04-May-2023

Gates Industrial Corp. Plc (GTES)

Q1 2023 Earnings Call

Copyright © 2001-2023 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

Rich Kwas
Vice President-Investor Relations, Gates Industrial Corp. Plc

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

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

OTHER PARTICIPANTS

Deane Dray
Analyst, RBC Capital Markets LLC

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Julian Mitchell
Analyst, Barclays Capital, Inc.

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

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

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

MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. My name is Kayla Baker and I will be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Corporation First Quarter 2023 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now like to turn the call over to Vice President of Investor Relations, Rich Kwas.

Rich Kwas

Vice President-Investor Relations, Gates Industrial Corp. Plc

Good morning and thank you for joining us on our first quarter 2023 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 first quarter 2023 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.

Copyright © 2001-2023 FactSet CallStreet, LLC

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.

We will be attending several investor conferences over the next month, including the Goldman Sachs Industrials and Materials Conference, the Wolfe Global Transportation and Industrials Conference, and the KeyBanc Industrials and Basic Materials Conference. We look forward to meeting with many of you.

With that out of the way, I'll turn the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Rich. Good morning, everyone, and thank you for joining our call today. Let's start on slide 3 of the presentation. Our global teams delivered another solid quarter and we posted Q1 revenues above the midpoint of our guidance in an operating environment that remains challenging and while managing through a cybersecurity attack on the enterprise.

As previously disclosed in an 8-K filed in February, our company experienced a cybersecurity incident in early February, which led to a temporary shutdown of most of our operations globally. Our operating and corporate teams work diligently and tirelessly to restart nearly all of our operations progressively over the course of 10 days. I am proud of the resiliency and successful response to such challenging circumstances.

Our Q1 results have been adjusted for costs incurred during the period associated with the incident, and Brooks will outline these in more detail later in the call. We estimate the cybersecurity event impacted our revenue growth rate by approximately 150 basis points in the quarter. The incident primarily disrupted our ability to support North American and European replacement demand, which is booked and shipped business. We estimate North America experienced approximately two-thirds of the sales dislocation, and we do not contemplate recovery of this volume in the current quarter.

Moving on to our results, our core growth was relatively balanced across the first fit and replacement channels. Geographically, our EMEA region registered another strong quarter of core growth supported by healthy OEM demand. China regional performance continue to recover as the quarter progressed after the most recent impact from COVID and modestly outpaced our initial expectations. We saw solid automotive replacement demand despite the disruptions to our output and service levels caused by the cybersecurity event.

Vehicles in operation and the car parc age both continue to increase in our major geographies, which should support steady demand dynamics for our business in the midterm. Supply chain and logistics headwinds continued to slowly ease and our global teams remained diligently focused on satisfying customer demand. Our profitability in the quarter extended meaningfully compared to the prior year. Our business teams executed well and our price cost position was more favorable when compared to last year's first quarter.

Overall, the supply chain is slowly improving and benefiting our operational performance. Our adjusted EBITDA margin rate was slightly ahead of our Q1 guidance midpoint, including the estimated $5 million expense impact from the cyber security incident during the quarter. Notably, we produced positive free cash flow this quarter. Our working capital use was well below last year's first quarter. We made progress normalizing our inventory position

Copyright © 2001-2023 FactSet CallStreet, LLC

which experienced a sizable decrease on a year-over-year basis. We have multiple initiatives under way to improve our inventory terms while also driving improvements to our service levels for our customers.

When coupled with easing supply chain impediments, we believe that further progress will be made as the year evolves. We are encouraged by the strong seasonal start to our cash flow. Underscoring our commitment to driving shareholder value, we announced today that our board of directors has approved a $250 million share repurchase authorization that expires in October 2024. The authorization provides us with added flexibility to enhance shareholder returns and we intend to use it opportunistically.

Please turn to slide 4. First quarter total revenue was $898 million and translated to core growth of 4% versus the prior year. Foreign currencies were a 350-basis-point headwind year-over-year. As outlined, we estimate the cybersecurity incident represented approximately a 150 basis points headwind to our growth rate. We realized solid growth in most of our end markets, led by a double-digit growth in energy and personal mobility, and high-single-digit expansion in off-highway. Diversified industrial growth moderated from recent quarterly trends. Adjusted EBITDA was $175 million, which yielded a 19.4% adjusted EBITDA margin, an increase of 180 basis points year-over-year.

