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Gates Industrial Corp. Plc (GTES)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Gates Industrial Corporation Third Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to your speaker today Bill Waelke. Thank you. Please go ahead sir.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thanks Erin, and thanks to everyone for joining us today on our third quarter 2019 earnings call. I'll briefly cover our non-GAAP and forward-looking language before passing the call over to Ivo, who will be followed by our CFO, David Naemura. After the market close this afternoon, we published our third 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 in or implied by such forward-looking statements. These risks include, among others, matters that we have described in our most recent Annual Report

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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. The results for the third quarter came in, in line with our expectations. In Q3, we remain focused on reducing our variable cost structure, driving down the levels of our inventory, and last month, we announced the first impacted facility that is part of our fixed cost restructuring program. We are quite pleased with the progress we've made in Q3. And while a significant amount of work is ahead of us, we believe, that we will be better positioned heading into 2020. That being said, our business based industrial end markets did remain under pressure and decelerated as quarter progressed in line with what we had anticipated.

Our automotive end market, however, saw signs of stabilization in Q3. Our automotive first-fit business improved sequentially from Q2. As did our automotive replacement business, which saw normalization of the destocking, we experienced in the first half of the year and overall improved business conditions. Jumping right into slide 3 of our presentation material, our revenue in the quarter declined 8.5% on a core basis compared to the prior year period. Our industrial end market continued to be impacted by additional channel inventory destocking, and reduced demand, particularly in the mobile hydraulics market. This is consistent with the trajectory of the business environment that we've noted on our last earnings call.

Sales into agriculture, construction and general industrial end markets, all experienced low double digit declines, while sales into the energy and heavy duty truck end markets were down mid to high single digits. In response to the industrial end market conditions and in combination with trade uncertainty, we experienced an accelerated level of destocking at key replacement channel partners, particularly in North America.

Sales into the automotive replacement channel were mixed in the quarter. In North America, our automotive replacement business decelerated modestly from the second quarter primarily due to some unique compare items, but the underlying business environment improved relative to Q2 in the first half. We are seeing signs that the recent destocking in the auto replacement channel appears to have normalized. In Europe, where we also faced a difficult prior year Q3 compare our business improved from the second quarter, helped by more typical weather patterns and reduced [ph] destocking (00:05:39) pressure. This year over year decline offset the mid-teens automotive replacement growth in China, which remains a resilient high growth market for Gates and we anticipate continuing to deliver a similar level of performance for the foreseeable future.

In total, our automotive first-fit business was down mid to high-single digits in the quarter, also, an improvement from what we experienced in the most recent quarters. Although our largest market of Europe and China were down mid-teens in a quarter, we are beginning to round trip the sharp declines that began last year and we believe we will see business stabilization as we head into 2020.

Looking at our results by region, in North America, our overall revenue performance in the quarter was down high-single digits on a core basis. Nearly all of our industrial end markets were down mid-teens led by the agriculture and general industrial. The declining industrial end market conditions impacted us across channels with first-fit customers reducing production and replacement channel partners reducing inventory levels in response to the environment. In Europe, we experienced a high-single-digit core revenue decline in line with what we saw in the second quarter.

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The decline continued to be led by the challenges in automotive first-fit, although this decline was sequentially much better than Q2 and was offset by the decelerating industrial market. Furthermore sales into our industrial end market, most notably agriculture and general industrial, experienced deceleration in a quarter.

In China, we experienced a high single digit core revenue decline in the quarter, primarily driven by first-fit sales. The decline in automotive first-fit production continued and we also experienced a significant decline in industrial first-fit sales led by construction equipment. These declines were partially offset by the continued strong growth in our automotive replacement business. I would note that based on the recent activities, we believe we will start seeing a return to growth in the near-term in China. The collateral effects of the challenging China macro environment remain noticeable in our East Asia and India region. The high single digit core revenue decline in the quarter was a slight deceleration from the second quarter driven primarily by weakness in the construction end market in Korea as well as the general industrial end market in Japan, while India saw deceleration driven by reduced activity in the auto and commercial construction first-fit market. As a result of the lower revenue volumes, our adjusted EBITDA in the quarter was $145 million, representing a margin of 19.4% a decline of 250 basis points from the prior year period.

