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Gates Industrial Corp. Plc (GTES)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Gates Industrial Corporation Q4 2018 Earnings Conference Call. Currently, at this time, all participants are on a listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] Also as a reminder, this conference call is being recorded.

At this time, I'd like to turn the call over to your host to Bill Waelke. Please go ahead.

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

Thanks, Dulem, and thank you, everyone, for joining us on our fourth quarter 2018 earnings call. I'll briefly cover our non-GAAP and forward-looking language before passing the call over to Ivo, who's here today along with our CFO, David Naemura.

After the market close this afternoon, we published our fourth 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 at 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.

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

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expressed or implied by such forward-looking statements. These risks include, among others, matters that we have described in our Annual Report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly earnings call if at all.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Good afternoon, everyone. Thank you for joining us to discuss our fourth quarter 2018 results. Let me start with a summary of the key highlights from the quarter beginning on the slide 3 of our presentation. We are pleased to report another strong quarter of performance. We generated revenues of $792 million, which represents a record fourth quarter for Gates.

Our core revenue growth was 3.5% over the prior year which was partially offset by foreign currency translation headwind of 3%. During the fourth quarter, we experienced solid growth from our industrial end markets. We believe that our broad portfolio of high-performing products and a global footprint are allowing us to supplement market growth with share gains which have been seen with particular outperformance in our hydraulics product line. In total, our industrial sales grew 7.7%.

We also had a strong performance in the automotive replacement channel, particularly in emerging markets where we continue to build out our distribution base and market-leading product coverage. Our automotive aftermarket channel grew 7.3% globally, including double-digit growth in emerging markets. This growth in industrial end markets and automotive replacement channel more than offset the significant revenue decline of 12.7% in our automotive first-fit channel which was concentrated in China and Europe.

We had anticipated a large portion of this decline when entering the quarter, but some of it was more significant than we had thought. I will touch more on this in our regional commentary next.

North America, which is our largest individual region, delivered strong core revenue growth in the quarter at over 8%, driven by strength at nearly all industrial end markets, as well as another quarter of outperformance in the automotive replacement channel. In Europe, we experienced strong demand across industrial end markets particularly at first-fit customers. This growth was offset by the significant weakness in automotive first-fit resulting from a substantial planned ramp-down of OEM projects that was further compounded by the market disruption from the WLTP emissions testing requirements. This has been little longer lasting and more impactful than we anticipated at first.

In China, we experienced mixed results with double-digit growth across our replacement channels which was offset by a decline in our automotive first-fit business. Automotive first-fit faced a very difficult compare as we have mentioned in our last earnings call, and ultimately were still a bit weaker and in the quarter than we have originally anticipated.

Our revenue in industrial end markets in China was impacted by a slowing of sales to export-oriented customers, a function, we believe, of the ongoing trade disputes. Despite these headwinds, our industrial business overall did grow modestly in China. Our automotive replacement channel continued to grow there in the high teens, a direct result of the significant growth in the aged car parc, a dynamic that we expect to continue to assist our sales growth in the market for many years to come.

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Now, turning to EBITDA. Our Q4 adjusted EBITDA of $186 million represents a record fourth quarter result for Gates. At 23.5% of sales, our adjusted EBITDA margin reflects 140 basis points of expansion over the prior year Q4. Q4 saw the final increment of our new fluid power capacity come online according to plan. Our new manufacturing facility in Poland is now producing in volume and commercial shipments have begun.

Additionally, our focus on revitalizing our innovation capabilities resulted in further introduction of differentiated new products that offer customers compelling value and provide us with additional opportunities to drive future growth.

Finally, one of our unrelenting areas of focus is deleveraging the business. We made additional progress in this area during the quarter, reducing our net leverage to 3.4 times, while significantly investing in the business. David will cover this in more detail momentarily.

Moving to slide 4, our $3.35 billion in 2018 net sales represents a record for the company. Underlying our core revenue growth of nearly 6% was broad-based demand driven by strength in our industrial end markets and strong sales in both the industrial and automotive replacement channels. This growth more than offset the mid-single-digit decline in our automotive first-fit business for the year.