Our price cost position was better relative to a year-ago quarter when commodity and energy inflation accelerated due to the Russia-Ukraine conflict. Gross margins increase year-over-year, helped by a better supply chain dynamics. Adjusted earnings per share was $0.25. Our operating income was up materially year-over-year and contributed a $0.06 per share of earnings. The year-over-year comparison was affected by higher effective tax rates and increased interest expense.

On slide 5, I'll review our segment level highlights. In the Power Transmission segment, we generated revenue of approximately $548 million in the first quarter, resulting in core growth slightly above 3%. FX was a 450 basis points year-over-year headwind. The segment experienced the strongest top line performance in energy, construction and personal mobility.

All these end markets experienced double-digit core growth which helped offset weaker demand in China. Diversified industrial revenues decreased mid- to high-single digits on a core basis in North America where we saw the most impact from the cyber security incident. While China was our weakest region in a quarter primarily as a result of the COVID pandemic disruptions, it came in ahead of our expectations and strengthened as we exited the quarter. Polymer supply availability continues to normalize and we are obtaining sufficient supply to support customer demand. We have strong design wins in the quarter, particularly in personal mobility which should support continued above-market growth on a go-forward basis. Our adjusted EBITDA margin showed nice recovery year-over-year helped by a balanced price cost position and improving supply chain.

Our Fluid Power segment recorded revenues of $350 million with core growth of approximately 5% year-over-year partially offset by 170 basis points negative pressure from currency. The energy construction and other replacement markets were the best growth areas in the quarter. We booked meaningful wins in agriculture and construction that will begin production in the second half of 2023. Fluid Power segment EBITDA margin improved 160 basis points year-over-year, benefiting from a more stable operating environment compared to the prior year.

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

L. Brooks Mallard

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

Copyright © 2001-2023 FactSet CallStreet, LLC

Thank you, Ivo. Moving now to slide 6 and an overview of our quarter revenue performance by region. Similar to fourth quarter 2022, EMEA was the standout region, growing revenues 10% on a constant currency basis. Personal mobility and Energy were the strongest end markets both growing well above 20%. Off-highway expanded at a mid-teens pace. Overall, our industrial end markets' core growth versus prior year was in the high-teens. First-fit sales experienced moderately stronger growth than replacement in EMEA.

North America revenues increased low single digits year-over-year on an organic basis. Off-highway and automotive generated solid growth in the quarter while diversified industrial moderated compared to last year. China declined mid-single digits, but activity strengthened in the last half of the quarter and modestly exceeded our initial expectations. Auto replacement was a distinct, bright spot in China, growing double digits. The relaxation of COVID restrictions in the country has fueled miles driven and an increase in garage visits driving higher demand.

East Asia and South America both generated high-single-digit core growth year-over-year with solid contributions across most end markets. Overall, it was a good start to the year and demonstrated the resiliency and dedication of the organization.

On slide 7, we provide an adjusted earnings per share walk from last year's first quarter. Operating performance contributed approximately $0.06 per share and includes a little over $0.01 per share of expense add-back related to the cybersecurity incident. The adjustment primarily reflects lost manufacturing production in addition to incremental SG&A costs. A higher effective tax rate drove a $0.06 earnings per share headwind while higher interest expense was a $0.03 earnings per share drag compared to the prior year. The other bucket includes the benefit of a reduced share count and lower minority interest versus the prior year.

Lastly, we recorded a $10.7 million pre-tax charge, or $8.5 million after tax related to a customer bankruptcy filing. The charge was added back in our adjusted EBITDA and adjusted earnings per share reconciliations.

Slide 8 has an update on our cash flow performance and balance sheet. Our free cash flow for the quarter was $38 million. Relative to the prior year period, working capital outflow was significantly lower, benefiting from a slowly stabilizing operating environment and improved inventory management. Our inventory turns increased modestly year-over-year. Our net leverage declined both year-over-year and sequentially.