Our adjusted EBITDA margin decline was a function of lower gross margin which was impacted by not only the lower revenue volumes but also by a reduction in our inventory levels which further impacted production output and the associated absorption. We are making solid progress in adjusting compressible costs across our manufacturing footprint and our global teams are executing well on our previously announced plans to reduce our fixed cost structure, which we expect will begin benefiting us meaningfully in 2020.

Our third quarter adjusted earnings per share of $0.22 was a decline from $0.30 in the prior year period, driven primarily by the lower adjusted EBTIDA somewhat offset by lower tax and interest expense. Our free cash flow in Q3 was $65 million, which represented a solid 100% conversion of our adjusted net income. The environment in our mostly short cycle end markets remain very dynamic. However, based on our recent view, we believe our full year guidance contemplates the challenging conditions that we expect to persist through the fourth quarter. Therefore, we are maintaining the guidance that we communicated in the previous quarter. With the continued impact of external factors creating uncertainty in our end markets managing what is our under control is essential. We have made solid progress adjusting our variable costs and manufacturing output and have reduced our inventory levels by over $50 million since the end of Q1 on top of the inventory we have seen coming out of the channel. Although this has been challenging, we believe it will set us up well for 2020. While we have implemented appropriate cost control actions, we are continuing to fund our major organic growth initiatives and related new product development across both of our segments, particularly as our end markets recover. We believe these investments will position us well for long-term growth.

As we discussed on our last call, the recent investments made in our footprint are enabling us the execution of our expanded restructuring program. Last month, we announced the first manufacturing plant action under this program, kicking off the consolidation of certain Fluid Power production within our North American footprint. We are working to accelerate these initiatives where possible and expect to announce additional actions in the future.

Moving now to our segments beginning on slide 4, our Power Transmission segment core revenue declined 6% in the quarter, a small deceleration sequentially from the second quarter. Sales into our industrial end markets remain challenged, led by anticipated declines in general industrial, construction, and energy, while we experienced a modest sequential improvement in our automotive end market. From a regional perspective, our Power Transmission business in South America was a bright spot as it grew solidly in the quarter but was offset by declines in the rest of the regions. Emerging market slightly outperformed our developed markets but both were down mid-single digit in total. Our Power Transmission adjusted EBITDA declined by approximately $19

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million in the third quarter compared to the prior year period driven primarily by lower volumes and to some degree, mix. The resulting adjusted EBITDA margin of 21% contracted 220 basis points compared to the prior year period.

Regarding our growth initiatives, Q3 saw incremental wins in South America, the Middle East and North Africa with the Micro-V belt platform we launched late last year targeted at emerging market. This comes on top of the wins we have already seen with this platform in places like Mexico and India earlier in the year. We also continue to make progress on our industrial and mobility Chain-to-Belt initiatives with solid wins in food and beverage, material handling, e-bikes and e-motorcycle applications just to name a few.

Moving on to slide 5, our Fluid Power segment had core revenue decline of 12.7% compared to the prior year period, representing a deceleration from what we saw in the second quarter. The largest year-over-year decline was in mobile equipment primarily in the agriculture and construction end market. But the weakness we experienced was broad-based across the majority of industrial applications.

On a regional basis, China was down the highest percentage at greater than 20%, driven most notably by the decline in first-fit construction equipment. North America was down mid-teens with softness in all industrial end markets but particularly sharp declines in agriculture and general industrial where we saw our customers reduce production output and channel partners continue to rightsize their inventories.

Our Fluid Power adjusted EBITDA declined by approximately $17 million compared to Q3 2018. The decline in adjusted EBITDA and resulting margin contraction of 310 basis points were attributable to the lower volumes and resulting production inefficiencies as we continued the reduction of variable production costs which we believe we have already mostly rightsized as we head towards 2020. Our Fluid Power organic growth initiatives also continued to progress well. As part of these efforts, we have market launched our smart connected crimper that allows customers to quickly and reliably make safe, leak-free hydraulics hose assemblies in a field. This IoT-enabled crimper platform not only improves the crimping process itself but also provides us with a valuable insight into product consumption to enable replenishment at the customer level and provide other valuable services to our customers.

