07-May-2019

Gates Industrial Corp. Plc (GTES)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Chris, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Q1 2019 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

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

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thanks, Chris; and thanks, everyone, for joining us on our first quarter 2019 earnings call. I'll briefly cover our non-GAAP and forward-looking language before passing the call over to Ivo, who is here today along with our CFO, David Naemura. After the market closed 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.

On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. A reconciliation of these non-GAAP financial measures is included in our earnings release and the slide presentation, each of which is available on 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 expressed or implied by such forward-looking statements. These risks include, among others, matters

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that we have described in our most recent 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 the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good afternoon, everyone; and thank you for joining us today. Let me start with high-level summary of the first quarter beginning on slide 3 of our presentation. Our start to the new year saw a more challenging environment from a market backdrop and operational perspective than we had expected. We will outline a number of actions we are undertaking to accelerate productivity, reduce cost and improve cash flows, as we manage through these challenges in the first half of this year.

In the first quarter, we generated total revenue of $805 million, which represents a core growth decline of 2.1% compared to the prior year. Total revenue was down 5.5% over the prior year which includes unfavorable foreign currency translation of 4.1%, partially offset by 70 basis points contribution from acquisitions. Our revenue performance reflected the continued headwinds in a number of our end markets which we noted on our fourth quarter earnings call, where we also indicated that the first quarter would generate the weakest core growth of the year.

Most notably, we saw challenging environment in Europe and China, particularly in automotive first-fit, with China being slightly better and Europe somewhat worse than we had expected. What we did not anticipate as we entered the new year was the significant replacement channel destocking that we experienced mostly in North America and to a lesser degree in Europe. This represented a shift from a period of constrained supply to replacement channel destocking. We will talk more about the environment by region; but overall, I would say, the environment is a bit more mixed.

We did see modest industrial core revenue growth in the quarter led by our performance in EMEA and South America, primarily driven by the heavy duty truck and construction and markets. We also had a solid performance in emerging market replacement channels, where we are seeing the benefits of our initiatives to expand our channel presence, and we remain positive on our ability to continue to outperform well into the future as we scale up in these markets.

Looking at the regional results in more detail. Europe, as we noted, was softer than expected while we largely anticipated the significant deceleration affecting our automotive first-fit business in Europe, the planned ramp-down of programs, slower market and lingering WLTP-related weakness. Our automotive replacement business also experienced a decline in revenue in the quarter, driven primarily by destocking. We believe the challenges facing our business in Europe will persist until late in the second half of this year.

In China, our Q1 performance was in line with what we expected. We saw another quarter of double-digit growth in our replacement business, which was primarily driven by the fast-growing automotive replacement channel, where we continue to build on our leading product portfolio and are executing our focused commercial initiatives. Our revenue in the industrial end markets declined slightly on a core basis impacted by the continuing trade uncertainty, which affected us more significantly at the export-focused manufacturers in the first-fit channel.

The challenging automotive first-fit conditions in China continued to negatively impact our business, but less so than what we experienced in Q4 of last year. We believe, with our business improving as the quarter progressed,

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that the most difficult conditions in China are likely behind us. Based on the currently improving trends, we expect core revenue growth in mid-single digit for the full year in China, primarily driven by growth in the automotive replacement market and market share gains in industrial applications. This view is not reflective of any potential trade war escalation between the U.S. and China.

In North America, our overall performance in the quarter was roughly flat on a core revenue basis. We saw growth in a number of our industrial end markets, which was the result of new products and share gains, but this was offset by a decline in our total replacement business. Although we believe this year harsher first quarter weather may have been a modest headwind, our replacement business was meaningfully impacted by channel inventory destocking, negatively affecting our total company core revenue growth by approximately 200 basis points.

The visibility we presently have into the replacement channels, particularly in North America, indicates that end user demand for our products remain stable and we expect most of the destocking activities to work through our business in the first half of this year. In response to the market environment, we have taken significant operational actions to realign our production output and our inventory levels with the prevailing business conditions.

