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Gates Industrial Corp. Plc (GTES)

Q4 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 Q4 2020 Earnings 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 conference over to your first speaker today, Bill Waelke, Head of Investor Relations. Thank you. Please go ahead.

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

Thanks, Megan, and thank you everyone for joining us this morning on our fourth quarter 2020 earnings call. I'll briefly cover our non-GAAP and forward-looking language before passing the call over to our CEO, Ivo Jurek, who will be followed by Brooks Mallard, our CFO.

Before the market opened today, we published our fourth quarter and full year 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.

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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. 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 first quarter report on Form 10-Q filed in May of last 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.

I'll now hand things over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good morning all, and thank you for joining us on our fourth quarter earnings call. As we begin, I would like to recognize and thank each of our global Gates associates for the commitment they displayed throughout 2020, working diligently through a very challenging COVID-induced economic environment, while staying through the Gates core values.

Not only did we step up to meet these challenges head on, we also continue to deliver on our mission to drive above market organic growth and expand margins. We accelerated innovation, improved profitability, generated strong cash flow, and strengthened our balance sheet by reducing gross debt.

Our fourth quarter results demonstrate the benefit of our transformation and highlight the resilience and strength of our business model as we return to strong year-over-year growth. The improved business activity we saw in the third quarter continued and expanded to all of our regions and both segments.

The solid growth performance in the quarter was accelerated nicely by our initiatives. Sales of our newer products performed well, continuing their trajectory that has been largely unaffected by the pandemic. The flexible posture we maintained throughout the pandemic allowed us to efficiently navigate the transition back to growth and expand margins in the quarter compared to the prior year despite COVID-related costs and inefficiencies. Our new manufacturing plants and the increased labor flexibility they provide played a key role in scaling up to support the growth. The Gates production system continues to provide a solid foundation for operational performance, delivering strong productivity gains that drove outstanding year-over-year margins expansion.

Additionally, our restructuring program is proceeding well and it will deliver more significant savings later this year, aligned with the plan we originally laid out. The fourth quarter was strong for cash generation. Given the large amount of cash we had accumulated, we took the first step in demonstrating our firm commitment to deleverage the business and reduce our gross debt by $300 million. We believe the strong cash generation capabilities of our business combined with our solid liquidity position provide us with plenty of flexibility moving forward.

Gates exited Q4 well-positioned and we're expecting a return to healthy growth in 2021. We are reinitiating our annual guidance, which I'll touch on later in the presentation.

So with the highlights covered let's move on to more details on the results. Slide 4 provides an overview of our fourth quarter results. Total revenue of $794 million increased 9.4% year-over-year including a positive foreign currency impact of 80 basis points. Core revenue in the quarter increased by 8.6% year-over-year. Our performance was significantly better than the high end of our guide we provided on our Q3 earnings call. The elevated uncertainty surrounding COVID-related shutdowns did not materially affect our results and we were able to drive mid single-digit market outperformance through new products and growth initiatives. We saw significant

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improvement across the business with all of our regions returning to positive core growth. Sales into replacement channels continue to accelerate nicely from Q3, but the most notable improvement came in our OEM business particularly in the industrial end market.

Fourth quarter adjusted EBITDA was $163 million representing growth of 20% compared to the prior year and margin expansion of 190 basis points. This margin expansion was primarily driven by gross margin improvement achieved through a combination of volume benefits and strong operational execution, offsetting COVID-19 costs and inefficiencies. Normalizing variable compensation in Q4 2019, this would represent an incremental margin of approximately 55%.

We maintained a positive price/cost position in the quarter and are confident in our ability to continue to offset raw material inflation. Our fourth quarter adjusted earnings per share were $0.20, an increase of 5% compared to the prior year period. The increase we saw in operating income was partially offset primarily by higher income tax.

Moving now on to slide 5, which shows the geographic breakdown of our revenue. We delivered a healthy growth across all of our regions with China performing the best. Growth in China was led by strong performances in the automotive replacement and industrial businesses. Growing the automotive replacement channel in China has been a significant initiative of ours and we have made great progress, exiting the year with our highest level of quarterly revenues there.

