S&P Global
Market Intelligence

Gates Industrial Corporation plc

NYSE:GTES

Company Conference Presentation

Tuesday, September 15, 2020 4:20 PM GMT

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Ivo Jurek
CEO & Director

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Presentation

Deane Michael Dray
RBC Capital Markets, Research Division

Good afternoon or good day, everyone. It's Deane Dray, a multi-industry analyst with RBC. We're delighted to have next up on the agenda Gates Industrial. We have Ivo Jurek, the CEO.

Ivo, thank you for joining us. I appreciate it. Since we're now in this virtual world, where are you dialing in and connecting from today?

Ivo Jurek
CEO & Director
Good morning, good afternoon to everybody. I'm actually dialing in from my office in Denver, Colorado.

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Question and Answer

Deane Michael Dray
RBC Capital Markets, Research Division

I appreciate that. So Ivo, we were very pleasantly surprised and pleased to see the company's announcement after the close last night. This is certainly consistent with the macro theme that we've been seeing of sequential improvement, but you all had a pretty compelling positive preannouncement after the close last night. So give us an overview of what's changed in the quarter, and then we've got a few questions for you about it. Take it away.

Ivo Jurek
CEO & Director

Thanks, Deane. So look, I mean, we have seen improving trends. We've mentioned them on our Q2 call. That gave us significant confidence -- seeing that continuation of those improved trends through August and into middle of September, that gave us the confidence to raise our revenue outlook yesterday. So we are quite pleased with that as well. We are seeing a very significant improvement versus Q2, approximately 20% sequentially, which is a very broad-based recovery from where we exited Q2.

We've previously talked about the resilience of our business and particularly our automotive replacement business. And we expect that business itself to actually print positive core growth in Q3, which is terrific for us to see.

Although our first-fit customers didn't really begin to see any improvement in Q2, we started to see some slight improvements as we exited Q2, and it has continued somewhat. But certainly, the first-fit customers are not performing as what we are seeing with our replacement markets.

And geographically, look, we spoke on my Q2 call that we'll see mid-single-digit core growth in China. We still continue to be the case. EU is recovering a little bit faster than what we have seen in North America despite the very difficult first-fit environment. And that first-fit automotive environment in particular, we don't anticipate to recover until 2021. However, we have been talking about less of an importance of auto first-fit for our business well into the future, and I think that this recovery and the performance that we are demonstrating is actually demonstrating the lower reliance on auto first-fit that I think typically our shareholders have been concerned with.

So from segments perspective, FP is recovering as rapidly as PT, but PT is going to do a -- PT is going to print better numbers than FP.

Deane Michael Dray
RBC Capital Markets, Research Division

That's all great to hear. One of the points maybe you can provide some additional color is since you -- so much of your product goes through distribution, do you have any sense of the sell-in versus sell-through? And is this a restocking by distributors? Or are you seeing -- you talked about the aftermarket. Is that actually what's drawing this uptick?

Ivo Jurek
CEO & Director

Yes. So look, I -- maybe I get a little bit long in the tooth talking about destocking. We started talking about destocking in -- on the second quarter of 2019, and I think folks were a little bit surprised about that.

When we exited 2019, we felt that we will continue to see some industrial destocking through the first half of 2020, which, obviously, we have seen maybe has been a little bit more exacerbated by COVID. But on my last call, I anticipated that we will exit Q3 more properly aligned between the underlying market demand to the supply into the channel, and that certainly is what we are seeing. We are not really

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seeing any rebound in inventory restocking yet. We are seeing an improvement in the underlying market fundamentals.

Deane Michael Dray
RBC Capital Markets, Research Division

You know what? That's really encouraging. I kind of wasn't sure you would be as exact or precise in terms of the sell-through versus restocking. But -- so is your sense that there's inventory in the channel, it makes sense at current levels? Or is there a restocking that could still come through, too?

Ivo Jurek
CEO & Director

My sense is that the inventories in the channel are quite lean. And I think as we exit '20 into '21, we could see some restocking to occur as those markets start behaving, I guess, more robustly than they are even today.