Turning to earnings. Our first quarter adjusted EBITDA of $166 million was below our expectations. At 20.6% of sales, our adjusted EBITDA margin reflects a decline of 100 basis points compared to the prior-year Q1. We maintained our positive price cost position in the quarter, but adjusted EBITDA was negatively impacted by a significant FX headwind and lower-than-anticipated volume, which primarily impacted our most profitable region of North America. We anticipate margins will remain temporarily compressed in the second quarter, as destocking continues and as we reduce production output to work down inventory levels before we expect to see margins recover in the second half of this year.

Based on a slower-than-anticipated start of the year, we are adjusting our full year guidance. We believe that our second quarter will remain under pressure, but we anticipate returning to more typical performance in the second half of the year. We expect the issues we have been facing in Europe and China, in addition to the destocking we have experienced in our largest replacement channels, to abate in the second half. We are also currently lapping an exceptionally strong performance in the first half of 2018, and we will begin to face an easier compare in the second half of the year.

Additionally, over the last several quarters we have introduced a number of new innovations and expect to begin recognizing revenues from these new product introductions later in the year and into the future. All of these factors we believe support the second half core revenue growth of roughly 3% to 4% implied in our updated guidance. During our fourth quarter earnings call, we highlighted our organizational readiness to begin implementation of certain business optimization actions. This will be covered in additional detail later in the presentation. But as outlined then, we are beginning the implementation of the structure realignment activities.

These actions are anticipated to result in savings of approximately $25 million annually with a total cost to achieve of approximately $40 million, primarily incurred over the next 18 months. Implementation will begin this year and reach full run rate savings in 2021. Despite managing through a more challenging environment overall, we remain fully committed to innovation to refresh our product portfolio and accelerate future growth of our business.

Within the quarter, we introduced multiple new products. We introduced a new high-performance synchronous belt for industrial applications, which has the ability to handle high levels of torque in smaller spaces and narrower drives, something directly applicable to our belt-to-belt as well as chain-to-belt growth initiatives. We released a new choke and kill hose for the Oil & Gas market, the design of which allows us to offer customer bespoke links and connection types, as well as shorter lead times.

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We also further expanded our PRO Series hydraulics portfolio with new lines of hoses and couplings, addressing specific performance requirements across multiple end markets. These products offer customers compelling value and provide us with additional opportunities for growth at richer margins. We anticipate these new product introductions contributing to our second half growth rate.

Moving now to segments, beginning with Power Transmission on slide 4. Our Power Transmission segment core revenue declined 3.7% in the quarter, while total revenue declined 8.5% as a result of significant FX headwinds. Revenue from industrial end markets grew high-single digits in the quarter on a core basis, led by construction and Agriculture end markets particularly in North America, where we had our highest regional growth rate. This growth was offset by a mid-single digit decline in our automotive business associated with the previously highlighted weakness in Europe and China, as well as destocking we experienced in the replacement channels.

With respect to core revenue on channel basis, in the quarter we experienced a low-single digit decline of our replacement business and mid-single digit decline of our first-fit business. Emerging markets underperformed developed markets due largely to the decline in automotive first-fit business in China. Outside of our automotive first-fit business, our Power Transmission revenue was roughly flat on a core basis compared to the prior-year first quarter.

Our focus chain-to-belt initiative continues to accelerate and our design wins are growing across a number of end markets with notable wins in personal mobility and light industrial automation. We anticipate this initiative will deliver double-digit revenue growth in 2019 over the prior-year revenue base. Our Power Transmission adjusted EBITDA declined by $15 million in the first quarter compared to the prior-year period, driven primarily by lower volumes and FX. The resulting adjusted EBITDA margin contracted by 90 basis points compared to the prior-year period, also driven by lower volumes and FX headwinds.

Going to slide 5. Our Fluid Power segment had modest core revenue growth of 80 basis points, with total revenue declining slightly by 20 basis points compared to the prior-year quarter. Solid growth in our Oil & Gas and General Industrial end markets was offset by a decline in our Agriculture end market and destocking actions by our channel partners. Core revenue growth in emerging markets significantly outperformed debt in developed markets for the segment as a whole. On a regional basis, our strongest core revenue growth was in China, where sales into the construction end market where the main driver; and South America, which saw double-digit core revenue growth in most end markets.

