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Gates Industrial Corp. Plc (GTES)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day. My name is Jarc, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Gates Industrial Corporation Q2 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]

It is now my pleasure to turn today's program over to Mr. Bill Waelke. Sir, the floor is yours.

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

Thank you, and thanks to everyone for joining us today on our second quarter 2019 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 second quarter results. A copy of the release is available on our website at investors.gates.com. Today's call is being webcast and is accompanied by a slide presentation.

On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. Reconciliations of historical non-GAAP financial measures are 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 expressed or implied by such forward-looking statements. These risks include, among others, matters that we

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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. Ivo?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good afternoon, everyone, and thank you for joining us today. Our second quarter results did not come in as we expected at the time of our last earnings call. As we move along our presentation today, I'll be providing additional color on what we are seeing in the markets, as well as the associated impact on our earnings.

Before I start, I'd like to take this opportunity to reaffirm our commitment to delivering the long-term strategic objectives we discussed at our Investor Day in February. We are committed to driving the growth in our business and firmly believe we have the right strategy in place to do so. We have invested significantly in our product development capabilities to organically drive the evolution of our product portfolio, and we are on the way to realizing the benefits of those investments.

We have added production capacity to support the growth of our new products and to facilitate the consolidation of less efficient components of our geographic footprint. Both of these objectives remain firmly in place, and while they'll put additional pressure on our results given the evolving market backdrop, we are positioning our business to drive sustainable growth in the future.

Now moving to slide 3 of our presentation material, our second quarter revenues came in lower than we expected, with the demand environment decelerating as the quarter progressed. Our revenue in the quarter declined 4.8% compared to the prior year, which was a departure from the trajectory we saw exiting Q1. Our industrial end markets decelerated, and the associated core revenue declined 2.3% year-over-year, with the agriculture end market experiencing the largest decline. In response to these softening industrial market conditions, many of our replacement channel partners, particularly in North America, continued to recalibrate their inventory positions in Q2. Despite the additional destocking we experienced, our industrial end market revenue in replacement channels outperformed [indiscernible] (00:04:44) channels.

Sales into the automotive replacement channels were mixed in the quarter. We continued to experience challenging market conditions in Europe, with the revenue down high-single-digits, largely due to the broader uncertain economic outlook, as well as the unfavorable weather. In North America, which is our largest automotive replacement business, we saw a modest decline. These declines offset the continued high-teens growth in China, where we are building on our leading product portfolio and distributor coverage. As we anticipated, our automotive first-fit business in Europe and China experienced double-digit year-over-year declines, driven by a combination of market weakness, program timing, and increased sensitivity around our pursuit of new programs. This environment was generally consistent with what we have seen in the previous two quarters, although we did see some increased deceleration in China automotive first-fit markets towards the end of the quarter. As I said, the performance of automotive first-fit in the quarter was largely anticipated, and if we look at the core growth excluding this impact, we would have been down 3.6% on core basis.

Looking at the specific regional results, in North America, our overall revenue performance in the quarter was down low single digits on a core basis. Modest growth in our oil and gas and heavy-duty truck businesses was more than offset by decline in all other end markets, nearly all of which decelerated as the quarter progressed. We saw the sharpest year-over-year decline in agriculture, impacting both the first-fit and replacement channels. In Europe, we experienced a high-single-digit core revenue decline, in line with what we saw in the first quarter.

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The decline was led by the continued challenges in the automotive end market, as well as the agriculture end market, which experienced a significant deceleration in the quarter.

In China, our Q2 mid-single-digit core revenue decline was also in line with the first quarter. Deceleration across industrial end markets, combined with the expected automotive first-fit weakness, was partially offset by the strong growth in our automotive replacement business. Exiting Q1, China showed signs of stabilization. However, Q2 was a change in trajectory. The construction end market in particular saw the most notable deceleration in Q2.