At the end of the first quarter, our net leverage ratio was 2.7 times, compared to 3.2 times last year. We ended the quarter with the lowest net leverage ratio for a first quarter in our history as a publicly traded company. We remain highly focused on driving incremental improvements to our balance sheet and will be opportunistic with regards to taking actions to strengthen our position.

As Ivo mentioned earlier, the board approved a new $250 million share repurchase authorization, which enables us to be efficient in optimizing our capital allocation options as we deploy excess cash.

Shifting to 2023 guidance on slide 9. We are reiterating our full year 2023 guidance which includes 1% to 5% core revenue growth, adjusted EBITDA in the range of $700 million to $750 million, and adjusted earnings per share of $1.13 to $1.23. Also, we still anticipate capital expenditures of approximately $100 million and free cash flow conversion of 100%. Please note that our guidance ranges do not incorporate any potential share repurchases.

For the second quarter, we expect revenues to be in the range of $915 million to $945 million. We expect low-single-digit core growth year-over-year inclusive of meaningful growth in China as the business comps against the

Copyright © 2001-2023 FactSet CallStreet, LLC

COVID-related shutdown that occurred during last year's second quarter. We estimate our adjusted EBITDA margin will expand approximately 50 to 100 basis points compared to the prior year.

With that, I will turn it back over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. On slide 10, I'll summarize a couple of key messages before taking your questions. First, I am pleased with the start to our year. Our results came in above the midpoint of our guidance while navigating through a cybersecurity incident. The operating environment continues to heal and our operating initiatives are gaining traction, both of which contributed to attractive margin expansion year-over-year. Additionally, we are intensely focused on our customer service metrics as the operating environment normalizes.

Second, we continue to make good progress improving our balance sheet and enhancing our ability to return capital to shareholders. We delivered positive free cash flow in the first quarter, a very strong performance when considering our normal seasonality usually results in an outflow. We are intently focused on converting 100% of our adjusted net income to free cash flow in 2023 and in the midterm.

On trailing four-quarter basis through March, our free cash flow conversion has measured 105%, which highlights our cash flow generation capabilities. Our net leverage ratio decreased by half a turn year-over-year and fell slightly from the fourth quarter level. Based on the strong cash flow performance in our business and improving balance sheet, our board of directors recently approved a $250 million share repurchase authorization that will enable us to opportunistically return capital to shareholders. The authorization provides us with another tool to deliver attractive returns to our shareholder base.

I'll finish by extending my deep appreciation to the 15,000 global Gates associates for their perseverance and dedication.

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

Copyright © 2001-2023 FactSet CallStreet, LLC

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Deane Dray with RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

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

A

Good morning, Deane.

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

A

Good morning.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, just to put some closure on the malware incident, when you say that you're not going to recoup the volume, so was that just – was it share loss during that period? Just why is there that expectation that you don't get it back or is it in future quarters?

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

A

Yeah. Hi, Deane. A lot of our business is book-and-ship. And so there was this period of time where we couldn't take some orders and that progressively got better as we went through the incident. And so our view is, during that time, we couldn't take orders. We probably aren't going to get those orders back. And so that piece of it we just don't think is going to come back to us because it's primarily that book-and-ship business where you take the order and you book it within, I mean, ship it within 48 to 72 hours.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. All right. So that's helpful. And then second question is, can you give us a sense of the inventory in the channel, how distributors are positioning, any destocking going on? Anything there would be helpful. Thanks.

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

A

The business is fairly balanced. Based on a point-of-sale data that we continue to very carefully look at and the related indicators, we believe that the inventories are consistent with the underlying demand still in a channel. But as you can imagine, we are also being very, very cautious and very mindful of what the market may do in a near-term future.

Copyright © 2001-2023 FactSet CallStreet, LLC

I'll say that we did see some choppiness in the industrial demand, as I stated in my prepared remarks, and As I stated in my prepared remarks, that I would say is more isolated to kind of logistics and distribution end markets that have weakened somewhat. But in general, the inventory positions remain in a reasonably good shape. And as we have also indicated, we started to take a nice chunk of finished goods inventory down.

