VIAVID
communications simplified.

Gates Industrial Corporation

Fourth Quarter 2017 Earnings Conference Call

March 13, 2018

CORPORATE PARTICIPANTS

Bill Waelke, *Investor Relations*

Ivo Jurek, *Chief Executive Officer*

David Naemura, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Jeff Hammond, *KeyBanc*

Deane Dray, *RBC Capital Markets*

Andrew Kaplowitz, *Citi*

Jerry Revich, *Goldman Sachs*

Charley Brady, *SunTrust Robinson Humphrey*

Jamie Cook, *Credit Suisse*

Sawyer Rice, *Morgan Stanley*

Steven Winoker, *UBS*

PRESENTATION

Operator:

Good afternoon, my name is Mike and I will be your conference Operator today. At this time, I'd like to welcome everyone to the Gates Industrial Corporation Q4 2017 Earnings Release Conference 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. If you'd like to ask a question during this time, press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. I will now turn the call over to Bill Waelke. You may begin your conference.

Bill Waelke:

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Thank you for joining us on our first earnings call as a public Company. I'm Bill Waelke, Head of Investor Relations and with me today are CEO, Ivo Jurek and CFO, David Naemura. Shortly after the market closed this afternoon, we published our fourth quarter and full year 2017 results on our Investor Relations website. A copy of the release is available on our website at investors.gates.com. Today's call is being webcast and is accompanied by a slide presentation which includes a reconciliation of non-GAAP to GAAP financial measures that we will use during this call and is also available on our website.

Please refer now to Slide 2 of the presentation, which is a reminder that our remarks and answers will include forward-looking statements within the meaning of the Private Securities Litigation and Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed or implied by such forward-looking statements. These risks include, among others, matters that we have described in our Form 8-K filed with the SEC and other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly earnings call, if at all. On our call today, Ivo and David will provide a review of our financial performance and segment results, as well as our guidance for 2018. I will now turn the call over to Ivo.

Ivo Jurek:

Thanks, Bill. Good afternoon. Thank you for joining us today to review our fourth quarter and full year results and provide outlook for 2018. I will begin on Slide 4. We are pleased to report strong results on this first earnings call as a public company. In the fourth quarter and full year 2017, we delivered strong revenue growth. Throughout the year, we were able to capitalize on our organic growth initiatives and the strong demand environment we are experiencing across many of our industrial end markets, resulting in core revenue growth of over 9% for the fourth quarter and full year.

We also continue to expand our long-standing presence in emerging markets where we experienced double digit core revenue growth since 2017. As a result of the strong revenue performance and continuous execution of the Gate's operating system, we were able to deliver record Q4 and full-year Adjusted EBITDA. We also demonstrated the ability to further expand margins with our Adjusted EBITDA margin increasing roughly 50 basis points in both the fourth quarter and full year, excluding the impact of 2017 acquisitions that I will cover momentarily. This margin expansion was achieved while we continued to invest in the business to position ourselves for further growth.

Over the course of the year, we upgraded and supplemented our commercial product line and engineering capabilities, particularly in our fluid power segment. We also expanded our commercial presence in emerging markets and strengthened our position as those replacement channels continue to develop. In late 2016, we made the decision to invest in additional fluid power capacity to accommodate our growth initiatives, as well as future customer demand. We are now nearing the completion of two new fluid power manufacturing plants constructed at existing Gate's locations which we expect to come online in the second half of this year and ramp up into 2019. We expect these investments to position us well for growth, particularly at a time where there is not significant excess capacity in the industry.

As mentioned, during 2017, we also completed two built-on acquisitions in our fluid power segment to accelerate our growth initiatives. Techflow Flexibles, acquired in June, is a manufacturer of high pressure hose and fittings for oil and gas applications that complements our product portfolio and adds to our technical capabilities. Atlas Hydraulics, acquired in October, specializes in the design and manufacture of hydraulics tubing and related assemblies, also expanding our product portfolio and presence in the North American industrial market. For the full year 2017, these acquisitions contributed just over 1% of our total revenue growth.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Finally, 2017 saw us make additional progress for our goal of deleveraging the business. With a combination of strong free cash flow generation and expected growth of Adjusted EBITDA, we expect our leverage metrics to continue to improve to work on a mid-term goal of getting below 3x net leverage.

Turning now to Slide 5. In our performance by segment, beginning with our transmission. Our power transmission business focuses on applications where belts, chains and other devices transfer mechanical power. We believe that most of these applications are inherently better served by belt-based drive systems, in part due to their lighter weight, lower maintenance requirements and energy efficient performance, to name just a few of the advantages. The power transmission segment delivered core revenue growth of 9.1% and 7.3% for the fourth quarter and full year 2017, respectively.