In our East Asia region, we began to see a more pronounced spillover effect from the weakening economic situation in China. Our high-single-digit decline in the second quarter was a deceleration from the first quarter, driven primarily by weakness in construction end market in Korea, as well as the general industrial end market in Japan.

With respect to profitability, our second quarter adjusted EBITDA was $165 million, representing a margin of 20.4%, a decline of 300 basis points from the prior-year period. As anticipated, this decline was gross margin driven, impacted by actions taken in the first quarter to align our output and inventory levels with the market environment. We saw additional gross margin headwinds from the consistent decline in revenue that we saw in Q2, and some additional margin impact from the long-term investments made in support of our long-term organic growth strategy. We are confident these investments in our new facilities, as well as in the evolution of our portfolio to capitalize on the significant industrial opportunities we see for our business, will enable future growth and enhance profitability. However, they are having the near-term effect of magnifying our margin contraction in these declining market conditions.

Our second quarter adjusted earnings per share of $0.26 was a decline from $0.38 in the prior-year period, driven primarily by the lower adjusted EBITDA. Excluding our investment in fluid power capacity, our Q2 LTM free cash flow of $219 million was largely in line with the prior-year period, despite the lower adjusted EBITDA. The uncertain market conditions and negative momentum we experienced coming out of Q2 have resulted in us revisiting our view of the full year. Given that our business is mostly short cycle and essentially operates on a book-ship basis, it remains unclear if these market conditions are indicative of a short-term pause or an environment that may persist for a more extended period. We therefore believe it is appropriate to reset our full-year outlook to reflect the market conditions we saw exiting Q2 and subsequently in July.

While continuing to operate the business with a long-term perspective, we are of course mindful of the near-term challenges and acutely focused on managing what is under our control in this environment. As a result, we are taking a number of actions to mitigate the decline in margins and maximize free cash flow generation. In addition to productivity initiatives and managing compressible operating costs and G&A expenses, our recent footprint investments helped position us to accelerate and expand upon our previously announced restructuring program, which David will cover in more detail in a moment.

We remain committed to deleveraging the business. As we adjust our working capital level and reduce our capital expenditures, we anticipate generating a substantial amount of free cash flow this year. Our stated goal of bringing net leverage below 3 times remains a high priority, although we no longer expect to achieve it this year due to the change in market conditions. However, we are comfortable operating with our current capital structure and have demonstrated the ability to deleverage the business as the top line stabilizes.

Moving now to our segments beginning on slide 4, our Power Transmission segment core revenue declined 5.3% in the quarter, while total revenue declined 8.8%, including a 3.5% foreign currency headwind. Our quarterly end market performance in Power Transmission was largely in line with the revenue trends I covered. From a regional

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perspective, declines were broad-based. Emerging markets again underperformed developed markets due largely to the expected decline in automotive first-fit business in China.

Our Power Transmission adjusted EBITDA declined by approximately $28 million in the second quarter compared to the prior-year period, driven primarily by lower volumes and the associated manufacturing inefficiencies, as well as FX. The resulting adjusted EBITDA margin contracted by 320 basis points compared to the prior-year period.

While we are mindful of the business environment, we will continue to prudently invest in the evolution of our product portfolio in order to advance our organic growth. We are confident that the significant opportunities we see across a wide range of industrial end markets will contribute meaningfully to our future growth.

On slide 5, our Fluid Power segment had a core revenue decline of 3.9%, with total revenue declining by 5.3% compared to the prior-year quarter, including a 1.9% FX headwind and a 50 basis point acquisition benefit. Our Fluid Power end market performance was also broadly in line with that of the total company.

On a regional basis, our strongest Fluid Power core revenue growth was in South America, led by strength in mobile equipment markets. Our highest rate of decline was in East Asia, driven by weakness in Korea, Japan, and India. Core revenue growth in emerging markets grew modestly in the quarter, led by growth in our oil and gas business in Middle East and general industrial business in Brazil.

Our Fluid Power adjusted EBITDA declined by approximately $12 million compared to Q2 2018. The decline in adjusted EBITDA and resulting margin performance were primarily attributable to the lower volumes and investment in new facilities completed at the end of 2018.

