01-Aug-2018

# Gates Industrial Corp. Plc (GTES)

Q2 2018 Earnings Call


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# MANAGEMENT DISCUSSION SECTION

**Operator**: Good afternoon. My name is Rob, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Corporation Q2 Earnings Release. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Mr. Bill Waelke, Head of Investor Relations, you may begin your conference.

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

Thanks, Rob. Thank you, everyone for joining us on our Q2 2018 earnings call. With me today are our CEO, Ivo Jurek; and CFO, David Naemura. After the market closed today, we published our second 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 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.

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

## Ivo Jurek

*Chief Executive Officer & Director, Gates Industrial Corp. Plc*

Thanks, Bill. Good afternoon. Thank you for joining us today to review our second quarter 2018 results. Beginning on slide 3 of our presentation material, we are pleased to report another strong quarter of performance. We generated revenues of $875 million, which represents a record quarterly revenue levels for Gates. Our total revenue growth was 13.8% over the prior year quarter, driven by accelerating core growth of 6.7% and contribution from acquisitions of 4.9%, as well as foreign currency translation benefit of 2.1%. We continue to execute on our growth initiatives and see strong demand environment across many end markets we serve.

We saw continued double-digit growth in industrial end markets led by construction, agriculture and heavy duty trucks. We also experienced good demand in automotive, driven by our aftermarket presence, which grew high single digits globally and was strong in both developed and emerging markets. Let me also note that we benefited from double-digit core revenue growth overall in emerging economies in both the replacement and first-fit channels.

Our Q2 adjusted EBITDA of $205 million also represents a quarterly record for Gates. At 23.4% of sales, our adjusted EBITDA margin is also a record, and reflects 15 basis points of expansion over the prior year Q2. Excluding acquisitions, adjusted EBITDA margin expanded by 60 basis points. We continue to invest in the business during the quarter to advance our large organic growth initiatives, including investments in commercial capabilities, new product development and incremental manufacturing capacity. Building on a company's commitment to product development and material science, we recently announced the global launch of our MXT premium hydraulics hose family for both the first-fit and replacement markets.

We believe MXT is truly a differentiated product that will offer the end user benefits such as lighter weight, better flexibility and improved ease of use with the same level of performance that Gates products are known for. So, we are off to a good start to 2018 with solid Q2 results and a record first half for the company.

Now, let's turn to the segment detail. Starting on page 4, beginning with Power Transmission. Our Power Transmission segment delivered total revenue growth of 7.6% and core revenue growth of 5% in the second quarter. We grew revenue across all of our end markets, with particular strength in the construction and heavy duty truck end markets. We also saw very strong performance in our automotive replacement business globally. In addition, the trend of emerging markets outperforming continued in the second quarter, as we generated total Power Transmission core growth of 7% in these faster growth economies and had over 9% growth in China alone.

During the quarter, we continued to advance our chain-to-belt initiative. As a reminder, we are targeting a focused set of end-markets and applications, which collectively represents a significant market opportunity.


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During the quarter, we had key wins in lumber, food and beverage applications, packaging, as well as personal mobility applications, where we had both e-bike and e-scooter wins in Europe and Asia. Although we remain in early stages, the feedback that we continue to receive remains very positive, and validates that we are on the right path and that our product value proposition is well understood by our customers.

The Power Transmission adjusted EBITDA margin expanded by 70 basis points in Q2 compared to the prior year. This margin expansion was primarily the result of higher revenues and ongoing productivity actions in our factories.

Moving to slide 5, our Fluid Power segment achieved another quarter of strong growth, with total revenue increasing by 26% compared to the prior year quarter. On a core basis, Fluid Power revenue was up 10.1%. We are executing well on our organic growth initiatives. Industrial end-market demand remains healthy and our Fluid Power acquisitions are contributing well to our growth.

Our premium hydraulics product line, which is our largest within the Fluid Power segment experienced mid teen core revenue growth in the quarter, driven by solid demand in industrial end markets, particularly in mobile applications.

Our Fluid Power revenue growth, along with manufacturing initiatives contributed to an improved adjusted EBITDA margin. In this segment, the year-over-year expansion was 50 basis points when excluding recent acquisitions. We achieved this margin expansion while making investments to continue to strengthen our commercial presence, application engineering, as well as product development capabilities.

