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Gates Industrial Corp. Plc (GTES)

Q2 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 Corporation Second Quarter 2020 Earnings Conference Call. [Operator Instructions]

I'd now like to hand the conference over to your speaker today. Bill Waelke, you may begin.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

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

On this call, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. Reconciliations of historical non-GAAP financial measures are included in our earnings release and the slide presentation, each of which is available in the Investor Relations section of our website.

Please refer now to slide 2 of the presentation, which provides a reminder that our remarks 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.

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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 filed in May of this year. We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly earnings call, if at all.

With that, I'll turn the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good afternoon and thanks for joining us today. I hope you and your families are staying safe and healthy. As we continue to confront the pandemic globally, we recognize the enormous effort our Gates associates put forward during the difficult second quarter. I want to thank each one of our team members for their unwavering dedication and effort during this time of great uncertainty.

Throughout the quarter, we maintained our focus on complying with the recommended safety protocols and mandates around the world to operate our facilities while adopting enhanced safety practices to protect the safety of our employees, the families as well as the communities in which we operate. Doing so remains our top priority.

Within this challenging business environment, we delivered performance that exceeded our expectations. In the face of the volume declines driven by the pandemic, we have been focused on what is under our control to mitigate the decline in margins while acting with the long-term interest of our business in mind. We have maintained operational and supply chain continuity throughout the crisis and have been a reliable partner to our customers many of whom participate in essential industries around the world.

We also continued to fund our key initiatives and did not compromise our ability to respond to improvements in our mostly short cycle end markets which we are now seeing across all of our regions. While we do not minimize the tragic effects of this pandemic that in many ways continues to impact the daily lives of our employees, their loved ones, and the general public, we believe the second quarter marked a turning point for our business.

Based on the incremental improvements in our end markets as well as positively trending macro data, we believe the most significant impact to our business from COVID-19 is likely behind us as shelter-in-place requirements in different geographies were lifted. Customers who had suspended operations began to recharge their supply chains and progressively resume production.

The overall increase in industrial activity, combined with an increase in personal mobility and driving levels, contributed to improving demands trends for our mission critical components throughout the quarter. Absent any broad reimplementation of movement restrictions, we believe April represented the pandemic's most significant impact on our business.

Exiting the quarter, we had returned to year-over-year growth in China and the recovery also began to take hold in North America and Europe. We continued to make progress on our restructuring plan we announced last year, taking two further actions. In June, we announced the closure of our power transmission plant in Korea, a market which we plan to serve from other facilities in the region. Additionally, in July, we announced our intent to establish a shared service center in Europe, which would consolidate certain functions that are currently distributed throughout the region.

We anticipate completing the closure of our Korea facility this quarter and intend to complete the European project in the second half of next year. These actions represent continued optimization of our operational footprint,

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resulting in increased flexibility without compromising our ability to provide our customers with highest level of service.

Although COVID-19 is certainly not yet under control, key macro indicators and improving levels of customer activity give us an early indication that absent significant additional waves of the virus, our business has turned the corner and is on a measured trajectory to recovery.

Now, moving to slide 4 and an overview of our second quarter result, this was a challenging quarter. Total Q2 revenue of $577 million declined 28.8% year-over-year, including a negative currency impact of 2.4%.

Core revenue in the quarter declined by 26.4% year-over-year, better than the midpoint of the range we provided on our last call. This is a result of our ability to maintain operational continuity throughout the quarter in the vast majority of our global production facilities.

Importantly, after bottoming in April, we saw significant improvement across the business. Our revenues progressively strengthened throughout the quarter, exiting with June core revenue down mid-teens year-over-year. The strength of improving business activity continued in July.

For the second quarter, sales into replacement channels substantially outperformed those into the first-fit channels. Second quarter adjusted EBITDA was $83 million, representing a margin of 14.4% and a decremental margin of 35%. The improved decremental margin from Q1 is primarily the result of cost reduction actions we have taken, enhanced productivity, and favorable product mix.