Similar to our Power Transmission segment, organic growth initiatives remain a high priority in Fluid Power. In late 2016, we took the decision to invest significantly in our Fluid Power segment, where we have a large underpenetrated core market opportunity, the largest portion of which is comprised of industrial applications. We have invested in our footprint to expand our geographic presence, as well as in enhancing our product development capabilities to bring a pipeline of value-added new products to a market that has historically not seen a substantial amount of innovation. When we made this decision nearly three years ago, [ph] we did felt (00:17:54), with the recognition that despite changes in market conditions being possible, this was a long-term opportunity for the company.

Our belief in the market opportunity and our future growth potential remains unchanged. Although the current market environment has not been helpful, we have seen solid early traction with our new products, with a meaningful number of customers adopting them globally in both the first-fit and replacement channels. Although our investments in new products and the footprint will be a near-term headwind, we expect these to be meaningful drivers of our growth as the market stabilizes.

With that, I will now turn it over to David for some additional details on the financials before I wrap up our prepared remarks. David?

David Naemura

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks, Ivo. I will now cover our financial performance beginning on slide 6. Revenue in total declined 7.5%, including a negative 2.9% impact from FX and a positive 0.2% impact from acquisitions. As Ivo noted, in Q2, we saw deceleration through the quarter, primarily in industrial end markets and the replacement channels in general.

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As some additional context, on our last earnings call, we discussed seeing a mixed Q1 overall, but that we did see some improvement as the quarter progressed with growth in the month of March. As we exited Q1, we saw some stability in April, particularly in North America, followed by a notable deceleration through May and June. The environment that we saw exiting the quarter continued in July. This resulted in second quarter revenues and adjusted EBITDA coming in below our expectations.

The gross margin pressure was amplified due primarily to a couple of factors: First, we had established our cost of sales footprint to facilitate the much stronger demand environment exiting 2018. We began adjusting our cost structure in Q1 and are now responding with further actions as we continue to adjust to the declining demand environment that we are experiencing. Secondly, the prior-year comparable represented all-time record quarterly performance with revenues of $875 million and an adjusted EBITDA margin of 23.4%.

I will touch more on the additional actions we are taking in response to lower revenue levels when I discuss our restructuring plans later in this presentation. Our second quarter adjusted EBITDA margin was impacted by the gross margin decline associated with the lower volumes that I referenced, as well as the impact of reducing inventory during the quarter. The decline in gross margin was partially offset by reductions in SG&A, with the net result being a 300 basis point decline in adjusted EBITDA margin. The decline in adjusted EBITDA impacted our adjusted earnings per share, which declined $0.12 compared to the prior-year quarter.

Moving to slide 7, since the contraction in adjusted EBITDA has been more notable, let me take a moment to recap the progression of the year. We entered 2019 in a more supportive demand environment, having just completed a substantial investment to support our growth initiatives and facilitate the optimization of our manufacturing footprint over the mid-term. We announced a restructuring program enabled by this investment and other productivity improvements of the past few years, something we intended to implement independent of the market conditions. As we progressed through the first quarter, it became clear we were entering a more challenging market environment. In response, we identified and began to implement a number of activities to align our output and inventory with the prevailing market conditions.

On our last earnings call, we communicated that these actions would negatively impact margins in Q2, which was the case. However, as we move through the second quarter, it was apparent that the end market conditions were decelerating further, putting increased pressure on our margins. Although a near-term headwind, our recently completed growth investment is allowing us to now expand and accelerate the previously announced restructuring program.

You'll see that this slide reflects the expansion of the broader restructuring that we introduced last quarter, which was intended to remove structural fixed costs in our manufacturing and distribution footprint, as well as in our SG&A back office functions. We will be accelerating and expanding the rooftop consolidation activities, and while we are still finalizing the plan estimate that this will result in approximately $20 million of incremental costs to achieve an additional annualized benefit of $15 million. This is in addition to the actions announced last quarter and results in total targeted annualized restructuring benefits of $40 million.

