02-May-2018

Gates Industrial Corp. Plc (GTES)

Q1 2018 Earnings Call

Copyright © 2001-2018 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

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

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

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

OTHER PARTICIPANTS

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Deane Dray
Analyst, RBC Capital Markets LLC

Julian Mitchell
Analyst, Barclays Capital, Inc.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.

Corinne Jenkins
Analyst, Goldman Sachs & Co. LLC

Steven Winoker
Analyst, UBS Securities LLC

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

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

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

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Sara and I'll be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Corporation Q1 2018 Earnings Release Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there'll be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Mr. Bill Waelke, Head of Investor Relations. Please go ahead, sir.

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

Thank you for joining us on our Q1 2018 earnings call. With me today are our CEO, Ivo Jurek; and CFO, David Naemura. After the market close today, we published our first 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 which includes a reconciliation of non-GAAP to GAAP financial measures that we will use during this call and is also available on our website.

Please refer now to slide 2 of the presentation which 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

Copyright © 2001-2018 FactSet CallStreet, LLC

expressed or implied by such forward-looking statements. These risks include, among other, 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 will now turn the call 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 first quarter 2018 results. Beginning on slide 3 of our presentation, we are pleased to report strong results for this first quarter of 2018. We generated revenues of $852 million which represents a record quarterly revenue number for Gates. Our total revenue growth was 16.7% over the prior year quarter, driven by strong core growth of 6.2% and contribution from our prior year acquisitions of 4.7%, as well as a foreign currency translation benefit of 5.8%.

We continue to execute on our growth initiatives and see a strong demand environment across the many end markets that we serve. Let me also note that we benefited from double-digit core revenue growth in emerging economy where we have a terrific market presence.

Our Q1 adjusted EBITDA of $183.9 million also stands as a quarterly record for Gates. At 21.6% of sales, our adjusted EBITDA margin reflects 60 basis points of expansion over the prior year Q1. Excluding acquisitions, on a comparable basis, our year-over-year adjusted EBITDA margin expansion was over 100 basis points with an incremental margin of over 30%, reflecting solid performance in this environment.

We continue to invest in the business during Q1 to advance our large organic growth initiatives, including investments in commercial capabilities, new product development and incremental manufacturing capacity. As we have discussed previously, we are adding additional capacity in our Fluid Power segment which will be coming online during the second half of this year.

In addition to our organic investments, last week, we announced the acquisition of Rapro in Turkey which will further advance our Fluid Power business in Europe. Rapro is primarily focused on the replacement market for which it designs and manufactures molded and branched hoses and other products used in heavy duty commercial and light vehicle engine applications.

We have successfully manufactured these products in North America for some time, and through this acquisition, we'll now have the capability on the European continent. Rapro's products will fit seamlessly into our distribution network and will also provide further runway for growth in the industrial transportation market. We are off to a good start in 2018 with solid Q1 results and another acquisition in our core markets completed. This builds further upon our exceptional momentum from 2017.

So with that, let me turn now to some segment details. Turning to slide 4, beginning with Power Transmission, as a reminder, our Power Transmission business focuses on applications where belts, chains and other devices transfer mechanical power. We are gaining momentum through additional market penetration across most of these applications with our belt-based drive systems, in part, due to their lighter weight, lower maintenance requirement and energy-efficient performance, to name just a few of the advantages.

Our Power Transmission segment delivered total revenue growth of 12.4% for the first quarter of 2018. On a core basis, Power Transmission revenue grew 5.8% over the prior year quarter. This growth was the result of a

Copyright © 2001-2018 FactSet CallStreet, LLC

balanced performance across our end markets, with particular strength in emerging markets where we continue to invest and drive our organic growth initiatives.

In terms of adjusted EBITDA margin, we delivered 80 basis points of expansion in Q1 on a year-over-year basis. This margin expansion was primarily the result of higher core revenue, continued productivity actions in our factories, and also, more efficient R&D spending.

As we have previously stated, we remain in the early stages of rolling out our broader chain-to-belt conversion initiative and we continue to pursue a number of conversion opportunities in target application verticals. From applications in the personal mobility market to a number of manufacturing and industrial process applications, we are validating our value proposition with our customers and are optimistic about the long-term revenue generation opportunity this initiative offers to gain.

On slide 5, our Fluid Power business offers customers fit-for-purpose products for a wide array of industrial applications in premium hydraulics, industrial hose and other fluid power solutions. Our Fluid Power segment achieved another quarter of strong growth, with total revenue up 25.1% compared to the prior year quarter. On a core basis, Fluid Power revenue was up 7.2%. We are executing well on our organic growth initiatives. Industrial end market demand remains healthy, and our Fluid Power acquisitions are all contributing to our growth.