Our adjusted earnings per share of $0.03 per share was primarily the result of lower revenues and associated earnings, partially offset by lower income tax and interest expense compared to the prior year.

Moving on to slide 5, as a side note, we will continue to provide geographic breakdown of our revenue for the remainder of 2020. Our business is a very global one, with over half of our revenue coming from outside North America and the regional trends we saw were largely in line with the general expectation we laid out last quarter.

Across our regions, extended customer shutdowns, particularly in the automotive first-fit channel, negatively affected demand for our products in a broad sense, with the most significant impact in Europe and Asia regions.

Now, let me move to Greater China. The stronger order trends we began to see in the end of March continued, with our business there returning to core growth in May followed by further acceleration in June. We saw growth in the quarter broadly across the region, with the exception of automotive first-fit, which improved significantly as the quarter progressed but remained core growth negative compared to the prior year. The construction and heavy-duty truck end markets notably outperformed other parts of the business in China.

After hitting a trough in April, our business in Europe improved throughout the quarter, most notably in June when movement restrictions had largely been lifted or significantly eased. Although sales into first-fit channels improved sequentially within the quarter, they were down significantly on a year-over-year basis, primarily due to the decline in automotive first-fit.

Our replacement channels were less impacted, with the automotive replacement channel in particular seeing nearly flat core growth performance on a year-over-year basis in June.

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Our business in North America performed in a similar fashion to what we experienced in Europe overall and improved sequentially after bottoming in April. Sales into replacement channels outperformed first-fit, with automotive replacement showing the most significant improvement within the quarter, exiting with mid-single-digit decline. All industrial markets were down significantly but improved during the quarter, with the most notable improvement also coming in the month of June. As to our East Asia and South America regions, those regions demonstrated slower rates of recovery in the quarter, with the largest impact coming from extended shutdown in India.

Moving now to our segments on slide 6, starting with Power Transmission business. Power Transmission business in Q2 saw core revenue decline 23.7% on a year-over-year basis. Within this revenue decline, our China business generated a modest level of growth, while our automotive business in China improved throughout the quarter. It was a solid performance in the industrial end markets, particularly general industrial and heavy-duty truck that drove the growth.

As to the other regions, North America was impacted the least and improved solidly throughout the quarter, driven by the larger percentage of sales directed into replacement channels, particularly automotive, agriculture, and general industrial applications. Our business in Europe showed the most significant improvement throughout the quarter, also led by the replacement channels, with our automotive replacement business rebounding in the quarter and exiting nearly flat on a year-over-year core basis in June.

One of the notable effects in the quarter that we anticipate will remain for an extended period of time is an increase in demand for our belts and related components in the personal mobility applications. Although it is a relatively small piece of our overall revenue, this business has been growing significantly, a trend we expect to continue, particularly as many commuters search for alternative forms of transportation and localized recreation during this crisis and beyond.

During the second quarter, we launched a number of new personal mobility products that cover a wide range of applications, from e-bike and traditional bicycles to powersport vehicles, capitalizing on what we believe are the inherent advantages of our belts versus traditional [ph] change (14:39) in applications that offer positive longer-term secular trends.

Our industrial chain to belt initiative had another strong quarter of design wins in applications, including automotive assembly plants, aggregate facilities, medical product manufacturing, and industrial dispensing equipment. We are pleased with our ability to drive a solid level of design wins, as we deployed virtual sales and marketing tools to continue to engage our global customers.

Let me move now to slide 7. Our Fluid Power core revenue represented a decline of 30.6% year-over-year, the result of very challenging market environment. After bottoming in April, all of our regions showed sequential improvements throughout the quarter. Similar to Power Transmission, our Fluid Power business in China returned to growth, aided by construction end market. Outside of China, North America was least impacted, the result of its exposure to the agriculture end market and automotive replacement channel.

Our Fluid Power business in Europe saw a large decline across first-fit customers in particular, with sales into replacement channels outperforming on relative basis. The lighter, more flexible new products we have been introducing to our customers continue to gain acceptance in the marketplace.

