05-May-2020

# Gates Industrial Corp. Plc (GTES)

## Q1 2020 Earnings Call


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# MANAGEMENT DISCUSSION SECTION

**Operator**: Ladies and gentlemen, thank you for standing by, and welcome to the Gates Industrial Q1 2020 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]

I would now like to hand the call over to your speaker today, Bill Waelke, Head of Investor Relations. Please go ahead.

## Bill Waelke

*Vice President-Investor Relations, Gates Industrial Corp. Plc*

Thanks, Josh, and thanks, everyone, for joining us on our first quarter 2020 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, Brooks Mallard. After the market close today, we published our first quarter results. A copy of the release is available on our website at investors.gates.com.

Today's call is being webcast and is accompanied by a slide presentation. On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. 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 will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking


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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 on Form 10-K and in other filings we make with the SEC including our Quarterly Report on Form 10-Q that will be filed this week. We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly earnings call, if at all.

I will now hand things over to Ivo.

## Ivo Jurek

*Chief Executive Officer & Director, Gates Industrial Corp. Plc*

Thank you, Bill. Good afternoon, and thanks for joining us today. The first quarter marked the beginning of an unprecedented environment for the global economy as governments, companies, and communities implemented strict measures to minimize the spread of the COVID-19 pandemic. Let me provide a brief overview of how we are responding to the spread of the virus before I cover the Q1 business results.

In early February, as our business in China was being impacted, we've mobilized a centralized crisis response team to develop and is tactically engaged in the implementation of countermeasures across our global footprint. While we are prioritizing the health and safety of our employees, and the communities around the world in which we operate, we have also been able to maintain operational continuity in support of our global customer base.

We are adhering to government mandates and guidance provided by the health authorities and have implemented remote work policies where possible. Additionally, we have enhanced protective measures in our plans to ensure we are able to safely supply our mission-critical components.

In particular, the method we used in China to manage through the COVID-19 impact have informed the approach we are successfully taking in our other regions. Our in-region, four-region manufacturing strategy is supported largely by local supply chains. We have taken the necessary steps to protect our raw material supply to ensure we are able to maintain continuity, and we have not experienced any significant disruption of our service to-date.

Before we move to slide 4 and jump into more detail on the quarter, I would like to take a moment to thank our global team of associates for their perseverance and dedication during these challenging times, particularly those in our manufacturing and logistics facilities whose essential jobs necessitate an onsite presence. I appreciate their commitment which has allowed us to continue to be a trusted and reliable supplier to our customers during this challenging time for everyone.

Now moving to slide 4 and a brief overview of our first quarter results. Q1 got off to a solid start with steady sequential improvement from where we exited 2019. Our core revenue in the quarter ultimately declined by 10%, which includes an approximate 7% negative impact from COVID-19. I would also note that we experienced significant revenue deceleration in our businesses in North America and Europe primarily over the last two weeks in March and stay at home orders to hold across numerous jurisdictions and geographies.

First quarter adjusted EBITDA was $121 million, representing a margin of 17%. The margin decline was broadly in-line with the expectations communicated on our Q4 earnings call and represents an improved decremental margin relative to Q4 and full year 2019, a result of the progress we have made in rightsizing the business.

On a percentage basis, our adjusted earnings per share of $0.21 represented a decline similar to that in our adjusted EBITDA. Our liquidity position is strong with over $1 billion available and no meaningful debt maturities


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until 2024. We also continue to expect to generate strong free cash flow in 2020 which will further strengthen our liquidity position.

Moving now to our segment on slide 5. Our Power Transmission business in Q1 was notably impacted by COVID-19 in China where core revenue declined over 30%. In Europe, our business had modest growth, the result of growth in the automotive replacement channel. In North America, the trajectory we saw in the fourth quarter decelerated modestly in Q1 primarily a result of weakness in the last two weeks of March.

Despite the uncertain business environment, we saw solid design wins activity from our global customer base in Q1. Our chain-to-belt initiative had design wins in intra logistics, material handling, food processing, and health service applications. We also recently launched our next-generation V-belt, representing another step in revitalizing our entire Power Transmission product portfolio.

This new V-belt family delivers superior performance for industrial applications while eliminating chloroprene from the belt construction. We believe our focus on innovation will differentiate us in a market and will enable future growth as our end markets return to a more normal state and we anticipate continuing to fully support our investment in innovation throughout 2020.