We previously communicated that most of the planned cost of the organization of the original plan would be incurred in 2020. And while that predominantly remains the case, our acceleration may result in some of that spend being pulled forward to 2019, thereby also accelerating the savings impact next year. In addition, we anticipate some level of restructuring charges in 2019, facilities associated with the rightsizing of our production head count and SG&A control. In recent years, we have incurred restructuring costs in the range of $10 million to $20 million. We anticipate that we would still be in that range this year before any impact from acceleration of the larger structural actions that I described.

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Slide 8 provides detail on key cash flow items. Trade net working capital as a percentage of LTM revenue increased, as we are currently carrying an elevated level of inventory because of the shift in demand that we have experienced over the first half, and exaggerated by the deceleration we experienced in Q2. Our free cash flow is presented on a last twelve months basis, and therefore reflects a portion of the higher CapEx spend in the prior year.

In the second quarter, our CapEx was down approximately $35 million from the prior year Q2, which helped maintain our LTM free cash flow at only $8 million below the prior year, when excluding our expansion CapEx, and actually $36 million higher than the prior year on an as reported basis.

With respect to leverage, we ended the quarter with a net leverage ratio of 3.7 times, flat to Q2 of last year, despite the lower operating results. This is a higher level than we had previously anticipated and a function of the reduced EBITDA levels that we have experienced in the first half of the year, with some offset by reducing CapEx.

Given the deceleration that we experienced through the second quarter and what we observed in July, we believe that the demand environment has significantly shifted from our view a quarter ago. Further, considering the short cycle nature of our business model, we believe that it is prudent to reflect this weaker environment continuing through the remainder of the year, with some of our end markets decelerating further. With this view, we are reducing our full-year core revenue guidance to reflect a decline of 5% to 7%. Our reduced revenue guidance reflects core growth of about negative 8.5% in the second half, with Q3 core growth a couple of 100 basis points worse than Q4 due in part to the easing compare in Q4.

Based on the significant revenue reduction, we are lowering our adjusted EBITDA guidance to a range of $590 million to $630 million. This reflects continued high decremental margins for the year overall, as we implement further manufacturing cost reductions and inventory take-out in response to the anticipated decline. Given our high gross margin and the percentage of fixed costs in our production model, responding to this level of revenue change will require some additional footprint consolidation, which we mentioned in our restructuring section.

As Ivo noted, the investments we've made to support our long-term Fluid Power growth have some negative drag in the current market conditions, but will allow us to more rapidly consolidate certain subscale operations, which is a critical component of our restructuring plan. Our actions will continue to adjust compressible costs to the current market environment in the year, and then execute our restructuring plan to remove structural fixed cost. We are also reducing capital expenditures with a new target of around $110 million. We believe that we will still have full-year free cash flow conversion of greater than 80% of adjusted net income.

Given the change in the environment from the beginning of the year, we will not achieve our deleveraging objective in 2019. Deleveraging to a level below 3 times remains a high priority for us, but the timeframe under which we achieve this objective will be extended. Having said that, the cash generation ability of our business, particularly as we reduce CapEx and inventory to more normalized levels, allows us to be very comfortable at the current leverage levels, even when taking into account the present market conditions.

Finally, I wanted to comment on two SEC filings you may have seen late this afternoon, a Form S-3 shelf registration statement and a preliminary proxy statement. These are routine filings that provide us optionality for share repurchases and issuances and are being made in the ordinary course. Under UK law, we are required to obtain shareholder approval for any plan to repurchase shares, which is why the proxy statement is required.

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

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Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks. Given the current market conditions, the year is not expected to play out as we had originally envisioned. We have accordingly reset our full-year view based on the current environment and are fully committed to the execution of our restructuring programs, as well as our focus on margin improvements and operational initiatives. We are encouraged by the progress we have made in our large organic growth initiatives and will continue to invest in this area to ensure we are able to capitalize on future growth potential.