Our businesses in Europe and North America continue to perform similarly, both displaying solid high single-digit growth in the quarter. Both regions saw above market growth rate, driven by new products and growth initiatives. In Europe growth was driven primarily by a significant improvement in sales into OEM channels. Sales into the automotive replacement channel also continued to grow nicely while the industrial replacement channel improved substantially from Q3. The high single-digit growth in North America was also led by a meaningful improvement in first-fit channels.

In our industrial markets, nearly all experienced year-over-year growth with the strongest performance coming in agriculture and diversified industrial applications. The automotive replacement channel continued its trend of solid growth. I will note that we saw the industrial replacement channel distributors increase their purchases to meet rising end user demand without any notable increases in their inventory levels.

Lastly, our business in East Asia and India showed the most significant improvement from the third quarter. The nice improvement we saw in the month of September there continued in the fourth quarter with particularly strong growth in our OEM business.

Slide 6, highlights of our segments, both of which had strong performances in the fourth quarter. Core revenue in our power transmission segment grew 9% on a year-over-year basis and improved 9.4% sequentially. After our total sales into replacement channels returned to core growth in Q3, we saw sales into OEM channels follow in Q4 returning to strong core growth as well. Segment EBITDA margins improved 170 basis points driven by strong operational execution and volume.

Our fluid power core revenue increased 8% year-over-year, representing significant sequential acceleration of 17% from Q3. Similar to power transmission, the growth was led by a recovery in our OEM business primarily in the on-highway and off-highway industrial applications. Sales into replacement channels also grew nicely. Fluid power segment profitability improved by 200 basis points due to higher volume, execution on our operational initiatives and higher efficiencies at our new plants we brought online in 2018. So across both segments volume

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benefits, pricing, and operational initiatives more than offset some raw material inflation and the elevated COVID-19 related inefficiencies.

With that, I will now turn the call over to Brooks for some additional detail on the financials. Brooks?

L. Brooks Mallard

Chief Financial Officer, Gates Industrial Corp. Plc

Thank you, Ivo. Moving now to slide 7, and some additional detail on key balance sheet and cash flow items. On an LTM basis, our fourth quarter free cash flow of $242 million represented 118% of our adjusted net income. Our cash flow performance was driven by lower capital spending, lower cash taxes and interest, and better working capital performance. As a percentage of annualized Q4 sales, trade working capital decreased by 340 basis points compared to the same quarter in 2019. While volume accelerated during Q4 we were able to reduce our overall investment in working capital by approximately $16 million net of FX impact.

Our return on invested capital was a solid 15% despite the challenging conditions we experienced for most of the year and represents an improvement of 100 basis points compared to Q3.

On slide 8, we provide detail on our available liquidity and debt maturities. At the end of the fourth quarter we used cash on the balance sheet to repay $300 million of our US dollar term loan which will result in approximately $11 million of annual savings in interest expense. After this debt repayment, we continue to maintain ample liquidity with over $900 million of cash and revolving credit lines available at the end of the quarter. We will remain opportunistic with respect to our capital structure and are committed to continue to reduce our overall gross debt.

Net debt in the quarter improved from Q3 to 4.3 times adjusted EBITDA. As our end markets continue to recover and based on our current view of 2021, we expect to be at or near net leverage of 3 times by the end of this year.

Moving now to slide 9 and a brief summary of our full year performance in 2020, which from an operational perspective was one of the most challenging years the company has experienced and a tale of two halves. Full core revenues declined 8.4% with an 18.1% adjusted EBITDA margin. However, our business recovered strongly after bottoming in Q2. We delivered 2% positive core growth in the second half and an associated incremental EBITDA margin of 66%. We took relatively limited temporary cost actions to protect both our ability to supply our critical components to our global customer base and to continue to advance our growth initiatives. While the year was difficult, we executed well and built strong momentum exiting 2020.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. With 2020 behind us, let's move on to 2021. Despite the remaining macroeconomic uncertainty, the end market environment has steadily improved and our business has strengthened giving us the confidence to introduce a full-year outlook for 2021. Based on the broad demands trends we are seeing, we expect core revenue to increase in the range of 9% to 14%. We expect our adjusted EBITDA margin to be in the range of 21% to 22%, reflecting significant margin expansion. This is in line with our commitment to deliver elevated incremental margin despite a significant COVID-related cost headwind during our return to growth.