We saw solid growth across all end market with particularly strong results in a construction, ag, and general industrial markets. Our emerging markets also performed well, a reflection of our focused organic growth initiatives in these higher growth countries. We are currently in the early innings of rolling out a broader chain-to-belt conversion initiative and we continue to pursue a number of conversion opportunities, examples of which include the personal mobility space, industrial MRO, and mobile equipment applications. Our focus in this area will be on fewer, larger opportunities where we can penetrate applications in markets of meaningful size.

In terms of Adjusted EBITDA margins, we delivered 163 basis points of improvement in Q4 and 86 basis points of improvement during full-year 2017 on a year-over-year basis. These results were delivered primarily through volume and continued gains in manufacturing productivity. On Slide 6, our fluid power business offers customers fit-for-purpose products for a wide array of industrial applications in premium hydraulics and other fluid transfer solutions.

The fluid power segment also achieved 9.1% core revenue growth during Q4, with 12.6% core revenue growth for the full-year. The execution of our organic growth initiatives, the healthy industrial end market, demand, and the two fluid power acquisitions that we completed during the year all contributed to our growth. In addition to the two new manufacturing facilities that I mentioned, we are building out further capacity at certain other of our existing fluid power sites. We believe that these investments, combined with a strong end market demand, and our growth initiatives to expand our addressable market in hydraulics will put us in a favorable position once our additional capacity comes online.

While our fluid power segment delivered strong growth in the fourth quarter and for the full-year, our Adjusted EBITDA margin does reflect the investments we have made in growth, both on an inorganic and organic basis. Our two acquisitions are performing in line with our expectations and are on a clear path to margin improvement, which we expect to result in earnings parity over the next 18 to 24 months. Our organic investments are being made to strengthen our commercial product line, application engineering, and product development capabilities to help us deliver on the growth opportunities we see in this segment.

Since this is our first earnings call, I would like to clarify what our approximate end market exposures are, based on 2017 revenues, to help add context to the numbers and also to help establish baseline understanding of our business. We have provided a few different breakdowns of our revenue on Slide 7. First, I will reference the pie chart on the far right and point out that over one-third of our revenues are generated from emerging markets which reflects our well-established presence in these markets and, frankly, some of the benefits of our in-region/for-region strategy.

In the center pie chart, we show a breakdown of our replacement versus first-fit channels and further detail our end market exposures. I will start by noting that our total revenues are positively correlated to global industrial production and not any one individual end market, principally due to the fact that 63% of our revenues are through replacement or after-market channels which are typically less volatile and more recurring in nature.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Beginning with the first-fit, about 18% of our total revenues is in the industrial first-fit end markets, with construction, heavy duty trucks, ag, and general industrial markets being the largest end market exposures. First-fit add-on in 2017 was 19% of our total revenues, with the majority of the 19 points being in emerging markets; China, being the largest single country. Developed market out of first-fit sales were about 9% of revenues and I would note that only about 2% of total sales were from auto-first-fit customers in the U.S. Our strategy is to remain very selective around the first-fit business we take. We will be opportunistic in developed markets and we'll look to participate where we can introduce differentiated products or a new technology.

In emerging markets, there tends to be a less developed aftermarket channel and our first-fit presence helps us to develop our aftermarket presence, which is a key objective of how we decide to participate. The replacement channel reflects the majority of our business and the majority of it is into industrial applications and end markets. Replacement sales into industrial applications are approximately 36% of total revenue, with the largest single end market being general industrial, a large portion of which serves manufacturing, process, and other industrial facilities.

Beyond general industrial, our largest end markets are ag, construction, heavy duty truck, and oil and gas. Our replacement business that serves automotive applications is approximately 27% of our total sales and behaves much differently than first-fit demand. Sales to the automotive aftermarket are driven by factors such as miles driven, the age of the fleet in a given geography, the price of fuel, and general economic conditions. We tend to see the most demand as the fleet age is into the seven- to 12-year range, which we view as a positive trend currently in North America as well as in emerging markets, particularly China, where the growth in the age portion of the fleet is very favorable.

Lastly, we are primarily focused on the do-it-for-me subsegment of this market. In total, about 9% of our total revenues are from developed markets first-fit auto applications and over half of our end market exposure is related to industrial applications. I hope this is helpful in establishing a base line. We do not plan on providing this information on consistent basis but may revisit it at some point in the future.