China and South America both also saw particular strength in their total replacement channel business, led by sales into industrial end markets. Our largest region of North America experienced a low-single digit core revenue decline. Growth in General Industrial and Oil & Gas end markets was offset by a decline in Agriculture end market which was impacted by both destocking and program attrition related to the recent capacity constrained hydraulics environment. Outside of the Agriculture end market, our Fluid Power core revenue in North America increased low-single digits.

Our Fluid Power adjusted EBITDA declined by $3 million prior to Q1 2018. This decline was primarily associated with the ramp up of our new hydraulic facilities, lower volumes with channel partners and increased investment in commercial, a new product development capability. While we remain focused on managing our business in this more uncertain environment, we are optimistic about the significant opportunities we see with our current and new customers and the new products we launched over the last several quarters. In addition to our recent customer wins, we have a large pipeline of opportunities that we are pursuing globally. This gives us confidence in our growth potential for the second half of this year and beyond.

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

David Naemura

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks, Ivo. I will now cover our financial performance beginning on slide 6. As Ivo said, revenue in total declined 5.5 points with a negative 4.1 point impact from FX and a positive 70 basis point impact from acquisitions. Excluding these two items, we had a core revenue decline of 2.1% in the quarter. We noted on our last quarter earnings call that we expected Q1 would be our most difficult quarter for core growth and we carried in a tough environment from Q4 against difficult comps. We did experience the headwinds we had anticipated, particularly related to Europe and China, with automotive first-fit being the biggest challenge.

As Ivo mentioned, we did however also see a more mixed environment with some increased softness in some areas as well as inventory destocking in our replacement channels, particularly in North America and Europe. As a result, revenue for the quarter came in lower than we had anticipated. It is not unprecedented for Q1 to get off to a slow start and we had anticipated that demand rates would accelerate as we progressed through the quarter. We did eventually see some improvement, but this was not until the second half of March and was not as significant as we had anticipated.

Our adjusted EBITDA of $166 million was a decrease of $18 million from the prior-year quarter. Our adjusted EBITDA margin was 20.6%, a 100 basis point decrease from the prior-year Q1, largely due to gross margin pressure from lower volumes and some inefficiencies in the quarter including adjusting our production and inventory levels. As a result, we did not decrement at the levels we would have expected. We anticipate these challenges persisting through Q2, as we complete the adjustments to our production levels and reduce inventory to align with the customer activity that we are now anticipating for the first half and rest of the year. I will cover this in greater detail in the outlook in a moment.

We did maintain positive price cost with our pricing exceeding raw material inflation and direct tariff impacts. This was dollar positive and about gross margin neutral. We anticipate this dynamic to continue through 2019. We grew adjusted net income to $0.28 per share on a diluted basis compared to $0.25 per share in the prior-year quarter, which was the result of reduced interest expense and a lower effective tax rate more than offsetting the impact of lower adjusted EBITDA at a higher diluted weighted average share count of approximately 295 million.

As you see in the results, we had a sizable, favorable, one-time tax item in the quarter that we have removed in reporting our adjusted net income and EPS. This item is primarily the result of reversing the valuation allowance on significant net operating loss carry forwards in Europe that currently have an unlimited life, but that we previously did not have adequate line of sight to utilizing. In Q1, we have completed the implementation of certain operational actions that have the additional benefit of allowing us to begin utilizing these NOLs. Therefore, in accordance with GAAP, we reversed the associated valuation allowance which is obviously a non-cash item in the quarter.

Slide 7 provides detail on key cash flow items and our focus on continued deleveraging of the business. Trade net working capital as a percentage of revenue grew by 130 basis points due to increases to inventory in the quarter. This inventory increase was primarily the result of the destocking that we experienced in replacement channels, particularly in North America and Europe. We anticipate normalizing our inventory levels during Q2, as we also align our production with current demand levels as previously discussed. Our free cash flow is presented on a last 12 months basis; and therefore, reflects the higher CapEx spend on the Fluid Power capacity as well as the increase in working capital associated with our growth.