Our pipeline of opportunities continued to grow, and we had a number of wins in the quarter with our new MXT and PRO Series hoses. Notably, we expect to see the sales of our new Fluid Power products grow this year

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despite the negative market dynamics. Although we are exiting a very difficult quarter, we are encouraged by the more positive business outlook and momentum behind our new products.

I will now turn the call over to our Chief Financial Officer, Brooks Mallard, for some additional detail on the financials. Brooks?

L. Brooks Mallard

Chief Financial Officer, Gates Industrial Corp. Plc

Thanks, Ivo. Moving now to slide 8, which provides a detail on key balance sheet and cash flow items, operating working capital decreased by $107 million compared to the second quarter of 2019, primarily driven by reductions in accounts receivable and inventory. Accounts receivable reductions were driven by lower revenues, somewhat offset by a higher mix to the automotive replacement business.

On an LTM basis, our second quarter free cash flow of $288 million represents an increase of $69 million compared to the second quarter of last year. The increase was driven primarily by lower operating working capital, cash taxes, and cash interest, partially offset by lower adjusted EBITDA.

With respect to CapEx, we are limiting new spending while still funding key initiatives, but we will maintain flexibility based on prevailing market conditions. As a reminder, we undertook a significant growth investment in 2017 and 2018 that improve the reach and flexibility of our manufacturing footprint.

Our return on invested capital was approximately 15% in the quarter, compared to approximately 21% in Q2 of 2019, with the reduction driven primarily by lower operating income. Despite the downturn, leverage has not been an issue for the business. Net debt to adjusted EBITDA increased to 4.8 times, as a result of lower adjusted EBITDA. Although we remain committed to bringing net leverage below 3 times over time, we expect net leverage to continue to increase this year on the decline in adjusted EBITDA. We are still confident in our ability to deleverage, particularly as our end markets recover.

Moving to slide 9, this provides detail on our available liquidity, financial covenants, and debt maturities. Our liquidity position strengthened to approximately $1.1 billion at the end of the quarter, consisting of $640 million in cash and $415 million in revolver availability. Our credit facilities remain undrawn, which we do not anticipate changing this year, and we do not have any material debt maturities until 2024. We continue to expect to generate substantial free cash flow in 2020, which will further strengthen our liquidity position.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Brooks. While we saw improving business trends throughout the quarter, the strength and pace of the recovery from COVID-19 remains uncertain. As such, we are updating our high level 2020 framework and do not plan to provide guidance in this environment.

Based on the data available to us today, we expect the second half of the year to get progressively better, with core revenue in Q3 anticipated to decline 10% to 15% year-over-year, which represents a notable sequential improvement from Q2.

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In China, we expect industrial end markets will continue to perform well, and sales into the automotive replacement channel will continue to grow. In North America and Europe, which have performed similarly, today, we expect to see a continued trend of improvement across the business. While sales into first-fit channel improved throughout the second quarter, they remained relatively weak overall. With the most significant improvement in first-fit sales only coming in June, we believe we will see the channel's performance continue to accelerate in Q3. We also expect to see incremental improvement in replacement channel sales, as distributors have largely maintained prudent inventory positions despite improving end market demand.

Our second half decremental margins are expected to be approximately 35%, a result of the benefits we are now seeing from the actions taken over the last four quarters to rightsize the business and respond to COVID-19. We are maintaining our full-year capital spending expectations of approximately $70 million to support maintenance and key growth initiatives. From a free cash flow perspective, our expectations haven't changed. We anticipate generating substantial free cash flow this year in excess of adjusted net income, while still funding key initiatives to build on our strong competitive position.

So let me wrap things up on slide 11. The challenges presented by COVID-19 are certainly not over. However, I am pleased with how our global teams executed in second quarter, delivering results better than our expectations three months ago, as we reacted to the unprecedented macroeconomic decline. Given the trends we are seeing, we are shifting our posture to what we believe will be continued trajectory of business recovery.