Beyond the introduction of our smart crimper we have made additional progress on our next generation hydraulics introducing new sizes of innovative MXT hoses to OEs and distribution customers.

I'll now turn it over to David for some additional detail on 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 9.9% which included a negative 1.4% impact from FX resulting in an 8.5% core decline. As Ivo noted, the revenue performance was generally consistent with what we had anticipated in the current environment and underlying the industrial-driven headwinds were some sequential improvements in our automotive channels. Our third quarter adjusted EBITDA of $145 million represented an adjusted EBITDA margin of 19.4%. We maintained our positive price cost position in the quarter and managed our SG&A spend in accordance with the environment. As we've previously noted, we have been focused on adjusting our compressible production costs to align with the current demand environment. We made significant progress during the quarter on compressing these costs but our adjusted EBITDA was still impacted by the inefficiencies associated with the lower production volumes. We believe that we exited the quarter with our variable cost structure more or less aligned with the demand environment. This progress was made throughout the quarter and the remaining inefficiencies incurred during Q3

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will be mostly recognized in Q4. So we anticipate a lower gross margin for Q4 which was contemplated in our guidance. But the key point is that we have rightsized our variable costs and we'll exit 2019 in a better position for 2020, which I will cover a bit more in the outlook discussion.

The compression of these variable costs is reflected in improved decremental margins in Q3, which are also on an easier compare. In Q4, we will have a more difficult compare on the lower gross margins that I referred to, but our underlying cost performance will be much better aligned with our expectations.

In addition to rightsizing our compressible costs, we are proceeding with our restructuring plans to address our fixed production costs, including optimizing the flexibility of our production capabilities. We announced our first plant closure action in October and we are advancing additional actions that we plan to announce at the appropriate time in the future. Our adjusted EPS in the third quarter was $0.22 which reflected the year over year decline in adjusted EBITDA, partially offset by lower tax and interest expense. For the full year, we now anticipate our underlying effective tax rate improving from the mid-20s to the low-20s percentage range.

Slide 7 provides detail on key cash flow items. The solid progress we made in realigning our production levels resulted in $37 million of total net inventory coming out during the quarter and, as Ivo noted, $50 million coming out since the end of Q1. We expect this trend to continue in the fourth quarter albeit to a lesser degree and that we will exit the year with a normalized inventory position. Our Q3 free cash flow was $65 million, representing a quarterly conversion of approximately 100% of adjusted net income. This is a significant improvement over the prior year, as we normalized CapEx back to historical levels and reduce inventory. On an LTM basis, our free cash flow of $256 million also represented a significant improvement over the prior year, again, normalizing back towards historical levels.

With respect to leverage, we ended the quarter with a net leverage ratio of 3.8 times, slightly up from Q3 of last year due to the lower operating results. Although our net leverage is higher than what we had anticipated entering the year, it is worth noting that we managed the business through the last downturn with much higher leverage and we are comfortable operating the business at the current level. Nonetheless, deleveraging remains a priority for us.

Turning to slide 8, on our second quarter earnings call, we noted that we expected the decelerating conditions in our industrial end market to continue. This is indeed what transpired in the third quarter which developed broadly in line with our expectations. And we expect the fourth quarter to remain similarly challenged. Persisting geopolitical and trade uncertainty has clearly contributed to a very dynamic environment in our end markets as well as contributing to volatility in foreign currencies.

However, we are maintaining our previously issued full year guidance, which we believe accounts for the current market conditions. We will provide our outlook for 2020 in February on our year-end earnings call, but it is worth noting that we believe we are appropriately positioning the business to exit 2019 at the right variable production cost levels and with restructuring actions in place to reduce our fixed production cost base. This should position us to drive gross margin expansion in 2020 at an improved rate and that should translate to incremental margins that are better than what we have historically seen.

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. As expected, we managed through another quarter of operating in a challenging market environment. We did see signs of stabilization in our automotive end market, while the industrial end market landscape remains very dynamic.

We have made solid progress in realigning our production and inventory levels to the current market conditions. We have seen free cash flow generation improve nicely which is a trend we expect to continue even as we continue to fund short-term restructuring and other key company initiatives. We are making headway with our restructuring programs and this quarter announced our first site consolidation. I want to recognize our global employees for their management of these key projects and I'm very pleased with the proactive steps our teams are taking to manage what is under our control.