FX translation, despite becoming a meaningful headwind in the second half of the year, contributed 60 basis points to our full year revenue growth. Our revenue growth helped to deliver full year adjusted EBITDA of $756 million and an adjusted EBITDA margin of 22.6%, representing expansion of 60 basis points over the prior year and in line with the guidance we provided.

Our improved operating performance in combination with reduced interest expense and a lower effective tax rate contributed to our adjusted earnings per share growth of over 50%, which was delivered on a significantly higher weighted average share base.

In summary, we executed well in 2018. I am proud of the Gates team for delivering record results in what was a complex environment, both from a macro perspective and a Gates-specific perspective as we successfully undertook several major initiatives, while managing through dynamic market. The macro environments affected our segments differently in the year, which I will now cover in more detail.

Turning to slide 5 and beginning with Power Transmission. Our Power Transmission segment experienced a revenue decline of 4.4% in the quarter driven by negative FX impact and a core revenue decline of 1%. Revenue from industrial end markets as well as our automotive replacement channel grew high-single digits in Q4 on a core basis. This growth was offset by a low-double-digit decline in our Power Transmission automotive first-fit business associated with the previously mentioned weakness in Europe and China. Outside of our automotive first-fit business, our Power Transmission revenue grew approximately 4% on a core basis.

For the full year, total Power Transmission segment revenue grew 4.5%, consisting of 3.6% core growth and a small favorable impact from FX. Our Power Transmission revenues had notable growth in the energy and construction end markets as well as in the automotive replacement channel particularly in North America.

In China, the segment experienced double-digit growth in sales to customers in replacement channels. Outside of the automotive first-fit business, our Power Transmission revenue grew at a strong annual rate of nearly 7% on a core basis.

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With respect to our chain-to-belt growth initiatives, we continued to refine our organizational capabilities and commercial approach globally. We had key wins during the quarter in wide range of applications including personal mobility, automated storage and retrieval systems, and material handling systems. We plan to provide greater insight into our midterm plan during the upcoming Investors Day in New York later this month.

The Power Transmission segment adjusted EBITDA margins expanded by 90 basis points in Q4 compared to the prior-year period despite lower volume and FX headwinds. For the full year, the Power Transmission adjusted EBITDA margin expanded by 70 basis points due largely to our revenue growth, favorable mix, and positive price cost dynamics.

Turning to slide 6. Our Fluid Power segment achieved another quarter of strong growth with total revenue increasing by 12.2% compared to the prior-year quarter. On a core basis, fourth quarter revenue growth was 12.3% including core revenue growth of 16% in our hydraulics product line with growth from acquisitions of 2.1% and FX headwind of 2.2%.

Industrial and markets demand drove broad-based growth across nearly all of our regions with the agriculture, general industrial, and construction markets having the strongest performance particularly in our largest region, North America.

The segment achieved double-digit growth in both the first-fit and replacement channels with the replacement channels growing at a slightly higher rate. For the full year, Fluid Power total revenue growth was up 21% compared to 2017, consisting of approximately 10.5% growth in both core revenue and from acquisitions with negligible FX impact. We had double-digit core revenue growth across nearly all industrial end markets and in nearly all regions with our overall Fluid Power business in South America having the highest core growth rate at nearly 20%.

The growth of our first-fit business outpaced that of replacement channels for the full year with double-digit growth in all regions. As I mentioned earlier, our new hydraulics facility at our existing campus in Poland came online in Q4. As the plant continues to ramp up through the first part of 2019, it will support existing demand, as well as market share gain opportunities in Europe, where this is our first fluid power facility of scale on the continent.

Concurrent with the opening of this new plant in Q4, we also announced the closure of subscale fluid power facility in Turkey. Our Fluid Power volume growth, along with favorable price cost, contributed to adjusted EBITDA margin expansion in both the fourth quarter and full year of 220 basis points and 70 basis points, respectively.

Now turning to slide 7, this is a summary overview of our 2018 core revenue growth by region. We experienced solid core revenue growth across most of our regions led by South America. We saw double-digit growth in automotive replacement channel, as well as double-digit Fluid Power growth in all end markets.