During this crisis, we have maintained our ability to respond to demand improvements, while increasing our operational flexibility and continuing to fund our key initiatives, which we believe will serve us well as our end markets continue to recover. The improvements in our end markets notwithstanding, we remain operationally focused on what we can control and continue to pragmatically manage our discretionary spending and compressible costs. We anticipate these actions, in combination with the progress made with our restructuring program, will allow us to deliver strong incremental margins as we return to growth in the near future.

We continued to win business in the quarter with our new products and also took share in the replacement channels due to the relative breadth of our product coverage and reliability of supply. Investment in innovation remains a significant priority, and we believe the benefits we have seen will only be further enhanced as our end markets recover. Our sales into replacement channels have fared significantly better than first-fit channels, particularly in our larger regions. We believe this speaks to the critical nature of our products across a broad range of end markets and applications we serve.

In closing, I'm very proud of our team's performance over the last three months. I am certain we will see additional obstacles, but I am confident in our ability to navigate through them and deliver value to our associates, customers, and shareholders.

Thank you, and we will now turn the call back over to Robert to begin the Q&A.

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QUESTION AND ANSWER SECTION

Operator: Certainly. Thank you. [Operator Instructions] Your first question comes from the line of Julian Mitchell with Barclays. Please go ahead. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good afternoon.

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

A

Hi, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Maybe just the first question on that top-line outlook, that low-teens decline dialled in for Q3, maybe just help us understand how you see the different trends between the two segments within that third quarter sales drop. And also maybe touch on China a little bit as well. You gave some good detail already, but maybe help us understand, are you seeing month-on-month improvements still in China? Or do you think we might be starting to see some kind of plateauing of that initial kind of [ph] full month (25:53) or so recovery pace?

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

A

Good questions, Julian. Let me try it this way. Look, based on the trends we have seen, we would expect the improvements in Q to be reasonably broad-based, frankly across both of our product lines. Our first-fit customers really did not begin to meaningfully recover from very depressed levels until June. They were the most impacted with most of the shutdowns that we have seen. So we expect plenty of room to be able to see continuation of the improvement in demand trends.

In the replacement channels, our main channel partners frankly are still largely managing their inventory levels in a very prudent way, particularly on the industrial side of our business. I would say that we have seen the sales out of the channel partners or the business that they do continues to outpace our sales into our channel partners. So that would give you an indication that they still manage their inventory to a degree, and at the Q3 level, we anticipate that we will start seeing more normalization of our sales into the channel, more in line with their sales out, taking into an account that we have seen a significant amount of channel inventory reductions over the last three or four quarters.

Coming back to China, we continue to see improvements in China in a very broad sense. Again as I have highlighted in my prepared remarks, July continued to see pretty much across all channels and all applications. So, our sense is that we will see continuation of improvement in China throughout Q3. And we have taken all of that into account, providing that guidance of 10% to 15% down year-on-year. And as I said, pretty significant reacceleration from what we have seen Q2, a very challenging Q.

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Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks, Ivo. And then just one quick follow-up, the decremental margin guide for the second half, that's kind of steady with what you just reported, even though you've got a narrower sales decline. Is that really about managing the – thinking about managing to that margin, so you're kind of reinvesting for the upturn? Maybe there's some return of temporary costs, [ph] but certainly (28:52) I could understand how the decremental could be narrower if you wanted it to be. So is it more about positioning for the upturn as to why it stays in that mid-30s level?

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

A

Yeah. I think that it's important to state that we continue to invest for the long-term future of our business. And we really haven't taken the foot off the pedal on portfolio reinvention and we'll continue to do that and maybe accelerate it as we move out of Q2. But we also, as you can recall, have begun to take significant cost actions in the second half of 2019. And as you very well outlined, when volumes improve in second half, some portion of the variable costs will start coming back with the higher sales.