Historical data would suggest we are well into the current downturn and we believe that the actions we are taking will position us better to operate at these current demand levels and also to perform better when market conditions improve. Our strategy remains unchanged. We are managing the business for the long-term while taking appropriate actions in response to the current challenges. Our team has had the experience of managing this business through the downturn before and we continue to be confident in our plans and 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.

QUESTION AND ANSWER SECTION

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

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

Q

Hi, good morning. Sorry, good evening. I guess a couple of questions, one, I think you commented on the call that trends sort of deteriorated as the quarter progressed. So can you just provide some color on that and what you saw into October? And then price/cost in the quarter would also be helpful. And then when we think about savings from some of the actions that you've taken so far, how do we think about sort of savings in the first half of 2020 versus second half? Thank you.

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

A

Jamie, good afternoon. We've seen a market environment that we've anticipated in certainly post Q2, and as the quarter progressed the industrial end-markets started to – they have deteriorated very much in line with what we have seen exiting Q2, and what we have anticipated in Q3 and in the second half of the year. The automotive market, frankly, started to stabilize a little bit. So net-net, we have seen the business condition, frankly, just as what we have anticipated. In terms of price/cost economics, price/cost economics – price is still positive versus cost. And as we exit 2019, we expect that price/cost economics is going to normalize and be neutral towards 2020. I'll turn it over to David to maybe provide better color on savings and the restructuring.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

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Sure. Thanks, Ivo. Yeah. Jamie, the savings from the actions that we've had so far were primarily taking out some excess production cost and that was probably $5 million plus in the third quarter. So, to the degree we've had those inefficiencies in the second half of 2019, we wouldn't see those recur in the first half of 2020, and a lot of this is going to be a little bit volume dependent of course. So, we're not giving outlook into what 2020 is going to look like, but we think we're exiting the quarter with those variable costs, pretty much rightsized which would position us well for 2020.

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

Q

Okay. Thank you.

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

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.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, you said something interesting that you think the high single-digit core growth – core revenue decline in China could return to growth in the near-term. What gives you the confidence to say that? Is it just easy comparisons in China first-fit auto that help you turn around along with continued strong replacement end markets? Is that kind of where you're getting that from?

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

A

Yes, Andy, great question. Look, definitely the comparisons in the auto first-fit is getting a lot easier as we are round-tripping pretty significant declines in the four quarters that we have experienced. Automotive replacement business continues to stay very strong, the teams are executing really well. We continue to grow mid to high-teens automotive replacement business in China. And frankly, we also have a good amount of new programs that will be ramping up into 2020, and that gives us reasonably good confidence that taking into an account not a dramatically improved market environment, so really looking at more of a present level market environment that we will see growth into 2020 and beyond.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, let me expand on that question in the sense that you kind of talked about Europe in the same vein as China when you talked about 2020. Again, is it more of auto commentary that [ph] you kind of have (00:29:45) better

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visibility that auto destocking is over now or ending? And do you think industrial destocking can run its course here over the next couple of quarters? Are you seeing sort of stabilization on the second derivative that gives you confidence with that sort of rightsized business that you talked about so that you could grow EBITDA in 2020 versus 2019?

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

A

Yeah. Again, very similar to China, we are kind of round tripping the really significant declines out of first-fit but also and remember we've talked about being lesser of a participant in auto first-fit particularly in Europe with more of the traditional products. As we are moving into 2020 and beyond, we will be launching new products that are specifically targeted in the automotive first-fit business into the hybrid space that are not only more complex but also will be a little better margins and we anticipate that in 2020 and beyond that will start giving us much stronger stability and frankly, start delivering some incremental growth in the auto first-fit business. In auto replacement side, we've actually seen a little better market environment. We believe that the destocking is running its course in the AR side of the business in Europe. And although we've seen deceleration in industrial, we believe that we have been experiencing that destocking in Europe industrial for couple of quarters. And we certainly believe that we don't want to call it the bottom or the end of the destocking, but as we exit 2019 and into 2020, it should start getting somewhat better as we exit 2020 kind of towards that end of Q1 into Q2.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

And Ivo or Dave, one more follow-up on that commentary, you had guided to 8.5% decline in sales really for the second half of the year. But we know that Q4 is an easier comparison, and you did 8.5% in Q3. So, did something go a little better than you expected, was it that auto side that maybe stabilized a little more in Q3, and then should you see a better or an improved deceleration, if you may, in Q4?