Moving now to slide 6. Our Fluid Power core revenue represented a 10.6% decline year-over-year, but a mid-single digit sequential improvement. In North America, core revenue in industrial end markets remain down compared to the prior-year period, primarily due to the weakness in the mobile hydraulics market, but improved notably from Q4. Our Fluid Power business in Europe declined year-over-year with core growth in the automotive end market offset by weakness in industrial end markets. In China, our Fluid Power segment was impacted by weakness in the construction end market, a trend that began to turn, however, with significant new orders in March. The solid pipeline of opportunities we have been building with our revitalized Fluid Power product portfolio resulted in Q1 being our MXT hose family best revenue-generating quarter since its launch. Similar to Power Transmission, we believe our focus on innovation differentiates us and we expect our new products will continue to build momentum when the current COVID-19 uncertainty subsides.

Slide 7. We don't plan to provide the information on this slide on quarterly basis going forward, but given the exceptional environment and the regional nature of COVID-19 pandemic, we thought it would be useful to provide additional color this quarter.

Beginning with China, our core revenue began the quarter with continuation of the solid growth trajectory we saw in Q4 before being significantly impacted by the measures taken to limit the spread of the virus. From a demand perspective, March appears to have been the bottom in China. We expect the general trend of improvement we saw in April to continue over the remaining two months of the present quarter.

In Europe, we have proactively managed our production levels in-line with demand and most of our plans have remained operational with the exception of a brief government-mandated suspension of operations at our plant in Spain. The automotive replacement business saw a slightly lower growth rate in March, but performed well throughout the quarter before declining in April, as shelter-in-place orders took a firm hold across the EU.

Our first-fit businesses experienced a notable decline in March and subsequently April as many of our largest customers temporarily suspended production. In North America, our business improves sequentially but industrial end markets remained weak as anticipated.


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Similar to Europe, our business was not meaningfully impacted by the effects of COVID-19 until the last two weeks of March when larger customers began temporarily suspending production and replacement channel activity notably declined, trends that accelerated in April. I would note that in April we experienced a significant decline in India where our operations were temporarily shut down in line with a broad government mandate. We began the process of reopening our manufacturing facilities there on May 4 and are employing the same tactics used in China to safely bring our operations in India back online.

I won't spend a lot of time on slide 8, but hopefully it illustrates some of the recent complexity involved with managing our global businesses. We have laid out a high level timeline of when the regions we operate and begun to be impacted by shelter in place and a rough estimate of what their path to improvement could look like on a relative basis through the second quarter.

The majority of our regions began to be adversely affected by these restrictions around mid-March and are now experiencing the significant impact that hit China in February and March. Although we do not expect the rest of the world to behave exactly the same way, we view the trends of demand recovery in China as informative and potential model for what we could experience in other geographies. Of course, we are very focused on being responsive to the changes in business trends and are ready to react to those changes as they come.

I will now turn the call over to our new CFO, Brooks Mallard, for some additional details on the financials. Brooks?

## L. Brooks Mallard

*Chief Financial Officer, Gates Industrial Corp. Plc*

Thank you, Ivo. Starting on slide 9, our total Q1 revenue of $710.1 million declined 11.8% year-over-year, which includes the negative impacts of 1.7% from FX and an estimated 7% from the effects of the COVID-19 pandemic. Adjusted EBITDA was $121 million or 17% of sales compared to $166 million or 20.6% of sales in Q1 of 2019. The decrease in earnings and adjusted EBITDA margins was driven by lower revenues partly from expected lower volumes and partly from the impacts of COVID-19. Our adjusted EBITDA decrementals in Q1 of 2020 were 47% when compared against the same quarter in 2019.

This is a sequential improvement to our Q4 2019 year-over-year adjusted EBITDA decrementals, a result of the work done in the latter half of 2019 to lower our overall operating cost structure. Our adjusted earnings per share were $0.21 compared to $0.28 in the same quarter one year ago. This is attributable to lower earnings in Q1 of 2020 partially offset by an improvement in our effective tax rate.

Moving now to slide 10 which provides detail on the key balance sheet and cash flow items. First quarter operating working capital declined 140 basis points as a percentage of sales, primarily driven by reductions in accounts receivable and inventory. Accounts receivable reductions were driven by lower revenues while lower inventories are a result of the efforts to optimize our inventory levels in the back half of 2019. As we expect revenue to decline for an intermediate period of time, we anticipate positive cash flow driven primarily by lower operating working capital requirements. With respect to free cash flow, Q1 typically results in a cash outflow for the business as we build working capital for peak seasonal revenue in Q2 and Q3.

