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Gates Industrial Corp. Plc (GTES)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Mike and I will be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Corporation Q3 2018 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] Thank you.

I will now turn the call over to Bill Waelke, Head of Investor Relations, you may begin your conference.

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

Thanks for joining us on our third quarter 2018 earnings call. I'll briefly cover our non-GAAP and forward-looking language before turning things over to Ivo who is on the call today along with our CFO, David Naemura.

After the market close this afternoon, we published our third quarter results. 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.

On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. A reconciliation of these non-GAAP financial measures is included in our earnings release and the slide presentation, each of which is available in the Investor Relations section of our website.

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Please refer now to Slide 2 of the presentation, which provides a reminder that our remarks and answers 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 or implied by such forward-looking statements. These risks include, among others, matters that we have described in our 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, which may not be updated until our next quarterly earnings call, if at all. Ivo?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Good afternoon everybody. I appreciate you joining us to discuss our third quarter 2018 results. Let me start with a summary of some key results. I'll begin on Slide 3 of our presentation. We are pleased to report another strong quarter of performance. We generated revenues of $828 million, which represents a record third quarter revenue level for Gates. Our total revenue growth was 8.9% over the prior-year quarter, driven by accelerating core growth of 7.2% and a contribution from acquisitions of 3.9%. This was offset partially by a foreign currency translation headwind of 2.2%.

The demand environment remains supportive across many of the end markets that we serve and right in line with our expectations. We saw continued strength in our industrial end markets and experienced a good demand environment in our automotive business, particularly in China and due to our significant aftermarket presence globally.

North America delivered strong core revenue growth in the quarter of 11%, driven by strength in nearly all industrial end markets, as well as another quarter of outperformance in the automotive aftermarket.

In Europe, our industrial end markets were favorable across both the replacement, and first fit channels. This offsets softer automotive first-fit sales which were primarily a result of planned ramp downs of OEM projects and the expected delays stemming from new emissions testing requirements. Our business in emerging economies continued to perform well in the third quarter, with growth across all of our end markets, including strong growth in our replacement channels.

With respect to China, in particular, we are very pleased with our third quarter core revenue growth of just under 10%. This growth was achieved with share gains and strong performance in our replacement business and came on the top of a 30% core growth in the third quarter of last year. Additionally, this performance came despite the fact that they have had to de-prioritize certain China sales to satisfy large, global industrial OEs in this capacity constrained hydraulic environment. While our China automotive first-fit revenue demonstrated solid growth in Q3, our full year guidance has contemplated a slowdown of these sales in Q4 due to comparison against Q4 in 2017, which along with Q4 of 2016 included very high demand, driven by tax incentives on smaller engine vehicles.

We believe that we remain well-positioned in China, with a pipeline of programs at both industrial and automotive OEs, as well as a strong position in replacement channels, including the rapidly developing automotive aftermarket.

Our Q3 adjusted EBITDA of $181 million represents a record third quarter results for Gates. At 21.9% of sales, our adjusted EBITDA margin reflects 30 basis points of expansion over the prior year Q3. Excluding acquisitions, adjusted EBITDA margin expanded by 50 basis points.

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In Q3, we continued to invest in the business. In September, the second of three planned increments of manufacturing capacity came online, according to plan and commercial shipments from that facility have begun.

Our strong execution from the first half of 2018 continued in Q3. I am proud of the Gates team for delivering record results all while operating many production facilities at full utilization, successfully executing the simultaneous addition of new capacity on three continents and integrating our acquisitions in different regions of the world. We have also maintained positive price cost in an inflationary environment as we said that we would. This execution drove solid results across our segments, which I will now cover in more detail.

Turning to Slide 4, beginning with Power Transmission. Our Power Transmission segment delivered total revenue growth of 2.5% and core revenue growth of 4.7% in third quarter. We grew revenues across nearly all of our end markets, with particular strength in the general industrial and heavy duty truck end markets. We also saw another quarter of very strong performance in our automotive replacement business globally. Our trend of emerging economies outperforming developed markets continued in the quarter.