As mentioned on our last call, the strong demand in hydraulics has resulted us fully utilizing our available capacity for these products. And as a result, we built a significant amount of hydraulics backlog in the first quarter.

During the second quarter, our hydraulics backlog remained relatively unchanged from where we exited Q1. The first increment of our increased hydraulics capacity began to come online in late Q2 in China, with the remainder expected to come online in late Q3 and Q4 in accordance with our previously discussed timelines.

Our new plants in Mexico and Poland also remain on track, relative to our previously discussed timelines. We did incur some incremental startup costs in Q2, and will have additional costs in the second half, particularly Q3, which we believe is normal when bringing this level of capacity online, and it is contemplated in our guidance. The total impact of these costs was about $1 million in Q2, and is expected to be around $4 million to $6 million in the second half of the year. Further, our recent acquisitions are progressing well, and we are seeing early stage benefit at Rapro from the implementation of the Gates operating system in a manufacturing facility.

Finally, in Fluid Power, I want to once again touch briefly on our launch of MXT. This is a new product innovation that combines material science and manufacturing process advancements to introduce a fully differentiated product line, hydraulic hose that weighs less, provides advantages of fuel efficiency when placed on mobile equipment and hose that is more flexible is much easier to thread through equipment in complex industrial environments. We are very excited to bring this new product to both our original equipment customers, as well as our replacement channel partners.

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*


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Thanks, Ivo. I will now cover our Q2 financial performance beginning on slide 6, where, as Ivo mentioned earlier, you can see the record quarterly results that we delivered for revenue and adjusted EBITDA. Core revenue growth was 6.7% in the quarter, and adding to that increase were an additional 4.9 points from acquisitions and 2.1 points from foreign currency, bringing total revenue growth to 13.8%.

The core revenue growth reflects continued strong demand in our industrial end markets across both of our segments, particularly at industrial first-fit customers. We saw continued strong demand for mobile applications with double digit revenue growth in the construction, agriculture and heavy duty truck end markets. We also experienced strong growth in our automotive replacement channel, which grew globally by about 8%, a function of strong growth in emerging and developed markets, particularly in China and North America, where we see increased end user demand through our channel partners.

Overall, we experienced broad ranging growth and we continue to benefit from our high emerging market exposure, where we had total core growth, up almost 12%. Our adjusted EBITDA of $205 million was an increase of $26 million or 14.5% over the prior year quarter. Our adjusted EBITDA margin was 23.4%, a record at an improvement of 15 basis points over the prior year Q2. Excluding the impact of acquisitions, our adjusted EBITDA margin was 23.9%, an increase of 60 basis points over the prior year Q2.

We did see continued raw material inflation in the quarter, but these inflationary impacts were more than offset with price, manufacturing initiatives and other procurement actions across our full spend base. For Q2, we saw our incremental fall through on a core basis in the high-30s.

As we have stated previously, our approach to pricing is to price for inflation, and we believe we are well-positioned to do that with our strong brand and replacement channel presence. We believe that we remain on track to be price material positive for the year. And although we anticipate inflation to increase in the second half, we have been out in front of it with pricing actions in the first half of the year and expect to be able to continue to respond to market conditions as needed.

We grew adjusted net income to $0.38 per share on a diluted basis compared to $0.26 per share in the prior year quarter, which was the result of better operating performance, a lower effective tax rate and reduced interest expense. Our GAAP effective tax rate in Q2 was 11% as compared with 35% in the prior year, as a result of benefits associated with clarifications on U.S. tax reform implementation, as well as a few discrete items. And we will touch more on the tax rate going forward in the outlook section.

Slide 7 provides detail on key cash flow items and our focus on continued deleveraging of the business. Our net working capital as a percentage of revenue excluding acquisitions for comparability purposes improved 190 basis points compared to Q2 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 expansion, which given the timing of the build-out was most significant in the first half of the year. We also typically build working capital in the first half of the year, which in 2018 has also included us providing for working capital associated with our revenue growth. Also the prior year reflects a non-recurring tax refund of about $40 million.