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We will talk about our outlook in a moment, but we would anticipate these items improving in the second half of 2019 and our conversion percentage moving back towards historical levels, as we have discussed previously. On leverage, we ended the quarter with a net leverage ratio of 3.6 times, a decline from 3.9 times at the end of Q1 of last year. The slight increase in that leverage from Q4 reflects some normal seasonal build in working capital as well as some higher inventory as we discussed. Despite the more challenging start to the year, the cash profile of the business is such that we believe we'll still meaningfully deleverage the business in 2019.

Moving to slide 8, we're providing additional data on the further business optimization actions introduced in the prior quarter's call. These actions include some rooftop consolidations within our operations footprint, streamlining of some activities as we drive globalization of certain functions and the establishment of certain shared service back-office functions. These actions are consistent with how we have discussed our intent to continue to drive efficiency in the company. The increase in plant productivity over the past few years enables us to now consolidate certain parts of the manufacturing footprint.

We have also previously discussed driving further productivity through streamlining G&A and these other actions are aligned with doing that. These actions will begin this year with the majority occurring in 2020, achieving the full run rate savings in 2021. It will have a total cost of approximately $40 million over three years with savings expected to reach a run rate of $25 million annually in year three. Further, we anticipate that from a cash flow perspective, we will break even on this investment in right around two years. These actions will be in addition to the restructuring spend levels that we have incurred in recent years.

Now, moving to our outlook on slide 9. The slower start to the year that we discussed today has resulted in us reducing our annual guidance. Our updated guidance range for 2019 is core revenue growth of 0% to 2% and an adjusted EBITDA range of $740 million to $760 million. We do not provide quarterly guidance, but will say that currently we see core growth improving a bit in Q2 from what we saw in Q1, but still slightly negative year-over-year.

For gross margin, we expect Q2 to be slightly better than what we saw in Q1 on seasonally higher volumes, but well below the prior year, as we work through reducing inventory levels to the current business environment and customer activity. We expect both core growth and gross margins to improve in the second half of the year. The revenue compare will get easier from what is a very difficult compare in the first half of the year. Also, revenue will benefit from continued progress on our organic growth initiatives with the impact from the increase in the second half of the year, reflecting about 100 basis points of growth for the full year or about 200 basis points in the second half.

As for gross margin, we anticipate working through the realignment of our output around the end of Q2 and we also anticipate as certain other cost headwinds will ease, enabling sequential gross margin improvements in the second half more indicative of what we expect from the business. Capital expenditures are expected to be approximately $140 million for the year and we are maintaining our free cash flow conversion guide of over 80% in 2019. We continue to see our net leverage reaching approximately 3 times 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 to Ivo. Ivo?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

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Thanks, David. The first quarter was more challenging start to the year than previously envisioned, and we have adjusted our full year view to reflect this. Our strategy and priorities remain unchanged and we remain fully confident in our ability to achieve our long-term targets. Focused execution continues to be the key priority for 2019. We are taking appropriate short-term and mid-term steps to manage those items under our control in this more challenging environment.

Absent additional unfavorable macro developments, our business is set to return to more typical organic growth in second half of the year based on our expectation of China returning to growth, Europe stabilizing and the majority of destocking activities taking place in the first half of the year. Our significant focus on new product development to refresh our portfolio with comparative and differentiate products is showing good promise. We have a significant and growing pipeline of opportunities related to these new products we have recently introduced, and believe the traction that we are seeing so far will contribute to growth this year and well into the future across all markets we participate in.

We will continue to invest in our business in order to position ourselves for long-term growth and expanded profitability, while being mindful of the near-term environment. We are also committed to the successful execution of our footprint optimization and other initiatives to make Gates the preferred partner for our customers. Finally, there is an omnipresent focus across our team on cash generation and the progress towards continued deleveraging and the enhanced strategic optionality it provides for our business.