In China, Power Transmission core revenue growth was almost 10% in the third quarter, driven by strength in our replacement business. During the quarter, we continued to add to our chain-to-belt organizational capabilities with resources aligned around targeting both first-fit and replacement opportunities with the key verticals we have mentioned. We had key wins during the quarter in pulp and paper, lumber and agriculture applications, as well as in personal mobility applications where we had both e-bike and e-scooter wins in China. We also recently announced the introduction of a new platform of Micro-V belts.

This new platform of belts will scale to appropriate performance in a range of applications and provide advancements in performance, energy efficiency and manufacturability. This new platform of belts is made possible by our material science and process engineering capabilities. Our first targeted application will be a new Micro-V belt set of products, specifically designed for the aftermarket segment in emerging market countries.

The Power Transmission adjusted EBITDA margin expanded by 30 basis points in Q3, compared to the prior year. This margin expansion was achieved despite some headwinds from emerging market effects.

On Slide 5, our Fluid Power segment achieved another quarter of strong growth, with total revenue increasing by 21%, compared to prior year quarter. On a core basis, third quarter revenue growth was 12%, with core revenue growth of 17% in hydraulics, which is our largest Fluid Power product category. Industrial end market demand drove broad based regional growth with mobile hydraulics markets having the strongest performance.

As our newly launched MXT hydraulic hose family gains adoption in the field, we are hearing consistent feedback that the value proposition is resonating with both first-fit and replacement customers, reduce weight and improve flexibility, as well as lower inventory requirements due to fewer hose construction [ph] times (10:47) are attributes that really do differentiate this innovative new product from our competitors.

In fact [ph] as I mentioned (10:54) earlier, our new hydraulic plant in Mexico came online in Q3. As the plant continues to ramp up into next year, it will not only alleviate some of our existing capacity constraints, but will also support market share gain opportunities from our Fluid Power initiatives. The last stage of our current hydraulics capacity expansion, the new plant at our existing campus in Poland remains on track to come online later in Q4 with its full production ramp into mid-2019.

Our Fluid Power revenue growth along with procurement actions and pricing contributed to an improved adjusted EBITDA margin. When excluding acquisitions, the year-over-year expansion in segment margin was 100 basis

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points. As previously discussed, the Q3 positive margin drivers more than offset both startup costs from the new plants, as well as significant inefficiencies from running at full utilization. These costs will continue to be incurred in Q4 and abate as we exit 2018. David will discuss this in more detail in his remarks.

Our recent acquisitions in Fluid Power segment are progressing well and we continue to see operational efficiency gains from the implementation of the Gates operating system. Overall, our recent acquisitions are meeting expectations and are on track to deliver the planned synergies.

With that, I will now turn it over to David for some additional details on the financials. David?

David Naemura

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks Ivo. I will now cover our Q3 financial performance beginning on Slide 6, where, as Ivo mentioned, you can see the record third quarter results that we delivered for revenue and adjusted EBITDA.

Core revenue growth was 7.2% in the quarter, while acquisitions contributed an additional 3.9% and foreign currency was a headwind of 2.2%, resulting in total revenue growth of 8.9%. The core revenue growth reflects continued strong demand in our industrial end markets across both of our segments, particularly in our replacement business. We saw continued strong demand for mobile applications, particularly in the construction and agriculture end markets. We also saw broad based demand in our general industrial business.

Finally, our oil and gas business performed well, driven in part by leveraging technology gained through the Techflow acquisition. We also experienced strong growth in our automotive replacement channel, which grew by nearly 7% globally, a function of very strong growth in emerging markets, particularly in China, where we continue to expand our leading product coverage and our distribution base throughout the country. Overall, emerging market core revenue growth was approximately 9% in total for the third quarter.

Price cost was favorable in Q3, consistent with the year-to-date trend, and we expect it to remain favorable for the full year.