In Q1 of this year, we generated $16 million of free cash flow driven by reduced investment in working capital, lower cash interest due to timing of interest payments following our Q4 bond refinancing and lower cash taxes. The significant improvement in LTM free cash flow was driven primarily by improvements in operating working capital compared to Q1 of last year.


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Moving now to capital spending, typically, our business has a low maintenance CapEx requirement of around 1.5% of sales. To preserve liquidity, we have limited new capital spending to initiatives deemed essential to our business. We will continue to manage our capital spending based on the prevailing market conditions. As a result of our lower adjusted EBITDA, net leverage in the first quarter increased 4.1 times from 3.6 times in Q1 of last year. Although we expect the attainment of our 3 times leverage target to be pushed out due to the current economic environment. Cash generation and deleveraging remain a priority.

Turning now to slide 11, this provides a detail on our available liquidity, financial covenants and debt maturities. As of May 1, our total liquidity was over $1 billion consisting of $616 million in cash and $440 million in revolver availability. We do not have financial covenants unless our ABL or revolving credit facility is drawn more than 90% or 30% respectively. As long as these credit facilities remain undrawn, we would not have any material debt maturities until March 2024. We believe our solid liquidity position will allow us to withstand the uncertainty associated with COVID-19 and its impact on our end markets, and we do not currently envision tapping into either our ABL or revolving credit facility this year.

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

## Ivo Jurek

*Chief Executive Officer & Director, Gates Industrial Corp. Plc*

Thanks, Brooks. So in lieu of providing full year guidance in this environment, on slide 12, we have tried to provide some context of how we are currently thinking about the year. Our two largest regions of Europe and North America did not begin to see an impact of COVID-19 until the latter part of March. Accordingly, we expect the second quarter to be the most difficult of the year with core revenue likely to decline in a range of 15% to 25% sequentially. I would note that April sales came in largely in line with our expectations, underlying how the second quarter will develop. As shelter-in-place restrictions ease and the level of business activity at our customers improve, we expect the second half of the year to get progressively better. Given the magnitude of the decline we anticipate to see in the first half of the year and thereafter the varied rates of demand recovery we will see across different end markets and geographies, we do expect the full year to result in revenue decline.

Reflecting the progress we have made last year in rightsizing the business, we would expect the full year decremental margins to be an improvement from what we saw in 2019 despite the relatively unexpected and significant decline in revenue as a result of the pandemic. We are undertaking incremental actions that we expect will further reduce our compressible cost and discretionary spend by approximately $50 million this year. Additionally, we are continuing to execute the restructuring plan we announced and then upsize last year to ultimately address $40 million of cost by the end of 2021.

With respect to CapEx, we plan to maintain a flexible posture but presently expect to spend approximately $70 million this year to support our business with maintenance and growth capital, but we'll react to any changes to business conditions and align our investment accordingly. We anticipate working through this difficult market environment and generating significant free cash flow this year while still funding some of our key initiatives to enhance our competitive position in the market and allow us to emerge from this downturn even stronger.

So wrapping things up on slide 13, the COVID-19 pandemic was clearly created an unprecedented, evolving environment and we are taking measures around the world to prudently manage the business. While the timing and trajectory of the recovery are unclear at this time, we look to our experience in China as a guide to manage through the near-term challenges.


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We remain focused on what we can control while being mindful that demand for our mission critical components will recover. In addition to tightly controlling discretionary spending, we will continue to manage our compressible cost to prevailing demand conditions and have contingency plans in place should they become necessary. Being cognizant of the potential magnitude of the COVID-19 impact, we are certain about the company's ability to operate in this challenging environment. Our mission-critical components, which we sell across a wide range of end markets and geographies, needs to be replaced. Our focus on innovation and recently introduced new products have strengthened our competitive position, and we believe will allow us to take market share during this downturn.

Focused on replacement channels, our business is resilient and has historically responded well after significant downturns. This was most notably evident in 2010 when core revenue grew 21% and recovered the decline of 5.5% and 15% in 2008 and 2009 respectively. In addition to the strength and flexibility of our liquidity position, our business has demonstrated ability to generate solid free cash flow when revenues contract.

We have begun to see green shoots in China and believe it is only a matter of time before we see them in our other regions. Until then, we believe we are well-prepared to not only manage through the uncertainty but also emerge a stronger company when more normal operating conditions return.

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

# QUESTION AND ANSWER SECTION

**Operator**: [Operator Instructions] And your first question comes from Andy Kaplowitz with Citigroup. Please go ahead.

**Andrew Kaplowitz**
*Analyst, Citigroup Global Markets, Inc.*

Q

Hey. Good evening, guys.