Within our elevated CapEx spending, underlying maintenance CapEx is in line with our historic range of approximately 1.5% of net sales and consistent with our expectation for 2018. On leverage, we ended Q2 with a net leverage of 3.7 times, reflecting our progress on deleveraging the business, while continuing to invest both organically and inorganically.


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Slide 8 contains our updated outlook for 2018. Based on our results through the first half of the year, we are increasing our outlook for the full year. We are increasing our total revenue growth range by 150 basis points at the mid-point, and increasing our core revenue growth range by 100 basis points. For adjusted EBITDA, we have increased the mid-point of the range by $7 million. As we look to our performance in the second half, we have considered that we will continue to experience certain inefficiencies from operating our existing Fluid Power plants at maximum capacity, and that we will experience incremental startup costs to bring our new capacity online.

We would anticipate that these negative headwinds will impact Q3 the most, and therefore the second half is expected to reflect better margin performance in Q4 than in Q3. We have also increased our capital expenditure outlook to around $180 million, reflecting our intention in the latter half of the year to accelerate certain planned organic investments. I will note that we are also performing a bit better than expected in working capital and believe that we will be offsetting a reasonable portion of the additional capital expenditure with increased improvement in full-year working capital.

Finally, on our tax rate, we previously communicated an underlying GAAP effective tax rate of 27% plus or minus 150 basis points. We are now seeing an underlying rate closer to 25% for the year, as a result of clarification of certain items related to U.S. tax reform. We would also anticipate that infrequent or non-recurring items could take the effective rate closer to 20%.

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 terrific results we delivered in the first half of the year and the continued strength in our end markets. We delivered a major new product launch with MXT and our growth initiatives continue to move forward on track. And we are pleased with the progress we've made with our recent acquisitions, which are also adding to our growth.

We continue to invest in a business including our investments in additional Fluid Power capacity. This capacity is beginning to come online, and we believe that this is well-timed with the current market backdrop. I would also like to thank the Global Gates team for their commitment and performance in delivering another outstanding set of results.

We remain focused on executing our growth strategies in order to capitalize on the significant core market opportunities we have in front of us. This is an exciting time for Gates, and we look forward to updating you on our progress in the upcoming quarters.

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


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# QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] And your first question comes from the line of Jamie Cook from Credit Suisse. Your line is open.

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

Q

Hi good evening and nice quarter. I guess a couple questions. Can you just talk by end market where you're seeing the most strength in China and what your assumptions are for the back half of the year, just because there is some concerns, China is overheating, we saw China heavy-duty truck sales I think down 15% for June this month, so just wondering on that, first.

And then, can you just talk about what your assumptions are on price cost in the back half of the year relative to the first half?

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

A

Okay. Jamie, hey, it's Dave. China, we saw a growth of 11.6% core in the quarter. It was pretty broad ranged, double-digit in automotive, in energy really high in construction. The only place we saw some headwinds is maybe agriculture, which is reasonably actually a very small market for us in China. So, it was – our growth in China was reasonably broad.

Transportation, which we would consider industrial transportation was kind of mid to high single digits. So, we continue to have pretty good growth. On the second half price cost side, we continue to – we believe we will continue to have positive price in the second half as we did in the first, and even on a tougher compare. So, we began to take price really second half of last year, and we'll carry – we carried a lot of that into the year. We've continued to take price in phase of increasing inflation, and we'll continue to have positive price in the second half. We anticipate raw material inflation will pick up in the second half, but we'd anticipate price still outpacing that.

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

Q

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

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

A

Thanks, Jamie.

**Operator:** And your next question comes from the line of Andrew Kaplowitz from Citi. Your line is open.

Andrew Kaplowitz
*Analyst, Citigroup Global Markets, Inc.*

Q

Hey. Good afternoon, guys. Nice quarter.


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

Thanks, Andy.

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

Thanks, Andy.

Andrew Kaplowitz
*Analyst, Citigroup Global Markets, Inc.*
Q

Ivo, maybe you could give us a little color regarding the improvement in the global auto replacement market, and your business growing 8% in the quarter, I think you grew less than 5% last quarter. At the beginning of the year you did mention that you expected improvement, especially in North America. So, what did North America grow at in Q2, I think it was less than 3% in Q1. And then, is it really just the headwind from 2008 and 2009 as you've been talking about, is there anything special you're doing in your product portfolio this year to enhance the growth?