Our adjusted EBITDA of $181 million was an increase of $17 million or 10.4% over the prior year quarter. Our adjusted EBITDA margin was 21.9% an improvement of 30 basis points over the prior year Q3. Excluding the impact of acquisitions, our adjusted EBITDA margin was 22.1%, an increase of 50 basis points over the prior year Q3. We delivered the strong adjusted EBITDA performance while managing the new plant startup cost, as well as costs related to capacity driven inefficiencies and initiatives to maximize output in a strong Fluid Power demand environment.

We grew adjusted net income to $0.30 per share on a diluted basis, compared to $0.23 per share in the prior year quarter, which was the result of better operating performance, and lower effective tax rate and reduced interest expense. The diluted weighted average share count in the third quarter was approximately 298 million, 17% higher than the diluted weighted average share account of approximately 255 million in the prior year period.

Our GAAP effective tax rate in Q3 was 10%. And we believe that our full year effective rate will now be in the teens with an underlying operational rate still in the mid to low 20s.

Slide 7 provides detail on key cash flow items and our focus on continued deleveraging of the business. Our trade net working capital as a percentage of revenue, excluding acquisitions for comparability purposes, improved 160

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basis points, compared to Q3 of last year, reflecting continued progress in improving our working capital efficiency.

Our free cash flow for the last 12-month period reflects the higher spend on the Fluid Power capacity expansions which will taper off in 2019. Adjusting for this provides a more like-for-like comparison of our free cash flow. We have also continued to build working capital to support our growth, particularly in the Fluid Power segment. Although we have continued to drive improvements in our working capital efficiency as a percentage of last 12 months sales, we have also had to provide working capital in support of our sales growth of 13.1% year-to-date and 14% for the last 12-month period, compared to the same prior year period.

Within our elevated CapEx spending, underlying maintenance CapEx continues to be in line with our historic range of approximately 1.5% of net sales.

On leverage, we ended Q3 with a net leverage ratio of 3.6 times, reflecting our commitment to deleveraging the business while investing in both organic and inorganic growth.

Moving to Slide 8, we are pleased with our performance in the quarter, a result of our team's focus on execution in a very dynamic environment. As an update on some of the second half costs that we previously discussed, in Q3 we were impacted by new plant startup costs, as well as inefficiencies from running some of our plants at full capacity. In addition, we also incurred expenses from actions we began taking to maximize output in certain facilities where we are constrained, including certain distribution capacity. These actions will allow us to continue to grow in an efficient manner and will further position us well for 2019, but are a near-term expense impact. We anticipate that we will continue to experience all of these impacts through the fourth quarter, but that these items will abate as we progress into next year. Nonetheless, we are maintaining our previous guidance for full year 2018 as unchanged.

With that, I will now hand it back to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks Dave. We are encouraged by the solid results we delivered in the third quarter. I am proud of the work of the Gates team globally and their delivery of record results, all while navigating a higher cost environment, operating production facilities at full utilization, successfully executing the simultaneous addition of new capacity on three continents and integrating three acquisitions in different regions of the world.

Our team performed well and in line with our plan, despite the challenges we faced in the quarter. We remain focused on execution. Our key organic initiatives and product launches remain on track and are gaining momentum. New product innovation is accelerating in pace, while leveraging our industrial technology and material science capabilities, VA/VE initiatives on existing products, productivity improvements, and footprint optimizations are significant priorities. We have always talked about shifting our improvement focus from plant productivity efforts, which have yielded great results, to VA/VE and the introduction of new products.

We are seeing that happen with the introduction of our MXT hose family, and next generation Micro-V belt platform. Both of these are very innovative products and we have a series of additional new product launches that will be happening in the coming quarters as a part of refreshing of our product portfolio. In addition to our organic initiatives, we also continue to maintain an active pipeline of acquisition opportunities to accelerate future growth.

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In closing, I would like to thank the global Gates team for their commitment and performance in delivering another outstanding set of results this quarter.

We will now turn the call back over to the operator to open up the Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Jamie Cook from Credit Suisse.

Jamie L. Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi, good evening and congrats on a nice quarter. I just have a couple of questions. If you could given the macro concerns that are out there, could you provide any color in terms of during the quarter or into October where you saw trends decelerate or on the flip side, accelerate just given some of the macro concerns that are out there, either by end market or by geography?