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CapEx is expected to be in line with our historical average of roughly 3% of sales ranging from $90 million to $110 million to support both maintenance and growth requirements. We also expect to continue to generate a substantial amount of free cash flow in 2021 in excess of 80% of our adjusted net income.

Given the unique dynamics of 2020, we are planning to provide additional detail on the prevailing quarter on a rolling basis. For Q1, we expect our total revenue to be in the range of $810 million to $840 million and our adjusted EBITDA to be in the range of $170 million to $185 million.

Now let me move on to slide 11. The fourth quarter marked an excellent performance and highlighted an anticipated business transformation-driven turning point for the business. As evidenced by our guidance, we believe 2021 will be a strong year.

We also believe the investments we have made in our portfolio and the work we have done to reposition the business provide us runway not just in 2021, but well into the future. The diversified nature of our business provides us with exposure to highly attractive end markets, which we have broken down in more detail here on slide 11. A significant number of these end markets are benefiting from nice secular tailwinds.

As we have spoken about in the past, we continue to bring in key design wins in industrial automation, logistics, and personal mobility applications to name a few examples. Many of these design wins have been made possible by our new products. As we move forward, we believe our revitalized product portfolio and investments directed towards targeted commercial initiatives in these attractive end markets provide us with an opportunity to deliver above market growth over the mid-term.

Moving now to slide 12 to wrap things up. We delivered results that significantly exceeded our expectations for the quarter. I am very pleased with the momentum we have seen in the business and the execution of our teams globally.

With significant progress that we attained on driving structural changes to our business, we maintain that we are in much stronger position today than when we entered this pandemic-induced recession. Our end markets are recovering and the investments we have made over the last several years are serving us well. Our new plants are providing the intended benefits, and sales of our new products continue to grow nicely, aided by solid secular market trends. We are driving significant operational productivity and thoughtfully managing price-mature economics through our Gates operating system, which in combination with the savings from our restructuring program we expect to contribute to additional margin expansion in 2021. Our commercial teams are focused on delivering above-market growth by executing on large organic initiatives that leverage our global scale, broad portfolio, revitalized products, and system design expertise into structurally attractive end market resulting in a positive view of 2021.

2020 was obviously a uniquely challenging year, however one that we believe validates the resilient and the quality of our business. We are excited about the potential that 2021 holds and look forward to demonstrating further progress on the investments we have made both in our product portfolio and footprint. We believe these investments in combination with improvements to our cost structure provide a runway for above market growth, margin expansion, and strong cash generation.

With that, I will now turn the call back over to Megan to begin the Q&A.

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QUESTION AND ANSWER SECTION

Operator: Certainly. At this time, we would like to take any questions you may have for us today. [Operator Instructions] Our first question is from Andrew Kaplowitz with Citi. Your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Good morning, everyone. Hope everyone is well.

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

A

Good morning, Andy.

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

A

Good morning.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Can you give us some more color into your 9% to 14% core sales growth guide for the year? Because if I look at Q1 you made 25% at least at the midpoint. You're baking in a Q1 that would be the high-water mark in terms of quarterly sales for Gates. So is that just conservatism given the short cycle nature of the business? Is there anything else going on? And are you concerned at all about the recent auto production shutdowns that we've seen?

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

A

Thank you for the question Andy. Look we are going to stay away from further breakdown of our guide beyond what we have already provided, but fundamentally, our markets are supportive of our growth initiatives, are performing well. Look, there's some macro that does remain, but we are quite constructive for the full year.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Easy enough. And then Ivo, maybe you could give us a little more color on the status of all your new product initiatives. I think this is the first time you've quantified the impact of your new product growth both in your quarterly results and now on your forward guide with that mid-single digit outperformance. So maybe give us a little more color into the acceleration you're seeing on the new product front. Which segment is actually having more impact if we look at the 9% to 14% core growth going forward?