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

Thanks, Andy. I think it's a great question. So, first of all, let me start with the fact that I think that the weather is helping us out a lot. It is pretty hot everywhere, and we like hot weather, and I think that the AR channel likes hot weather. So, let me start with that.

Our North America AR business grew about 8.4%. So, we see very, very strong results in North America. I think that you're right as well. We're starting to see that the headwinds from 2009 are turning into tailwinds, and so we expect that the market is going to continue to recover. But honestly, we've had a very, very nice performance across the globe, and as well as we performed in the developed markets, we've performed even better in the developing markets, and China is doing quite well as well. So, we are very bullish about what's happening in the AR market.

Andrew Kaplowitz
*Analyst, Citigroup Global Markets, Inc.*
Q

That's helpful. And Dave, I think we understand the startup costs that you sort of mentioned for the quarter and for 3Q, and my question around Fluid Power is just even if we exclude the $1 million that you mentioned in startup, you did mention a step-up in investments or I think that's what you mentioned, and it looks like the incrementals came down a bit ex-acquisitions from last quarter, so maybe you can talk about sort of what you're doing there in investments, kind of incrementals that we saw ex-acquisitions in 2Q is that what we should expect excluding the extra costs from the startups going forward.

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

Yeah, I think what you saw in the second quarter was some of the headwinds from the startup costs ticking in. So, we experienced just over $1 million of that, plus some increased inefficiencies that we think will abate over time, Andy, as we bring the new capacity online.

So, we think that we'll get back to kind of more of a fleet average more similar to what you saw in Q1 as we get in.


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

We're also benefiting quite a bit from price, and Fluid Power given the constraints in the environment is a place we're taking a lot of price and that has a very favorable impact on incrementals as you can imagine.

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

Yeah. I would – maybe the only thing that I would also add, Andy, is that as we mentioned we launched this major new product line and that also requires obviously cutting into production capacity to be able to run all the trials that you need to run and do all the validation, so that you can actually conduct the product launch. Outside that – that's probably the only other supplemental item.

Andrew Kaplowitz
*Analyst, Citigroup Global Markets, Inc.*
Q

And is it possible guys to quantify that startup of the product line and or the inefficiencies, is that adding sort of another $1 million or $2 million to the cost in 2Q?

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

Yeah. The startup costs were $1 million, the inefficiencies were at least that maybe a little more. We see those inefficiencies continuing, and so the startup costs alone we think were another kind of $4 million to $6 million, as Ivo mentioned, and we're going to continue to have some of these inefficiencies in the back half of the year, as we just – we just run flat out.

Andrew Kaplowitz
*Analyst, Citigroup Global Markets, Inc.*
Q

Appreciate it guys. Thanks.

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

Thanks, Andy.

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

Thanks, Andy.

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

Julian Mitchell
*Analyst, Barclays Capital, Inc.*
Q

Thanks. Good afternoon. Maybe a first question around the free cash flow, so you had an outflow of about $20 million in the first half. Understood that CapEx is obviously being high and your operating cash flow was about flat in the first half. But is there any color you could give on your full year free cash flow expectations, and maybe how you see working capital trending in particular from here given the comments around backlog work through?


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

Yeah. So, generally speaking, Julian, we tend to build a lot of working capital in the first half that has to abate itself and by the end of the year it's our low working capital point of the year. So, we look to increase our percentage of sales. We had – frankly, our goal entering the year was about 50 basis points. We now see that being a little bit better and that's kind of what I was referring to when thinking about full year working capital performance. Beyond that – I'm sorry, what was the second part of the question?

Julian Mitchell
*Analyst, Barclays Capital, Inc.*
Q

Just what do you think your free cash flow is, let's say, for the year as a whole, after doing minus $20 million in the first half?

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

Yeah. So, look, we weren't giving full year free cash flow guidance, but I think we've given the pieces, and I think the working capital performance efficiency is – and the increased strength there should go into the calculation.

Look, we think working capital would be strong in the second half and then you also got to factor that the majority of the CapEx will have occurred in the first half. We're talking about $180 million for the year, and I think we're $112 million or $115 million here through the first half and that has to do with the timing of the plan spend.