Core growth in North America was also led by Fluid Power with double-digit growth in most end markets and a strong performance in the automotive replacement channel. Despite the Q4 weakness in automotive first-fit, China delivered 7% core revenue growth for the year. This growth was led by Fluid Power and a strong Power Transmission performance, in automotive replacement channel in particular.

In the EMEA region, solid Fluid Power core revenue growth in industrial end markets and Power Transmission growth in the automotive replacement channel offset the significant automotive first-fit second half weakness. Within our East Asia and India region, we had strong growth of 17% in India where we experienced double-digit industrial growth, most notably in the construction and heavy-duty truck end markets. This growth offset a slight

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core revenue decline in East Asia where amongst some other challenges, certain industrial channels were constrained as we directed available fluid power capacity towards other regions.

Before I hand it over to David, I would like to touch on a topic of footprint consolidation opportunities. As we have operated Gates over the past few years, we have improved operations significantly but have not engaged in many site optimization or rooftop consolidation projects.

Although our recent plant expansions have been based around campus concepts in China, Mexico, and Poland, we still have significant number of facilities and believe that we have opportunity to optimize our overall footprint.

We talked earlier about closing our subscale Turkey hose plant now that we have the Poland plant online. This is one example, and we believe that we will have additional opportunities for self-help and we are actively looking at what activities we may want to undertake in the coming few years.

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

David Naemura

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks, Ivo. I will now cover our financial performance beginning on slide 8 where, as Ivo mentioned, you can see the record fourth quarter results in revenue, adjusted EBITDA, and adjusted EBITDA margin. Core revenue growth was 3.5% in the quarter while acquisitions contributed only an additional 70 basis points of growth with Atlas having gone core at the end of the prior quarter.

Foreign currency was a headwind of 3%, resulting in total revenue growth of 1.3%. The core revenue growth reflects continued strong demand in our industrial end markets where we had growth of nearly 8%. The construction and agriculture end markets were supportive, particularly as it relates to mobile, hydraulic fluid power applications, and we saw broad-based demand in our general industrial business. Further, our automotive replacement channel grew over 7% globally with double-digit growth in emerging markets, particularly China. The core growth in these channels was partially offset by a 12.7% decline globally in our automotive first-fit channel driven by declines in EMEA and China, as Ivo discussed.

Aside from these specific challenges in automotive first-fit, the business environment remained healthy with the rest of the company experiencing 7.5% core growth in Q4. Price cost was again favorable in Q4, consistent with the trend we have experienced throughout the year. Our adjusted EBITDA of $186 million was an increase of $13 million, or 7.4%, over the prior-year quarter. Our adjusted EBITDA margin was 23.5%, a significant increase over the prior-year Q4 and reflective of what turned out to be very high fall-through in the quarter.

On a core basis, our incrementals were about 50%, which is about 15 points higher than we would have expected to see. This was a function of continued favorable price cost and favorable mix resulting from the decline in our automotive first-fit business, as well as some favorable items hitting on what amounted to a lower net revenue growth quarter, exaggerating the fall-through.

We grew adjusted net income to $0.36 per share on a diluted basis, compared to $0.16 per share in the prior-year quarter, which was the result of better operating performance, a lower effective tax rate, and reduced interest expense on higher weighted average share count. The diluted weighted average share count in Q4 was approximately 295 million shares, almost 17% higher than the diluted weighted average share count of approximately 252 million in the prior-year period as a result of shares issued during the IPO. The effective tax

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rate factored into the Q4 adjusted net income was approximately 9%, which reflected an ongoing rate in the low 20s, reduced by some additional discrete tax benefits in the quarter.

Turning to slide 9 to address our full year financial performance. Full year revenue growth was 10.1% with core growth of 5.9%. Acquisitions contributed 3.5% we realized a small benefit from FX. Core growth was strong in our industrial channels, as well as our automotive replacement channel which grew just under 7% for the full year. Automotive first-fit declined 4.6% for the full year due to the second half decline, mostly occurring in Q4, some of which we had planned for and part of which came in lower than expected.