Deane Dray Q
Analyst, RBC Capital Markets LLC

That's real helpful. And just lastly, it's not a question, just a comment. That's very impressive on free cash flow this quarter. Thanks.

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

Thank you.

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

Thank you.

Operator: And the next question comes from the line of Andy Kaplowitz with Citigroup. Your line is open.

Andrew Kaplowitz Q
Analyst, Citigroup Global Markets, Inc.

Good morning, everyone.

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

Good morning.

Andrew Kaplowitz Q
Analyst, Citigroup Global Markets, Inc.

Ivo, on your last earnings call, you mentioned the availability of highly engineered polymers is improving and it seems, like you said that again in today's presentation, it seems like it did help your margin performance in power transmission given the significantly higher margin and lower sales. So, with the understanding that maybe Q1 was your easiest comparison in terms of supply chain headwind, would you expect that more positive performance to continue especially in PT or are you just being conservative in terms of your supply chain expectations?

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

Thank you, Andy. I mean, I've been pretty consistent and maybe very open about our struggles with the polymer supply and availability. And so, look, we're making really good progress. We have secured adequate amount of resins. That was a big headache, particularly in Q3 of last year. So, while Q1 of last year was probably the easiest but predominantly driven by inflation and that was brought in by the conflict in Russia, in particular, and obviously some of the other issues that we have all seen in end of 2020, we think that the polymer-based comp will be easier in Q3 than it was in Q1. I feel that we have what we need and we should progressively be able to continue to drive our margins up as we have guided in our prepared remarks.

Copyright © 2001-2023 FactSet CallStreet, LLC

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

And then, Ivo or Brooks, can you just give us a little more color into what happened with the customer bankruptcy here? And I think it would be a good time to ask you about how tighter credit conditions are impacting your customers and/or markets and that you would expect this to be a relatively isolated incident.

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

A

Yeah. So, I mean, look, there's not a lot to say. The customer towards the end of January filed for bankruptcy proceedings. They've been going through the process. As we learned more information, at some point, it became prudent for us to go ahead and book a credit reserve for that particular customer. And we do think it's an isolated incident. We have again good methodology in terms of how we track the credit worthiness of our customers and how we look at bad debt and different things like that. This one was a particularly big automotive supplier. And so it was – it happened fairly quickly. But we have a good process in place where we manage our – both our customers' credit worthiness and looking at our receivables and managing our bad debt. So, we feel pretty good about where we are.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate the color, guys.

Operator: And the next question comes from the line of Julian Mitchell with Barclays. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe just to try and drill Just trying drill into the sales outlook a bit more. Just wondered in the first quarter the sort of price versus volume spread within sales. And when you think about volumes for the balance of the year, volume growth, anything to call out sort of on a quarterly basis or seasonal basis? And are we still thinking it sort of 3-ish points of 3 to 4 points of price tailwind for the year?

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

A

Julian, good morning. Yeah, I think you're thinking about it correctly. Look, I mean, in Q1 again to restate, right, I mean, we had a full quarter of Russia and then in the comps, and then obviously we had COVID impact in China in Q1 of this year. So, based upon what we see the order intake pricing and the underlying performance of the markets, we believe that our outlook remains pretty prudent as we have described in our guidance.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks so much. And the sort of the price tailwind eases gradually or narrows gradually through the year. Is that the way to think about price and sales?

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

A

Copyright © 2001-2023 FactSet CallStreet, LLC

Yeah. I think that's the exact way to think about it. It will – as inflation – the rate of inflation starts to decrease, I don't think we're seeing deflation certainly yet. But the rate of increase in inflation starts to slow, that'll trickle through the price-cost relationship. And then that will slowly go down over the course of the of the year, quarter by quarter.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks very much. And then just on the balance sheet usage. It's encouraging to see the free cash improving a lot in the first quarter. So you do have much more optionality sort of looking ahead on cash usage. Maybe just talk us through sort of the aspiration here to try and get the sort of the free float, if you like, or change the structure of the shareholder base to a degree at Gates, the appeal of that versus kind of M&A because I'm sure you're chomping at the bit to get some M&A done. Maybe just how are we thinking about that sort of even distribution between the two or just given the valuation of the stock there has to be a sort of buyback is a much higher return?