Julian Mitchell
*Analyst, Barclays Capital, Inc.*
Q

Thanks. And then my second question, just trying to sort of pin it down a little bit more on margin. So, the gross margin was down about 50 bps year-on-year in Q2, even with sort of 7% organic sales growth, so it's a little unusual. I understand there are some of those inefficiencies and maybe new product launch costs you'd mentioned. But is the assumption that the gross margin will rebound year-on-year in the second half?

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

Yeah, big part of that minus 50 bps here, Julian, is the inclusion of our acquisitions, primarily Atlas, which is significantly lower gross margin business that we think will improve over time. If you had a comparable basis and excluded the acquisitions, you'd be plus 50 basis points, which I think is more indicative of the underlying performance.

Julian Mitchell
*Analyst, Barclays Capital, Inc.*
Q

Thank you very much.

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

You're welcome.


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**Operator:** And your next question comes from the line of Jeff Hammond from KeyBanc Capital Markets. Your line is open.

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.

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

Hi, Jeff.

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

So, just on the guide, is it fair to say the Fluid Power strengths guiding it or would you say that the PT business is also exceeding expectations?

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

It's really broad strength, I think the Fluid Power clearly we have a lot of momentum in the end market environment there. But I think you also see a lot of momentum on the automotive aftermarket in the PT business. So, I think the strength we've seen in the first half is broad, and I think we're thinking that continues.

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

Okay. And then I think you mentioned backlog in Fluid Power flat sequentially. Can you just give us the updated backlog year-on-year on a core basis?

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

We don't report backlog, Jeff, to be honest. We haven't talked about it before and the only real reason we talked about it the last quarter was because we had such a significant move. But to be frank, we're not a backlog business, of course, we have unfulfilled orders like everyone else, but we don't run the business on a backlog basis. We run it on a book ship basis, and we really stay away from reporting backlog, and so we haven't measured it that way so to speak.

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

And then just on that point on the new plants coming in, do you see 4Q kind of the early timeframe where you start to eat into that backlog as these new plants ramp?


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

Yeah. Look, we will – the facilities are going to start slowly coming online from this quarter onwards. And – so our expectation is that we should start seeing an ability to eat up into that backlog as we exit Q4, and really meaningful in Q1 of next year.

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

Okay. And then, just last interest expense was a little bit lower, can you just update us on how you're thinking about interest expense for the year or second half?

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

Yeah. I think for the full year, I think interest expense $170 million cash full year. Prior year interest expense included some recognitions from deferred financing fees associated with refinancing to some of the debt. So, year-over-year compared can look tricky, and then we've also lowered rates a couple of times since – over the course of last year. The lower rates and lower debt as a result of IPO pay down and some higher items in last year given some of the refinancing, some of the recognition, some of the deferred fees of $170 million cash for the full year.

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

Okay. Thanks, guys.

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

Thank you.

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

Thank you.

**Operator**: Your next question comes from the line of Steven Winoker from UBS. Your line is open.

Steven Winoker
*Analyst, UBS Securities LLC*
Q

Hey good afternoon, guys.

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

Hi, Steve.

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

Hi, Steve.


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Steven Winoker
*Analyst, UBS Securities LLC*

Q

So, could we just go back to China for a minute, and actually the tariff question and as tariffs have expanded in reality and then the potential, maybe just talk about the potential impact on Gates, how you guys are thinking about it from a broad perspective and risk mitigation.

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

A

Look, Steve, as we stated we're kind of in region for region manufacturing organization. So, our primary focus in China is to support our customers in China that consume the products in China. That being said our expectation is that it will start to a degree filtered through some economic psyche.

And I think that the customers will be all watching very carefully about what that will result in from kind of the macroeconomic sense. If you think about what it means in dollars and cents, our expectation is that, the presently announced Section 301 tariffs are going to kind of be $10 million to $15 million headwind for us, and our expectation is that, we have a very – good position to be able to offset that without any major difficulties.

Steven Winoker
*Analyst, UBS Securities LLC*

Q

Okay, that's helpful. And then, going to the growth investments both capital and operating expense, the capital side on the additional $10 million at the high-end, just maybe talk through that in a little more detail, what kinds of things that is tied to, so we have a better idea of where – what kind of spending that is. And then, there's a broader question, maybe more on the R&D and other line that we've talked about in the past, which is, these growth rates are obviously quite strong; some part of that is just market strength, some part of that is you guys outgrowing the market, and you've got these initiatives across the business. How are you thinking about that, Ivo, in terms of what's what and how we might think about sustainability of these things and the cost for you to get there?