Given the current environment that we are in and the gross margins that we generate, we certainly believe that 35% decremental margin is an appropriate target for second half of 2020. But I also would remind everybody that over the midterm, if all of our restructuring benefits start flowing through the P&L, we would expect that the target is going to start trending lower. So second half 35% is probably appropriate plus or minus, but it will trend lower as our restructuring is nearing completion.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

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

A

Thank you.

Operator: Your next question comes from the line of Deane Dray with RBC Capital Markets. Please go ahead. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good afternoon, everyone.

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

A

Hi, Deane. How are you?

Deane Dray
Analyst, RBC Capital Markets LLC

Q

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I'm doing very well, thanks. Could we go back to your comments, Ivo, about the distributors? You said that there was some destocking going on in the quarter, but you thought that might begin to normalize this quarter, but the idea is would there be a – would that be a very gradual process, where you might see sell-in then reverse and it would be – would it come in a bigger chunk or would be very gradual? Any sense of how distributors are acting in this environment.

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

Yeah. So, Deane, as I said, we are still seeing sales out, out of our channel partners, outpacing our sales in more or less. I will remind everybody that we have seen inventory channel destocking for a reasonable amount of time now, right? This is not the first or second quarter that we are seeing that. So my sense is that inventory levels, at least with the largest distributors, that we have a reasonably good visibility. We feel quite confident that they are nearing or approaching the end of destocking; there still may be some level of limited destocking going through Q3, but not-too-distant future from now, my expectation is that we will start seeing the sales to approach their sales out. And ultimately they'll need to start outpacing their sales, because of the level of inventory that they have managed down to. So, I think that inventories are in reasonably good shape from where we sit.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Good to hear. And then can you comment on price cost in the quarter and expectations in the third quarter?

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

Yeah. Price material economics remain positive, Deane. We anticipate that it will remain so for the second half of the year. And as you know, we are reasonably focused on that. [indiscernible] (32:49) a downturn or an upcycle, we always want to make sure that we outpace material economics.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Got it. And just last question, the idea that you're getting good traction with some of your newer products, so just kind of take us through and highlight which of those products you think are making a difference here. And are the – is your approach to sales, doing it more virtually, how has that worked out, and anything like permanently [ph] that's (33:22) going to change in terms of your go-to-market post-COVID?

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

Yeah. So let me start with the second part of your question, and I'll come back to the first a little bit later. So we have deployed a number of virtual sales tools. We are investing actually quite aggressively in a digital front-end. And we have seen reasonably good progress in our ability to switch into this virtual new world, that certainly for 110-year-old industrial company, I think this was quite new for us. So we are – I'm very pleased with how well we have been able to respond to the restriction in people's movement. We have conducted virtually hundreds of virtual training sessions and marketing sessions over the last quarter. And I would say that we've probably had the largest – and that's very surprising to me, the largest number of folks attending these training seminars and educational sessions and marketing session more so than what we actually see in person.

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So my sense is that we will lean forward on utilizing these digital marketing tools well into the future, regardless of what happens or how fast we're going to be able to return to more normal business conditions. So, I think that there is an attribute of this that's a very good outcome for companies that invest in those tools.

Now coming back to the first part of your question, Deane, we see a very nice pace of not just design wins, but also invoicing of products that we have launched over the last 18 months, in particular fluid conveyance products. As you know, we have been speaking now for a significant amount of time about reinventing our Fluid Power portfolio. And we now are seeing the fruit of that labor to frankly start coming to fruition. So we anticipate that we will have the highest sales of these new products that we have seen over the last 18 to 20 months or so. And that bodes really well for the future when you take into an account that last quarter, the sales in Fluid Power were down about 30%. And yet with being down 30%, the sales of new products were flat to up year-over-year. So that is really, really good.

Now we also have put a pretty significant effort into the reinvention of our Power Transmission portfolio. And as I've highlighted in my prepared remarks, we are now starting to see a very nice acceleration of design wins, whether or not it is in the personal mobility space, which is growing quite nicely for us, and it's a business that's kind of $75 million, $80 million in scope, yet the business is going to grow very nicely in 2020 despite the COVID-19 pandemic. So we are very excited about that business.