Our strategy and priorities remain unchanged. And we will continue to manage the business for the long term, while taking appropriate actions to navigate the challenges presented by the current conditions. As you can tell, despite these short-term challenges, we remain confident in our business. Our products play critical roles in important applications and need to be replaced. There will be shorter-term market-driven fluctuations in the business, but this basic tenet remains unchanged.

We have a longstanding presence in high-growth regions, and while we are presently experiencing some volatility in those markets, we believe we are positioned well to take advantage of their long-term growth prospects. We have directed a significant amount of investment to expand our presence in the industrial end markets over the past couple of years to broaden our geographic reach, refresh our product portfolio, and revitalize product-centric commercial and engineering capabilities. Industrial end markets represent our largest organic growth opportunity, and we are encouraged by the progress we have seen, as well as the growing pipeline of opportunities. The current market backdrop is providing to be a headwind, but we are confident that the investments will assist us in driving incremental growth through the cycle.

With our larger capital investments now mostly behind us, our free cash flow generation is poised to improve and return to more typical levels going forward. This will support our objective of continuing on a path to deleveraging the business and strengthening our balance sheet. We are confident in the quality of our franchise, and combined with our team's collective experience of managing the business trade downturn before. We have confidence in plans in place and our ability to execute through the cycle.

Thank you. And we will now turn the call back over to the operator to begin the Q&A.

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Julian Mitchell with Barclays.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good afternoon.

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

A

Good afternoon, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Maybe just a first question around the decremental margin assumptions. It looks as if you're guiding for those to be around sort of 40% to 50%, I think, at the operating level in the second half. Just wanted to check if that's roughly correct, and what does that embed for under-absorption efforts on your part to try and clear out excess inventories quickly?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Julian. It's Dave. You're about right. I'd say once you consider that we'll probably be taking out about $35 million of inventory in the second half, the underlying decrementals are about 50%. And what that reflects is us having an experience not too dissimilar from what we had in the first half, where we're having to make a large adjustment to a new level of revenue. So we're having to remove direct labor and kind of semi-fixed cost in a rapid manner and in response to the decline in revenue, and that's what results in the negative decrementals.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you. And then a second question maybe for Dave as well. Just on that free cash flow guide, I see the conversion rate guide of 80% for the year. But understood that there are a bunch of adjustments within that adjusted net income line, so maybe if you could give us any help as to what dollar numbers for free cash flow you're thinking for this year relative to about $22 million in the first six months?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

We think we would be – look, there's a lot of moving parts still in the year, Julian, particularly around working capital, but we would think we would be in that $250 million range for the year.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Understood, and that's with that big inventory reduction in the second half?

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yes.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Julian.

Operator: Your next question comes from the line of Jerry Revich with Goldman Sachs.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes, hi, good afternoon. Can we just dig in a little bit more on the decremental margin topic that Julian brought up? So, as we think about in a – [ph] for a level on (00:35:00) business like you folks have, you typically look for decremental margins to be slightly better than gross margins, and obviously we're looking for decremental margins that are worse than that in the back half of the year, and I'm just wondering if you could just expand on what levers are you folks [ph] opting not (00:35:16) to pull to get the decremental margins lower, and under what scenario would you go into that next layer of cost savings that might result in [indiscernible] (00:35:27)?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Jerry, thanks. Look, depending on how quickly we take out cost, I think 50% would represent us kind of flexing the costs that are rather adjustable within the year pretty well. So I think we're not holding back on any cost take-out, but I think we're trying to address those costs that are within our control. The tough part is the fixed cost base, and so – and that's what we're getting after next year. I would go back to the beginning of the year where we said, that was always part of our plan to consolidate some of the less efficient components of our fixed cost base as a result of the productivity initiatives we have had over the prior year, that's somewhat enabled by the new capacity we've put online. And now we will look to do more of that than we had previously anticipated to set ourselves up for next year as we get the more variable costs off the books in the current year.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And in terms of – just for context, [indiscernible] (00:36:31) sales were down 20% peak to trough, the run rate in the back half of the year is halfway there. Just hypothetically speaking, if we do have demand to take another leg lower than the fixed cost reductions that you're talking about, what kind of decremental margins would we look for on that next leg down in sales, and hopefully the conditions won't be that bad, but just for context, how do you expect decremental margins to perform from here if demand deteriorates?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