Our premium hydraulics product line, which is our largest within the Fluid Power segment, experienced strong revenue growth in the quarter, driven by solid demand in industrial end market, and particularly, in mobile applications. This robust demand in hydraulics has us basically maximizing our available capacity for these products, and as a result, we've built a significant amount of hydraulic backlog in the quarter. Our hydraulics products grew low-double digits, and if we were able to fulfill the demand at normalized rate, we would have grown in the high-teens.

Our upcoming incremental capacity, which is all hydraulics-related, will help us return to our normal book-ship condition by year end. The first increment of capacity will begin to come online in late Q2, with the remainder expected to at the end of Q3 and into Q4 of 2018. We believe that these capacity investments will position us well to execute on our hydraulics growth initiatives and expand our core addressable market and are very timely in this capacity-constrained environment.

Our Fluid Power revenue growth also contributed to an improved adjusted EBITDA margin. In this segment, the year-over-year expansion was over 50 basis points. We achieved this margin expansion while making investments to continue to strengthen our commercial presence and product development capabilities to help us deliver on the initiatives that I have referenced earlier. We remain very encouraged about the large underpenetrated core market opportunities that we have in Fluid Power, in general, and in hydraulics specifically.

With that, I will now turn it over to David.

David Naemura

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks, Ivo. I will now cover our Q1 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 6.2% in the quarter and adding to that increase were an additional 4.7 points of growth from acquisitions and 5.8 points from foreign currency, bringing total revenue growth to 16.7%.

Copyright © 2001-2018 FactSet CallStreet, LLC

The core revenue growth primarily reflects strong demand in our industrial end markets, particularly at first-fit customers. We saw a continued strong demand for mobile applications with double-digit revenue growth in the construction, agriculture and industrial transportation end markets. More broadly, we experienced robust demand across a range of categories and saw a significant growth in our hydraulics business, in particular.

As Ivo mentioned, we exited the quarter with a significant backlog, whereas we typically carry very little backlog as a book-ship business. Our current hydraulics factory utilization is running at historically high rates and we are pleased that we will have additional capacity coming online over the remainder of the year to address these increased demand levels.

The first increment of capacity will be from the build-out of the remaining space in our existing China hydraulics facility and that will begin to deliver products around the end of Q2. Our two new fluid power plants are scheduled to come online in late Q3 and early Q4.

Our adjusted EBITDA of almost $184 million was an increase of $31 million or 20% over the prior year quarter. Our adjusted EBITDA margin was 21.6%, an improvement of 60 basis points over the prior year Q1. Excluding the impacts of acquisition, our adjusted EBITDA margin was 22.1%, an increase of 115 basis points over the prior year Q1.

We did see some continued inflation in the quarter, with raw materials increasing about $3.5 million over the prior year. These inflationary impacts were basically offset with continued procurement actions across our full spend base. We also had favorable pricing which resulted in our price material dynamic being very favorable in the quarter.

In the prior quarter, we discussed that the pricing that we implemented during the prior year was on about a one quarter leg and that we believe that we would be price material neutral to positive by the end of this first quarter of 2018, and that, in fact, was the case. This contributed to gross margin expansion in the quarter of 15 basis points in total. And on a comparable basis, excluding the impact of acquisitions, gross margin expanded about 125 basis points.

We grew adjusted net income to $0.25 per share on a diluted basis compared to $0.18 in the prior year quarter, which was primarily the result of stronger operating performance in the quarter. Our effective tax rate in Q1 was approximately 28% which is a bit higher than where we would anticipate the full-year effective rate to be. This slightly higher effective rate is primarily due to non-operating expenses in Q1 for which there was no corresponding tax benefit, such as those related to our debt redemptions.

Slide 7 provides detail on key cash flow items and our focus on continued deleveraging of the business. Excluding the incremental trade working capital that we acquired with Atlas Hydraulics, our trade working capital improved over 80 basis points as a percentage of our last 12-month sales as compared to the prior year Q1.

As a reminder, our working capital has a seasonal trend, whereby the end of the year is typically our low point, with working capital tending to be built in the first half of the year. We have presented last 12 months free cash flow as cash flow provided by operations, less CapEx, and reflected free cash flow conversion as a percentage of adjusted net income.