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

A

Yeah. I mean, the auto business frankly has been incrementally better. What I would restate is that the market conditions are more or less coming the way we have foreseen that after our Q2 call. And so, yes the compare gets easier a little bit in Q4. But Andy we also anticipate that the industrial destocking is going to continue. I think that customers are still in a wait and see -with a wait and see attitude. My expectation is that we are so close to the end of the year, they will really not try to restart until they start seeing what's happening early next year.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Ivo.

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

A

Thank you.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

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Hi, good afternoon and good evening.

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

Hi, Jerry.

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

Hey. Hi, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Can we just talk about, conceptually, the moving pieces around 2020 margins? So Ivo, you mentioned price/cost [ph] within this period to be (00:33:33) neutral. With the cost savings actions that you've put in and the inventory that's been tough to take out this year from an efficiency standpoint, are we at a point where if core growth is flat in 2020, we could be looking at margin expansion in a couple of hundred basis points, [ph] what the math (00:33:51) would imply on the destocking impact and inventory cuts this year?

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

Yeah. Jerry, I'm not going to go so far as to size next year's gross margin delta. I don't think it's quite a couple hundred basis points but I think your thesis is right that we won't have the inefficiencies from getting a little bit of excess capacity offline here. We won't have the inefficiencies of taking out inventory which further reduces our production volume and creates inefficiencies. We'll also begin to get some benefit from our restructuring programs. So assuming a neutral price/cost relationship and kind of all other things being equal, it should help us expand gross margins at a rate, frankly, higher than we have historically. So you're correct.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Thank you. And in terms of the magnitude of customer inventory destocking, I know you have better data in some regions relative to others. But can you just give us a ballpark estimate of how much your distributors have reduced inventories in this cycle compared to prior downturns?

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

Jerry, I would say that on the industrial side we see a very similar magnitude certainly in the developed countries that we have seen in that 2015, 2016 downturn. So we see very similar reaction to destocking, kind of as compared to the prior recession, nothing really more out of ordinary than that.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Thank you. And in terms of particular end markets and regions where the destocking has been the most pronounced, can you just flesh that out for us year-to-date or since a year ago when I think you started to destock?

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

I would say that the most pronounced destocking has been in North America, Jerry. And we have started to talk about destocking frankly after our Q1 earnings call or during our Q1 earnings call. So we have kind of been experiencing it now for several quarters. And so we feel that we are probably closer to the end than the beginning although we will not call whether or not we are at the end, right. So, that's probably the best color I can give you at this point in time.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Thank you.

Operator: Your next question comes from the line of Jeff Hammond with KeyBanc. Your line is open.

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

Hey. Good afternoon, guys.

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

Hi, Jeff.

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

Hi, Jeff.

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

So, Dave you gave us some good color on decrementals into 4Q and some of the dynamics there. But can you just remind us what you think more normal decrementals are and just given the restructuring when into 2020 you start to approach those more normal decrementals?

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

Well, in 2020 I mean we have to see if they're decrementals or incrementals, right? We haven't made a call on where we see revenue for 2020. But if the gross margin line is a high gross margin business and having about 25% of our cost of sales fixed we obviously decrement at a rate higher than – we have decremental gross margin higher than our run rate gross margin rate. As we were able to – and that's been exacerbated by having some excess costs and taking out inventory in the current year. So we would anticipate that as we neutral – the top line balances out or returns to growth a little bit here, it was kind of my point that as we get – we don't re-incur those inefficiencies and we're not taking inventory off the books and as those things normalize, we should experience incrementals that are greater than we have historically. And that's kind of what we would anticipate planning going into 2020, albeit it's a dynamic environment, we haven't set that guidance yet.

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

Q

Okay. And then I know you said I think overall things have kind of been deteriorating or kind of progressing in line, but it does sound like auto aftermarket feels a little bit better [ph] and Fluid Power (00:38:06) came in a little lighter in my model. So anything within Fluid Power specifically that's trending worse?