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Jerry, first of all, one of the reasons we're trying to be as realistic as we can about what we see today is so that we can get ahead of the next leg for the rest of the year of potential cost reductions in our manufacturing footprint. But kind of our decremental rate, without taking out fixed cost of 50% to 55%, would still hold true. And so we're hoping – we've been reactive here a little bit as we've seen the market move beneath our feet and decelerate in the second quarter, so we're hoping to go a little more in front of it by the time we exit the year and position ourselves well for next year.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And lastly, I'm wondering if you could talk about what you're seeing in terms of your industrial aftermarket sales performance in the quarter, and whether that's deteriorated in 3Q as you've guided to for the business as a whole.

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

A

Sure, Jerry, this is Ivo. We've definitely seen deceleration as the quarter progressed, particularly anything ag related. And so we have been pretty pragmatic looking at the back half of the year and extrapolated the deceleration for the second half.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And that's in aftermarket as well, Ivo, just to be clear?

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

A

That's both, yes.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Jerry.

Operator: Your next question comes from the line of Andy Kaplowitz with Citi.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good afternoon, guys.

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

A

Hi, Andy.

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hey, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, I just wanted to ask you about this downturn versus previous downturns and how the businesses are acting. One of the attributes of the company in the past was that its large replacement business would lead to some resiliency in the downturn, but those businesses, I think in most cases, have weakened as much as first-fit during this downturn. So, why do you think your replacement businesses have not been more resilient this cycle, and what's your visibility toward North American and European auto replacement market in particular stabilizing at this point?

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

A

Sure. So through the cycle, the replacement businesses are more resilient, Andy, than our first-fit businesses, and we've certainly seen that in Q2 as well. But as market moves, you have a tendency to see the replacement businesses to decelerate first and reaccelerate first. And so our view is that we will see the same type of a behavior that we have seen over the last couple of recessions in – during this market uncertainty that we are experiencing today.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks for that, Ivo. And then just focusing on the guidance, Dave, you mentioned that your new revenue and EBITDA guidance for the year is reflecting the demand as you exited Q2. Have you seen any stabilization here over the summer in July, and what do you think the risk is that your business could still get worse? You've mentioned ag a few times, obviously there's still some tariff-related noise around ag, so how much have you discounted the risk in ag in particular?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Andy, what we saw in July was rather consistent with what we saw in June. And as we look to the rest of the year, we've kind of, as you said, extrapolated that environment, but we did include a little bit of further deceleration, which is why you see the back half coming in at negative 8.5%. We know automotive first-fit this year is soft, and that hasn't been the cause of the further deceleration we've had that caused reasonably close, but – [ph] that called (00:40:44) reasonably close, but it's really the industrial end markets as Ivo referred to, plus maybe a little bit of incremental softening in China, as we saw through June and July, that we've extrapolated to the rest of the year, so that environment plus a little bit of deceleration in some of the industrial end markets.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

And Ivo, I just wanted to ask you about Chinese auto replacement, it's been obviously quite strong and resilient. Do you see that continuing? Is it sort of new product related on your part, just the market itself? Maybe any more color there you could give us on resiliency in that market.

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

Sure. So, look, I mean, the Chinese auto AR business is expected to continue to deliver solid growth for us for foreseeable future, primarily driven by the positive dynamics in growing installed base of cars in use or a car parc. The business grew approximately 16% in Q2. And our very strong coverage of our portfolio, with continuation of build-out of the distribution presence in Tier 2, 3 and 4 cities, gives us the confidence that we should continue to see positive attributes with that business in China.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Thanks, guys.