Moving on to geographies. As you can see on Slide 8, we experienced strong core revenue growth across most of our regions. This growth was driven by combination of targeted commercial actions, strong industrial end markets globally, and increased sales in certain first-fit applications, primarily in emerging markets. Our strongest core growth came in China where we had double-digit growth across all of our end markets for the full year. The strong growth in China was followed by EMEA, with North America and South America also contributing solidly. In East Asia and India, growth in our replacement markets was offset by continued headwinds in the off-shore oil and gas end markets, which have not recovered like the land-rig=driven oil and gas market in North America.

We are seeing generally positive macro environments throughout our regions and believe we are well-positioned, particularly with our in-region/for-region manufacturing strategy and significant commercial presence, to take advantage of these favorable market dynamics.

With that, I will now turn this over to David to provide additional inputs on our financial results. David?

David Naemura:

Thanks, Ivo. I will now cover our Q4 financial performance beginning on Slide 9 where, as Ivo mentioned earlier, you can see the record results that we have delivered for revenue and Adjusted EBITDA. Adding to our core growth of 9.1% in the quarter were an additional 3.2 points of growth from foreign currency and 4.8 points of growth from our acquisitions, bringing total Q4 revenue growth to 17.1%. The core growth of 9.1% was in large part driven by our industrial end markets, particularly ag and construction, which grew about 17%. Energy was strong at about 15% growth, driven primarily by oil and gas in North America, and heavy-duty truck was up about 15% with growth in all of our major regions.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Our Adjusted EBITDA of $173 million was an increase of $25 million or 17% over the prior year Q4. Adjusted EBITDA margin was 22.1%, about flat with the prior year due to the temporary dilutive impact of acquisitions in the year. Excluding the impact of acquisitions, Adjusted EBITDA margin was 22.6%, an increase of about 50 basis points over the prior year Q4.

We did see some modest inflation in the quarter, with raw materials increasing about $5 million, which we more than offset with price within the quarter. Our net earnings for the quarter and for the full-year were impacted by a few items that we don't see recurring in the future. Earnings were favorably impacted by a one-time non-cash net tax benefit of about $118 million. This benefit resulted from the implementation of U.S. tax reform, which I will talk more about on a later slide. Also, impacting earnings was a portion of the revaluation of our Euro-denominated debt that is not designated as a net investment hedge and therefore flows through P&L. As part of our IPO structuring, we have removed this impact from flowing through P&L in future periods.

The impact to pre-tax earnings from this revaluation was $11.7 million negative in Q4 and $61.2 million negative for the full-year 2017. On this slide, we have presented a year-over-year comparable adjusted net income number, which adjusts for these non-standard items and also adds back intangible amortization from the LBO in 2014, as well as a few other items, with the reconciliation provided in the appendix.

Now, jumping into the full-year results on Slide 10, full-year core revenue growth was 9% with an additional 0.5 point from FX and 1.2 points from acquisitions, resulting in total growth of 10.7%. Our growth profile for the full-year was similar to that in the fourth quarter, with double-digit core growth across most industrial end markets driven primarily by ag and construction as well as oil and gas in North America in our general industrial category that serves a number of end markets and applications.

For the full year, we grew in all of our major commercial regions and grew in all of our major end markets as well. We ended 2017 with Adjusted EBITDA of $669 million and an Adjusted EBITDA margin of 22%, both records for the Company. On an apples-to-apples basis with the prior year, excluding the impact of the two acquisitions in the year, our comparable Adjusted EBITDA margin was 22.2%, representing margin expansion of just over 50 basis points over 2016. We did see increased inflation during 2017, partially driven by global shortage of a key part order input earlier in the year, as well as modest increases to general inflation in the latter portion of the year. We believe that raw material inflation in the year was about $20 million and that we effectively offset about 75% of this in the year with price and that we will be fully offset by the end of the first quarter of 2018.

We agree with most views that we are entering a more inflationary environment and remain committed to react with pricing where appropriate. Given our greater-than-60% replacement market focus and the strength of our brand, we believe that we are well-positioned in this regard. Our adjusted net income for the year increased by about $25 million over 2016 with the benefits of the higher Adjusted EBITDA flowing through, partially offset by a higher normalized tax rate in 2017 as well as higher interest expense due to the accelerated amortization and deferred financing fees resulting from the debt refinancing in April.