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

A

Hey, look, I think, first of all, we're really pleased with our cash conversion in Q1 as we continue to drive improved profitability as the supply chain optimizes. We feel good about our cash conversion for the year and that's going to give us a significant amount of cash to deploy, right, from a cash optionality perspective or a capital deployment perspective. And so, look, we've got a midterm target of getting our leverage down to 1 and 1.5 terms. That's going to come through a combination of both gross debt paydown and improved profitability. And it's probably split pretty evenly. So we'll continue to drive that leverage down both ways.

We want to remain flexible so that if an opportunity comes out for us to do some stock repurchases, I mean, that's going to be nicely accretive for the company and we want to have that optionality. And then, we also want to make sure that we have M&A in front of us because all those are good options. We continue to look at our pipeline of M&A opportunities. We continue to make sure we keep those in front of us in case something becomes actionable. But in terms of debt paydown or stock buyback, those are great capital deployment opportunities. And I'll say further we're not going to let the cash sit on our balance sheet. And so in the short run, if we have more opportunities to pay debt down, reduce cash interest, improve earnings per share, then we'll do that. And as we continue to generate cash, we'll look at other options.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

Operator: And your next question comes from the line of Joshua Pokrzywinski with Morgan Stanley. Your line is open.

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

Q

Hey. Good morning, guys.

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

A

Good morning, Josh.

Copyright © 2001-2023 FactSet CallStreet, LLC

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

Q

Ivo, just wondering as you guys look out across pretty big, or call it mega-project funnel out there that some folks in the broader industrial orbit are seeing, are you seeing an uptick in either the OE business or folks in distribution who are trying to prep for those things or new design wins or anything I guess that would just give Gates access to the higher CapEx spending that we're seeing now and probably get further momentum into 2024?

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

A

Yeah. I think that maybe I'll point out to the prepared remarks a little bit, Josh, too. I mean, we've talked about some nice wins in construction and off-highway equipment that we believe we will start production with in the second half of this year. So I would say that some of our participation, biggest participation is going to be more in the infrastructure build-out as a first stage. And then as a second stage, as you start looking more out to the industrial automation, the equipment that actually is going into those facilities we have a ton of products that are components of the in-production equipment that we have a ton of a ton of products that are components of the in-production equipment that our products get used to. So we have to be reasonably confident that we're going to have a good participation as this project go from an early stage to more latent stage of development. And so this could provide a nice benefit for our revenue generation kind of into 2024 and beyond that timeframe, so definitely something that we look forward to participating on.

Outside of that, I wouldn't say that we don't have like in electrical equipment, so we don't participate in the early stage of that build-out of those megaprojects.

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

Q

Got it. That's helpful. And then, I guess, if I just think about the balance sheet, you gave some helpful color already, but what's the level at which you feel like it's sort of inefficient to continue to pay down debt? Do we see a lot more sense of urgency at two times or where do you guys kind of want that to land before you really get more aggressive?

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

A

Yeah. Well, look, I think, I think that depends on the environment. I mean, clearly we're in a higher interest rate environment right now. And you have to look at our complete debt picture in terms of how much of it is fixed versus how much of it is variable, in terms of what the paybacks are. And we've said before we want to get down to below $2 billion of gross debt. So that was the basis of a ways to go in terms of paying that down.

But we want to be balanced, too. And so we want to look at what's best for the shareholders. Certainly, as we pay down debt and improve profitability, get closer to our goal, pay down more of the high-cost debt, buying back stock, maybe a little bit, maybe a little bit more attractive for the shareholders. And then on the M&A side, Ivo?

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

A

Yeah. Look, I mean, I will start with, we really like our product portfolio and how we participate in the end markets where we participate. We believe that we have a very strong set of opportunities ahead of us to nicely continue to grow our enterprise and do it at very strong type of margins that we can deliver. But that being said, we don't feel

Copyright © 2001-2023 FactSet CallStreet, LLC

any pressure to do an M&A, we want we want to continue to demonstrate that this business has a strong opportunity to have that, frankly, a bulletproof balance sheet. And that is our primary focus.