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

A

Good. Steve, I'll take the first piece on capital, and then kick it over to Ivo. So, some of the new things we're talking about, the incremental $10 million that you referred to are items that we frankly would have been executing in the first half of next year that we're trying to accelerate. One thing I'll talk about is the new design of coupling that we haven't necessarily brought to the market yet, but we're looking to bring some of that capacity into emerging markets, and that'll dovetailing off the Fluid Power, hydraulics growth that we're seeing in the market today.

We also have a very large VA/VE project and I won't go into too much of the details, but it is aimed at improving gross margin. And then, finally, we have some projects around the highest end of Fluid Power capacity, so we're adding a lot of Fluid Power capacity, but the biggest demand is at the highest levels. So, we haven't fully capacitized these plants, but we're going to be bringing in what we call spiral wrapped hose, we're going to be bringing in some more capacity for that or few lines because we're just having such a hard time keeping up with that level of demand.

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

A


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And so, Steve, maybe I can take that growth piece of it. And look, I mean, when we decided to build these manufacturing facilities, none of us really could predict what is going to happen with the market and when the market is going to recover. So, we didn't necessarily spend the CapEx to time it with the market recovery. I guess, it was probably a smart decision and it was well timed from that perspective. But we've invested the CapEx so that we can expand into these bigger markets, where frankly what we feel is very exciting set of new high pressure premium hydraulics product portfolio. We started with the MXT that I have talked about earlier a little bit, and we believe that it is very differentiated product, that's going to allow us to continue to – the trajectory of performing above market growth rates and start taking market share away from some of our major competitors out there.

And we have a ton of supplemental innovation that is coming online towards kind of the second half of this year beginning of next year, where we believe that's going to further help us reposition our hydraulics business – that much more from a footings, where we again believe that we're going to be extremely well-positioned to take advantage of the capacity we stood up and differentiate ourselves in a marketplace with very, very differentiated innovative products. So, we're pretty bullish about what's happening at Gates. And as Dave said, we are also investing in ton of VA/VE activities that are going to help us to continue on a trajectory of continuing to expand our gross margins, and so we are reasonably bullish about what's ahead of us.

Steven Winoker
*Analyst, UBS Securities LLC*
Q

Great. All right, very helpful. Good luck. Thanks.

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

Thank you.

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

Thanks.

**Operator**: Your next question comes from the line of Jerry Revich from Goldman Sachs. Your line is open.

Jerry Revich
*Analyst, Goldman Sachs & Co. LLC*
Q

Good afternoon and good evening.

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

Hey, Jerry.

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

Hi, Jerry.

Jerry Revich
*Analyst, Goldman Sachs & Co. LLC*
Q


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I'm wondering if you could talk about how you're thinking about CapEx decisions on a multi-year basis, as you pointed out you're opportunistically accelerating CapEx programs here near term, but with some of the longer lead time decisions as you pointed out take one to two years to play out. So, how has your thinking evolved around capacity broadly? Can you just give us an update how you're thinking about the 2019-2020 CapEx outlook and the buckets of opportunities that you folks are thinking about?

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

A

Yeah, great. Look, Jerry, I think directionally I would explain it like this. I think we will see the high CapEx year being 2018. And I think over the course of 2019 and 2020, we'll get back to a more normalized rate for the business, which historically has been closer to that 3% of sales. I think we'll continue to invest in Fluid Power related activities, but clearly the big capacity piece we've put in is the large investment, we believe we'll have investments around certain new VA/VE projects, as we've discussed. I think there'll be some PT related items that aren't building new plants, but are building more efficient lines within existing footprint. So, I think we'll see it abate over time and come back over the next couple of years to a more normalized level. Ivo, would you add anything to that?