Overall, our global replacement channels had core revenue growth of 6.9% and our first-fit channels had core growth of 4.2%, driven by the continued strength in industrial first-fit sales, which grew 12.9% with continued strong growth in hydraulic applications.

Our revenue growth translates through to EBITDA growth and margin expansion as EBITDA dollars grew 13% and EBITDA margins expanded 60 basis points. Price cost continue to be managed well throughout the year and we were able to stand up our new capacity as planned.

We incurred new plant start-up costs and manage through a number of other capacity-related challenges. We believe that the full-year EBITDA reflects very solid execution in this environment. Our adjusted EPS grew by over 50% primarily as a result of the increase in adjusted EBITDA and lower interest expense resulting from the lower debt balance in the year.

Slide 10 provides detail on key cash flow items and our focus on continued deleveraging of the business. Our trade net working capital as a percentage of revenues was flat from the prior year where we would typically be expecting about 50 basis points of improvement. We experienced inventory build in a number of areas that offset other improvements within the year. These inventory builds were associated in part with certain strategic increases and other activities associated with fulfilling fluid power demand and should moderate this year.

The overall increase in working capital dollars is associated with the overall 10.1% revenue growth rate for the year. Our free cash flow reflects the higher CapEx spend on the fluid power capacity expansions, as well as the increase in working capital associated with our growth. We will talk about our outlook in a moment, but we would anticipate these items to improve in 2019, and our conversion percentage to move back towards historical levels. On leverage, we ended the year with a net leverage ratio of 3.4 times, reflecting our continued commitment to deleverage the business while still investing in growth.

Moving to our outlook on slide 11, for 2019, our current outlook for core growth is a range of 3% to 5% with higher growth in the second half of the year. Underlying this growth rate is continued growth in our industrial markets, as well as in our replacement channels, partially offset by some further decline in automotive first-fit.

In China, we are anticipating a weaker first half, particularly Q1, which we believe will reflect further deceleration from Q4. For the full year, however, we are still expecting growth in China as a result of our replacement channel exposure and the opportunities we have to expand our Fluid Power business.

Our outlook for adjusted EBITDA is $775 million to $805 million, which reflects some impact from an FX headwind for the year based on current rates. Capital expenditures are expected to decrease to approximately $150 million, a decline from just over $180 million in 2018. And as I noted earlier, we would anticipate our free cash flow conversion increasing to over 80% in 2019.

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Our growth in earnings combined with the higher conversion rate would imply a significant increase in our free cash flow in 2019. Based on our current outlook, we also anticipate that we will be below 3 times net leverage by the end of 2019, barring any larger M&A, which is not foreseen at this time.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, David. We delivered solid results in 2018, our first year as a public company. The Gates team executed well globally and, as a result, we delivered record results in a dynamic environment while effectively executing a number of large initiatives. The diversity of our business model served us well. Our industrial end markets and replacement channels remain supportive, which allowed us to deliver solid core growth of 5.9% despite the headwinds from certain auto first-fit markets.

I would like to thank our global Gates team and congratulate them on their performance in delivering our upward revised guidance despite the challenges we faced in the second half and, particularly, in the fourth quarter. We demonstrated the ability not only to maintain positive price cost economics, but also to continue expand our adjusted EBITDA margin. We generated solid adjusted EBITDA growth and incremental margins particularly when adjusting for the impacts of FX and acquisitions.

Focused execution remains our top priority. In 2018, we dedicated a significant amount of capital to large strategic initiatives which will serve us as a foundation for growth in 2019 and beyond. New product introductions are moving forward at an accelerated pace and will support our growth targets and reinforce our position as value adding partner to our global customers.

Despite significant investment in the business in 2018, we continued our path of deleveraging and we have a line of sight to being below 3 times leverage by the end of the year. The regions and end markets where we have the majority of our business are performing well. Our outlook for 2019 reflects solid core growth and margin expansion, as well as significant improvement in free cash flow conversion; moving forward, a conversion rate that is more representative of our business model.