The other business that we are very excited about is the pace of design wins in industrial chain to belt. We continue to touch applications that range from industrial automation, warehousing products. I've spoken a little bit about aggregate materials. So we are converting the equipment used by folks that deal with aggregates. It's very exciting time, and I feel that over the midterms, this will bode well for our business, and it should bode well for our shareholders as well.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you.

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

A

Thank you.

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

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

Q

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Hey, it looks like July orders continued to kind of improve sequentially, but just wanted to understand better what the July orders look like relative to the guide and how much more improvement you have sequentially from July and, if any, into August, September to kind of get to that 10% to 15% decline.

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

A

Yeah, look, so we saw a broad trend of improvements across our business during second quarter exiting second quarter. That trend, as I have highlighted, has continued nicely in July. I think I said that core revenue was down 30s in April improving to high 20s and then in June, we have seen declines kind of in mid-teens.

So, frankly, sales into the replacement channels continue to see greater improvement throughout the quarter. First-fit was still pretty tough but it has improved in June, and it has improved to the next level in July. We see still an elevated level of uncertainty certainly that's out there as you can appreciate and I think that as you hear from many of the companies in your coverage. But frankly, the trends are improving and what we have seen in July gives us high degree of confidence that we will be able to meet our guidance for Q3.

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

Q

Okay. And are there any markets that seem to be – I mean, it seems like good sequential improvement again but any markets that seem to be kind of plateauing at a level versus continuing to improve?

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

A

At this point in time, we have not seen that, Jeff, but again, I will caveat that with there is lots of uncertainty and lots of our customers have had a really tough Q2. Many of them have been shut down for a substantial amount of time. So we anticipate that Q3, we're going to start seeing some degree of normalization, although I put the normalization in apostrophes because I don't think that we're going to see the normal rate of production for EBIT into the future yet.

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

Q

Okay and then just housekeeping. The minority interest line seemed to swing and maybe there's just a one-time charge in there. Can you just explain what's going on there and should we see kind of more normal run rates as we go forward?

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

A

No, that was just the impact of the restructuring. This is Brooks, by the way. That was the restructuring impact of the Korean announcement that we made.

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

Q

Okay. Okay, great. Thanks, guys.

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

A

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Yeah.

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. Please go ahead. Your line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Hi, good afternoon and good evening.

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

Hi, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Ivo, I'm wondering if you could expand on your comments so it doesn't sound like you saw a slowdown for the pace of the recovery and you had mentioned that you had exited June with core growth down 10% to 15% year-over-year. So in July, did we move towards the single-digit range in terms of the year-over-year performance?

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

No, Jerry. I said that June, we exited down mid-teens and that we continue to see improvement from June into July. That is what I've said and my sense, Jerry, is that the improvements, they are here in July certainly from where we sit today, but as I said, we anticipated that will occur and we've taken that into account when we issued the outline guidance of 10% to 15% down for Q3.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

And Ivo, which replacement end markets outside of China are turning positive or close to turning positive in July?

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

Automotive replacement in Europe has been positive and we have seen an improvement across – yeah, pretty much across both of the replacement set of applications in PT and FP, but Europe has turned positive in July.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

And any others that are close?

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

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I'd say North America AR, very close.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And then as you folks complete the tweaking of the footprint and the restructuring, can you talk about what are you learning as you complete those actions? Is there an opportunity for further productivity improvement even once the recovery gets going? Are there things that are coming up as you're dealing with the crisis plus the restructuring that could drive actually opportunities as we think about the footprint a couple of years from now?

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

A

Yeah. So first of all, one of the things that I would say that's most astounding is that we are able to do restructuring during a time where you are constrained in people's movement. So as you can imagine, we have not been able to send our most qualified people from a plant to a plant to ramp down one facility and help to ramp-up in other facilities. So our teams are performing extremely well in duress and this also speaks about the in-region for-region capability that we have been building over the last couple of years. So I'm very proud of how our teams have been executing.