Slide 11 provides details on key cash flow items and our focus on continued deleveraging of the business. Excluding the incremental trade working capital that we have acquired with Atlas Hydraulics, our trade working capital improved 100 basis points in 2017 as a percent of sales. We have presented free cash flow as net cash flow provided by operations less cap ex and reflected that as a conversion of adjusted net income. This free cash flow measure is unfavorable versus the prior year on dollar end conversion basis. Although we improved EBITDA performance in 2017 over the prior year, we had higher cap ex associated with our growth investments and our sales growth had the impact of increasing working capital dollars, even though it was at a lower rate than in prior years. Finally, we also, benefited from a $41 million tax refund in 2016 that we did not have this year.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

For 2017, our cap ex was about 3.7% of sales, up from the historical rate of 2.5% to 3%. This higher cap ex is associated with additional growth investments, primarily the buildout of additional fluid power capacity to support our organic growth initiatives. Given the growth opportunities that we see, we anticipate maintaining or possibly even slightly increasing this level of spend on a percentage basis over the next couple of years. Finally, on leverage, we ended 2017 with a net leverage ratio of just over 5x. If we were to look at 2017 year-end on a pro forma basis and adjusted for the IPO proceeds that were all used for debt-reduction purposes, our net leverage at that point would be just under 4x.

Turning to U.S. tax reform, we received a one-time non-cash net tax benefit of approximately $118 million, primarily driven by revaluation of our deferred tax liabilities at the new lower U.S. rate, partially offset by a few negative items, primarily, transition tax. Excluding this favorable tax benefit, our effective tax rate was a bit artificially high due to pre-tax income, including a loss on the revaluation of our Euro-denominated debt which I mentioned before and which is not deductible for tax purposes.

Normalizing for these items, we see our underlying run rate effective tax rate for 2017 around 27%. We are still determining all of the go-forward impact of tax reform but currently estimate the impact to our effective tax rate would be plus or minus about 150 basis points in 2018 from the normalized 2017 baseline of 27%.

Moving to our outlook on Slide 13, we believe that 2018 will be another year of strong performance as we see good momentum in our end markets and as we continue to execute on our large-growth initiatives. We are introducing guidance for 2018 total revenue growth in the range of 7.5% to 10.5%. Underlying this revenue growth is core growth that we believe will be in the range of 5% to 6%. We are not providing segment-level guidance but believe that our growth in fluid power will again outpace that of power transmission. We plan to continue to invest in our commercial and product line organizations and expect that Adjusted EBITDA for 2018 will be between $735 million and $755 million, or around 22.5% Adjusted EBITDA margin of about 50 basis points of expansion over 2017.

With that, I'll now hand it back to Ivo.

Ivo Jurek:

Thanks, Dave. I'm extremely pleased with the performance we delivered in 2017, which is a result of solid execution of our entire global team. We grew organically in our core markets and supplemented our growth with acquisitions. We were also able to improve our Adjusted EBITDA margin and reduce our leverage while continuing to invest in the business to position the Company for further growth. We continue to build on the progress that we have made improving our operations and not just from factory productivity standpoint but in safety and quality as well. We are excited to have Gates entering its next phase as a public company and we believe we are well positioned to achieve our growth objectives while remaining focused on creating value for our Shareholders.

With that, I'll turn the call over to the Operator to open up Q&A.

Operator:

At this time, I'd like to remind everyone, in order to ask a question, press star, one on your telephone keypad. We will pause for a moment to compile the Q&A roster.

Your first question comes from Jeff Hammond with Keybanc.

Ivo Jurek:

Hi, Jeff.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Jeff Hammond:

Can you hear me, guys?

Ivo Jurek:

Yes, I'm on the line.

Jeff Hammond:

Hey, good afternoon. You touched on price cost. Can you just walk us through what you announced more recently into this year on pricing, what you captured in price last year? Then, if you can just walk us through some of the major raw material inputs that you'd be impacted by?

David Naemura:

Yes, sure. Generally speaking, last year there was a bit of a shock to the system with rapid inflation of butadiene that happened in, really, the first quarter of the year. I think the whole industry reacted. It was more a disruption in the supply chain. I would say that was over half of the inflation we saw during the year. We reacted to that with price, as did most people that used those polymers, synthetic rubber from things we make to tires (phon) but there was a delay in doing that so I think we were kind of chasing that factor all year.

As the year progressed and we saw the ramp up in the industrial end markets, a lot of particular demand on the fluid power side, we did respond with further price in the second half of the year. The additional inflation that we saw in the second half was principally around steel and metals, both of these items obviously impacting our fluid power business. I think we carried pretty good price into the year, fair given what we're seeing on the raw materials side. It'll always be plus or minus, but we've always thought we were well positioned to price given the nature of our business and I think we've, so far, accomplished that.

As far as raw material inputs, our two biggest inputs are metals and polymers, most significantly. Raw materials, I would tell you, is about 60% of our cost of sales and those are the two biggest categories.