While we improved last 12 months EBITDA and adjusted net income performance in Q1 over the prior year period, we had significantly higher CapEx during the current last 12-month period associated with the spend for

Copyright © 2001-2018 FactSet CallStreet, LLC

our fluid power capacity build-out. Also, in the prior year, last 12-month period, we had an inflow of approximately $40 million associated with a onetime tax refund.

Looking forward on CapEx, our underlying maintenance CapEx in 2018 is expected to be in line with our historic range of approximately 1.5% of net sales. However, our Q1 CapEx level was elevated due to the growth investments on our additional fluid power capacity. Total CapEx was $61 million in Q1 due to the timing of this capacity investment and we would anticipate that total CapEx for the full year will be approximately $150 million to $170 million.

Finally, on leverage, we ended Q1 with a net leverage ratio of 3.9 times, reflecting our net IPO proceeds of $799 million which were used along with additional cash on hand to repay approximately $914 million of outstanding debt.

Moving to our outlook on slide 8, the full-year outlook for 2018 presented here is consistent with our previous guidance, with the exception of the impact from the acquisition of Rapro, which we completed at the end of April. For the remainder of the year, we would anticipate Rapro generating approximately $15 million in sales, which we expect contribute to adjusted EBITDA at about the level of Gates's average margins.

As I previously noted, we are introducing additional color on CapEx given the significant growth investment underway to expand our market opportunity. Further, despite the more uncertain tax environment that we are in, the previously communicated effective tax rate range of 27%, plus or minus 150 basis points, remains the current view for the full year.

Finally, we know that inflation in tariffs are a very current topic. As we have referenced earlier, we believe that we are well-positioned to manage in this environment and would note that we experienced favorable price material again in Q1 as we did in Q4 2017. As it relates to the Section 232 tariff on imported steel and aluminum and Section 301 tariff on selected Chinese imports, we do not anticipate significant impacts at this time, primarily because of our in-region, for-region manufacturing strategy. I would also note that we believe these factors, along with appropriate offsetting actions, are already contemplated in our annual guidance.

It is worth mentioning again that we will also be bringing up the additional fluid power capacity at three sites, two of which are brand new plants. Accordingly, there will be startup costs beginning in Q2 associated with bringing this capacity online which were already factored into our full-year guidance as well.

With that, I will hand it back over Ivo to wrap up. Ivo?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Dave. We are encouraged by our strong start to the year which gives us confidence as we look forward to the remainder of 2018. Global industrial production continues to drive demand across our diversified end markets and geographies. Our presence in replacement channels is providing stable recurring revenues across our segment, while our first-fit business is robust.

We remain selective on opportunities where we can introduce differentiated products or new technologies in first-fit applications or advance our organic growth strategies. We believe we are taking the appropriate steps to position our business on a trajectory of long-term growth as a result of our strategic investments in commercial capabilities, new product development and the necessary manufacturing capacity to deliver on resulting growth.

Copyright © 2001-2018 FactSet CallStreet, LLC

We believe we have a compelling strategy and our global teams are focused on executing on our large organic growth opportunities. Q1 was a very good start to 2018 and our team will remain focused on execution as we move further into the year.

I will now turn the call back over to the operator to open up the Q&A session. Sara.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Andrew Kaplowitz from Citigroup. Please go ahead.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Good afternoon, guys.

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

Hello, Andrew.

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

Hey, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Ivo and Dave, you mentioned that your hydraulics capacity is limited to power growth in the quarter. If hydraulics were able to grow high-teens, as you said, how much higher would the 7.2% of the segment have been the organic growth? And as you know, there's been some increased concern regarding markets really since its hydraulics peaking. Have you seen any evidence of a slowing in any of your Fluid Power markets, and how – can you talk about your visibility given that you've actually built backlog in the segment?

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

Yeah. This is a great question, right, and I – look, I'll stay away from whether and how the markets are behaving. I think that you guys are in a better position to judge that than we are. But look, we are very encouraged with the start to 2018. The markets are behaving very similarly that we have exited 2017 with. So, we are very encouraged by the behavior.

Our customers are doing really well. As we said, we are increasing our backlog. If we were able to manufacture all of the orders that we have received in the quarter, Andy, we would have probably printed another 5% of core growth or so in the Fluid Power segment, so you were looking at somewhere north of 12% core.

We've told you on our last quarterly call that we have been running at pretty elevated levels and we've just reached the levels where we just were not able to, frankly, to fulfill all of those incoming orders, and we don't see any reduction in forecast as we are looking into the future period.