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

Thank you.

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

Thanks, Andy.

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

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thanks. Good afternoon, everyone.

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

Good afternoon, Deane.

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

Hey, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, could we talk about pricing? Oftentimes in downturns, you get different pricing behaviors out of competitors. And have you observed anything, any sort of responses, competitive responses here, maybe if we start there, please?

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

I would say, Deane, that we start to see a somewhat more competitive backdrop to the market particularly in Europe, where we have seen much more market compression over the last couple of quarters. So there, we see

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that it's becoming more competitive. In North America, less so, to be honest with you, and in China, we haven't really seen tremendous pricing compression or competitive threat in terms of [ph] pricing it (00:43:11).

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Understood. And then I may have missed this, but when you talked about the restructuring plans being layered this year and next year, it sounded like there was an opportunity to pull forward some of the restructuring and do more of this, but it sounded tentative. What's that contingent on, and why – what would the – like the gating factors be why you would not accelerate these restructuring actions further?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Deane, we will definitely look to, I think, a little of the tentativeness, as you put it, would be around just the execution particularly in some of the foreign jurisdictions and some of the complexities associated with moving lines. So, we will push it as hard as we can, but we also recognize that we have to be careful of taking some risks that are inherent in some of these projects.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got that. And then I think I missed this in your answer to Andy's questions, because it came up also in prepared remarks that you are assuming some markets decelerate further. Were those geographic references, or there's particular verticals that you think worsen from here?

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

A

We have anticipated that particularly in North America is going to decelerate further, and industrial markets, primarily driven by ag, are going to decelerate further into second half.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. Okay. Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Deane.

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

A

Thank you, Deane.

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

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

Q

Hey, good afternoon, guys.

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi, Jeff.

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

Q

Hey, so I think you called out like drawing down inventories, $35 million. I'm just trying to get a sense of if you take the destock you're seeing from your distributors and then your destock, like where do you think we are versus normal as you enter 2020 given the demand landscape? And just any learnings from kind of assessing where inventories were? It just seems like maybe you got caught a little off guard by the inventory levels here.

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

A

So, Jeff, I would say that we have seen a good amount of destocking [ph] role to (00:45:33) the automotive replacement channels, particularly in Europe and North America in the first half. And our sense is although – as you can imagine, it is difficult to predict precisely, but our sense is that that is working itself through, and we're probably closer to the end of that destocking at the beginning. We have seen an acceleration of destocking in the industrial channel, particularly in North America, where the destocking has been much more pronounced versus the sales out. And so our sense is that our customers are readjusting the inventory position towards a lower level of visibility as we roll into the second half. And we are probably kind of in more early stages or [ph] earlier (00:46:26) stages of destocking in the industrial channel, particularly in North America presently.

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

Q

Okay. And then I think your guidance is just kind of high-single-digit, low-double-digit declines for the back half. Can you just give us a sense of what OE looks like within that mix versus aftermarket?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Jeff, we're not giving the guide by channel, but I would say rather – I would say most of the deceleration, the incremental deceleration is going to be more so related to industrial, and we're seeing it both on the aftermarket and the first-fit side.

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

Q

Okay. And then just last one on the comment about the filings and repurchase, like you're not considering – I mean, is it basically the reason you put those one out because you're thinking of buying back stock, or just how do you think about buyback given the leverage?

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. Those filings are done in the ordinary course of business to give us the optionality to do that in the future, and they're not associated with any current plan. We've talked about our priority being deleveraging the business while doing what's right for the long-term health or growth of the business, and that remains unchanged.

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

Q

Okay. Thanks, guys.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks, Jeff.

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

A

Thank you.

Operator: There are no further questions at this time. I will now turn the call back over for closing remarks.

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

All right. Thank you, everyone, for joining us on the call. As always, the team here is available for any follow-up questions, using the contact info on the press release or on the Investor Relations website. Have a good evening.

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

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