We are excited both by the progress we have made and the opportunities that remain ahead, and we look forward to demonstrating the merits of our business in the coming years.

With that, we will now turn the call back over to the operator to open up the Q&A.

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QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question comes from Andrew Kaplowitz from Citi. Please go ahead.

Alan Fleming
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Good evening, guys. It's Alan Fleming on for Andy.

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

A

Good evening.

Alan Fleming
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Ivo, I want to start on the auto replacement Can you talk about your visibility here on that side of the business? I mean, last quarter I think auto replacement demand was up 7% and was up another 7% this quarter. Obviously it looks like the U.S. or North America is hanging in there and China is quite strong. Is there any reason why you can't continue to deliver on this mid-single-digit type growth on the global auto replacement demand in 2019? And do you see these trends kind of holding steady?

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

A

Look, at this point in time, we feel pretty constructive about what's happening with the automotive replacement business. As we've discussed, we are doing quite well in China where we continue to build out our portfolio, build out our presence with channel partners. North America and Europe continue to have a supportive market dynamics particularly driven by the 2009-2010 decline of car registrations and the fact that the sweet spot for our demand is in that 7 to 11 years which we finally turned the leaf over of the declines from 2009. So although we will not provide additional guidance to that level, we feel reasonably positive about where we sit with the auto replacement business that we have.

Alan Fleming
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. And flipping over to China and the industrial demand, your comments there about maybe seeing some pressure from export-related demand, is it possible that China industrial gets worse before it gets better in 2019? And what kind of uncertainty or risk have you factored into the guidance for the possibility that we don't get a U.S.-China trade deal and demand could deteriorate further?

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

A

Look, I think that we've tried to highlight some of the risks that we see. I would tell you that we probably see more uncertainty with the exporters and particularly not buying, not building inventory because they don't want to be stuck with any products in case that the trade conflict doesn't get resolved kind of over the next three to six months. But outside of that, I think that we are being pretty realistic about what that market environment looks

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like, and we are really not counting on any significant rebound in Q1 in particular. And I think that we have taken that into account for our guidance for 2019.

Alan Fleming
Analyst, Citigroup Global Markets, Inc. (Broker)
Q

Okay. I'll leave it there. Thank you, guys.

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

Thank you.

Operator: Thank you. Our next question comes from Jeff Hammond from KeyBanc Capital Markets. Please go ahead.

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

Hey. So just on auto first-fit, just maybe if you can bifurcate the level of weakness in 4Q in China and Europe and then how you see those playing out. I think you mentioned China weakness, but are you seeing Europe stabilizing?

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

Sure. Look, let me start with the fact that Europe and China are two largest automotive first-fit businesses as we have indicated in the past. And frankly, one of the things that's kind of a nuance for us is that in Q4 in particular, that quarter is more heavily weighted as an automotive first-fit quarter due to the regular seasonality.

So when you think about our Q4 results, they're kind of disproportionately impacted by the China and Europe weakness in Q4. Look, in Europe, we've counted on good amount of that decline particularly because better visibility on the programs that are rolling off. And that is aligning to our strategy that we have communicated from basically the time that we hit the IPO Roadshow. We saw that we want to be very selective in how many programs we're going to take. So kind of think about half of that decline being planned.

The emissions testing standards that were implemented had a larger impact than what we initially thought, and we really anticipated that that's going to get resolved as we kind of entered the fourth quarter or exit the fourth

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quarter, and we really have still seen reasonably good impact of that emissions testing process being deployed. And that's kind of how we think about the auto decline in Europe. So, reasonably weak, and again half planned, half – maybe a little less expected.

For China, we came through a very tough compare as we mentioned on the Q3 earnings call. And the market frankly was a little bit softer than what we have anticipated, again not just in the auto first-fit business but also in the industrial sales as we have highlighted in our prepared remarks. It is worth noting though that we are seeing healthy double-digit growth in replacement channels for both the automotive and industrial end markets.