Copyright © 2001-2018 FactSet CallStreet, LLC

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Okay, Ivo. That's very helpful. And then, last quarter, you had mentioned that you saw your North American auto replacement business could pick up a bit in 2018. But depending on which industrial company we talk to, auto aftermarket was relatively lethargic in the first quarter. So, did you see a pick up? And talk about your outlook in that part of your business, auto replacement, maybe as a whole for the company.

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

A

Yeah. Sure. I think that that's a really good question. Our total replacement business in Q1 was approximately – it was slightly under 5%. It was about 4.9%. And the North America business grew slightly under 3%, so about 2.7%. So as I said on the last update, we saw that the business is doing a little bit better. It's true.

Again, as we have explained, I think on the last call, we see that the headwinds from 2008, 2009 are starting to dissipate. We are primarily focused on the seven year-plus old fleet. And so, we expect that that's the market that's going to provide stability for us as we move forward into 2019 and beyond.

And frankly, the emerging economies are behaving really well. I mean, there is a very robust growth in car fleet. And maybe just give you a number on China, as an example, our AR business in China grew about 13% or so.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Got it. So, it sounds like steady as she goes in the business and good growth in first-fit as well.

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

A

In our first-fit auto business, we grew about 4% globally. So again, it's not a big part of our business overall but we continue to see growth with differentiated products, and the growth in hybrids is doing really well.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Ivo.

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

A

Thank you.

Operator: Your next question comes from Julian Mitchell from Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good afternoon. Maybe just give a little bit of color on the overall sort of developed market growth rate in the quarter. I mean, I think one trend you have seen in general is emerging market growth, very buoyant, developed market's weaker. So, I think you'd said emerging market growth was double digits. So, how is developed market growth in Q1 and what was it in the prior quarter? Thank you.

Copyright © 2001-2018 FactSet CallStreet, LLC

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

Good afternoon, Julian. Thank you. Yes, as we said, the emerging markets continue to perform really well for us. Again, we have a terrific presence there. We're spending quite a bit of resources to continue to grow our presence in those markets. I would say that the developed markets have grown kind of the low-single digits. They are doing reasonably well. We are not displeased. They are behaving the way that we've planned and we anticipated for 2018.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

And then...

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

And I would probably – I would maybe add, Julian, if I can, that if we had the capacity available in Fluid Power, we would have probably seen maybe another 3 points of core growth in the developed economies, so it would probably be growing kind of mid-single digit. The demand is not the issue. It's our available capacity to support all the orders that we see coming in.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Understood. Thank you. And then, my follow-up would just be around the – circling back maybe to that price versus cost equation. As you pointed out, you had good adjusted gross margin increase in the first quarter. When you're thinking about that price cost delta, is that becoming even more of a tailwind when you look at the back half of the year in terms of all the remaining nine months in terms of the gross margin impact or you think it will be fairly steady with what you saw in Q1?

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

Julian, it's Dave. I think the way we're thinking about it is that we'll maintain – we'll be probably price material neutral or materially so for the year. I think the compare gets a little tougher. We added a lot of price last year. I think we were well-served to be proactive. Early in the year, we had some things that maybe were unique to our industry, like the impacts of inflation [indiscernible] (00:26:55) which didn't impact everyone but it caused us to probably move a little earlier on price.

Accordingly, I think we carry a good price into the year and we'll begin to compare against that. So, I think the compare does get a little harder as the year goes on. I think we're looking very favorable right now and we anticipate the price material economics neutral, if not, a little bit better than neutral for the full year.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Great. Thank you.

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

You bet.

Copyright © 2001-2018 FactSet CallStreet, LLC

Operator: Your next question comes from the line of Jerry Revich from Goldman Sachs. Please go ahead.

Corinne Jenkins
Analyst, Goldman Sachs & Co. LLC

Q

Hi, this is Corinne Jenkins on for Jerry Revich. So, I understand the utilization story for Fluid Power. I was hoping you could talk about what you're seeing in your Power Transmission business and where you're seeing that had this utilization for that across your global footprint?

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

A

Yeah, good afternoon. I think we've updated that on the last quarter as well. Look, demand remains quite solid for us. Again, emerging economies are growing very, very nicely. It's a very constructive market environment, particularly the emerging economies. We're running higher capacity utilization rates in those emerging economies. We're not dramatically capacity-constrained in Power Transmission, with the exception of couple of product lines that we are rectifying but they're not really giving us any headaches, so to speak. So, it's a very constructive environment and I think they are well-balanced with our capacity available to support further growth.

Corinne Jenkins
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And then, it sounds like you expect the hydraulic power demand to remain pretty elevated. Can you talk about how long you expect to take to work down the backlog that you have exiting this quarter, and then, if we should think about any sort of catch up in sales?