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

A

Andy, it is reasonably broad-based. We have been able to see the acceleration of some of those highlights that we have provided over the last, I want to say five quarters to six quarters. We've seen really nice gains in

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businesses like personal mobility as an example, which grew over 20% in 2020, despite all of the COVID-related headwinds that we have seen.

We have seen a significant amount of design wins in some of the attractive end markets that I've highlighted on slide 11 that are associated with industrial, automation, logistics and robotics. And we also see a pretty nice set of uptake in demand for our new products in fluid power. I have spoken quite a bit about the MXT and MXG product portfolio revitalization. Those sales exited at frankly the best position that we have seen since those products were introduced in December. And we are very optimistic that as we work with our customers, and they are looking at some of their underlying trends and building their machinery and equipment that they want to launch that is more efficient, lighter, consumes less energy and provides more uptime, that's really the sweet spot of what the reinvention of our product portfolio brings to those customers.

So it was very broad-based. It was across all regions and it was nicely represented across both of our segments.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Ivo. I'll turn it over.

Operator: Your next question is from Jeff Hammond with KeyBanc Capital Markets. Your line is open.

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

Q

Hey, good morning guys.

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

A

Good morning.

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

A

Good morning.

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

Q

Just on inventory levels, it sounds like inventory is still low and you're not really seeing any restock of note or maybe there are some areas. Just talk about what do you think or what you're hearing from your customers and what you've kind of built into the guide in terms of any restock happening.

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

A

Yeah. I think – thank you for the question first of all, Jeff. Look, I think as I've mentioned in my prepared remarks, we really have not seen any elevation in the channel in the – particularly, in the industrial replacement channel. We have seen that our customers are starting to buy more products. I think that they're feeling more confident about their end market demand than from the data that we look at on a monthly basis. We've seen that those purchases are very much in line with where the end user demand. So no elevation there.

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On the automotive replacement side, the market has been performing quite well. We have been able to outperform the market with our results, and I think that we are benefiting from operational continuity that we have been able to demonstrate throughout the second half of the year and we also have not seen a significant or frankly any elevation in inventories.

On the OEM side, as you know, Jeff, if it becomes a little more tricky, we generally speaking build to what our customer releases look like, but if you take a look at some of the publicly disclosed data from some of the large OEMs, the expectation is that that they have seen an inventory decline, not necessarily an inventory rebuild of their equipment. So my sense is that you know the markets are just in a healing stage, not really at a significant restocking phase.

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

Q

Okay, that's great. And then just your slide 11 was really helpful in terms of the end market breakdowns and updates. If you look at that 9% to 14% kind of growth you're building in and you look at the end markets, are there any that are clearly going to be at the top end or outperform in the top end or vice versa kind of when do you see is as bigger laggards within that?

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

A

Yeah. Look, my sense is that – and again, I think I answered it when Andy was at the helm of questioning there. Look, we're very constructive on personal mobility. We have been building a very nice product portfolio there, differentiation, particularly, replacing chain in personal mobility and some of the trends. That you are seeing with people staying away from public transportation, that bodes well for us. And we expect a performance above that guide that we have provided you.

We're also very constructive on diversified industrial. There are a lots of secular trend winds. And we have spoken quite a bit about the design wins in warehousing, logistics, robotics, some of the e-commerce trends that continue – we all continue to see and benefit from. So we are very constructive on that market segment, and we have a very good presence. And we have done a lots of work particularly over the last couple of years.

Look, automotive replacement is very strong and we have continued to do a terrific job in growing our presence there. I've spoken about our China business in automotive replacement. In particular, it exited 2020 kind of on a $100 million run rate. And just kind of for a reference, our China team has more than doubled that business in under three years. So we continue to see that there's some positive tailwinds in that business as well.