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

A

Good afternoon, Jamie. Thank you. Look, the quarter has developed very much in line with our expectation and maybe a little bit stronger, to be honest with you, with China auto. We have expected that we will start seeing deceleration in Q3. And that's really not occurred yet. But as I stated earlier, our expectation is that you will start seeing abating not necessarily because of significant drop in demand, but primarily because of the significant growth numbers that we have printed in Q4 in 2016 and 2017.

I would say that maybe Europe OE is pretty well documented that that's kind of slowed down because of the new emission testing standards. But the rest of it was pretty much in line with what our expectation was, and maybe a little bit stronger on the industrial side. That's probably the best color I can give you at this point in time.

Jamie L. Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And can you just talk about how you're feeling about your ability to meet demand and weather, freight or supply chains disruptions has had any impact in the quarter or going forward?

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

A

Yes, look, I'll start with the fact that we were a little bit surprised that we didn't see any abatement of the very high pressure hydraulic product lines. We anticipated that we're going to start seeing a little more than normalization of growth rates, and the growth rates continue to stay strong. We are taking market share basically in most of the regions. Capacity is very tight.

We have – actually had to make some tough calls on shifting some production capacity from one region to another. China comes to mind where we have frankly de-committed some volume, because we needed to service some of the larger OEMs. But we are trying to be very proactive and take decisions – and we took some decisions in Q3 where we started repositioning some of our capacity to ensure that we position ourselves well as

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we exit Q4 into 2019. So it's very tight out there. There's not a ton of available capacity in the supply chain. And we feel pretty good about where we sit and what 2019 may bring.

Jamie L. Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you. Congrats. I'll get back in queue.

Operator: Your next question comes from Andrew Kaplowitz from Citi.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey good afternoon guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi Andy.

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

A

Hi Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, last quarter, I think, you said global auto replacement demand grew 8%, this quarter 7%. I think last quarter you said you were seeing double digit replacement growth in China. It seems like that you're still kind of seeing that, or at least you saw that in Q3. You didn't expect – you [ph] did (24:43) mention expected a slowdown in China auto first-fit, I guess mostly based on comps. But could you give us more perspective on what kind of visibility you might have into 2019, particularly in the global auto replacement market? You can talk about the first-fit also, but, I guess my particular emphasis will be in China, what you see there?

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

A

Thanks Andy. That's a great question actually. I would say that in Q3, we've seen the same trends as we've seen in Q2 with our auto replacement market, again, very, very solid growth. China is still low-double digits and developed markets still growing very, very strongly. So we feel very positive about the trend line that we see. And as we explained, I think in our last call, I've may mentioned that, we see the headwind that we have experienced in the prior years from the drop in car registrations in 2009 to abate and that should become tailwind as we move into 2019.

So we feel quite constructively about the AR market globally in 2019. We feel very well, very good about the AR market – in auto replacement in China. We've been building our presence there and that car parc, that aged car parc in China is growing pretty handsomely. So I think that that's going to be a very strong position for us.

In the auto first-fit, we've probably shared that with you all on the call. Look, we are very selective in what business we take. We have decided sometime ago during our strategy development that we want to stay relevant. We don't necessarily want to be a broad market participant. And this is playing out the way that we have

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expected. So the mix is helping us out, but we are very constructive on the AR market and not overly concerned about what's happening in the first-fit registrations.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks for that, Ivo. And Dave, your incremental margin actually looks modestly better in Q3 than in Q2. Overall, despite what was supposed to be an increase in startup costs and inefficiencies that you did talk about, is it mix toward aftermarket that's helping you? Maybe it's the premium products that you mentioned. I know you talked about price versus cost and your covering cost, but you're more than covering costs, and how much in the way of startup costs and inefficiencies did you end up seeing in Q3?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes. So Andy, you're right. I think it was partially some of the premium sales which helped mix things up, but also price. We talked about price costs being positive and it was well positive and that's obviously very helpful from a fall through perspective. As far as the costs that we incurred, they're right in line from a startup cost perspective. We talked about $4 million to $6 million. In the second half of the year I think we're on track with that.