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

A

Look, I mean, my expectation is that – let me give you a company-specific answer rather than try to opine on what I think the cycle of the business is going to be. Look, we see a very strong demand. We expect that demand to carry forward after frankly several years of very weak construction equipment, ag equipment and mining equipment sales. So, my expectation is that the end market is going to be very supportive of further growth.

The way that we are thinking about how we are positioning ourselves is that we have tremendous investments in new technology in fluid conveyance. We're already starting to demonstrate the technology with our third party OE customers. They are quite excited about the technology. We believe that we have a significant opportunity to take incremental market share away. We are putting capacity in support of this new technology and the opportunities that we have across the globe. We are a reasonably small player outside of North America. And so, we believe that that capacity in Poland, the incremental capacity in China and in North America, we should continue to see pretty reasonable growth rate well into the future.

And maybe the last piece of your question about that backlog, look, our expectation is that the backlog is going to be extinguished by the end of the calendar year 2018 where we expect to go back into our kind of a normal operating mode of book and ship. We're not a big backlog business, we are more of a book and ship company, and we expect that by the end of the year, we will be there.

Corinne Jenkins
Analyst, Goldman Sachs & Co. LLC

Q

Copyright © 2001-2018 FactSet CallStreet, LLC

Good. Thank you.

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

Thanks, Corinne.

Operator: Your next question comes from Jamie Cook from Credit Suisse. Please go ahead.

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

Hi, good evening. Two questions. First, you talked about demand being constrained by your own capacity issues. But were there any external factors impacting demand, whether it's labor inability to ship product or supply chain issues?

And then, my second question, just with regards to where the strength is coming from, in particular, first-fit, in the mobile equipment markets, does that have any impact on mix or profitability?

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

Hey, Jamie. Good afternoon. So the first question, let me say – let me start with the second question first. We don't expect a significant impact to our results. I mean, the mix is slightly shifted towards OE, maybe 2 points to 3 points overall. And we have really not seen external factors to be impacting our ability to supply Fluid Power products. It's been all company specific. We're just running extremely high rates of asset utilization. And that's why we've frankly seen an opportunity to make investments about a year and a half ago and that's where we started to stand up the capacity and it's coming in what we believe is a good timing for those new assets to help us offset the capacity shortfalls that we are experiencing presently.

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

Jamie, the...

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

Okay – sorry, go ahead.

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

The negative impact of mix was under 30 basis points as we see some of that mix shift in the quarter, so under 30 basis points at the gross margin level, of course.

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

Okay. And for the year, what's the expectation?

Copyright © 2001-2018 FactSet CallStreet, LLC

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

I would give guidance for the year on that. We'll see how the revenues come out for the year. But in the first quarter, we saw, as Ivo said, 2-point or maybe 3-point shift in mix and it had a 25%, 27%, – sorry, basis point impact at the gross margin level which obviously is more than offset by a number of positive things.

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

Okay. Great. Thanks.

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

Thanks, Jamie.

Operator: Your next question comes from the line of Jeff Hammond from KeyBanc Capital Markets. Please go ahead.

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

Hey. Good afternoon, guys.

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

Hi, Jeff.

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

Hey, Jeff.

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

Hey, just back on the Fluid Power ramp and supply chain, clearly, a lot of people are kind of feeling pressure and didn't seem to show up in your incrementals. As you look forward and you try to catch up some of the backlog and you ramp these new plants, are you anticipating any redundant costs or need for working capital build and any kind of negative impact on incrementals as we go forward?

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

Good question. First, on incrementals, on the face of the income statement, Q1 reads at 25% but that's negatively impacted by the acquisition. If we adjust for Atlas on an apples-to-apples basis, we would see about 32.5% incrementals. That's also negatively impacted by FX. And so, if you thought about it on a core basis, you'd be quite a bit closer to 40%, if not, at 40%, which is – would be a pretty good quarter for us.

I think there are some start-up costs. We don't see a huge working capital build. We're going to have to bring in some raw materials, but from a cost standpoint, we think there's a few million dollars and we've contemplated that

Copyright © 2001-2018 FactSet CallStreet, LLC

in kind of how we've got [ph] the people (00:34:35) to the year, and there'll be some inventory impact but not meaningfully. So, we think we've got it contemplated and I don't think there would be a large impact to incrementals.

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

Okay. Great. And then, just as you look at some of your competition in Fluid Power, how are you thinking about your lead times versus theirs? Is this an opportunity where you can capture some share even though you're building some backlog? Maybe just let me know what you're seeing from the comps. Thanks.