So, look, we feel that we are set up pretty nicely to weather the current automotive first-fit weakness and frankly the trade war headwinds. And, look, as David noted, we believe that we see some further deceleration in China particularly in Q1. And this current environment frankly is contemplated in our guidance. So that's kind of how we feel about auto.

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

Q

Okay. Great. And then just can you talk about order rates in the Fluid Power business? Clearly top line was strong, but I think some of your peers showed some deceleration just talk about order momentum in that business.

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

A

Look, we don't provide guidance on order rates because frankly we don't really track order rates as we said – the backlog business, we have book and ship business. But what we have seen in kind of exiting the year, is what we have seen at the beginning of this year, and that's probably where I would leave it at.

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

Q

Okay. And then just on the 3% to 5% core, do you expect both segments? I know you don't give segment guidance, but do you expect both segments to be in that 3% to 5% range?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

We would expect Fluid Power to be higher than Power Transmission, consistent with how we have run the last few years, maybe not as exaggerated as we've seen last kind of year-and-a-half but we would expect FP growth to be higher.

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

Q

Okay. Thanks, guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Jeff.

Operator: Thank you. Our next question comes from Julian Mitchell from Barclays. Please go ahead.

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Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good evening.

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

A

Good evening, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Good evening. Maybe just a first question around the free cash flow. I guess you have that base free cash flow sort of $130-ish million in 2018. Is it right that you're guiding for sort of $300-plus million in 2019. And in terms of – if that's correct, and then maybe flesh out some of the moving parts, I guess CapEx is dropping $40 million (sic) [$30 million] or so year-on-year. But what are you expecting around working capital for example? Does that become an actual cash, a big cash inflow in 2019?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Julian, I think $300 million, you're kind of in the zone. I think that would show us returning to conversion levels kind of consistent with how we've historically operated. Big pieces are going to be EBITDA dollar growth. Secondly, on the working capital side, we run at a pretty high percentage of revenues. We look to improve that year-over-year, but the bigger drivers are revenues. So with 10% revenue growth last year, we've provided a lot of working capital dollars that will obviously be lower this year. And then the other component would be from reduction to your point of around $30 million in CapEx. So I think that would get you close.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. And then related to that, the CapEx in 2020, does that return to a sort of normalized level at that point?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

We've always said the business should run around 3% of sales, plus or minus and then see – I think what you see is us walking our way back towards that. And I think will continue to come down a little bit as a percent of sales in 2020 from 2019.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you. And my second question really around the organic sales guide, the 3% to 5% sort of core assumption, is the right way to think about that, you're at the bottom end of that range in Q1 and it steps down a little bit from Q4 because you are assuming China maybe gets a little bit worse. And then you're at the top end plus of that range in the second half of the year. Is that the right way that you're modeling it?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

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Yeah. I think directionally that makes sense. I think we see the second half a little stronger than the first half, and with the China weakness coming out of the year, that's quite directionally right, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thank you.

Operator: Thank you. Our next question comes 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

Hey, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

I just want to circle back on auto first-fit. Does the headwinds you saw this quarter change your appetite in any way your exposure to first-fit auto? You're growing so many other markets faster. And I know you turned down more business in auto first-fit than you actually take. But is there any change in your appetite here based upon the quarter?

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

A

Deane, I don't think that we are changing the perspective on the auto business. I think that we are being consistent with what we said. We're got to continue to be very, very selective in what business we take. I think that we recently released an announcement out there on several really interesting new technologies that we believe will offer a highly differentiated performance for auto first-fit customers that should allow us to take business at very nice premium margins to kind of more what the historical business has been and continue to support the automotive replacement business as we go forward. But we don't really feel that we want to be taking a ton of auto first-fit business, and as you very correctly stated, our interest is continue to outperform in industrial and continue the evolution of our portfolio heavily weighted towards that industrial set of applications.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

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That's really helpful. And then on Fluid Power, you've talked in the past several quarters about this global capacity shortage, and you've brought capacity on pretty smoothly here. Is there still that shortage? Because now you're also talking about the ability to go after some of your underperforming plants, and I presume some of that's in Fluid Power. But just where is the equilibrium right now and in capacity and demand of Fluid Power?