Deane Michael Dray
RBC Capital Markets, Research Division

Great. And then any color on the orders in -- I know it's an uptick in orders. But in terms of size of orders, is there any sort of market intelligence you get from that as well?

Ivo Jurek
CEO & Director

So we don't report color on orders. We obviously track our orders. What I would tell you is that our orders remain above our invoicing, so our book-to-bill remains positive, which I think bodes well for the future.

Deane Michael Dray
RBC Capital Markets, Research Division

Good. All right. So I just want to step back. And I was -- enjoy reminding investors that Gates is over 100 years old. And in your debut as a public company not too long ago, this wasn't exactly the macro that you all had planned for. And you did embark on some capacity addition that was needed, so you made those investment decisions. There's a bit of a trade war that caused some destocking and then COVID happened. Assuming that you've survived all these and you made all the right actions, what does this say about your positioning now here today with the restructuring that you've taken, the capacity that you've added? Where does the business plan stand today?

Ivo Jurek
CEO & Director

Look, Deane, I don't think that I could have summed it out better. And sometimes, when you reflect on what has happened since we've become a public company, we truly have to deal with a significant amount of adversity. But I feel quite positively about where we sit today. I think that we are trying to manage for the long term without necessarily ignoring the short-term effects that we have to deal with.

We have positioned the company on to a trajectory to be able to capitalize on recovering markets. We have positioned the company, I think, on much more solid footings when it comes to driving innovation and introducing significant amount of new products into the marketplace. That was the original pretext into putting some of the capacity in place and, frankly, positioning the company with a capacity around the globe to be fully in region -- 4 regions, so to minimize any potential supply chain disruptions whether or not they are macro driven or micro events driven. And so the company has been positioned really, really well.

Now when we started to take on the capacity expansion, we also anticipated that we wanted to dramatically streamline our overall fixed overhead footprint. We had a number of facilities that were great facilities with terrific people that were manning the equipment in those facilities, but those facilities were subscale, and scaling up and putting that capacity into not only lower-cost countries but, more

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importantly, into countries where we felt we have a good access to available direct and indirect labor was very important for us.

So as we exit this period of the first 3 years in which we have been a public company, we are exiting with improving macro, we are exiting with terrific amount of new products and we are exiting with a lower cost. So we are well positioned to not only accelerate our revenue generation but do it at improved gross margins and earnings to go along with that improving top line.

Deane Michael Dray
RBC Capital Markets, Research Division

So just I want to pick up on one of your points, Ivo, that was really important, is the idea that you really didn't do much in the way of layoffs or big salary cuts. And those were conscious decisions because, in many ways, if you cut too deeply, you really sacrifice your growth opportunities on the other side. Where does -- talk about those decisions. And what's the consequence of having done that and preserved your growth potential? What does that mean about incrementals on the other side?

Ivo Jurek
CEO & Director

Yes. Absolutely. So look, we felt that we have to be a good corporate citizen and take care of -- number one, take care of our employees, take care of our customers and give ourselves the optionality to react to changing market demand environment. As we have experienced, we are a very-short-cycle business. We don't have lots of visibility, so we wanted to err on the side of being able to react. That resulted in us taking, frankly, decisions that, as you have highlighted, no furloughs, no real fundamental reduction in salaries. All of our employees have been paid as we have paid them historically. We haven't cut any 401(k) distributions or any -- and contributions, anything of that sort.

And from that perspective, when the market improves into 2020, and we are seeing the early signs of that recovery today with our recent announcement yesterday, we believe that it positions us to be in a situation where, frankly, we don't have to talk about COVID. I want to be in a situation where we can talk about clean results.