Jeff Hammond:

Okay. Great. Then, just on fluid power, you explained some of the margin contracture around the acquisitions, but it looks, even ex that, you came in a little bit. I don't know if that's just tough comp from 4Q which looked elevated or any noise or any headwinds you're seeing in that business around just the rapid rate of growth that would have impacted that?

David Naemura:

Yes. Two things, I think you're touching on, Jeff. First, we invested in the business. We actually got more efficient in R&D on the power transmission side and then we reallocated that spend over to the fluid power side on some of the growth initiatives that we have, as well as some new products that we're pretty excited about. Also, as we saw the industry snap back rapidly, that was a little disruptive to us and there was some inefficiencies associated with that. An example would be we had to outsource some slab stock that we would usually typically manufacture ourselves and there were a few other factors like that—expediting freight and things like that. We have a lot of important OE customers and we look to take care of those guys and do whatever it takes. Those were the two things that were really a bit disruptive in the fourth quarter.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Jeff Hammond:

Okay. Thanks, guys.

David Naemura:

Thank you.

Operator:

Your next question is from Deane Dray with RBC Capital Markets.

Ivo Jurek:

Hi, Deane.

Deane Dray:

Good afternoon, everyone.

David Naemura:

Hi, Deane.

Deane Dray:

Hey, I would like to start with China. We're all used to seeing some pretty strong growth numbers coming out of China, but not 27%. That begs questions about where—you said all end-markets were up double digits—where were they the strongest and then was there a comp issue and what's your level of confidence in—what's the sustainable growth rate looking ahead?

Ivo Jurek:

Hi, Deane. Thanks. Yes, we had a terrific year in China as we have discussed in past conversations. We've been positioning ourselves for growth, making nice investments in China and, frankly, we have seen very strong performance across all end markets—strong in auto, continuing to see significant growth in that market; very strong in infrastructure and general industrial on both sides of our market segment. Although we are a bit timid about forecasting 2018—again, we don't necessarily forecast by region nor do we give guidance by quarter—we have accounted for slightly lower growth in 2018 but remain very positive about what we see in China and the effort that our teams are putting forward to execute.

Deane Dray:

Okay. That's good to hear. Then, as a follow-up question, I'd like to hear more around the capacity that you're adding in fluids. You've got the two plants that are coming online. You said you're also adding other capacity in existing plants. At what level of capacity utilization do you pull the trigger and say, "We need to add"? Where was that level? Then, when you look at this capacity coming online, how much is already spoken for in terms of your visibility on demand? How quickly will these facilities ramp up?

Ivo Jurek:

Yes, that's many questions in one. I will tell you that we had the foresight to come in and start planning the capacity expansion project of the two new green sites in Q3, Q4 of 2016, which, frankly, wasn't a great time to talk about capacity expansion as we were in the midst of the industrial downturn. We felt that

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

our organic growth initiatives, our investment in product line expansion will necessitate further capacity as we were kind of thinking about it in middle of 2018. While we exited the industrial downturn a little bit faster in the middle of last year, we have made some quick decisions to add incremental capacity in our existing footprint. We have done that. This capacity's going to start coming onstream during the Q2 of this year with the two new sites coming onstream in a measured way from latter part of Q3 into Q4. I would stay away from how much of the capacity is bespoke (phon), Deane. It's a very robust market that we see presently and I expect that that capacity's going to be well received.

Deane Dray:

Great. Thank you, and congratulations on your first quarterly earnings.

Ivo Jurek:

Thanks, Deane.

David Naemura:

Thanks, Deane.

Operator:

Your next question is from Andrew Caslowitz with Citi.

Andrew Caslowitz:

Hey, good afternoon, guys. Congrats on the quarter.

David Naemura:

Thanks, Andy.

Andrew Kaplowitz:

Ivo or Dave, could you give us a little color regarding the breakdown of core growth in 4Q '17? What I mean is, the 9.1% core growth in power transmission was higher than we had modeled—9.1 in fluid power was maybe a little lower—but was the higher growth in power transmission at all because of—I know the chain-to-belt is in the very early going—was there anything there or was it really just acceleration and construction ag and industrial as you mentioned? Then, could you give us any color on how the auto replacement business performed in that business?

David Naemura:

Yes, briefly, I would say in the fourth quarter we were a little bit surprised by how robust China was on the automotive first-fit side. As you know, we really like automotive first-fit in emerging markets, particularly China, but the year-over-year compare was crazy. Last year, China was very robust—growth in the 40s, I think, in Q4, given the government incentives that were in place on lower sized engines and lower emission engines—and we didn't think we would have as much growth off that as we did, but we did grow off that and I was actually personally modelling a bit of a decline. We were robust on the industrial side. I think we came in a little higher, driven by emerging market first-fit.