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

A

Hi, Andy.

**Andrew Kaplowitz**
*Analyst, Citigroup Global Markets, Inc.*

Q

Ivo, so [ph] you've gone (24:26) to 60% year-over-year drop in Q2 revenue. We obviously know that auto builds around the world will likely be down close to that. So could you give us more color on whether for instance your replacement businesses are outperforming that drop? And how much is drop that's due to either your customers or you being shutting down as you said versus destocking or just end market demand being weaker?

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

A

Well, in Q1, the replacement market significantly outperformed the first-fit market; again, this was predominantly the result of what we have experienced in China, Andy. Obviously, in Greater China, the automotive first-fit market in particular has taken quite a substantial hit. And so we anticipate that the replacement channels are


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going to rebound before the first-fit channels will, and that is what we have seen in April as well. And so we anticipate we will see that as the quarter progresses.

**Andrew Kaplowitz**
*Analyst, Citigroup Global Markets, Inc.*

Q

That's helpful, Ivo. And then, obviously, you still have a fair amount of production capacity that is in some form of shut down. So when you think about decrementals in Q2 given the guidance for the full year and to extent you want to talk about it, how would you think about decrementals and have you seen at this point supply chain – any supply chain issues that you've had sort of ease out as well?

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

A

So let me answer the last question first then. From a supply chain perspective, our supply chain issues are very limited or non-existent, Andy. We have been pretty proactive early on when we start seeing the issues in China to ensure that our supply chain certainly don't hamper our ability to support our customers, and our team has done a terrific job to do so. Now, as to decrementals, we anticipate the decrementals to be kind of mid-40s in Q2 which is, as you may recall, quite a substantial improvement from 2019.

**Andrew Kaplowitz**
*Analyst, Citigroup Global Markets, Inc.*

Q

That's good to hear. I mean, you do have the same decrementals, Ivo, for the year sort of modelled, so is it possible as sales declined the ease that you could see better decrementals as you go into the second half of the year or are you being conservative and you sort of guide for the year?

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

A

Well, we've – the situation is very fluid, Andy, and although we do anticipate that Q2 will be the worst quarter of the year and thus you could extrapolate from that statement that decrementals should improve, it is very difficult presently to say how the second half will perform vis-à-vis demand. So if the demand improves as we anticipate, we anticipate to have a little better leverage in second half.

**Andrew Kaplowitz**
*Analyst, Citigroup Global Markets, Inc.*

Q

Great. Thanks, Ivo. Be well.

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

A

Thank you.

**Operator**: Your next question comes from Julian Mitchell with Barclays. Please go ahead.

**Julian Mitchell**
*Analyst, Barclays Capital, Inc.*

Q

Hi. Good afternoon.


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

Good afternoon, Julian.

**Julian Mitchell**
*Analyst, Barclays Capital, Inc.*
Q

Good afternoon, Ivo. Maybe just the first question on the top line, I just wanted to clarify something. I think the first question just now talked about a 60% sales drop year-on-year in Q2. I was getting near a 30% year-on-year at the midpoint for Q2 based on the comments in the slide. So, I just wondered if you could confirm what kind of year-on-year revenue changes implied in Q2. And also within that, just to clarify, how much your orders or sales in April were down and if there's any sort of color you could give on regions or segments within that please?

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

So, your, your statement was correct about the Q2 revenue, Julian. So it's in the – our decline is in the 30s, that's what we anticipated for the sequential decline of 15% to 25% would imply. So, you're correct. I apologize. I think [indiscernible] (28:52) Andy's comment there earlier. What I would about April is that April came in kind of in the mid to high-30s. So that would give us a reasonably good support to what we anticipate is going to be a second quarter deceleration sequentially 15% to 25%.

And I would say that maybe from a regional color, China got significantly better. China went from kind of that high-30s, mid-40s February-March to kind of teens in April, and we anticipate that that will progressively get better as May and June come into books. Europe and North America were kind of high-30s deceleration.

**Julian Mitchell**
*Analyst, Barclays Capital, Inc.*
Q

That's very helpful, Ivo. Think you. And then maybe just one quick follow-up. If we look at the cost savings, let's say that $50 million of discretionary spending this year, maybe just help us understand the weighting of that and how that impacts the P&L and any sort of longer term fixed cost reduction measures you may be thinking about or those are kind of [indiscernible] (30:25) unless you see the sales outlook get even worse in the second half.