I think the other cost, the inefficiencies that we've talked about, continued to be there as well as we were trying to explain [indiscernible] (28:04) And then frankly as Ivo mentioned, we entered some new activities to reposition some of our footprint to continue to help facilitate growth that was both on the fluid power manufacturing side and also from a distribution perspective to enable more capacity and wasn't without its cost and that'll be a Q3 and Q4 cost as well, but I think we've – not huge numbers, but they will kind of add up to your point, and that's what's resulted in the negative margin from a gross margin perspective year-over-year even excluding the impact of the acquisitions.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks guys. Good quarter.

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

A

Thanks Andy.

Operator: Your next question comes from Steven Winoker from UBS.

Steven Winoker
Analyst, UBS Securities LLC

Q

Hey, thanks. Good afternoon guys.

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

A

Hello Steve.

Steven Winoker
Analyst, UBS Securities LLC

Q

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Hey, just maybe spending a little more time on those questions. Can you actually give us or quantify, if you add them all together, what that impact was that you expect to go through to Q4 on all of those actions and inefficiencies, et cetera, and sort of what should we be thinking about and how much of an abatement maybe in basis points or something, just a little more kind of aggregate view of all of that that you were fighting.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, I would say, it's [indiscernible] (29:17) points of gross margin in the third and that probably increases at the gross margin level to almost 100 basis points in the fourth, as we continue to take these actions to quantify it. As you've noted, we've contemplated most of it, and I think we've increased it a little bit, but I think it's still kind of within the realm of what we've expected, but we wanted to share an update and let you know that we're continuing to do these things.

Steven Winoker
Analyst, UBS Securities LLC

Q

Okay. And can you maybe just go back to price cost in the thinking around what you were seeing in terms of China and tariffs? I know you've covered it before a little bit, but maybe kind of revisit in light of what we're seeing coming this January and the degree to which that is or is not a risk?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes, that's great. We are aided by obviously our in-region, for-region strategy, and although in these times of supply constraint, we've probably moved a few more things cross borders than we otherwise would. As we look forward in beginning of January, we don't think our exposure is any greater than really what we've talked about before. So we've talked about $10 million to $15 million in previous calls and we think that's still relevant. There's a handful of things that [ph] we'll bring into (30:24) China.

We continue to think that the broader impacts on inflation are probably [ph] will be more what we'll see (30:31) but our strategy remains to price for that and we've priced ahead. We think we've been a market leader in price and we continue to believe we're well positioned heading into 2019 as we were in 2018.

Steven Winoker
Analyst, UBS Securities LLC

Q

And through any kind of professional or other channels, there's no delay impact that you have on pricing when you decide to, as you said, price ahead, if you decided you need more, some other folks may have a longer delay.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

See, there's always a lag and it depends on channel and it depends on region honestly, but that's kind of built into our thinking. And I think that's been there all along we continued to stay ahead of it and I think we'll continue to do that.

Steven Winoker
Analyst, UBS Securities LLC

Q

Okay. All right. I'll pass it on. Thanks.

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

Thanks Steve.

Operator: Your next question comes from Jerry Revich from Goldman Sachs.

Ben Burud
Analyst, Goldman Sachs & Co. LLC
Q

Good evening everyone. This is Ben Burud on for Jerry.

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

Hi.

Ben Burud
Analyst, Goldman Sachs & Co. LLC
Q

Could you guys please provide some color on where your lead times are currently, where you see them going in Fluid Power?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

Well, it honestly depends on the products. We're most constrained at the highest level of our hydraulics portfolio. In other words, kind of the highest pressure applications, and lead times are definitely coming down as we bring new capacity on, as we do the things we've talked about doing in the second half. But we're not a backlog business. We don't operate a backlog. We operate book-ship. Admittedly, we are not satisfying all the demand that we see out there, but what was once being measured in kind of multiple months, I think we're now starting to measure in kind of the four to six week-ish type of lead times and reducing.