And when opportunities arise, there are lots of companies out there that we believe we would benefit or they would benefit from combination with, with Gates, and when the opportunities arise for the right valuations, we'll be on a standby to look at some of those potential transactions.

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

Q

Right. Let's talk in the meantime.

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

A

Thank you.

Operator: And the next question comes from the line of Mike Halloran with Baird. Your line is open.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Great. Good morning, everyone.

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.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

So, maybe some thoughts on first, the demand side again, just how you think about backlog, backlog normalization through the year. And is there – we certainly heard your response to Josh's first question I think about how some of these larger projects will cadence and project wins will cadence in through the year? But any – any nuance by end market from an underlying demand perspective positive or negative that you're thinking about as we look at the back half of the year from a trend perspective?

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

A

Yeah. No, I think that, that is a very good question, Mike. So, look, I mean, book-to-bill remained above 1, let me start with that, taking into account what we've gone through with the cyber incident, which frankly was a very challenging period of time for our teams here. Our age backlog and our backlog remains way too elevated. And frankly, we do not anticipate that we're going to be able to start reducing it in a meaningful way until second half of the year. Maybe additional color is more [indiscernible] (35:56). And I think I said it a couple of moments ago. And we do see some choppiness, particularly in the industrial replacement business, but it remains in-line with our expectations, particularly as the supply chain normalizes and the lead times overall start normalizing there-

Copyright © 2001-2023 FactSet CallStreet, LLC

normalizing already. We believe that you're going to see a little bit of that choppiness. But again, book-to-bill above 1. the inventory levels in the channel remain very, very solid with the present level of demand.

And so we do think that the business should continue to evolve around how we have viewed the year at the beginning of – at the start of this year, which is probably some slowdown in second half, particularly is driven around some of the credit constraints and late in the cycle and so on and so forth. So we feel pretty good with what we see.

I mean, I'll maybe give you a little more color in here. Our auto demand was very solid. Global auto up kind of poor. Energy up very strong high, high teen. Underlying market demand staying very strong. Off-Highway, very solid at plus 8%. Obviously, we talked about personal mobility still in high teens.

And so the only kind of the only choppiness that we have seen was more in the diversified industrials and it was down kind of mid-single-digit level. So, all in, pretty good, pretty solid and kind of what we anticipated but we're being very cautious and we're being mindful of the underlying macroeconomics that we are all operating in.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Very helpful. And then follow up, when you think about the optimization programs you announced a couple of quarters back, just an update on how things are progressing on that side?

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

A

Yeah. Look, I mean, our gross margins are up quite nicely, obviously flowing through operating margin, very good leverage on incremental revenues. So that was pretty solid. And I would say that we were predominantly helped in the first quarter by a less negative supply chain situation. And so our prime wheel or prime pump is getting pumped up.

And we think that we are in a good place to continue to drive improvements that we have described. And we certainly believe that over the next couple of years, the gross margins should go up very nicely and that the underlying improvement should filter through the profitability as we have highlighted in last earnings call.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Thanks, Ivo. Appreciate it.

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

A

Thank you.

Operator: And the next question comes from the line of Jamie Cook with Credit Suisse. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning and congrats on a nice quarter. I guess just I mean, most of the questions have been asked. I guess I would just say assuming that the macro does deteriorate, can you talk to some of the changes in your

Copyright © 2001-2023 FactSet CallStreet, LLC

business model, either from a cost side or end market focus and how either from a cost side or end market focus, how your business performs in a potential downturn this cycle versus previous ones, and any actions you're contemplating right now in the event that things do deteriorate. Thank you.

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

A

Good morning, Jamie. Thank you for the question. Look, I would start with that. I think that we're a lot more cognizant of the macros. We have been maybe – I think somebody told me that I've maybe been too negative about the underlying market conditions, but we're just trying to be pragmatic. And so, as I said earlier, we started to take down our inventories levels quite nicely, so we are positioning ourselves to be in a situation where while we want to have a flexibility and we're absolutely laser-focused on servicing our customers more effectively, we also don't want to be caught up with significant amount of inventory in a potential scenario where the macros filter through the underlying demand.