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

So the $50 million we anticipate to realize in the calendar year 2020, Julian, so there is compressible cost that we anticipate to be managing through the rest of the year, SG&A predominantly, obviously. The fixed cost reductions we have announced a $40 million fixed cost reduction plan in the latter part of 2019 which we continue to execute against well despite even some of the difficulties, as you can imagine, that you see from lack of ability to travel and some of these impediments that that you know we have all encountered presently over the last [ph] eight (31:20) weeks. We continue to proceed reasonably well with those and we anticipate to be on track to attain as we have outlined those in the second half of the year.

Should the business get worse than what we anticipate, we have number of other projects sitting on a shelf that we would enact. We believe that we would just have the management capacity to go and execute those incrementally. So we are, I think, reasonably well-positioned to potentially seeing a further deterioration. We don't certainly anticipate it that's what's going to happen. But at the end of the day, there is an unprecedented lack of visibility, and we have a number of scenarios on a shelf to be able to go and execute.


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**Julian Mitchell**
*Analyst, Barclays Capital, Inc.*

Q

Great. Thanks, Ivo.

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

A

We're not going to shy away from structural improvements of these businesses. As you know, we have spoken about that quite substantially and we believe that we have a number of these projects that we will be able to continue to execute on.

**Julian Mitchell**
*Analyst, Barclays Capital, Inc.*

Q

Perfect. Thank you.

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

A

Thank you.

**Operator**: Your next question comes from Jamie Cook with Credit Suisse. Please go ahead.

**Jamie Cook**
*Analyst, Credit Suisse Securities (USA) LLC*

Q

Hi. Good evening and hope everyone is well. I guess just first question and I'm sorry, I hopped on a little late because I had multiple calls going on. But can you just distinguish what you're seeing in the channel in terms of inventory and how long that sort of takes to correct? And then second question just by end market, have you given any color in terms of like how much what you're seeing in April in terms of auto versus some of the other mobile equipment markets? I'm just trying to see where demand is most weak, I assume its auto. But if you could give any color that would be helpful. Thank you.

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

A

Sure. So on the channel side, Jamie, in April, auto was the most dislocated, about 2x of the industrial OEs. Certainly makes sense as vast majority at OEMs have been shut down throughout the month of April. We have seen a significant number of notices of auto OEMs coming back. So we certainly anticipate that although not terrific, it will get better over the next two months of the present quarter. The industrial OEMs, they have start shutting down earlier than the auto OEMs, Jamie, and many of them are restarting. So we anticipated that also will start get – will start getting a little better for the remainder of the quarter.

I think the biggest challenge is that these OEMs are facing is to ensure that their supply chain is not dislocated. Now, although we are ready to supply, I think that they have to make sure they have all the components that they require to be able to build their own machinery and equipment in itself. I hope I – did I miss something? I feel I have...

**Jamie Cook**
*Analyst, Credit Suisse Securities (USA) LLC*

Q


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Yeah. I was asking – hey, sorry too. I was just asking about sort of what your channel inventory if you can make any commentary on that.

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

Oh yes. Yeah. Sorry about it, Jamie. Yes. So as you know, over the second half of last year, we have talked quite a bit about the compression of channel inventory, both industrial in particular and the normalizing channel inventory in automotive replacement side. We certainly believe that some of the improvement that we have seen in Q1 on the industrial in North America in particular has been associated with the fact that we have seen our supply more aligned with the demand environment So, we believe that the inventory has stabilized in the channel – in the industrial channel certainly in particular in North America. And we don't anticipate a dramatic headwind coming from that if that makes sense.

**Jamie Cook**
*Analyst, Credit Suisse Securities (USA) LLC*
Q

Thank you. I appreciate your help.

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

Thank you.

**Operator**: Your next question comes from Jerry Revich with Goldman Sachs. Please go ahead.

**Jerry Revich**
*Analyst, Goldman Sachs & Co. LLC*
Q

Good afternoon and good evening, everyone.

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

Hi, Jerry.

**Jerry Revich**
*Analyst, Goldman Sachs & Co. LLC*
Q

What we're hearing from some other companies with construction and [ph] market exposure (36:08) is essentially a really painful start to April, and then reduced year-over-year pain if you will as we've gone through the latter parts of April. Have you seen that type of improvement in any parts of your business particularly on the replacement side? [indiscernible] (36:29) there, but wondering any other regions or any other parts for your business that may have followed a similar pattern as we went through the month.