Ben Burud
Analyst, Goldman Sachs & Co. LLC
Q

Understood. And also could you provide an update on the timing of the production ramp at the two new facilities you've added?

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

Yes. So in Q3 we've basically been able to quite progressively ramp up our incremental capacity in China. That capacity is now running nearly in two shifts. So sometimes end of middle of November, we should be running full two shifts in China. In Mexico, the expectation is that we will exit Q4 kind of [indiscernible] (33:03) two shift ramp up of this facility.

We have been able to pre-qualify most of our product lines in Poland, but we are still in full product qualification and we expect that we will be exiting kind of at a quasi one-shift production ramp up Q4 and getting to that full one shift early in Q1 of 2019. And so kind of towards the end of Q1 of 2019, we should be in a very, very reasonable run rate on all three facilities.

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Ben Burud
Analyst, Goldman Sachs & Co. LLC

Q

Got It. Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

You bet.

Operator: Your next question comes from Jeff Hammond from KeyBanc Capital Markets.

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

Q

Hey, good afternoon guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi Jeff.

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

Q

Can you just give few clean up items. One, you are getting into the fourth quarter, you kind of left at EBITDA range, any kind of biases around tightening that towards the high-end or low-end?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, no, we thought it was an okay range size. There's a lot of uncertainty aside from some of the cost actions I talked about. There's some emerging market currencies which actually, as you've all noted, negatively impacted us in the third quarter. So we thought the range was an okay size to leave it.

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

Q

Okay. And then, you talked about a lot all these startup costs, and I think Steve asked a question [ph] and kind of (34:36) moving into 4Q, but is there a way to kind of add those up in terms of how big of an impact that is in 2018 all in and what would go away into 2019?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes, I think 2018 we're talking about kind of $14 million to $16 million, maybe at the top-end. I think those will for the most part decline pretty quickly in 2019 as we get the new capacity up to speed. We'll still see a little bit of startup costs. I think as we stop operating at really full capacities from our other fluid power plants, we won't have as many expediting costs, we won't have as much kind of premium freight and expensive temp labor and things like that that are really a drag right now. And then the repositioning work we talked about, which is actually reasonably expensive, are things that will be done in the first quarter. So [ph] the things (35:30) should come down reasonably well.

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

Q

Okay, great. And then just finally on cash flow, clearly good growth and you need to invest in working capital, and you got a lot of moving pieces, but how should we think about working capital into 4Q, and as you get some of these plants up and running, what's the opportunity to really drive some of the extended working capital out of the system? Thanks.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes, so generally speaking, I think as we think for year-end we'll be hitting our low point of working capital for the year. Our working capital is rather seasonal. We continue to look to improve working capital as a percent of sales over the prior year, historically kind of talked about 50 basis points. I think we'll do better than that. We've been running better than that year-to-date. I think we will be better than that for year-end.

And next year we'll look to improve again. We'll target inventory at a reasonable level next year. We think there's still good opportunity there. And as we get the plants up and running, I don't think that's going to materially hurt or help our working capital position, but clearly we'll look to improve and we'll be targeting more improvement in inventory in the coming year.

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

Q

Okay. Thanks guys.

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

A

Thank you.

Operator: Your next question comes from Julian Mitchell from Barclays.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good afternoon.

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

A

Good afternoon, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Maybe a first question just on the Fluid Power incremental margins. I guess this year because of some well discussed items it's running at about 20%, last year was I think just under 20%. So when we think about 2019, should we think about a big step up in the incremental margin or is there something in the business that you think means that this sort of 20%ish plus rate is that you've seen in the last two years is a useful sort of go forward placeholder?

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

The primary impact in 2018 has been the addition of Atlas. So when we look at Fluid Power, just sort of using the third quarter as an example, the incremental would have been, think about – it would have been, excluding the acquisition, would have been about 35%, which I think is a little more indicative of the business.