So I would say lots of green shoots versus where were maybe as recently as two quarters ago. And the fact that our view is that the markets are just healing, not really kind of being totally robust yet, we think that all of our segments with the exception of energy resources is going to be a plus in 2021.

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

Q

Okay. Great color, Ivo. I'll jump back in queue.

Operator: Your next question is from Damian Karas with UBS. Your line is open.

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Damian Karas
Analyst, UBS Securities LLC

Q

Hi. Good morning, everyone. Really nice quarter.

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

A

Thank you, Damian. Good morning.

Damian Karas
Analyst, UBS Securities LLC

Q

So we have been hearing from some other companies operating in some of same end markets about supply chain issues. Was just wondering if you could give us any color on what you're seeing and hearing and to what extent if at all you've maybe accounted for such issues in your guidance for the year.

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

A

Yeah, sure. So when I think about your question, Damian, I kind of think about in two ways. One is inflation. And we have seen a moderate increase in inflation, raw material inflation in particular in fourth quarter. But this is something that we have anticipated taking into an account what you see in terms of liquidity and what you see in demand, some of the demand coming back reasonably nicely. And so we have been very actively managing our raw material costs.

And we certainly are very confident that we will be able to offset any raw material inflation with actions that we have taken either by new products that are more efficient, they're using less raw material to perform the same function and/or positive price realization. So they will be on one side.

On the other side, look, lots of disruptions associated particularly with logistics. But again, I think that the work that we have done, the transformation that we have driven at Gates, particularly with the new plants that came online in 2018, are giving us a great in-region, for-region operating strategy. It gives us multiple sources for raw materials. And certainly, we have not seen much in terms of disruption of our supply chain.

But I would tell you that if you're trying to get product on the ocean or airship it, it's very difficult as the additional complexity associated with the availability of freight. But I think that that's where our ability to have gotten and leaned forward in the transformation process that we have gone through and giving us the opportunity to be much more in-region, for-region frankly with very de minimis amount of transatlantic or transpacific cross shipments, I think is positioning us well. And the last point of your question is that we've anticipated inflation and we've anticipated incremental logistics in our guide.

Damian Karas
Analyst, UBS Securities LLC

Q

Okay. Got it. That's really helpful. And then I wanted to also ask you about the margin guidance here, 21% to 22% adjusted EBITDA margins. I was wondering how much discretionary cost savings from this past year you expect to come back if any at all. Maybe you could just kind of bridge the margin in terms of the fixed cost savings kind of still have yet to hit the P&L, any of that discretionary costs coming back potentially and I guess just any other considerations factoring into that margin guidance.

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

A

Hey, this is Brooks. I'll take that one. So first on the – just kind of highlight the restructuring. We're still on pace to deliver our run rate of $40 million by the time we get to the end of 2021. We've got some savings in 2020. We'll get most of the incremental savings in 2021 and then we'll still have a little bit left over that we get in 2022. So that's going to help drive the margins.

As far as discretionary cost, I would say that we're still seeing more headwind from an efficiency perspective in the factories than we're saving on a discretionary basis on the SG&A line. So you have absenteeism, you have people moving in and out, you have training, you have these different headwinds that we're seeing as we make sure we were able to supply our customers. And so as that starts to alleviate through the year, that'll probably offset the comeback of the discretionary cost. So net-net, probably still a little bit of a headwind as we get through COVID, but should start to abate as we get toward the end of the year and we get out of this.

Damian Karas
Analyst, UBS Securities LLC

Q

Okay, got it. Thanks a lot. I'll pass it along.

Operator: Your next question comes from Jamie Cook with Credit Suisse. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. I guess my first question, obviously, the margin guidance is strong for 2021. I'm just wondering how we should think about the margins by segment. At what point does fluid power start to catch up more with the power transmission business? So I guess that's my first question.

And then my second question, obviously, you said you'll hit your – or you should hit your leverage target of about 3 times by the end of the year. Just sort of thoughts on capital allocation beyond that. Thank you.