With that, I'll now turn the call back over to the operator for Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question is from Deane Dray with RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, thanks. 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

I just want to make sure I understand how the destocking issue manifests itself in the quarter. Maybe give us to us in the context of sell-in and sell-through, because I think I heard you say that the end user demand was stable, so the sell-through sounds like that wasn't the issue. I'm not sure if that was a comment specific to Power Transmission or Fluid Power or total, but maybe you can start there.

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

A

Sure. Look, first of all, we were a little bit surprised with the destocking to be completely honest about what we have experienced. We look at our POS activities with our largest channel partners, particularly in North America, where we have a reasonably good visibility – a better visibility than in other places. And we have seen, frankly maybe even a stronger performance of sales out than we've anticipated entering the year.

So when we look at the products selling into the channel, we couldn't quite reconcile the divergence between the performance at the end customer demand and the sales into those channels. And if you look at most pronouncedly, maybe to the second part of your question, the most pronounced declines in the inventory of the destocking was impacting our Power Transmission business and to a degree Fluid Power business in North America as well.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

And then maybe you can share with us the thinking on how the destocking runs through, and all that is worked through by the second half. And maybe in your answer you can share with us the cadence in the quarter by month. It sounded as though April was still negative, but had trended better. So just how do you extrapolate and say that it's all worked through by the second half?

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

A

Yeah. So again, our assumption, Deane, primarily is focused on the sales out and we continue to see robust activity with sales out of our products from the channel. That would give us an indication that we're probably closer to seeing the end of the channel destocking sometimes in Q2. At some point in time, a normal replenishment cycle needs to start occurring because the sales are reasonably robust with our products.

We have started the year – I would say, the first two months of the year are always kind of – they can go either way. January and February don't necessarily indicate how the quarter may go. We can have a softer January and February, and March can be very, very robust. This year we really didn't see the robustness to start coming until the third and fourth week of March, and it was a little bit too late to see a rebound in our results.

And then, I would say that April was probably more or less in line with what we have seen in March, the environment we have exited Q1 with. So, I think that that's when they've indicated that we see little better performance in Q2 or we anticipate a little better performance in Q2 in terms of core growth, but we still try to be realistic again and we expect that there's still destocking that's going to continue throughout the Q2 before we start seeing a more positive sales and sales out balance.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thanks for the color.

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

A

Thanks, Deane.

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Operator: Your next question is from Jamie Cook with Credit Suisse. Your line is open.

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

Q

Hi. Good morning. Just a follow up on the prior question. In terms of when you are saying things improved a little in March, can you comment was that specific to a certain geography or market and was one more pronounced than the other? And then, is there any way you can help us with sort of the amount of excess inventory that you think is in the channel, whether you wanted to fine it by months or however you can define it?

And then my last question is, I think you commented on price costs in the quarter, but what is your expectation for the remaining part of the year? And is price ticking, given sort of a softer start to the year? Thank you.

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

A

Thanks, Jamie. So, I would say that China got reasonably better in April over March, and March was nicely better than January and February. There'll be probably the best regional activity. North America got slightly better, but I would say the environment is more in line with March than anything. In terms of how much inventory is in the channel, from my vantage point where I see, Jamie, to be completely honest with you is, I don't believe that there is a massive amount of inventory in the channel.

I can't really quite speak to why there is such a significant destocking, there's probably a better question to some of the channel partners out there. But again, I would reiterate that our sales out activity remains reasonably robust. And when we kind of consider what level of destocking has been occurring, we felt that we wanted to rebalance our inventory as well, just in case that we are not seeing something in there. But I just would not – from where I sit today, Jamie, I would not expect destocking.

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

Q

Okay. Thank you. And then just saw your expectations on price cost in the remaining part of the year?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, Jamie. It's Dave. I noted we were positive on a dollar basis in Q1, and we would expect maintaining that for the full year as we did similar to what we did last year. We carried in a reasonable amount of price that will continue to anniversary over the course of the year and there'll be some level of new price. So as the environment changes, that dynamic might change a little bit. I think we're pretty well positioned to be generally flat from a price cost perspective. Last year we were positive and we said that would narrow; and this year we'll be closer to flat, and I think that's what we see today.