So the impact of Atlas, which we will be able to expand but it's been brought in as a reasonably low margin business and it will provide us the opportunity to grow EBITDA dollars in future, is muting that. So we think when run well on a core basis the business is kind of in that mid-30s and maybe in kind of the low-to-mid 30s, and I think Fluid Power should resemble that in kind of normalized times.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

I see. And maybe, Dave just remind us sort of how quickly you think those acquisition or acquired margins can step up in the next couple of years?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

So at the end of the third quarter, Atlas becomes core to us, so now it will be comparing against results that include Atlas. Part of the challenges we have had in – Atlas has played out like we thought it would, but honestly with the demand on Fluid Power we haven't been able to do some of the things we've wanted to do there.

So I think we will get above average dollar growth out of our Atlas investment, but it has a reasonably low jumping-off point. So I don't think it's going to be too dramatic because it's not that big a business, but I think it'll be accretive to our EBITDA dollar growth in 2019.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thanks. And then just my follow-up would be around the cash flow. Understood the CapEx is very inflated this year and also within the operating cash flow that was down in the nine-month period because of working capital. When you think about those two items, the working capital and the CapEx for next year, do you think as a result of changes in the free cash conversion should step up dramatically?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

Yes, I do. I don't know if it gets all the way back to the 100% level that we target. We're going to work our way back to a normalized CapEx level over the next few years, but as a percent of sales that will improve year-over-year. And again, I think we'll be able to drive some working capital efficiency, additional working capital efficiency next year as well. So we should see help from both of those components.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Great, thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

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Thank you.

Operator: Your next question comes from Charles Brady from SunTrust Robinson Humphrey.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Hey, thanks. Evening guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

Hey, Charles.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.
Q

I wonder if you could just on the commentary about de-prioritizing production in certain regions, moving stuff that go to China to somewhere else. You can kind of comment on that a little bit in terms of is there any way you can quantify potentially what the lost – I guess, lost sales, for lack of a better term, would've been, and once this capacity comes online, you can now bring in that work that you couldn't have otherwise done.

I'm just trying to get a sense of if I look at the core growth rate, which is obviously already pretty good, how much better could that be. And if we go into 2019, we've got more capacity that gives a little more gas relative to what you might've seen in 2018 assuming the demand level stay where they are.

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

[indiscernible] (41:04) that comment was primarily made around the China consumption. We frankly couldn't satisfy all demand in China. I really would probably prefer to step away from how much it was, because the demand is so constrained and we just needed to support the global OE customers first and foremost in some of the outlying regions.

Look, the best way to characterize it is that industrial demand, in particularly the highest pressure of hydraulic products remain robust and we are being very proactive in trying to ensure that we free up as much capacity as we can, and that's frankly what we've tried to do in Q3 and Q4. And I think that Dave outlined some of the incremental costs that we have undertaken to be able to increase further output in those most premium products that we manufacture.

We remain very bullish and our expectation is that we are well positioned and we are positioning ourselves better for 2019.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.
Q

All right, thanks. And just, you referenced some of the project wins on the chain-to-belt conversion in the slides of your prepared remarks. Can you give a little more color on that as far as maybe sizing it or just kind of when does that come into revenue as far as ramping on those projects?

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

Sure. So look, we are converting some of these projects into revenue over next couple of quarters. So we expect that the new wins will start contributing to revenue of Q2 of next year and ramp up from there. We will provide you with much better clarity on our visibility and our expectation with chain-to-belt during our Investor Day in late February of next year. As we said, we are very bullish on the secular opportunity. It explained the way that we have expected. We're making investments. We are building out organizational capability. It requires little different go to market approach in some of these applications. And we remain very optimistic about what this has to offer for us over the long term.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Thank you.

Operator: Your next question comes from Deane Dray from RBC Capital Markets.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thank you. Good afternoon everyone.