So as revenue improves and we are delivering significantly greater incrementals, so now I have on the record to say that we expect to deliver incrementals in the first year post recovery, that those incrementals be greater than our decrementals were in 2019. And as you know, Deane, our decrementals in 2019 were about 50% driven by the capacity expansion and by the trade war that has significantly reduced our top line. But as we exited 2019, we have started to realign our cost base, and that helped us as we entered into that COVID-19-impacted war. And we feel very good about where we sit, and I believe that we will deliver incrementals in 2021 on incremental revenue there in excess of 50%.

Deane Michael Dray
RBC Capital Markets, Research Division

Wow. All right. That's a -- it seems aspirational, but the numbers support it based upon the kind of leverage that you have. So it's something we'll be watching carefully.

Let's pivot and talk a bit about the business model and the level of complexity that you have and maybe some efficiencies that you can wring out. And I remember the first time I saw the business, and I was struck at this extraordinary number of SKUs. It just -- you can provide a timing belt for a '57 Chevy pretty quickly when that model hasn't been in production for decades. So just talk about that SKU, 360,000, what that means to manage and how you get through that complexity issue.

Ivo Jurek
CEO & Director

Yes. Absolutely. Thank you. I mean we do have a reasonably complex business model. On the top of the complexity of SKU count, which you have very effectively outlined, we also -- because we are a aftermarket-focused company, we pride ourselves of being able to supply over 95% of all orders that we receive today within 72 hours. So not only do we have an incredible complexity to the SKU count that, by

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the way, is a massive moat, comparative impediment for others to come in and compete with us, but it also gives us a great deal of pleasure to be able to be highly effective in fulfillment side of our business.

So from where we certainly sit, one of the things that I have envisaged when I started talking about driving innovation forward, innovation had 2 underlying tenets for us. Number one, completely revitalize our product portfolio. And as you know, Deane, it is very complex to do when you have 400,000 or 360,000 SKUs. And number two, industrial companies don't do that well. But we felt that as a 100 and nearly 10-year-old company, we were due to be able to completely revitalize the portfolio.

But the second tenet of the revitalization of our portfolio was to significantly reduce the complexity under the skin. So we wanted to go in and launch these products that would be comprised of significantly smaller number of major product clients, yet not impacting our ability to supply that 1956 Chevy to our customers. And I think that we are well on the way to be able to accomplish both of these objectives.

And that, by the way, is going to do 2 things for us. Number one, new products, as we always have been able to demonstrate, generate more gross margin. But that reduced complexity also gives you a better efficiency that you will realize that will ultimately translate itself into an improvement in gross margins well into the future.

So those were the key tenets of looking at our business model and reducing the complexity of that business model and drive reward for our shareholders.

Deane Michael Dray
RBC Capital Markets, Research Division

That's great to hear. I want to pivot over to the balance sheet and the amount of leverage that Gates has taken on. And the way I look at the leverage today, it's so -- it's not the same the way I looked at it last quarter when it seemed like, oh, we're in the middle of this downturn, how are you going to come out of this. Well, you're emerging from it. And so the debt burden seems a heck of a lot more reasonable given the upper trajectory of the business today. But just give us a sense of where leverage stands, the deleveraging plans and free cash flow generation in the business.

Ivo Jurek
CEO & Director

Yes. So first, let me start with the fact that as a public company, we certainly recognize the importance to equity investors of bringing our leverage down.

I have been on record that my interest is to very rapidly come below 3x levered. We were well on the way to delever to that level until we have entered the trade war-induced recession. So fast forward to COVID, we anticipate that we will peak at 5x gross leverage. But we also anticipate that as we are exiting Q3 into 2021, we will start seeing a very nice deleverage to reemerge.

I do want to point out that throughout this period of time of uncertainty, a great degree of uncertainty, the company has continued to generate a great deal of free cash flow even in a very difficult Q2. And we have never been stressed to repay our debt or service our debt. We haven't had to tap any lines of credit. We hadn't had to increase our financing or borrow more money. We have over $600 million that's sitting on our balance sheet that gives us great deal of flexibility to look and -- not only look at potentially reducing our gross leverage down with that available cash that's sitting on the balance sheet, but also we believe that those improved business conditions are going to give us an opportunity to pretty dramatically drive that gross and net leverage ratio down pretty quickly.