Andrew Kaplowitz:

Did auto replacement, is that a low single-digit grower or how is that business?

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

David Naemura:

I think we saw stabilized growth in automotive replacement in developed markets in particular. Continuing to click along well in emerging markets, but I think we saw steady-eddy in automotive replacement as we typically do.

Andrew Kaplowitz:

Okay, that's helpful. Then—go ahead, do you want to say something, Ivo?

Ivo Jurek:

Yes, Andy, I would just say that we've probably seen maybe improving conditions as we were exiting Q4, particularly in North America AR. That was a probably a more positive sign of what was happening in that market.

Andrew Kaplowitz:

Got it. Ivo, do you think that that business can grow in 2018? Is that your current expectations?

Ivo Jurek:

Yes, my expectation, Andy, is that we're going to see improved performance in AR, particularly in North America again. We have grown that business very nicely outside of North America, but we now are entering a phase where the 2008/2009 recession and the drop of car registration is going to start filtering through in the aged car parc—that seven- to 12-year old car parc—that should provide some tailwinds for the business in North America in particular and, frankly, the growth in the emerging economies and obviously you see the registration growing in China so we should start seeing more positive market dynamics there as well. As we have explained, we've been investing quite significantly there to capitalize on that as well.

Andrew Kaplowitz:

That's very helpful. Then, David, maybe if I could just ask you a follow-up on fluid power. You mentioned a higher investment and a bit of outsourcing you did. Would your margins have been closer to flat year-over-year without those things? Then, did the capacity constraints—I don't know if you want to call them that—slow down your growth. Would your growth actually have been higher if you weren't a bit supplier constrained in fluid power?

David Naemura:

Yes, I would say—look, it is—the investments and the shock to the system and how quickly we had to bring up capacity or why we were down year-over-year in the quarter, if not for—look, maybe the full year is better—we were down nine bps excluding the impact of the acquisitions. I would say the R&D investment impact to the full-year was about 60 bps, if that gives you an idea of where the year would have come in without the investment. The supply shock was a little bit more of a Q4 issue. Yes, I think we would have been okay right around where we had been running.

Look, the investment we're putting in is for new product. It's for some really exciting VA/VE stuff that we'll be bringing out, talking about more in the spring, I think, and we're really excited about that so we're putting the wood behind the arrow on that.

As far as, could we have sold more? Yes, we probably could and that's why we're ramping up capacity and we feel good about the capacity coming online in the fourth quarter. Frankly, we continue to also, as

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

we speak, to fill up open floor space in existing plants that we're not bringing down to the ground. We're continuing to bring up capacity as quickly as we can.

Andrew Kaplowitz:

Got it. Thanks, guys.

David Naemura:

Thank you.

Ivo Jurek:

Thank you.

Operator:

Your next question is from Jerry Revich with Goldman Sachs.

Jerry Revich:

Yes, hi. Good afternoon, everyone.

David Naemura:

Hi, Jerry.

Ivo Jurek:

Jerry, hi.

Jerry Revich:

I'm wondering if you folks can talk about, as you look across the global manufacturing footprint, where's capacity utilization the tightest and, in those areas, how much scope do you have to increase production as you continue the Gates Operating System debottlenecking process versus bringing on additional headcount? Can you just give us some context on the drivers of production growth in those areas that I'm sure are baked into the operating plan?

Ivo Jurek:

Yes, Jerry, this is Ivo. I would say that the tightest capacity constraints that we see, frankly, are in Asia. Again, you're seeing very solid growth numbers there. We also are bringing capacity fastest there. We feel reasonably well positioned being able to support the demand. In a developed market—I speak now starting with fluid power—in the developed market, the situation is pretty robust across all of the geographies, as we outlined in our prepared remarks. We are running as fast as we can to get the green fields up and running and we expect, as I indicated, to start getting capacity to marketplace sometime in Q3. Very tight out there right now from where we sit.

On the power transmission, we are in a good place. Again, I will tell you that probably the tightest capacity, but not to the degree that we've seen fluid powers in China with power transmission. In the other geographies, we're in a pretty good place. We continue to drive Gates Operating System, create more capacity, drive productivity. We feel pretty good about meeting.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Jerry Revich:

Okay. Then, from a Gates Operating System standpoint, the focus of the past couple of years have been on operating efficiency improvement. What about, philosophically, price costs going forward? A lot of characteristics that you described about business would suggest pricing at a material cost over time and obviously we didn't see that in '17. Are you optimistic that we'll see pricing ahead of inflation in '18 and how do you think about your ability to push pricing ahead of inflation through the cycle now that the Gates Operating System is, call it, three years in place?