So, I would say that's probably change, number one, maybe from the previous cycle. Change number two, I think we have a lot more balanced portfolio where we believe that some of our end markets should have a pretty strong dynamics even in slowdown of the macroeconomic environments. So, automotive replacement business is in a very good shape, and we believe that that should provide a nice cushion for us.

We have done lots of work with the change of our portfolio. I mean, obviously, we have taken our automotive OEM exposure down by nearly 50% since we become a public company. So we believe that there should be less exposure to a cyclical auto market. And we have fundamentally improved our footprint where we have a capability to flex our muscle a little more effectively maybe than we have been able to do in the past down cycle.

And lastly, we still have a ton of restructuring projects on the docket that we haven't really spoken about a lot since we said sometimes late last year that we are in planning stages of executing those, and we will be coming out midyear and providing an incremental update on opportunities that we see with we're driving, putting ourselves to a position to lower our breakeven point.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thanks. I appreciate it.

Operator: Again, if you would like to ask a question, press a star and the number one on your telephone keypad. Our next question comes from the line of Jerry Revich with Goldman Sachs. You may begin.

Q

Hi. This is [ph] Clay (42:19) on for Jerry. Just one quick one for me. Second quarter EBITDA or EBITDA margins are typically the high point for the year looking at normal seasonality, would you expect any deviation from this in the second half or just – thank you.

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

A

Yeah. No. Look, I think overall Q2 tends to be our peak year. I do think when you look back at 2022, there are some choppiness in terms of when we started to see the Russia-Ukraine impact come through. If you remember

Copyright © 2001-2023 FactSet CallStreet, LLC

Q3 and Q4, we had the supply chain disruptions last year and then we expect the supply chain to get progressively better.

So when you look at our – we're kind of thinking a bit more first half versus second half, and we expect a pretty even split when you think about gross margin improvement through the year, a pretty even split when you think about gross margin improvement through the year pretty even from the first half to the second half. We do expect to have more variable comp in the second half of 2023 so that's going to – when you look at a year-over-year perspective, that's going to be a headwind from a comp perspective, but I would think of it that way in terms of the first half versus the second half.

Q

Thanks.

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

A

Yeah.

Operator: And the next question comes from the line of Jeff Hammond with KeyBanc. Your line is open.

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

Q

Hey, guys. Just on, I guess any changes within how you're thinking about Fluid Power versus PT growth? And just confirm, I jumped on a little late, where all the cybersecurity revenue shortfall hit.

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

A

Yeah. Good morning, Jeff. We believe that we still have a little more opportunity for recovery in Power Transmission. Power Transmission was more impacted in the second half of last year vis-à-vis the polymer shortages that we have discussed. So we're seeing that the opportunity remains there to continue to perform nicely in the second half.

And on your first question, most of our cybersecurity impact was realized in North America and Europe, and two-thirds of about $15 million that we have highlighted were impacted in the North America business, predominantly in the replacement side of our business.

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

Q

Okay. And then this kind of industrial replacement choppiness, can we chalk that all up to destock or is there some certain end markets or pockets that feels like some real demand weakness?

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

A

Yeah. I think I said it earlier, Jeff, logistics and distribution equipment has been weaker. I mean, I think that that's pretty notable. But I would also say that the cybersecurity impact touched North America and Europe in particular. So we don't really see a lot of destocking at this point in time. We feel pretty good about the inventories in our

Copyright © 2001-2023 FactSet CallStreet, LLC

channel being nicely balanced. And outside of maybe that warehousing equipment side of the business, I would say that the rest of it remains pretty robust.

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

Q

Okay. Thanks a lot, Ivo.

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

A

Thank you.

Operator: And there are no further questions at this time. Rich Kwas, I'll turn the call back over to you.

Rich Kwas
Vice President-Investor Relations, Gates Industrial Corp. Plc

Right. Thank you, everyone, for joining our first quarter conference call. If you have any follow-up questions, feel free to reach out to myself. Thanks again. Have a great day.

Operator: And this concludes today's conference call. You may now disconnect.

Disclaimer
The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2023 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.