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

A

I think, Jeff the Fluid Power businesses came more or less with our forecast or anticipation. Maybe the original equipment manufacturers, I think that – I would say they're more or less in line with what we've anticipated. I mean it is not – the environment is very dynamic and we knew walking into Q3 that now we're going to see some challenges. We have – we've certainly seen the reduction in production output from our OEM customers and we have accounted for that in our guide – updated guide in the year.

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

Q

Okay. Thanks, guys.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good evening.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Hi, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hey. I just wanted to follow up on the decremental margin guide for Q4 because the EBITDA range is $40 million still. So it's a very wide range for only one quarter left. I think your previous comments had been to the effect that decrementals would be wider in Q4 than Q3. But just as you've seen Q3 behind you, do you still think that's the case and maybe just remind us what moving pieces might drive that higher decremental margin?

Julian Mitchell
Analyst, Barclays Capital, Inc.

A

Sure, Julian. In my remarks, I was trying to point out that there is a lag in which these things roll through. So as we saw the top line decline in the third quarter that creates – and as we were still in the process of reducing some of the variable production costs, that creates some inefficiency that – it's got to go into and then come out of inventory and really more so will impact fourth quarter. So that third quarter inefficiency will roll through in the fourth and then, frankly, from a compare standpoint it just is a tougher compare. So, I think the underlying – I was trying to communicate that the underlying performance we feel better about because we have the cost structure rightsized. But how and when it flows through is going to negatively impact fourth quarter.

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Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you. And then just my second question around maybe the CapEx budget, I think you spent about $50 million in the first nine months. The guide for the year is $110 million. So maybe help us understand if you really do see that CapEx surging now and maybe what's the CapEx outlook for the next, call it, couple of years. Obviously you had very elevated CapEx last year in 2018. Just wondered how you're thinking about the overall medium term cadence for capital spending.

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

A

Hey Julian. So we have previously communicated that it is our intent to bring our CapEx down closer to our normalized historical levels of kind of at plus or minus 3%. And so we've certainly been able to do that sooner than anticipated primarily due to the significant investment that we have made in 2017 and 2018. And the acceleration of that investment in 2017 is giving us some benefits – probably a little more benefits than what we have originally anticipated. So we certainly believe that that's a good number kind of mid-term. And as to adjusting a guide on CapEx, I mean, we just did not feel that we wanted to update our guidance. I mean our practice is to adjust the guidance when something significant is going to change. And we certainly feel good about what we said presently.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much.

Operator: [Operator Instructions] Your next question comes from the line of Deane Dray with RBC Capital Markets. Your line is open.

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

Hi, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. Maybe for Dave, on the free cash flow, which was a pretty impressive conversion this quarter, you got some benefit from the inventory drawdown. Just the expectation – I mean it probably wasn't baked into your guidance for the year but what's your expectation for the fourth quarter and where you'll turn out in terms of other inventory actions?

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David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Sure. So Deane, first of all, we're making good progress getting inventory out, we feel good about that. But it does – we are buying less stuff also so it has a little bit of an offset in payables in the near term. I would simplify it just by saying, look, on the last quarter we talked about a free cash flow number for the year of $250 million and I think we still feel comfortable with that.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. And just if I listen to the tone of this call, it does feel as though you've got pockets of stabilization, if I could characterize it that way. And is there any risk that you – and you've taken out the variable cost, but is there any risk that you've pushed too far in terms of cost out that might jeopardize or compromise what kind of recovery that you'd see on the other side of this?

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

A

One of the things that we've communicated through our strategy is that we wanted to ensure that our manufacturing footprint is in locations where we have much, much greater flexibility than during the last cycle. And we are certainly being able to accomplish that. So we believe that if we see an upturn coming, we will be able to react through being more flexible than what we have been, again, the last time around. So we don't feel badly about that.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. Thanks for the color.

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

A

Thank you.

David Naemura
Chief Financial Officer, Gates Industrial Corp. Plc

A

Thanks Deane.

Operator: There are no further questions at this time. I'll turn the call back over to the presenters.

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

Hey. Thanks everyone for joining us. As always, the team here is available for any follow-up questions or clarification. And we look forward to updating you on our progress in February. Have a good evening.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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