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

A

Yeah. The only thing that I would add is Jerry that, again, I think we started our discussion about some of the exciting programs that we have in Fluid Power, we see the next evolution of our product portfolio in Power Transmission, and we will be very open and forthcoming about investments that we need to make if we need to them, and they will be made keeping in mind that we need to generate premium returns for our shareholders. And so, again, we are quite excited about what's on the table, but we think that continuing to invest in our business is the right thing to do for the long-term of the company.

Jerry Revich
*Analyst, Goldman Sachs & Co. LLC*

Q

Okay. And in terms of – in Fluid Power, you mentioned the backlog was about flat sequentially. Can you just give us some context by region in terms of how orders have shaped up over the course of the quarter, I guess we're seeing pockets of capital equipment and order growth slowing, and I'm wondering if you're seeing that flowing through into your order rates when you piece out the individual components of the backlog?

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

A

When we'll – look, Jerry, we'll talk about I think demand as it came through in revenue. Again, I don't think we don't necessarily run it on a typical kind of book and bill and order type business. But we saw continued Fluid Power strength in China, significantly, double digit low-20s.

North America was kind of high single digits; globally obviously the core growth of 10% that we talked about; South America is small business for us, but had very high growth. And EMEA was low teens, which is pretty robust as well. So, I would characterize our Fluid Power growth as broad based and strong in emerging markets.

Jerry Revich
*Analyst, Goldman Sachs & Co. LLC*

Q

Okay. Thank you.


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

A

Thanks, Jerry.

**Operator**: Your next question comes from the line of Deane Dray from RBC Capital Markets. Your line is open.

Deane Dray
*Analyst, RBC Capital Markets LLC*

Q

Thank you. Good afternoon, everyone.

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

A

Hi, Deane.

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

A

Hi Deane.

Deane Dray
*Analyst, RBC Capital Markets LLC*

Q

Sticking in Fluid Power. And it was good to hear the new capacity is coming on as planned. One of your competitors in Fluid Power was talking recently about bringing on new capacity in Turkey? And I was wondering why that change any other competitive dynamics in the second half? Because what they saw is they similarly had built all this backlog, and then because customers were double ordering, just anticipating the capacity issues. And then, as capacity comes on, that backlog begins to shrink. Is that just for expectation purposes, do you think it's going to play out similarly for you?

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

A

Deane, I don't – I can't completely comment about what they are seeing. What I would suggest to you is that, we continue to see strong demand across all the regions. I listened to that call I think as well yesterday. But my sense was that the capacity addition was reasonably limited to what they have added.

And again, what I would just kind of keep coming back to is that, look, we are adding capacity to support our growth with highly differentiated products that we are launching, where we believe we have tremendous opportunity to take market share. And that is the foremost reason why we've put the capacity online, and we certainly believe that that remains to be at the front-end center, and the market backdrop is just an incremental benefit for us that we see today.

Deane Dray
*Analyst, RBC Capital Markets LLC*

Q

Got it. That's really helpful. And then, since it's come up a couple of different times, the new launch of the MXT product. Is that – will that represent incremental growth for you, increase the market share or will it cannibalize any of your high-end products do you believe?


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

Our expectation, Deane, is that this is going to bring an incremental growth to us over the mid-term.

Deane Dray
*Analyst, RBC Capital Markets LLC*
Q

Could you just size for that, and then also has it already been launched? Are you already shipping, and where are you making it?

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

Yeah. So the answer to that is, yes, we are already shipping to several of our OEM customers. Our expectation is that as we progress over the course of this quarter into the next, we will start fully launching globally across all of the replacement markets. So far the response to that launch was very positive. And we are manufacturing in all three regions this new product line.

Deane Dray
*Analyst, RBC Capital Markets LLC*
Q

Great. That's real helpful. Thank you.

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

Thank you, Deane.

**Operator:** And your next question comes from the line of Charley Brady from SunTrust. Your line is open. Again, your next question comes from the line of Charley Brady from SunTrust. Your line is open.

Charles Brady
*Analyst, SunTrust Robinson Humphrey, Inc.*
Q

Hey. Yes. Thanks, guys. Good evening. Hey, just on the growth question, I guess, well maybe a larger macro picture I'm going to [indiscernible] (42:35), I understand it's probably hard to analyze this, but given that your capacity constraint, underlying market growth seems very strong. I'm just wondering do you have any sense of is a capacity constraint maybe causing you not to get book sales that you otherwise would book. And then once that capacity comes on you could potentially see an acceleration in the underlying growth rate because now you're freed up to – take more orders than you could have otherwise taken and customers aren't having to go somewhere else?