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

Good afternoon, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, 2019 has come up several times in Q&A this afternoon, and would be curious if just based upon the trends that you've seen, the backlog, that kind of visibility, is it fair to say you're still on this growth track of roughly [ph] high T (43:58) plus 2 or 3 percentage points, and what would be kind of the bias, way you see it playing out today?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc
A

Deane, I want to stay away from 2019 too much, but generally speaking, I think we see markets that continue to be supportive and we've talked about our kind of [ph] high T (44:18) plus business model. We have no reason to think right now that we wouldn't be in that realm next year. There's going to be puts and takes, but we've got new NPIs that we're bringing to market and a bunch of other initiatives. And we're not holding back on the things that we think we need to do for next year, like these costs in the second half, like the capital investments we've made. So we continue to position ourselves and we remain reasonably bullish. [ph] If you could add something, Ivo (44:43)

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

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I think that you said it well. I think that Deane, I would say that we are quite optimistic actually about what we are doing. We continue to stay on our thesis that we have shared with everybody during our IPO process and markets are supportive. We feel that we are in a good place.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Yeah. And then just Dave, you had said on the new products, maybe you can spend a moment or Ivo on this Micro-V belt, just the way you described it, can you talk about the size of the addressable market? What's the specific applications and does it cannibalize any of your previous models or versions of industrial belts?

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

A

Sure. Let me take it for a bit here. Look it moves into a very large market first and foremost, and we expect that this platform is going to give us an opportunity to kind of do three different things. Number one, the first launch that's occurring as we speak is a launch that's going to give us an opportunity to go after some of these markets that we have historically not got after in the emerging countries. And that's kind of a $200 million, $300 million marketplace. So we're quite excited about that, and we expect that's going to be really accretive to us over the mid-term.

We are also expecting that we will start replacing some of our existing product lines with a better quality product that gives our customer better energy efficiency in these applications, and frankly, it makes it a lot easier for us to manufacture these. So this is a really good platform that should be very accretive both from new opportunities that are out there as well as with refreshing our existing product line.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you.

Operator: [Operator Instructions] The next question comes from Sawyer Rice from Morgan Stanley.

Sawyer C. Rice
Analyst, Morgan Stanley & Co. LLC

Q

Hi good evening.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi, Sawyer.

Sawyer C. Rice
Analyst, Morgan Stanley & Co. LLC

Q

Can you just maybe update us on how you're thinking about the balance of organic versus inorganic investments here, and particularly how you're seeing the size of the M&A pipeline?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

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Sure. I think we'll stick to what we've said, and we're going to remain – it remains an opportunity. I think the pipeline is pretty robust. We continue to target bolt-ons. There's always a large pipeline. There's always two or three things that are of interest, but we're going to remain reasonably opportunistic. In balance our inorganic opportunities, we're continuing to deleverage the business. So as we look to 2019, I think 2019 might be similar to what we saw in 2018 and 2017.

We've done three deals over two years of kind of a bolt-on size, and I'm not guessing ahead what will happen next year. We could do no deals, we could do a couple of deals, but I think past behavior here is kind of reasonably indicative of how we expect things to develop.

Sawyer C. Rice
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then maybe just following up on the tariffs question from earlier, that range that you gave that contemplates that 25% step up in January and then maybe if you could give us a framework of how to think about, you've done good job mitigating with your in-region, for-region strategy, but any, what percentage of your kind of supply chain that is from China is not currently tariffs, just give a framework for potential lists for? Thanks.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes, that does contemplate the 25%. It's an annualized number. And we really have just a very few discrete set of items from the products we produce and would bring in. We have a handful of raw material inputs that we would [ph] anticipate (48:54) tariff based inflation on, but our in-region, for-region strategy is really the key here. We don't produce in China for the U.S. market with the exception of a product or two. And so it's really that that's at play here and for the U.S. market we're producing domestically in the United States or in some cases in Mexico as well. So that's the situation.

Sawyer C. Rice
Analyst, Morgan Stanley & Co. LLC

Q

Thanks. Great. Thanks. Terrific quarter.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks Sawyer.

Operator: There are no further questions at this time. I will turn the call back over to the presenters.

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

Thank you very much for joining us for our results call in Q3 and we look forward to speaking with you while we're going to be updating our Q4 performance early January. Thank you.

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

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