Deane Michael Dray
RBC Capital Markets, Research Division

That's great to hear. In terms -- one of the things I find interesting is how much of material science is involved in the business and just the amount of new product introductions that you've been able to maintain despite all -- some of the macro pressures. But just give us an update there, new products and the role of material science.

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Ivo Jurek
CEO & Director

Yes. So Deane, again, I'll -- I'm going to say the obvious. We haven't decommitted $1 throughout this period of uncertainty that has been directed to innovation and to capital investments to drive higher rates of growth in the future.

Significant portion of our innovation is centered on leveraging material science as well as process innovation. And those 2 tenets go hand-in-hand. You cannot truly leverage the material science if you're not going to drive innovation in terms of new processes. There have been a tremendous amount of chemical advances or advances in chemistry, but the processes have not been advanced to take -- to leverage that innovation in chemistry. And we have been focused over the last couple of years on building our own industrial process automation to be able to do just -- to be able to do just that.

So whether or not it is carbon fiber reinforcements that give us an ability to build Carbon Drive belts, that give us an opportunity to accelerate our chain-to-belt set of opportunities, and we see a great deal of increase in revenue generation from that initiative, to also, look, our processes that we have deployed in those new factories that we have built, as such that give us the opportunity to dramatically reduce cost as we drive these new innovations into the marketplace. So we are quite excited about that.

And we believe that in an example of, say, belts, I've spoken about the Carbon Drive ad nauseam historically, but one of the first things that we have done in this industry, in the belt industry, is we have eliminated chloroprenes as a part of a chemical compound that you have to use if you want to build belts. We have substituted chloroprenes that are not environmentally friendly with ethylene elastomers. And those ethylene elastomers are very difficult to process. So again, there is a good innovation out there in material science, but if you cannot process these new materials, you will not be able to build these new products that we are launching. So that's a really good example of when I say, hey, look, we need the process innovation to be able to leverage the chemistry. And that's probably one that I would highlight.

Deane Michael Dray
RBC Capital Markets, Research Division

Great. So some of the investors had the ability to send me questions. And so I did get a question. Someone wanted to get an update on the $40 million structural cost-out initiative, how that has progressed, is it -- what the timing and the payback is.

Ivo Jurek
CEO & Director

Yes. Absolutely. So on the last call, I have given an indication that we anticipate to get about $38 million to $40 million of structural improvement in 2021. And that's comprised of closing a couple of factories, a couple of distribution centers, realigning our European footprint, establishing shared service center in Poland. All of these projects are on time, on target, and we certainly anticipate to be able to deliver those incremental savings.

So in 2021, we talked about $40 million of savings, and that $40 million is basically offset by about $20 million of restructuring costs. So the net savings in 2021 will be incremental to $20 million net of restructuring.

Deane Michael Dray
RBC Capital Markets, Research Division

Great. That's real helpful. And maybe touch on the -- and I get this question often, and -- all the opportunities in electric vehicle. And just give us, as you see it today, the conversion to electric vehicle. What does that mean for your business, the dollar content and so forth? It's a frequent question, and I think there's some really interesting perspective that you can add.

Ivo Jurek
CEO & Director

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Yes. Look, we are quite excited about the potential adoption of electric vehicles. I don't spend a tremendous amount of time speaking about the opportunities on electric vehicles, and I think I need to do a better job of doing that. But one of the things that we always want to ensure is that we focus on the opportunities that -- the nearest opportunities for us to deliver growth.

Although we are very excited by electric vehicles, we still anticipate that the adoption is going to take some time and give benefits to most when there is a large installed base of devices in the marketplace. And we still believe that, that's going to take some time to drive that significant adoption that will translate into an [H] car parc, which is the most important metric for us.

Now in terms of content, the reason that we are very excited about EVs is because if I look at a content that we have on, say, a straight combustion engine-driven powertrain, and I use that as a kind of a unit of 1 or 100%, the content increase is about 20% greater on an EV for our products than it is in an ICE.