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

Q

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

Operator: Your next question is from Andrew Kaplowitz with Citi. Your line is open.

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Q

Hi. This is [indiscernible] (00:36:02) on for Andy.

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

A

Hi.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Good afternoon.

Q

Hi. You previously mentioned closing of a [ph] sub-scale (00:36:10) plant in Turkey and you mentioned additional productivity actions that seemed to be bigger and faster than expected with adjusted EBITDA decrementals about 40%, understanding there's a higher sense of urgency. Given weaker markets, what is the decremental you think you could do in the business moving forward?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, I think our goal is going to be around 25%. I think it's hard to do. I don't think we're going to necessarily be able to respond to 25% decrementals kind of quarter-in, quarter-out. The decrementals kind of that you're referring to of 40% here reflects some of the inefficiencies of taking out of the destocking and taking out some of our inventory as well.

The restructuring actions we refer to are over a three-year period and really frankly aren't in response to the current environment, but more we've been talking about for a period of time and announced last quarter. But having said that, we always have some level of underlying activities relating to adjusting to current business levels, and we'll be doing that as we take out some production shifts to normalize our production output as well as our inventory levels in light of the environment we see.

Q

Thank you. And as a follow up, cash flow guidance remain greater than 80% free cash flow conversion. Can you discuss what needs to get better for cash flow for you to meet your target for the year?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. So we maintain a reasonably high percentage of sales of working capital as a reasonably high percentage of sales. So, that is a bit of a tailwind as the top line normalizes a little bit. Having said that, it'll be about inventory and our focus on getting out inventory will help enable us hitting our cash flow objectives for the year.

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Q

Thank you.

Operator: Your next question is from Jeff Hammond with KeyBanc Capital Markets. Your line is open.

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

Q

Hi, guys.

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

A

Hi, Jeff.

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

Q

Good afternoon. Hey. So just back to destock, I think you maybe quantify, you said sales would have been flat with the destock, so maybe $18 million to $20 million. What do you think that number looks like in 2Q?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

We think for the full year it's about a point, Jeff. So call it, similar to what we saw in Q1 and we see it running its course through the first half.

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

Q

And how do you think that will split between PT and Fluid Power? It sounded more on the PT side.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

I think probably a little more on the PT side. There was some on the Fluid Power side as well.

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

Q

Okay. And then, talking about sell-out, I guess you were surprised by the inventory destock. But as you look at the sell-out run rates, whether it'd be by geographic basis or an end market basis, anything surprised you positively or negatively as you went through the quarter?

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

A

Look, I mean, my sense if I just kind of rewind back as we were entering 2019, I would say that the North America sales out remains at very nice level of activity. I would have anticipated when the destocking starts rolling in that you would have seen some market decay and we haven't really seen that. So, that was probably more surprising.

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China is in a reasonably good shape. Europe was doing okay on FP, but we have seen destocking on PT side. I think that you probably have heard some others to comment on that in terms of channel partner performance.

So my sense is that, I'm just a little bit surprised at the level of destocking that took place. But we just – we were surprised and we don't want to be surprised, not reacting and entering second half of the year with little larger inventory position that's probably prudent. So we are taking actions to align ourselves to ensure that we can rebound our performance in the second half.

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

Q

Okay. And then just last one. The new core growth 0% to 2% – I mean, clearly PT seems a little softer in 1Q, but any biases on the two segments around that core growth number? Thanks.

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

A

I mean, I would say that we expect FP to remain slightly up. We have a very significant amount of new opportunities, very large pipeline due to the new products that we have introduced, and we remain very positive about the opportunities that are in the marketplace for us to capitalize on due to these new product introductions, and then we are more neutral on PT.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

The one thing I'd add, Jeff, is the compare for PT against the prior-year downturn in first-fit in the second half will get quite a bit easier. Other than that – typically, we would expect our FP business to grow at a little faster rate than PT, given what we're seeing in the year.

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

Q

Thanks a lot, guys.

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

A

Thank you.