That being said, I think that we are making great progress with all of the activities and I think that we anticipate we will be done kind of mid-year next year with all of the already announced actions. But as you have very correctly outlined, we are also learning that we have more capabilities to do potentially more restructuring but we will identify those and highlight those as we complete the projects that we are presently having on a docket. And we think that this is basically a process that's going to go on for a good amount of time, particularly as we are getting bigger and broader presence in areas that have a greater availability of labor with much greater flexibility to react to supply and demand changes.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you. Appreciate the discussion.

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

A

Thank you, Jerry.

Operator: And your next question comes from the line of Andy Kaplowitz with Citi. Please go ahead. Your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Good afternoon, guys.

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

A

Hi, Andy.

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Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, so we know it isn't that large, but India and then maybe Southeast Asia in general seems like it's been a drag on both your decrementals and your revenue decline. Have you been able to generally get back online in all of your facilities, including India? If you can talk about how much of a drag on profitability on your business India was in Q2, that would be helpful.

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

A

I don't think that I'll be breaking down the profitability of India and Southeast Asia but, yes, we are finally back up fully in India. And I would say that the demand is starting to slowly come back. We anticipate that we're probably going to be, I don't know, 60% to 75% back in India in Q3, and we anticipate that that's going to progressively get better in Q4.

India was really the toughest place for us, Andy. It was, for all practical purposes, shut down for the entire second quarter so it was a reasonably good amount of drag. It represented a good amount of drag and as we have discussed, it's about a $90 million some-odd revenue in India for the full year. So it's not a huge amount of revenue, but when you are dealing with a pandemic, every drag is just another headache that you have to deal with. So I'm glad to see that India is back up. It's operating well. It came up well but we are now looking towards the healing of the demand in India.

On the second part of your question, yes, all of our facilities are now operational. Everything that we operate in all regions are now for practical purposes producing products for customers' demand to a different degree obviously of demand levels.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

It's good to hear, Ivo. So just if I remember correctly, in China, auto first-fit has been a little bit tougher than auto replacement for you guys sort of over time. And I think you mentioned that auto replacement's already turned the corner here. So maybe you can talk about sort of Gates' market share in China, sort of what are you seeing on the auto side as we do see some recovery there? I mean obviously on the industrial side, we've seen recovery and how you've done in terms of market share in the different sort of verticals that you've talked about.

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

A

Yeah. So auto first-fit, we anticipated that the trajectory of improvements is going to continue into Q3 and if I had to guess, my sense is that auto first-fit is going to be kind of flattish into Q3 and it was down mid-single digits to high single digits in Q2, auto first-fit that is. AR in China was a positive core growth and we anticipate that that will continue.

Industrial first-fit was nicely up in teens in Q2 and again, our expectation is that that will continue. And the industrial replacement was up mid-single digits and again, our expectation is that, that that trajectory continues throughout the quarter.

So China is healing nicely. The biggest impediment that we had in China in Q2 was auto first-fit. That took a little a little longer to repair, but our anticipation – the market, that is and my anticipation is that we will see kind of a flattish Q3 in auto first-fit there as well.

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Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, just one quick follow-up on that. I think I remember that you had that sort of expansion or renovation of your China facility. So is that helping you in Fluid Power here as the industrial markets come back?

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

A

Absolutely. I think this is a great point. Some of these investments, as difficult as they look in one year, the next year, they look really smart and I would say that, that that investment that we have made in Fluid Power in China has been very, very instrumental in our ability to deliver that growth when the growth became available, and being able to supply these products for our customers when they need them during their rebound of their business activity.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Ivo.

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

A

Thank you.

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

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

As always, thank you, everyone, for your interest in Gates. For those of you in particular dealing with the effects of the storm now on the East Coast, stay safe and we look forward to speaking with you again in November.

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

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