, and there's some inefficiencies there. And then you're sort of taking out capacity as well. Is the capacity reduction in both divisions or more centered on Fluid Power, because you're adding more in Power Transmission?

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

A

So let me take the front end of that question, Julian, on the capacity attribute. So the capacity that we are adding in PT is predominantly focused on product lines, where we see a tremendous amount of growth, and also, really a rather substantial growth in our backlog and past-due backlog. So, particularly associated with personal mobility and industrial chain developed. The business continues to grow tremendously. Our design wins in that space

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continue to grow tremendously. And for better or worse, our past due and the backlog continues to escalate quite dramatically there. So, the capacity is very specifically focused on that sub-segment of our end markets and our transmission business.

The other capacity that we are refreshing, frankly, in PT, is capacity on our industrial and automotive Micro-V Belts that we have developed a new manufacturing process that gives us a fundamental improvement in substantial drive towards productivity. So I would say, that those are the two areas where we are adding capacity.

We are really – you shouldn't really think about our moves as moves that will extinguish capacity. We are not capacity-rich. We are keeping with our growth of our business presently. And our desire is really not to extinguish capacity. Our desire is to drive productivity, reduce the complexity of our business and reduce the complexity of our footprint. And I think that, that's kind of how you should think about it.

And we will give you more color about that on a next quarter's earnings call as we get through all of our approvals – I mean, and all of our announcements internally, so that we can give you a clear-cut delineation of where these projects will be and how they will be impacting the various segments of our business.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, and on the first part of the question, we don't really want to get into the guidance by segment. But just take into account what Ivo said about each of the segments and how they're performing and what the drivers are. And I think you can draw your own conclusions from that. But we don't want to get into forecasting by segment.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Fair enough. And then, just my follow-up on China. I think you had a very insightful perspective back in the early summer that China was not having a V-shaped recovery after the Shanghai lockdowns. So, you had low-single digit growth in the quarter in Q3. How are you assessing the slope of that China recovery today?

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

A

Julien, I think it's a steady recovery. I mean, I think that we see month-on-month improvements. We anticipate that we're probably going to see mid-single digits growth in Q4, and so, it's definitely getting better. But let's remind ourselves that there's quite a bit of a set of challenges that are coming out of China where the rollout of zero-COVID policy. And almost every day you see a new city getting impacted. And so, we are cautious about what's going to happen in China.

And we feel that the business is recovering, more or less in line with what our anticipation was. And we don't certainly anticipate that it's going to be any dramatic growth that you're going to see that will truly require lifting of the zero-COVID policies. And I just don't see anything that is actually occurring in China. We are hopeful that it will occur, but so far, it is still very challenging there.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

Operator: Our next question comes from Mike Halloran from Baird. Please go ahead. Your line is open.

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Q

Hey. Good morning, everybody. It's [ph] Pat on (00:50:17) for Mike.

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

A

Good morning.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Good morning.

Q

Good morning, just a quick question going back to the supply chain side of things. I'll take a little bit of a different approach. It's my understanding that there's not very many suppliers through these highly engineered polymer. Can you maybe just provide a little color on your discussion on the suppliers and maybe what some of their limitations have been that are causing some of the spottiness that they're seeing and causing delivery issues?

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

A

Look, I think that the biggest factor that you see is that there are fewer very large global companies that, frankly, are dealing with the core of the, call it, the feedstock that then ultimately gets subjugated to incremental processing. And number of the suppliers is in Europe and number of the suppliers is facing extremely challenging conditions associated with a dramatic escalation of energy inputs.

And as you probably may know or you may not know, the petrochemical industry is extremely energy-intensive. And so, I think, that, that's one set of attributes that's driving their desire or inability to process as much material, while they are ramping post-COVID. And ultimately, you certainly see some restrictions, particularly in Europe, where the supply of the feedstock, that in the past used to come from Russia; that now they scramble more and try to get elsewhere. So, I would say that's a big attribute.

And then the second attribute is, hey, look, I mean, it's – from end-market perspective, and there's lots of demand for refined petrochemicals and specialty polymers. And so, we are dealing with that. We are engineering some of these polymers out. We are engineering around this. As you can appreciate, that is not an over-simple tasks. We produce products that are mission critical, and generally speaking, operating in harsh and hazardous environments. So, we've got to be very thoughtful about engineering these things out or substituting these materials with more effective solutions.

Now, we have done that on the FP side. Those products also, obviously, are operating in harsh, and hazardous and mission-critical applications. And we're making great progress on the PT as well. But it is a complex challenge to solve.

Q

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That color is super helpful, Ivo. Thank you. And switching gears a little bit, it seems like there is a bit of a divergence in first-fit versus aftermarket trend. Can you maybe provide a little bit of color on what you're seeing between those two applications specifically?

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

A

Sure. So, I mean, first-fit is – continues to grow in teens. And the replacement side of our business is growing in mid-single digits. What I would try to point out is that we've had a very strong business in Russia. And it all went – most of it went through the replacement channels. So, if you kind of think about it, ex Russia, our core growth would have been about 300 basis points higher, so kind of low-double-digit growth. And most of that would have come through the replacement channels. So, absent Russia, the replacement business actually is doing quite well, too.

Q

Got it. That's super helpful. Thank you, Ivo. And thanks, Bill, for all your help.

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

A

Thank you.

Operator: We have no further questions in queue. I would now like to turn the call back over to Ivo Jurek for any closing remarks.

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

Well, thank you very much for joining us for our Q3 earnings call. Again, we truly appreciate Bill's support over the last four-plus years. We'll miss him here. But I will be making additional announcements about the replacement for Bill's role here at Gates. And I certainly look forward having the opportunity to share with you our results in early February post-Q4. Thank you and enjoy your holidays.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.

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