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

A

Thank you for your question, Jamie. Look, from margin recovery into fluid power, fluid power is still not reaching the potential of volume that we have seen in 2018. So we still have a ways to go and we anticipate that as the volumes start catching up, we're going to start seeing those gross margins to – and EBITDA margins to come up nicely in line with what we've been able to accomplish in 2018 and beyond. So that's probably the biggest driver, Jamie, in terms of seeing that EBITDA margin recover on fluid power.

In terms of capital allocation priorities, I would say that a primary focus still is to deleverage our balance sheet. But we are frankly going to remain very opportunistic on growth-related set of priorities as well. I think that we are in significantly better position than I think most folks anticipated when we exited Q2. We are very constructive and committed to get to and below 3 times net leverage. We believe that we will get to 3 times leverage by end of this year, and that will substantially open up additional flexibility for us well into the future. So we feel quite good where we sit and we believe that everything is on the table.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

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Thank you.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes, hi. Good morning, everyone.

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

A

Good morning, Jerry.

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

A

Good morning.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

I'm wondering if you folks can talk about where lead times stand today and the levers that you would pull if you had to scale production up above the high end of your sales range. So sales continues to – or demand continues to improve versus expectations [indiscernible] (00:38:41) can we just talk about the levers we would pull in the footprint today and then how that compares to the last cycle?

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

A

Thank you for your question, Jerry. I think that I'll come back to the expansion of our capacity that we've brought online in 2018 and beginning of 2019. That gives us quite a substantial headroom to be able to deliver volume above that year that we have experienced in 2018.

We've also been able to create a lot more flexibility. In a sense, if you remember, Jerry, I've been talking a lot about getting to locations where we can hire folks and ramp up production more readily. So we have machine capacity in place that will give us a very nice opportunity to deliver whatever volume or incremental volume that's potentially coming and that we may realize.

And lead times, lead times are for us still within a reasonable level. We anticipated lead times will start stretching a little bit as we are able to support the customers that are coming in with may be more robust demand and with a new design wins to be spoken about. And we have the opportunity and the flexibility to be able to ramp up and support them as that may occur.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And what's interesting is 2021, the first year of recovery, your margin guidance is just a point away from where margins peaked in the last cycle. And I'm wondering if you can talk about if the recovery continues into 2022, can you sustain the level of operating leverage that you're delivering in 2021, or how should we think about potential for new highs in margin if the cycle does continue?

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

A

Yeah. So Jerry, I don't want to get over my skis here too far. But look, I think some times in 2019 during our capital markets update day we've talked about 24% EBITDA margins. And frankly we don't see any reason to be committed. We believe that is certainly in play and I believe that the quality of our business is such and the transformation that we have driven both operationally as well as from a portfolio perspective is such that we should be in a situation to be able to come within a striking distance of that 24% EBITDA margin.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. I appreciate the discussion. Thanks.

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

A

Thank you, Jerry.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe just the first question around the margin outlook. So it looks like you're dialing in sort of 45%, 50% incremental margins in Q1 and for the year. So just wanted to check that that's roughly the right ballpark. And is the way to think about it, it's about 35% sort of baseline incremental and then you're adding on a good chunk of those restructuring savings for the balance? And then what's the sort of medium term expectation around incrementals?

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

A

Yeah. Hey, this is Brooks. I'll take that one. So I think you're thinking about it the right way. The one caveat I would put on that is we are seeing some tailwinds from FX. And so we're not going to lever up at the same rate on the FX. That's going to be about our normalized EBITDA margins of 20%. So you've got to separate the core growth out from the FX when you when you do those calculations.

As we go forward based on the profile of the business, and I think what we've said before is 35% to 40% on the on the top line leverage on a go-forward basis is what we would expect, once we get through these restructuring activities that are that are obviously additive.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. And then Brooks, maybe a follow-up for you as well around the – I don't think cash flow has been touched on yet in the Q&A. So I understand that the CapEx is seeing a decent rebound in 2021. Just wondered, any more color you could give us around what scale of working capital, cash headwind we could expect from that revenue bounce? It seemed like in Q4, the working capital kept to a strict discipline even with the revenue turning around. But I wanted for the full year 2021 how big the headwind could be and should we expect free cash flow dollars to still be up year-on-year in 2021 even with that working cap and CapEx headwind?