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

Yeah. Jeff, I think that you're spot on. I mean, we believe that that incremental capacity that we are spending up is going to give us tremendous opportunity to capture further market share. And frankly, the investment that we are making in NPI is also going to further accelerate our competitive position. So, we feel really well about where we stand presently in terms of [indiscernible] (00:35:35) our business.

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

Thanks, guys.

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

Thank you.

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

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thank you. Good afternoon, everyone.

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

Hi, Deane.

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

Hi, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, just want to stay on that very last point on Jeff's question regarding that build in backlog. And maybe this is the glass half empty view, but is there any negative fallout in not being able to do the book and ship that your customers are usually expecting? And might any of this backlog go away if any competitors picking up share because of your capacity constraint?

Copyright © 2001-2018 FactSet CallStreet, LLC

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

A

So Deane, I think that that's a very thoughtful question that you raised. But what we are dealing with is we are frankly dealing with a global capacity constraint. There are really no competitors that have the ability to just walk in and offer incremental supply because there's just simply none available. And in terms of lots of the OE business, frankly, we're doing everything that we can to support. You also need to go through a significant amount of qualifications which is not something that you can just simply do overnight.

So, we're working very diligently. We feel good about that backlog. We do not believe that that backlog is cancelable, and frankly, there are no inventories in the channel. So, it's kind of an interesting situation and we feel very constructive about bringing that capacity online right now and taking advantage of the economics.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's good to hear and thanks for that clarification. And then, how about some color on the acquisition, the Rapro deal? Some questions that immediately come to mind is what kind of manufacturing capacity are they operating at and are there any kind of best practices that either they'll share with you or you'll share with them? And then, lastly, where are they in this – the branding side? It's all aftermarket, but you guys on a good, better, best. Gates is all up there on the best and maybe a little bit of better, but where are they in that continuum on sort of premium brand?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. Okay, Deane. Great question. The products that Rapro manufactures are something that we do very well here in North America. It's actually a very high margin product for us. And as we were looking at this opportunity, one of the big opportunities in this is bringing our knowhow and expertise to them.

So, we think we're going to have an ability to drive volumes as we drop this business into our aftermarket channels, we set up seamlessly. And as we're able to ramp volumes to our distribution base, we think we could quite come close to doubling the existing capacity out of their current manufacturing footprint. So, we're pretty bullish on that in us basically bringing the Gates' operating system to what is already a very good company.

And from a brand perspective, they're a well-recognized brand in Europe. We actually source a little bit of their product for European models ourselves, and they're well-recognized and I think they fit well into kind of the Gates' tier of brand recognition here.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's good to hear. And just last one is are there more Rapro deals in your pipeline?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. It's highly fragmented global markets that we play in and we like to believe that there will continue to be a good runway of accretive bolt-on acquisitions. We're always working on them and I think we just got to kind of find the right ones and we'll kind of continue as part of our strategy.

Copyright © 2001-2018 FactSet CallStreet, LLC

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Deane.

Operator: Your next question comes from the line of Charlie Brady from SunTrust Robinson. Please go ahead.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hey, thanks. Just following on Deane's question on Rapro, just wondering does Rapro bring to you any new customers or distribution that you don't have now that maybe you get and you can leverage that up?

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

A

Sure, Charlie. Good afternoon. Yes, they do. Obviously, they have a reasonably good presence. I mean, it's not a big business but they have good customer base in Eastern Europe and in Middle East and some in Western Europe. So, they do bring customers to us where we believe we're going to be able to cross-sell our products that are core to us. And frankly, as Dave indicated, we feel really positive about our ability to take those products, and then, funnel their products through our channels, particularly in the EMEA market space.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. And then, just one on the – back of the hydraulic, the backlog and the capacity utilization issue you're facing right now, I'm just wondering, when you're running a plant flat out, you're obviously running to some inefficiencies because you're making it as fast as you can make it. I'm wondering from a margin perspective, can you put some color on maybe kind of the negative impact to margin that just being going flat out is having and how that pressure, when that pressure gets relieved, aside from startup costs on the new plants, how that might benefit margins in that part of the business?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. Look, I think we mentioned a little of this in the last quarter. But for sure, we saw that in the fourth as we were ramping up fast. We continue to see some of that in the first. It's there, it's not massive, right? I think, at the total level. Sure, there's kind of $1 million or $2 million here and there as we've had to outsource certain products that we otherwise might make. And to your point, just running a factory flat out is not as efficient at running it in an optimal level. We'll get more efficient. To your point, we have some inefficiencies of bringing these other plants up, but I think once we hit kind of more of a steady state next year – but it's not going to be a big number at the total level here, I wouldn't think.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Copyright © 2001-2018 FactSet CallStreet, LLC

Thanks. And just final one for me, can you just give us the share count you guys are using for the earnings this quarter? I just didn't see it in the release.