Operator: Your next question is from Jerry Revich with Goldman Sachs. Your line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good afternoon, everyone. Ivo, I'm wondering if you could just say a little bit more about the Power Transmission aftermarket performance. You had an excellent 2018 on an aftermarket basis globally. Looking back on it now, do we think some of that was inventory stocking? And so, we're just comping up against that now that availabilities are better and global supply chains are better. And so, I guess, how much visibility do we have on comps turning positive in PT aftermarket, considering what looked to be some pretty tough comps in 2018?

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

A

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Great question, Jerry. Thank you for joining us today. Look, on the PT side, when I take a look at, particularly in North America – let me start with North America and break it down regionally a little bit. North America, the inventory levels have compressed reasonably well to the tune of north of $10 million in Q1 alone. Yet our sales outperformance in Q1 was stronger than last year Q1. So, I really don't exactly comprehend why there was an inventory takeout; perhaps it might have been related to an inventory positioning by the distribution channel partners in Q4, but I don't know that for certain.

I can tell you that our service levels have also improved in North America nicely in the second half of 2018. So maybe our distribution channel partners are more confident that we can fill much faster than we were filling in 2018, and that gave them a level of confidence that they can take some further inventory positions out. But to a degree of speculation on my part, when I take a look at the data in North America where the business is the biggest, I was a little bit surprised to be honest with you.

In Europe – I think in Europe we're facing probably a little different set of issues. I generally feel that the macroeconomic environment is a little more negative. In my sense in talking with some of the customers that I've talked to is that they're more negative than they were even in Q4. And my sense is that that probably is driving some of their decision making.

So, that would be probably around the two biggest pieces of our aftermarket business and China was terrific. We've continued to grow north of 20% automotive replacement business so that the thesis there remains intact, and we also had a very good performance in AR in Latin America. So, it's primarily the destocking in North America which I'm scratching my head about a little bit; and Europe, where I can understand because of the macroeconomic environment there.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you. And then, can you just say more about the assumption that Fluid Power organic growth accelerates over the course of the year, because when we look at those markets, supplier availability is now improving. So what's the risk of destocking those markets, especially as production rates should be slowing at some point in truck and construction markets in particular?

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

A

Yeah. Yeah. I mean, I would say that you're right, Jerry. But my expectation is that – I think I have said that to the question from Jeff. We have a very significant pipeline to the tune of $160 million to $200 million of new opportunities that we are working on. We're winning a good amount of these opportunities.

And my expectation is that in the second half, we're going to start seeing a nice contribution of filling some of these opportunities and ramping those opportunities up with MXT in particular, with our PRO Series hydraulics. Customers love the product. It's highly differentiated. It's got a great value proposition. So we are reasonably positive about our opportunity to start contributing through the NPI to the growth in the second half in FP.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And sorry, Ivo, just a clarification. How much is that tailwind from new products back half of 2019 versus first half of 2019? Can you just give us a rough sense?

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

Jerry, we had said in my remarks, I believe that we expected one full point of growth for the year of core growth from new products second half over first half. And we would expect the biggest piece of that to be our hydraulics and PRO Series MXT.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Thank you.

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

Thank you.

Operator: Your next question is from Julian Mitchell with Barclays. Your line is open.

Jason Makishi
Analyst, Barclays Capital, Inc.
Q

Hi. Good afternoon. This is Jason Makishi on for Julian.

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

Hi, Jason. How are you?

Jason Makishi
Analyst, Barclays Capital, Inc.
Q

Doing all right. Thanks for taking my question. Just a small question on how you're managing the extra capacity, given that so much of investment last year was on building out this capacity and how you're going to sort of manage these costs moving into Q2, in what appears to be sort of a slowing – still a slow volume environment, and maybe even in the back half of the year should any of these headwinds persist?

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

Okay. So, I just want to make sure I understand your question. In my mind, there are kind of two questions there; the short-term question about what we are doing short-term to manage some of the headwinds. And the answer to that question to get it out of the way is that, hey, look, we're looking at reducing our output. The destocking has happened across predominantly PT, some with FP, in the first quarter and we are realigning our shift patterns and the number of shifts that we work each week to what we have a present visibility on demand, while taking into an account the inventory reduction that we have targeted ourselves with. That's kind of the short-term activity.