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

Yeah. So I'm going to be careful about predicting the dollars on working capital because that's going to be pretty tied to how the volume looks in the second half of the year which is obviously a ways out there. And as Ivo said, we don't want to provide any further update on that in terms of other than the guidance that we've given.

I would tell you that Q4 of this year our working capital performance was really strong. We know our collections were good. We did a good job managing inventory. Our payables offset a lot of the increase in raw material inventories that we tried to lay in as we're ramping up production. And we had a little bit of help because we were a little bit more mixed toward the first-fit business in Q4 and that helps us a little bit on the terms, what they are, so we're able to collect a little bit more cash than normal. Obviously that's probably the single biggest thing when you think about what working capital is, that when you get back to a more normalized mix of products we will see a little bit of terms creep toward the replacement business. And so that's certainly one of the factors that's going to affect us.

And then also, as we inflect toward growth, there's going to be some investment in working capital. So that's just one of the things that we're going to have to deal with, right.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Great. Thank you.

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

Yes.

Operator: Your next question is from Deane Dray with RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hello. Good morning, everyone, and thanks again for moving to the morning call timeframe. Thanks.

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

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Just to follow up on Julian's question on free cash flow for Brooks, what's the – on the increase year-over-year in CapEx dollars, could you talk through some of the projects that those are targeting?

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

Look Deane, I think that our normalized rate of maintenance CapEx is cut off in that 1% to 1.5%. We also are doing quite a bit of work in Europe on additional IT infrastructure. So that's going to get some CapEx allocation.

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That's probably a good chunk of the increase. And then we – generally speaking we have about 1%, 1.5% of growth CapEx. And we have done a terrific amount of work over the last three or four years in rebuilding our capital structure, putting new equipment. I've talked a lot about our innovation, frankly, is driven by our ability to revitalize our production processes that are unique and differentiated to us. That gives us an ability to accelerate our innovation cycle and develop these new products that give us the opportunity to drive growth.

And so we will continue to maintain the growth CapEx about 1%, 1.5%. And so that's really kind of the composition. So maybe what's different is a little bit of an investment into IT infrastructure in Europe to help [ph] ourselves (00:47:34) on the enterprise side.

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

A

Yeah. The only thing I would add to that is typically we have more good projects to go after. And so for us, it's all about allocating our time and resources toward the best projects and what's was going to deliver the best bang for the buck. 2020 was obviously a one-off. So it was really kind of back to normal in terms of the good projects that are going to drive strong cash flow and good IRR for the business, so.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

All right. That's real helpful. And then Ivo, you mentioned that you're seeing higher efficiencies from the new plant investments that you made. How is that translating – just qualitatively, what are you doing better? Is it your shorter lead times, higher efficiency, more automation? Just how are those new plant investments translating into better margins?

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

A

I wonder if you [ph] were in (00:48:34) about plants, Deane. You just did a very nice summary of that. So obviously, the new plants, they're larger in scale. So they give us the opportunity to have much more efficient usage of manufacturing overhead. We have new semi-automated – some semi-automated equipment that we have launched in those three – particularly these three new facilities that we have built and brought online in 2018 and early 2019. That gives us the ability frankly to be much more flexible with supporting our global customer base and keep our lead times more in check. But I think it's overall cost structure that is lower and much more efficient manufacturing infrastructure that we have put in place that give us, A, an ability to scale up more rapidly, and frankly do it at a lower cost.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. And then just last question for me, and Ivo, the past couple of quarters you've been real good about highlighting some of the COVID macro trends that are translating into your business like less use of mass transit so you're seeing more people getting a second or third car as well as more investment in personal mobility. And so I'm interested in hearing, when you talk about all these on the diversified industrial part of the slide 11, automation, logistics, robotics, warehouse – that from what we're seeing is going to be a big growth opportunity for industrials over the next several years. What are the chances that you're going to be able to have that as one of these separate categories that we would see on slide 11? How much do they represent today? What kind of growth rate are they expected to see that next year or so? Just those like what I'll call hyper-growth opportunities?