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

We're using 289,750 – let me see, 289,756,379.

Charles Brady
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Thank you.

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

Thank you.

Operator: [Operator Instructions] Your next question comes from the line of Steven Winoker from UBS. Please go ahead.

Steven Winoker
Analyst, UBS Securities LLC
Q

Thanks. Good afternoon, guys.

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

Hi, Steve.

Steven Winoker
Analyst, UBS Securities LLC
Q

Hey, just maybe backing up for a second on – not Rapro but just the whole point around the impact and how are you thinking about deleveraging. You mentioned the 3.9 times post the IPO. You're still fitting in some of these smaller, very small bolt-ons occasionally. But any thoughts given also the performance in the business of accelerating or deleveraging or how are you thinking about that now, Ivo?

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

Steve, this is Dave. I said – we've always said it's a balance, right, and deleveraging remains a focus area for us. We continue to think in the mid-term here, we should be able to get to 3 times or better and we're focused on that. At the same time, we're trying to balance that with the investments for long-term growth. So, the increase in capital spend and doing a few bolt-ons that we think accelerate our strategy have been our approach.

So, it remains top of mind but we remain with kind of a balanced approach where we're going to keep investing in the business. And frankly, as you point out, that growth in EBITDA and our ability to continue to grow the business well and grow adjusted EBITDA will help us de-lever as well quite a bit.

Copyright © 2001-2018 FactSet CallStreet, LLC

Steven Winoker
Analyst, UBS Securities LLC

Q

But you're not going to step up over these sort of smaller bolt-ons, most likely?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

I think what you saw from us last year was pretty reflective of where we're at. I think we deployed a little over $100 million of capital last year and that was with doing a pretty good-sized deal with Atlas. Look, Rapro was not a big deal. We paid about 8-ish, a little over 8 times EBITDA for it. We think, post-synergies, we'll be in the 5 times range. And those are kinds of deals that when they're in our core business make a lot of sense for us.

But again, small deal, and I think what you've seen out of us last year and beginning this year with Rapro is kind of how we're thinking about bolt-ons. Never say never, there's a lot of opportunities out there to help us accelerate our strategy but I think it kind of indicates kind of how we're going about it.

Steven Winoker
Analyst, UBS Securities LLC

Q

Right. You guys – since the IPO, it seems like I know I get a lot of calls where you're getting saddled with the auto first-fit label. But to your point on this call, in addition to the growth that sort of blows that away, that's right about 17% to 18% that's first-fit now in auto and you're still growing that kind of, as you said, mid-single digits. Any kind of color about changes there and why that's kind of a smaller – become a smaller part of the business?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

It's a great question and you're right. I think the – we've been saddled with a bit of a misnomer and we're in the teens number. And over half of that – half or over half of that number is emerging market-based where – if you think of first-fit emerging markets, we're growing at a good rate there, and it's an important vehicle to establishing that aftermarket business that we want as the aftermarket guys.

So relative to developed markets, we're very low, sub-2% of sales in North America where I think people have concerns about registration rates, and frankly, we turn away as much business as we take. So from that dynamic, we've put in a very strategic filter that, one, we got to get paid for it, and two, we want to be able to introduce innovative products. And so, we're very, very highly selective. So, I appreciate the question because I think it's an important point.

Steven Winoker
Analyst, UBS Securities LLC

Q

Okay. And just a couple of clean-up questions, on – as we're sort of steering at second quarter, you've got a lot of the investment dynamics that everyone's been focused on for the call. But normally, I guess, last year, you ran just under half of your sales in the first half, half in the – not just over in the second half. EBITDA was pretty close. Other than the – I guess, given the dynamics that you've talked about on the investment and capacity front, should we expect a very different second half, first half dynamic this year?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Copyright © 2001-2018 FactSet CallStreet, LLC

I'm going to stay away from quarterly guidance and I appreciate that's not exactly what you're asking, Steve. But it is a unique environment here with a capacity constraint on the Fluid Power side having a little higher backlog than we otherwise would have and bringing out that capacity in the second half. So, I don't want to frankly kind of guide beyond the year here but I acknowledge that that dynamic probably introduces a little nuance and this is consistent with prior year. I mean – but I'll let you kind of quantify that.