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

Yeah. So the OEMs I think you've correctly stated was pretty painful April. Obviously, they all – not all, but substantial amount of the OEMs that taken a shelter-in-place order pretty seriously and did not produce lots of machinery, we did see a reasonably good return of demand in China in April. So, there was kind of down high-single digit in China on the industrial OE side. India was down, obviously, full month, so that was quite painful for us there. Europe and Americas, we're kind of fleet average kind of high-30%s down for us and the replacement


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markets performed better everywhere for us across the globe on the industrial side, kind of maybe at 30% better performance than the OE side.

**Jerry Revich**
*Analyst, Goldman Sachs & Co. LLC*

Q

Okay. Thank you. And then as we think about what incremental margins look like whenever the markets are recovering hopefully in 2021, can you talk about whether there are going to be levers you can pull to drive higher incremental margins coming out of the cycle because at the peak we've got hit by supply shortages and then obviously that market deteriorated over the past two years that you made decremental margins, I think, tougher than otherwise would. I'm wondering does that all translate into better incremental margins in a recovery compared to what we've seen in prior cycles for this business?

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

A

Well, I'd love to have a discussion on when the growth returns. So thank you for putting a positive spin on that. It will come. Look, I mean I think that we are making the business substantially better and I think that I have been pretty forthright before. We have experienced this deceleration associated with this COVID-19 situation that our incremental margins should be better than our decremental margins were in 2019. And absent of giving you an absolute number, I certainly anticipate the incremental margins to be nicely better than the decremental margins that we have experienced in 2019. So I think that we're all looking to be able to demonstrate the rebound and the profitability of the business when that occurs.

But frankly right now, we are simply focused on ensuring that we can manage through the next couple of quarters and minimize the impact on our business and position the business in the best possible situation to be prepared for that eventual rebound that will come.

**Jerry Revich**
*Analyst, Goldman Sachs & Co. LLC*

Q

I appreciate that. Thanks.

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

A

Thank you.

**Operator**: Your next question comes from Jeff Hammond with KeyBanc. Please go ahead.

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

Q

Hey. Good morning or good afternoon, guys.

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

A

Hi, Jeff.

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

Q


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Hi. Just on the auto aftermarket, I know this is kind of a unique situation where people are driving less, but if you just take kind of normal economic recessions? And in that dynamic, how do you think that impacts kind of the pace of snapback or recovery? I know you said aftermarkets have been holding up better?

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

A

Yeah. So look I think that everybody is focused on the miles driven, right? I mean, that certainly is a good metric and there's lots of reports that you can look at. And what I will tell you is that when we do some of these analytics, you see a really nice rebound actually in the miles driven. You'll see that the miles driven have declined in early part of April pretty dramatically and then they started to increase nicely. We certainly anticipated miles driven are still going to be down in May as the wide-ranging shelter-in-place requirements stay in place more or less.

But what we anticipate is that the demand for our products is going to sequentially start improving from April to May to June predominantly because the automotive replacement market fundamentals remain very solid, the age of the fleet is at near record high. Well, the consumer when they start coming back, I think the consumer will be much more inclined to drive then take a public transportation or take an airplane to take a trip. Gasoline prices are very low. So certainly we believe that the influence on driving versus selecting other modes of transportations will be favorable for driving.

And then look up, our products are critical in nature. If you're going to have a bone hose on your HVA, a bone belt on your car, you'll need to replace it. It is a discretionary item. It is a necessary item to operate your vehicle. So we are reasonably positive on the recovery when things starting to at least – when we start seeing some stability in the market. I believe that if you look back at some of the things that O'Reilly has announced most recently, they've been announcing that they have seen decline kind of bottoming out at about 15% plus or minus in mid-April and then start to feel a little better performance in their store performance. And we certainly anticipate that that's going to start filtering through our business as well if they start having a need for inventory replenishment.

So my view is that kind of 45 to 60 days out, you should start seeing the same trend as you would have seen with some of our large customers seeing presently. So I know that I've given you a pretty long-winded, convoluted answer, but in a short synopsis we believe that this market is going to rebound nicely – the demand for our products is going to rebound nicely simply because it is an essential set of products, not a discretionary product.

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

Q

That's very helpful. Just on working capital, it looks like, yeah, it was a little bit of a use seasonally in the first quarter and certainly last year you put together a nice year-end, kind of bring it back, but how are you thinking about – in this kind of declines how much cash you can generate from working capital?