David Naemura:

Yes, Jerry, I'll take that one. It's Dave. I would say that, first of all, as it relates to the Gates Operating System, we'll continue to get benefits, albeit at a lower rate than we have in the last three years as we've done a lot of things that were before—but we're in our cost improvement mode and I think we will see that transition more to BA/BE (phon) activities where we'll try to get cost out of the product and introduce products that are more efficient from a manufacturing perspective. I think that is where Gates Operating System transitions, too, as well as influencing the front end on the new product development design side.

On the price-cost side, that has always been in place and always been our philosophy. I think we're getting better at it. We did lag a little bit in 2017 but, again, I think I said in my remarks, I think we've priced for 75% of the inflation that we saw which came rapidly and I think we'll be price-cost neutral at the end of this quarter for the inflation we've seen. We're pricing ahead. Will it be enough? We think we're well-positioned, but there's a lot of uncertainty out there. There's a lot of uncertainty around inflation and other things and so we're—I think we're being appropriate in the marketplace and we'll continue to do that. I can assure you it is front and center for us.

Ivo Jurek:

Maybe if I can add on, Jerry, the way that we want to run this Company is to ensure that pricing offsets material economics and that's probably the best way to think about it as we enter the more inflationary environment.

Jerry Revich:

Dave, just a clarification, in the first quarter, you're getting enough pricing to not only offset inflation that you're seeing in the first quarter but to make up for that 25% shortfall from '17. Is that correct?

David Naemura:

That's what we anticipate. It's best measured at the end of the quarter, obviously. We're in the biggest month here. But the idea was that that lag should catch up and so, yes, we'll catch up what we'll see this quarter plus what we were lagging coming out of the year.

Jerry Revich:

Okay. Thank you.

David Naemura:

Thanks, Jerry.

Operator:

Your next question is from Charley Brady with SunTrust Robinson Humphrey.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Charley Brady:

Thanks. Good evening, guys. I was just wondering, on the capacity additions that are coming online and particularly the green field plants you've got coming on in QH, how come the margin impact factors into your guidance for the full-year? I would think, obviously, there's some inefficiencies when you're spooling up a plant like that. Do you get the offset for the first half of the year on the additional capacity? Because obviously that's existing footprint and it's probably going to spool up pretty quick. It's probably margin-accretive. But I'm just curious on how the big plants that are going in, how does that impact the margin? Then, obviously, it's going to flow into 2019. Do you make up for that on a year run rate?

David Naemura:

Yes, so, the impact, there are some inefficiencies as we stand up these large plants. Thankfully, they're at existing sites so we don't have a lot of idle indirect and those kinds of things, but we think the impact to gross margin—ultimately, EBITDA margin—of the inefficiencies is about 25 basis points and that's baked into the guidance that we've put forward for 2018. You're right, as we get into 2019, we'll get some benefits and we'll have the opportunity, then, to continue to build out capacity throughout 2019 on these large footprints.

Charley Brady:

Great. That's helpful. Then, just on the chain-to-belt conversion that you spoke a little bit about on the prepared remarks, I wondered if you could just expand a bit on that opportunity? Obviously, it's going to be an expansion over time and a ramp-up like you said, but maybe what's ultimately—it be helpful, I think, for folks to get an understanding of the ultimate size of the opportunity and maybe granularity on really more specific on the types of applications you're pursuing there?

Ivo Jurek:

Yes, sure. Look, we are at very early innings of realizing this opportunity, but we have begun to see attraction in the market as well as we're identifying a significant number of future opportunities. While the chain-to-belt is a significant opportunity, we are currently focusing on few handful of applications to convert; thin grain elevators, infrastructure, aggregate material process, wide industrial distribution opportunities, and so on and so forth. We have had number of ongoing initiatives in personal mobility, including bikes which are well-documented; bike share in China which is something we have entered in 2017, probably think we probably saw somewhere in that $10 million to $20 million in these conversions over the last 18 months and we expect that continues to ramp up.

Look, the way that we look at this market, it's a $17 billion market space where we are just entering the early stages of being able to convert applications and we think over next five to 10 years we should be able to progressively generate a nice set of runways to drive the organic growth in the range that we've communicated with the investors during the pre-IPO roadshow.

Charley Brady:

Thank you.

David Naemura:

Thank you.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Operator:

Your next question is from Jamie Cook with Credit Suisse.