Steven Winoker
Analyst, UBS Securities LLC
Q

Okay. Well, since [ph] you didn't answer that (00:47:13), my last question is on the free cash flow in the quarter, not the trailing 12 months, that$ 87 million, of which, $60 million was CapEx, $26.5 million [ph] CFO (00:47:22). That $26.5 million, can we maybe talk about the dynamics there? Was that anything unusual other than build on the growth?

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

That's built on the growth. I think we got a little more efficient as a percent of sales. But we always – one, we always build during this period as well coming off a low point from year end towards seasonally higher at the end of the second quarter. And we grew at a fast rate and we had to provide with that, right?

Steven Winoker
Analyst, UBS Securities LLC
Q

Right. Okay. All right, guys. Thanks a lot.

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

Thank you.

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

Thanks, Steve.

Operator: Your next question comes from the line of Sawyer Rice from Morgan Stanley. Please go ahead.

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

Yeah, thanks. Good afternoon, guys.

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

Good afternoon.

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

Maybe staying a bit here on the Fluid Power side, can you maybe give us a little view of the level of capacity utilization post all of this capacity coming online? And then, maybe asking Deane's question a little bit differently,

Copyright © 2001-2018 FactSet CallStreet, LLC

are there any regions, I guess, globally, that you'll see more of a need for capacity introduction, either organically or inorganically, in the future?

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

Sawyer, it's Dave. I guess we'll see – so, capacity is going to ramp. We're at very high levels right now. I think we'll come down to a very healthy level which would probably be in the 60-ish percent range, and then, we'll ramp from there. As we noted, we're going to enter this new capacity with some backlog and it's going to take time to come up.

The new plants rolling are going to be one-third capacitized as it is. So, these are big plants we're building. We're going to lay out a third of the floor plate. And then, as we get into future years, and frankly, the capacity we're putting in here are less as well, and then, as we get into future years, we'll have opportunity to grow into it more eloquently.

Your point around where we have opportunities, we're very well-penetrated, although we still have a ton of opportunities. This is a 12-plus billion dollar market of which we have $1 billion of share, but relatively more penetrated in North America currently. So, I would say internationally, in both EMEA and Asia-Pac, we still have significant opportunities to take share and I think that's consistent with where you see us bringing up the capacity.

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

Great. And then, maybe if I could have just one follow-up on the PT side of the business, maybe just some incremental – any incremental data points on the chain-to-belt, if there's any positive reception as you go to market with that through the quarter. Thanks.

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

Hey, Sawyer. This is Ivo. Look, as we characterized, we are in very early stages of this initiative. But frankly, we are also very encouraged by what we see. We're validating that the market is very big and we are continuing to unearth really interesting opportunities. And kind of anecdotally, we started to focus on this opportunity in North America last year and we've identified bunch of interesting opportunities, everything from mobility to grain silos, asphalt manufacturing facilities, lumber mills where we have helped a couple of lumber processing facilities to significantly improve safety and reliability of operating those assets.

And I [ph] task (00:50:53) my regional guys across the globe and say, hey, look, you guys go out there and start talking to your customers and let me – let's validate that this opportunity exists across the globe. And lo and behold, we're finding different type of applications. So in Asia-Pacific, it may be associated more with personal mobility. We are finding opportunities in oil and gas. If you can believe it, we have opportunities there, as an example, [indiscernible] (00:51:36) in oil extractions. We're finding opportunities in EMEA in light manufacturing, industrial complex. And we're finding opportunities in offshore marine where people are struggling with keeping chain from being rusted and maintaining servicing their equipment that is quite important in loading and offloading various payloads.

So, we're validating actually directly with customers that the opportunity exists and we are winning a number of applications. We are converting them and we are realizing that once we convert one, we have an opportunity to convert 40, 50, 60 plants that those customers may be operating once they have gotten to proof-of-concept.

Copyright © 2001-2018 FactSet CallStreet, LLC

So, I know it's a long-winded answer but I think that we can sense there's a general degree of enthusiasm about what this represents for Gates for the long term, and although we are early, we are quite bullish on the construct of that strategy.

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

Q

Great. Thanks.

Operator: I'm showing no other questions at this time. Let me turn the call back over to Mr. Bill Waelke for closing comments.

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

Thank you all for joining us on our call today and for your interest in Gates. We look forward to next speaking with you to report our Q2 results and in the interim. If you have further questions, please don't hesitate to contact me. Have a good evening, everyone.

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

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

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

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2018 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.