**L. Brooks Mallard**
*Chief Financial Officer, Gates Industrial Corp. Plc*

A

Hey, this is Brooks. Yeah, I mean, certainly we think in Q2 when you're going to see probably the trough in revenues, we're going to see nice cash generation from working capital. I think as the year goes on, the rate of rebound is really going to determine how much cash we generate from working capital based on the framework that Ivo laid out earlier, we think it should be a good source of cash for 2020, and then as the rebound comes in 2021 obviously, that'll be a little bit of a different story. But then if the rebound comes sooner, right, it may turn and be not as much of a source as we think, right? But that would be a good problem to have, so if the rebound come sooner than we anticipate, so.


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

Q

Okay. Excellent. Thanks, guys.

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

A

Thank you, Jeff.

**Operator**: Your next question comes from Josh Pokrzywinski with Morgan Stanley. Please go ahead.

**Joshua Charles Pokrzywinski**
*Analyst, Morgan Stanley & Co. LLC*

Q

Hi. Good evening, guys.

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

A

Hi, Josh.

**Joshua Charles Pokrzywinski**
*Analyst, Morgan Stanley & Co. LLC*

Q

So [indiscernible] (45:03). I'm going to ask this question a slightly different way though. Ivo, if I just kind of normalize your OE customers having the lights on, so obviously lot of audio OEM shut down here in the interim, going back to work fairly soon. Normalized miles driven, I don't know what the new normal is but probably something better than April. What does that imply for the sequential improvement into perhaps 3Q? Calling the individual months is probably a little too fine a point, but thinking about the step-down and then the step back up, how are you guys thinking about it, how are you calibrating the cost base?

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

A

Yeah, Josh, sorry there. Look, our anticipation is that we've kind of seen the bottom. We anticipate to seeing a bottom in the AR or the automotive replacement side kind of mid to latter part of April. We definitely have seen some improvements in order rates as we exited April, and we certainly anticipate to see a progression as we exit Q2. But we are really not counting on a very dramatic second half recovery. We are using China as a guideline, but we by no means believe that we're going to see a carbon copy in North America or in Europe.

And so if you look at China as a guide, China has been recovering reasonably nicely in the AR side, right, growing from nearly no activity with vast majority of the country shut down, a condition that you didn't have in North America nor in Europe. But then going up and stepping up pretty dramatic improvement in activity in March, although still at a very unfavorable rate. And then April you had another dramatic improvement or significant improvement in activity.

So my sense is that, AR you're going to see bottoming out in April, you're going to see some improvements in May and June. And then sequentially it should be significantly better in Q3. Now significantly to be flat to up, I don't think so, but I don't certainly expect that even a [ph] C, D (47:53), a significant demand destruction that we have seen in April with this market.


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So I agree with you, you can argue what normalization will look like. My sense is that we will probably be all driving our automobiles more than taking alternate modes of transportation. But I think if we had a better visibility, we would probably at least offer some guide posts on revenue in Q3 and Q4. And we really want to see Q2 how it develops before we are able to provide a better insight on the second half of the year.

**Joshua Charles Pokrzywinski**
*Analyst, Morgan Stanley & Co. LLC*

Q

Got it. Understood. I guess the other part of that question, I missed the answer too if you gave it, was on the OE side, the customers coming back to work, obviously a lot of shutdown in the interim. How much would you say that is worth on kind of a consolidated Gates basis?

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

A

April was worse than March obviously because in the automotive first-fit side, predominantly because vast majority of the globe was shut down with the out of plants activity, and China was just restarting. I think China had a very late restart in a first-fit auto side in April. And so my sense is that you got to kind of see declines in the mid-40s for the quarter in auto first-fit business. That's probably going to be the most unfavorable market dynamic that we will – that we are anticipating to be exposed to in Q2.

**Joshua Charles Pokrzywinski**
*Analyst, Morgan Stanley & Co. LLC*

Q

Got it. Appreciate it. If I can just squeeze in another one here. Competitive dynamics, I mean, obviously with a lot of market volatility waging for a couple of years now in some cases in some markets, how do you see the competitive landscape? Is there an opportunity to kind of selectively invest either capacity, working capital, et cetera, and maybe capture some opportunity where some of your competitors are in a more challenged position, smaller, et cetera? Are you seeing any action on that? Any color would be helpful.

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

A

Yeah. Look my sense is that from where I sit today, Gates is sitting in a pretty enviable position. We have been able to operate throughout Q1. We continue to operate and support our customers as we speak today. We have been selectively picking up some support for some clients that are not our present customers that we anticipate we'll have an opportunity to turn over to become Gates customers on more permanent basis. There are some competitors that I think are going to have some difficulties to continue to operate uninterrupted over certainly the midterm period of time. Lots of our competitors have gone through a reasonably substantial shutdown. And they'll have to restart, and that's always very, very challenging as we have certainly experienced in China despite the fact that we've been able to start up reasonably flawlessly there.