On the extra capacity that we've brought on stream last year, I want to remind you that – look, we didn't bring this capacity on stream because we thought that we're going to see a significant market rebound in 2018. When we started these projects, we were still at the tail end of the industrial recession and we strategically decided to put additional capacity in order to be able to have an opportunity to deliver growth.

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And two, we have targeted ourselves with completely revitalizing our product portfolio, which we have started to do as our most recent announcement demonstrate. And we felt that with these new products that we will bring online, we will require that incremental capacity well into the future. We also didn't anticipate that we're going to fill that capacity in year one after we bring it online, and that's how this is playing out. And we anticipate it will fill that capacity over a longer period of time. So, I hope that I answered those two components of your question, and I'm very happy to add anything else that I missed.

Jason Makishi
Analyst, Barclays Capital, Inc.

Q

No. Thank you. Thanks for the detail.

Operator: Your next question is from Josh Pokrzywinski with Morgan Stanley. Your line is open.

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

Q

Hi. Good evening. You've actually got Sawyer Rice on for Josh.

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

A

Hi, Sawyer.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi, Sawyer.

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

Q

Maybe just a couple here from me. First, maybe continuing that vein, just thinking about the potential downside scenario here. How do you guys thinking about your ability to accelerate some of these potential restructuring if things do inflect more negative here?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Well, I think we'll take – you'll see us take some typical restructuring actions that are a little more short term and more responsive to the environment. The broader program that we outlined is more structural in nature and it's just going to take time; of course, we'll try to do it a little bit faster. But I think what you rather see, Sawyer, is us augmenting that with more typical restructuring actions that can be executed in a much shorter timeframe.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Now, I would add on that, Sawyer, that make no mistake, we're going to be very pragmatic about what we see in the marketplace. And frankly, we have decided to take more aggressive reduction in output in Q1, to ensure that we position ourselves well for second half of the year.

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

Q

Got it. And then maybe just moving to more current events here, obviously, some fluid situation developing this week around trade. But maybe just help us size potential impact to gauge if we do get tariff escalation in line with what's been discussed here?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah, I'll go back to what we said last year relative to the tariffs that are in place today. We talked about kind of $10 million to $15 million direct tariff impact, Sawyer; and that's what we're experiencing through Q1. I think you can extrapolate that to a different environment. The bigger issue frankly for us would be the business environment in China, which is a very large market for us. And frankly, we're also seeing that spillover into some of the countries that also sell into China.

So I think we talked about seeing a little bit of softness with machine builders and exporters, and that's where I think we see the broadest impact. But from a direct tariff impact, we're kind of in that $10 million range now, that could step up, we would take the same approach of trying to price for it, we'd get a partial year impact of that. But because of our in-region, for-region, it hasn't been the biggest number for us. There's just a few product categories that we import from China.

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

Q

Got it. And then maybe, if I could just squeeze one more in. Europe sounds maybe a bit weaker than expected. It sounds like some pressure in auto that was unforeseen, and obviously some of the destocking. But anything in non-auto businesses there that have you more cautious heading into the rest of the year? Thanks.

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

A

I think that the industrial performance was actually pretty good for us in Europe in Q1. Again similarly, Sawyer, to what I said about the broader set of opportunities in FP, we see very significant set of opportunities ahead of us with FP in Europe in particular, where we have now put a large-scale Fluid Power plant and we believe that we are very well positioned to be able to execute on the longer-term vision and fulfill the promise of putting that plant in there to take more market share with our highly-competitive products in Europe.

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

Q

Great. Thanks.

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

A

Thank you.

Operator: And this concludes the Q&A portion of today's call. I'll now turn things back over to Bill Waelke, for any closing remarks.

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Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thank you, everyone, for joining the call and for your interest in Gates. We look forward to updating you on our first half progress in August. Have a good evening.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you.

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

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