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

Yeah. Good question, Charley. I think it's not quite as it ever is right that black and white. But I will tell you that we have not been as adamant about generating demand given the constraints that we have. Now, that we're adding capacity and frankly bringing new product introduction with MXT, we will be looking to generate more demand than we otherwise would.


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We've always believed that our capacity was coming to market, it was a well-timed with the market strength, which should give us some opportunities to continue to grow share, but I don't think, again, we don't run this by backlog. I'm looking at some large backlog reduction opportunity that's fundamentally going to bring this kind of huge step function, but I think we'll have more opportunities to continue to grow our Fluid Power business greater than the fleet average of the business and stronger with the market backdrop in the new products. We think we're well positioned to the rest of this year and into next year at a minimum.

Charles Brady
*Analyst, SunTrust Robinson Humphrey, Inc.*
Q

Thanks. That's helpful. And just, one more on the MXT products. From a profitability standpoint, I'm assuming that is it a better profitable – profitable product or kind of in line and is that sort of a sliding scale as you're going to need to ramp production initially maybe not as much the full rate production when you're rolling them out you're at a better margin profile?

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

Yeah. On average at a standard level it will have a better margin profile than the existing premium products. So, I think it's been developed as a combination of manufacturing process innovation, as well as material science and it's a very innovative product, and we'll have a better margin profile. So, as it gets adopted slowly over the coming quarters and years that should be accretive to the fleet average.

Charles Brady
*Analyst, SunTrust Robinson Humphrey, Inc.*
Q

Great. Thank you.

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

Thank you.

**Operator:** And your next question comes from the line of Sawyer Rice from Morgan Stanley. Your line is open.

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

Yeah. Hi. Good afternoon. Good quarter.

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

Hi, Sawyer.

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

Thank you.

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


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Maybe just say a question on the chain-to-belt initiatives, can you maybe size some of the opportunities you're seeing here in the quarter. It sounds like that trend is pretty in line with your expectations? And then, maybe just an update on the mix impact of that, how that – or whether that's margin accretive to the overall business? Thanks.

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

A

Yeah. So, Sawyer, a good question. Look, all of the opportunities that I cited in my prepared remarks are kind of north of $0.5 million in size. We expect that they are all going to start ramping up kind of during the course of Q4, Q1, Q2 next year, kind of in total, kind of a $10 million annually in scope.

And we remain quite bullish about the response to this technology and working very diligently on our business model, scaling up our marketing resources and field application resources to be able to support the demand of the – of these type of conversions. But it's very, very exciting, especially since couple of these opportunities are with large multi-national companies that are running these pilots and conversions of their broader footprints, pretty good response to this initiative.

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

A

And on the margin front, Sawyer, I think it will vary, will be the answer. When we're doing a lot of items in emerging markets, that can have different implications, but ultimately, I think chain-to-belt will generally be a premium product. And it will have a lot of carbon drive in it. And so, when we're selling that product and Poly Chain, I think those are typically premium products, which carry up higher than the fleet average margin, which we would expect.

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

Q

Got it. Makes sense. And then, maybe just one more on the quarter, can you give us a little insight into the cadence of growth in the quarter, did you see any particular trends as a whole, and then maybe by region as well?

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

A

Look, I think for the quarter, it was continuation of the good environment that we had been seeing. We're continuing to see strong first-bit demand, but frankly demand in the replacement markets overall was very good as well. So, I would say it was a lot of kind of what we've seen with some increased momentum in our automotive aftermarket business, and we like that, right, we're the aftermarket guys. So, I think we've seen a very good environment kind of continue through the first half of the year.

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

Q

Great. Thanks.

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

A

Thank you.


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**Operator:** There are no further questions at this time. I will turn the call back over to Mr. Bill Waelke for some closing remarks.

## Bill Waelke

*Vice President-Investor Relations, Gates Industrial Corp. Plc*

All right. Thanks everyone for joining and for your interest in Gates. We look forward to keeping you apprised of our progress on the next call. And as usual, I'm available for any follow up questions. Have a good evening.

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

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