So the competitive dynamics I think is going to be rewarding companies like Gates that have a strong liquidity, that have inventory available to supply customers. And frankly we have continued to invest pretty significantly in innovation and R&D, and we are on a trajectory to continue to launch a dramatic amount of new products and fully revitalize our product portfolio as we have discussed on prior calls – or prior conferences. So we feel that they are very well-positioned to be able to emerge frankly in a leading position in the products that we manufacture.

Now that ultimately will also offer incremental opportunities potentially for whether or not it is M&A or frankly for acquisition of substantial amount of customer base that we would have historically not been able to do. So I like


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where we sit. We have lots of work to do. We are predominantly focused managing through the turbulence in the short term, but we by no means are retrenching from making investments for the long term, whether or not it is in innovation or in supporting our capital needs with some incremental capacities or incremental tooling that can help some of our global customers. So, that's [indiscernible] (53:16) pretty good where we sit.

**Joshua Charles Pokrzywinski**
*Analyst, Morgan Stanley & Co. LLC*

Q

Great. Thanks for the color, Ivo. Best of luck to you.

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

A

Thanks, Josh.

**Operator**: Our next question comes from Deane Dray with RBC Capital Markets. Please go ahead.

**Deane Dray**
*Analyst, RBC Capital Markets LLC*

Q

Good afternoon, everyone.

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

A

Hello, Dean.

**Deane Dray**
*Analyst, RBC Capital Markets LLC*

Q

Hey. Maybe we can stay with the competitive dynamic question. And do you see any changes, balance of power, whatever, for the sale of Eaton's hydraulics business? How does that impact Gates?

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

A

Oh, gosh, I do not believe that it impacts Gates frankly at all. I mean, I think that again I'll borrow a little bit from what I've said to Josh. We continue to innovate, Dean. We continue to launch new products. Our MXG product portfolio has had probably the best quarter since we launched it in terms of driving revenue generation and taking incremental volume from customers that we have not supported in the past or taking market share away from our competitors. And so I believe that if we stay focused on managing our business while the rest of the dynamics are going to work themselves out.

Now I would say that this is a very difficult time to do a large scale M&A. And frankly, if I was in those shoes, I'm not quite sure exactly what we would be focused on because you have all of these dynamics associated with the demand destruction associated with COVID-19 and then trying to figure out how you're going to be driving integration, which is very challenging, I think on their side. I'm sure they're going to figure it out, but meanwhile we are focused on what we can control and that is innovation, supporting those customers, and making sure that we fulfill our requirements to those that we obligated to.

**Deane Dray**
*Analyst, RBC Capital Markets LLC*

Q


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That's good to hear. And then in the prepared remarks, it sounded like you had some meaningful wins in chain-to-belt. Anything you can share there, what does the pipeline look and when did those convert to revenue?

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

A

Yeah. So I would actually say that Q1 was interestingly a terrific quarter for us in terms of design wins. It was one of the biggest design win quarters that we have had probably in three or four quarters, which is unusual taking into account what everybody has been dealing with, particularly in the second half of the Q. We've gotten some terrific new design wins across industrial and personal mobility landscape on chain-to-belt. A pipeline on chain-to-belt is frankly near $100 million. We believe that we're going to be able to deliver nice growth despite the very challenging business environment with chain-to-belt initiative in 2020 and that bodes really well for 2021 for us, Deane.

### Deane Dray
*Analyst, RBC Capital Markets LLC*

Q

So when you say $100 million, is that an increase in a market that was previously served by chain or is that actually a revenue opportunity?

A – [07HVJM-E Ivo Jurek]>: That is a revenue opportunity pipeline that we are converting presently that we anticipate is going to start ramping up through 2021 and beyond. So it's an incremental opportunity taking away chain.

### Deane Dray
*Analyst, RBC Capital Markets LLC*

Q

Great to hear. Thank you and best of luck.

A – [07HVJM-E Ivo Jurek]>: Thank you, Deane.

**Operator**: There were no further questions at this time. I'll turn the call back to Bill Waelke for closing remarks.

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

Okay. Thanks, everyone. As always, we appreciate the interest, and we look forward to updating you again which should be in August. Have a good evening.

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

Thank you. Stay safe.

**Operator**: This concludes today's conference call. Thank you for joining. You may now disconnect.


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