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

A

Look, we've brought a significant amount of capacity on stream and so we see several of our product lines to come more towards that equilibrium. We do still have some product lines that constrained and we expect that that's going to continue certainly throughout the first half of the year. We continue to not necessarily add capacity, but get more productive with existing set of assets that we have to release some of those constraints and assist our customers with their needs to build their products. But we feel that we are in a lot better shape, exiting 2018 and entering 2019, capacity-wise.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Yeah, go ahead, Dave.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, you asked about the footprint. I would say you're right about that that would provide us a few opportunities probably on Fluid Power side as we get more into it.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good. And then just – I might have missed it in the 2019 guidance, but can you comment on tax and was there anything unusual about those discrete tax items in the fourth quarter?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

The fourth quarter was – there were a host of new regs that dropped in the fourth quarter and they gave us line of sight to utilization and support on tax credits that we previously didn't have line of sight to, so that resulted in some VA release in the fourth quarter. For next year, I think kind of more normalized tax rate – effective tax rate of around 25%, and maybe 25%, 27% on a cash tax basis.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. Thanks, guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Deane.

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Operator: Thank you. Our next question comes from Jerry Revich from Goldman Sachs. Please go ahead.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good afternoon and good evening, everyone.

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

A

Hi, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

I'm wondering if you can talk about the manufacturing footprint plan a bit more. So let's say, on the Fluid Power side, if demands, call it flat over the course of 2019, to what extent do have an opportunity to accelerate that rationalization program? And can you talk about what the longer-term opportunities are moving towards the larger scale campuses, as you mentioned, as they eventually over time displace some of the smaller locations. What are the unit economics of improvement there?

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

A

Look, we will not be making any announcements on this call about footprint rationalization. But, as you mentioned, we do have some opportunities particularly driven through the productivity improvements through the deployment of our Gates operating system. We did scale up those campuses so that gives us some opportunities to look at some future plant consolidations. Look, I think that the Turkish plant is a really good example, right? We had a subscale facility. We opened up a regional facility that's of scale, and we fold the demand into the new facility. There are many others that we that we will pursue over the next few years. And when we are ready, we will make an announcement on what those are.

Operator: Thank you. Our next question comes from Josh Pokrzywinski from Morgan Stanley. Please go ahead.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good evening, guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hey, Josh.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Just a first question. Ivo, you talked a little bit about some reluctance from some of your customers to take on inventory ahead of trade resolution or not really knowing the state of play there. Maybe comment more broadly on what you're seeing in inventory? Was there anyone who is on the other side of it who is perhaps pre-buying

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ahead of tariff? Just trying to understand where there may be ebb and flow in the channel. I guess any commentary across the different end markets or geographies would be helpful.

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

A

Yeah. So, Josh, my comment was particularly directed towards the inventory not being taken up by the export-oriented manufacturers in China. That was the comment I was making. Kind of the more general comment, we really don't see any significant build-out in channel inventory. I'd probably say that we haven't really seen any, but there may have been some that we have not been able to visualize.

So we think that, in Fluid Power, the inventories are reasonably lean. On Power Transmission, we again did not see any pre-buys either. So, I would not be in a good position to be able to give you any outside of this commentary on any trade-related pre-buys associated with our products.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then just following up on free cash flow and working capital question from earlier, Dave, if I understand it right, it does sound like inventory is perhaps a little bit of a benefit, at least directional benefit to 2019 on the 80% conversion? Does that mean normalized conversion is then below 80%? Or as CapEx comes down, it kind of offsets that pull-down in inventory? I'm just trying to conceptualize what the right rate is if we normalize everything going forward.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. I'd say – what we've consistently said, Josh, is that we're looking for kind of 50 basis points of improvement when we look at net working capital dollars as a percent of last 12 months' sales. And we didn't see that this last year, and that was really a function of some decisions we made around places we're going to build some inventory for some strategic actions, as well as have continued inefficiencies associated with some of our Fluid Power activities. So and that includes having a little more hose on the water coming from China to the U.S. as we try to fulfill some of the higher demand to some customers here.