Jamie Cook:

Hi, good evening. Most of my questions have been answered. I guess, just two follow-ups. One, can you just comment on the order trends or what you've seen so, far in the first quarter? I would assume the demand trends continue to be strong and I don't know if they're trending above your targeted 5% to 6% organic growth, although it's early in the year—I get that—but any color there? Then, my second question, any more color you can provide on free cash flow in 2018? Just any anomalies—do we have to build a little inventory just given some of the manufacturing investments and just given that demand is so strong? Thanks.

Ivo Jurek:

Yes, sure. Let me start with the order trends. Look, we're not forecasting our orders, but taking into an account that we are late in Q1, I would say that we see similar order patterns that we have seen in Q4, which was a pretty strong quarter. Please remember that there's some seasonality that we see with our business. Generally speaking, Q4 is the weakest quarter, Q1 and Q3 are the second strongest, Q2 is the strongest quarter for us. We don't have anything that we would say presently that is different than what we have seen with order trends and market environment exiting Q4 into Q1. Dave, why don't you take the free cash flow?

David Naemura:

Yes, on the free cash flow side, I guess the real consideration here is less, I think, inventory build as we bring up these new facilities more around our cap ex. We converted slightly at a slightly lower rate this year on our adjusted net income metric and we would continue to target—the general guidance I would give you is we would continue to target 100% conversion or better except for the higher amount of growth capital that we invest. I would say that we would invest at about that same rate that we invested in the prior year as a percent of sales, if not a little bit higher. I think that's probably the one anomaly I would give you some color on.

Jamie Cook:

Okay. Thank you. I'll get back in queue. Nice quarter.

David Naemura:

Thank you.

Operator:

Your next question comes from Sawyer Rice with Morgan Stanley.

David Naemura:

Hi, Sawyer.

Sawyer Rice:

Hi, evening. Congrats on the first quarter out of the blocks, here.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

David Naemura:

Thank you.

Sawyer Rice:

Most of mine have been asked and answered, but maybe just one on the M&A front. Just thinking about the appetite for Gates for M&A, particularly prior to reaching that three times net leverage mark and then any areas of focus you guys have in the M&A pipeline? Thanks.

David Naemura:

Okay. You bet. Look, M&A's got to be a balance for us. I think we've been pretty consistent about saying we're not looking to go do a transformational deal—never say never—but, ultimately, we're focused on deleveraging the business but, ultimately, our priority is growth and we will use M&A to accelerate our really good, large, organic growth priorities where appropriate, being mindful of leverage. Bolt-ons tend to have higher returns and we think there's a lot of opportunities out there for that, given the highly fragmented nature of the markets that we play in. We have a continued pipeline. We're looking at emerging market deals. We're looking at industrial opportunities associated with our growth initiatives you know kind in the range of what you saw in 2017 is how we're still thinking about it. We'll see as that develops, but thanks for asking that.

I think we'll take one last question.

Operator:

Our last question comes from Steven Winoker with UBS.

David Naemura:

Hey, Steve.

David Silberman:

Hey, thanks. This is David Silberman on for Steven Winoker. Can you talk about how you're thinking about electric vehicle proliferation? Theoretically, you have a comparable amount of dollar content NAVs relative to ICE and even more content, I think, in hybrids, but it's immaterial to your business today, likely to become more important over time. Just wondering how and if you're positioning your business to prepare for electric vehicle growth?

Ivo Jurek:

Sure. Thanks for the question. Look, we have an addressable content on EVs that's similar to what we have on ICE. Although the content will shift from majority BT to majority FP on EV, we feel that we are in a very good position to be able to continue to capture content on that sort of applications. Look, we are the aftermarket player in automotive sub-segment and so we care primarily about a car parc that's seven to 12 years old. The car parc, if you extrapolate to 2030 and you take a pretty optimistic set of projections on the adoption of the electric vehicles around the globe, the expectation is that, by 2030, that car parc—that aged car parc would be about 5% to 6% by 2030. Still very, very insignificant.

But as we look at the car parc growth—that aged car parc, again—we see that the biggest growth opportunity is going to be with miles and full hybrid and Gates is very well-positioned in those applications where we have much more significant content of more differentiated products in that mild and full hybrid set of applications. We feel good about where we stand in terms of EV. We feel very good where we

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

stand in terms of the hybrids and, primarily, as it relates to the aftermarket opportunity that we are primarily focused on.

David Silberman:

Thanks, that's helpful.

David Naemura:

Thank you.

Ivo Jurek:

Thank you.

Operator:

I will now turn the call back over to the presenters.

Bill Waelke:

Thanks, everyone, for joining us here on this inaugural call. We're excited to have had the opportunity to update you on our progress. We look forward to delivering on our growth objectives and continuing to update you on our progress in the future.

Operator:

This concludes today's conference call. You may now disconnect.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com