So although I do understand that there may be some degree of concern that folks have about companies like ours that, hey, look, what's going to happen to your business, well, what's going to happen to our business, it will naturally grow with a greater adoption of EVs. And we are quite excited about that.

Deane Michael Dray
RBC Capital Markets, Research Division

That's great. And just to clarify, that's not just Power Transmission, but that's also Fluid Power? That's including both segments, correct?

Ivo Jurek
CEO & Director

That's correct. And the biggest opportunity that we have on EVs is obviously in Fluid Power, in battery cooling in particular, more specifically. But that being said, we do have opportunities on Power Transmission, and we are working on several programs for the leading supplier of electric vehicles today on deployment of those products into that application for that vehicle manufacturer.

Deane Michael Dray
RBC Capital Markets, Research Division

And I just wanted to circle back on the commentary regarding the positive preannouncement that you started with, just to make sure I got this correctly, that auto replacement is looking to be positive growth in the quarter. It's been a while since we've seen any of our companies posting positive growth, but I just want to make sure that it's not sequential. But that's a year-over-year number?

Ivo Jurek
CEO & Director

That's correct, Deane. We anticipate that the automotive replacement market will print a positive core growth globally for us.

Deane Michael Dray
RBC Capital Markets, Research Division

And any sense geographically how that breaks out?

Ivo Jurek
CEO & Director

Sure. So China, obviously, is performing quite well. Europe in AR is performing quite well. North America in AR is performing quite well. So the 3 biggest markets where we have a dominant market share are performing very, very well in AR.

Deane Michael Dray
RBC Capital Markets, Research Division

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Gee, it seems as though that's -- and your sense, it's not just an inventory replenishment, which is awfully surprising. Or it's so encouraging is how I phrase it.

Ivo Jurek
CEO & Director

I think, Deane, one of the probably misunderstood misconceptions is that some of these markets are not going to benefit from COVID-19. And I believe that actually, the automotive replacement business in particular is benefiting from COVID-19 because people are forced into personal mobility. And whether or not it is an automobile, it is a bicycle, it is a motorcycle, it is an RV, I think that you are seeing some short-term positive pickup, and we are benefiting from that pickup. And I believe that, that's going to stay with us for an intermediate future.

Deane Michael Dray
RBC Capital Markets, Research Division

Yes. I saw some references that our auto analyst, [Joe Speck], had done, the phenomenon of more people buying second cars because you've got more people living at home and so people need second cars. A lot of times, those are used cars, and that's certainly -- that's right in the sweet spot for you guys in terms of an [H] car parc in terms of replacement.

Ivo Jurek
CEO & Director

Absolutely. And I think what you'll start seeing is that even millennials will start buying those vehicles because they want to get around as well. I think that they're all sick and tired of sitting in their homes, and many of them are vacating their beautiful apartments in big cities and moving back to their parents' basements.

Deane Michael Dray
RBC Capital Markets, Research Division

I can attest that I've had one of my adult kids doing that, but it's not in the basement. But that's -- looks like we're out of time here, Ivo. I just -- I want to thank you for participating in our conference. I want to congratulate you on weathering what was some extraordinary pressures on your business. And you didn't change anything in terms of your approach on a daily basis and how you communicate with The Street and what your business model was. And it's that kind of consistency you'll be able to look back on and -- with a sense of satisfaction, I think, in terms of that's -- the business model works, it holds up to some extraordinary pressures and then you get the benefit on the recovery.

Ivo Jurek
CEO & Director

Thank you, Deane. We like our business, and we like where we sit.

Deane Michael Dray
RBC Capital Markets, Research Division

Good. Terrific. Well, thanks for participating. My best to you and the team. And we'll call this, the Gates presentation, to a close. And all the best for everyone. Thanks for participating. Bye now.

Ivo Jurek
CEO & Director
Thank you. Bye-bye.

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