But having said that, we think we'll get back to reducing that and being a little more efficient and that the overall dollars won't grow as much as we did in the prior year as a result of a lower sales growth in 2019 as related to 2018. So all of those things, we believe, are additive to this idea of getting back to over 80% which is where we feel the business model should deliver free cash flow conversion in relation to adjusted net income. And I think to the earlier point, the math would imply a significant step-up in free cash flow generation.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Right. So just, I mean, just to be clear on it, short of giving 2020 free cash flow guidance, which I understand is absurd, that number should be higher than 80% than the outyear as some of the mechanical items shift. I just want to make sure I'm not missing anything.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

No, I think that's fair.

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Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Perfect. Thanks for the color.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thank you.

Operator: Thank you. Our next question comes from Jerry Revich from Goldman Sachs. Please go ahead.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Thank you. Can you hear me now?

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

A

Yes, Jerry, we can.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, Jerry.

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

A

Sorry about that.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Perfect. Thank you. It's probably on my side. So, Ivo, I just wanted to better understand the cost savings that you folks are going to achieve, let's say, on this Turkey example or another example of switching from a smaller facility towards the new campus approach. Can you just flesh out the opportunity set and what the ultimate margin opportunity does that – it creates as we think about what business will look like in the next cycle?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. I think, Jerry, it's Dave. Using Turkey as an example, we think Turkey will provide in that a couple of million dollars of savings per year. We can produce maybe a little more effectively but also we're able to eliminate some indirect and overhead. But that's an example of a very small footprint item probably our smallest.

The way we've discussed it internally, and again and want to stop short of announcing anything here because we're still working on it, we think there's a good opportunity to average one or two a year for the next few years, and we probably look at those different regionally, and I think the idea would be now that we've got capacity at scale certain sites and some of our other larger plants, Ivo alluded to productivity which is enabling us to then further consolidate some activities. We'll look at how we can benefit to a rooftop of two. You add to that?

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

Yeah. And what I would add maybe, Jerry, is that we also as I think we have said on couple of these calls is we are working on tremendous amount of new technology, as well as new manufacturing technology, which should give us the opportunity to further drive productivity improvements, improvements to need for additional manufacturing footprint and so on so forth. So we feel that there will be some good opportunities to drive further productivity.

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

And then, Jerry, regarding how that impacts the model, I'd say for us we look at like a payback of a Turkey opportunity to be very short, probably a year. But most things are going to be in kind of that one- to two-year payback period. And they're reasonably decent scale and take time to execute. So that's why they would happens slowly over time. But that gives us the opportunity to drive a little bit of incremental gross margin and frankly we've used to probably not necessarily drop through to the bottom line but go fund more go-to-market and R&D activities as we continue to kind of expand EBITDA margins in the mid-20s here.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Okay. And then on the Fluid Power outlook for this year, are there any meaningful discrete customer wins or any program tailwinds that we should be thinking about as we overlay what end demand looks like versus how it might look for Gates?

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

I would say that we continue to build a ton of opportunities in Fluid Power, Jerry. Again, frankly, that's an opportunity to me kind of get on my soapbox about we've built this Fluid Power capacity not necessary to consolidate other sites, we've built that Fluid Power capacity to be able to take more market share away. It's a giant market, we are a large player in that market, but we still have a reasonably small market share when taking into an account the regional presence and footprint. So we're working on a significant amount of new opportunities particularly in the regions that we're adding the capacity. So we feel reasonably constructive about our opportunities in 2019 and beyond with Fluid Power.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Yeah. I appreciate the discussion. Thanks.

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

Thank you.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Thank you.

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Operator: Thank you. This concludes the Q&A session. At this time, I would like to turn the call over to Bill Waelke for closing remarks. Please go ahead.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

We appreciate everyone joining this afternoon and the interest in Gates. If many of you are aware, the team here is always available to assist with any follow-up questions. We look forward to updating you after the first quarter. Thanks, everyone. Have a good evening.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you.

Operator: Thank you, ladies and gentlemen, for attending today's conference. This concludes the program. You may all disconnect. Good day.

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