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

You know I think that you hit something that I have been trying to, on several of these earnings calls, hint at, and that is that those are macro trends that we are front and center on. There's couple of very good customers of ours that reported over the last quarter that have a market leadership in industrial automation as an example here in the US and every good customer of ours. And we are working very diligently particularly on a [indiscernible] (00:51:25) opportunities. If you can imagine, Deane, the big opportunity here is to drive efficiency not just because there is more efficient equipment that's being launched and everybody's trying to automate. But you also want to eliminate any potential hazards that industrial chains have a tendency to bring in, environmental hazards.

We are much lighter, much more efficient, consume less energy. We eliminate a significant amount of problematic chemicals in manufacturing our products. So we see these opportunities as very big for us, secular in nature.

And look, my mission in life is to eliminate all industrial chains. And as we have highlighted in the past, that's a very large market opportunity for us where we don't necessarily compete with traditional competitors. We are competing with a completely different and unique technology. So to your point, it's a big opportunity for us and we are very constructive about what it may represent for us as we get out of 2021 into 2022 and 2023.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

That's real helpful. Thank you.

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

Thank you, Deane.

Operator: Your next question is from Josh Pokrzywinski with Morgan Stanley. Your line is open.

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

Hi. Good morning guys.

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

Good morning, Josh.

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

Good morning.

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

So Ivo, Brooks, you covered a lot of ground already, but maybe putting together a couple of the questions that were already asked, I think at the midpoint of the guidance you guys are above where you were in 2017. Margin's

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not quite back to those levels so maybe a little bit of conservatism, just putting that together with some of the comments you made about your factory efficiency, Ivo.

I guess maybe taking that to the next logical step, when you guys get back to 2018 levels, presumably margins should be higher, right? Like that conversion on that extra couple of hundred million dollars between those two years sounds like it should be structurally higher between the savings in 2022 that Brooks mentioned and that operating leverage. Is that a fair point?

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

A

So, Josh, I think that you are thinking about it the right way and I think, as I have pointed out, we don't – certainly we don't believe that we need to [ph] de-commit (00:53:58) a 24% EBITDA margin target over the midterm here as we get out from completing the transformation that we have driven with this business.

I would also point out that we are trying to be realistic about COVID. Although we're all I think learning how to operate with COVID, there are significant amount of inefficiencies that we are still facing. All of the companies around the globe are facing those with folks getting infected, not necessarily in your factories or your facilities but they get infected by – on the outside. That means that they end up in quarantine. And that drives quite a significant amount of disruptions in your facilities because in general, you don't get a sprinkling of few people across your entire enterprise. You generally speaking get hit in locations quite well, and it ends up causing a pretty significant disruption. So we anticipate that it's going to be with us, Josh, at least through the first half of 2021 or until we start getting more robust level of vaccinations that we will be all able to live with once that occurs. So those are probably the two big points that I would like to make.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Okay, that's helpful. And then just on the first-fit side in automotive, obviously a lot of activity going on with new startups, new technologies, [ph] stack (00:55:41) every three days, and presumably some new customers to go along with that. Ivo, I know you've mentioned that your entitlement on an EV can be just as high or higher than on the first-fit side. But what is the actual pipeline telling you? Or are you kind of living up to that especially with some of these newer players? Is there any discernible difference there just kind of the mix changes on the first-fit market here over the next several years?

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

A

Yeah, sure. Really good question, Josh. Thank you for asking it. But when I think about electrification in mobility in particular, I actually look at it more broadly. I look at it if we were looking at our slide 11, I look at it from mobility and recreation all the way to on-highway applications. And we see a very substantial set of opportunities in across that span of the universe. We probably – I would say much more presence in the personal mobility and the recreation space. And we see an opportunity to drive growth quite nicely, kind of a little bit in midterm double-digit level of growth with a degree of consistency facilitated by the fact that it is much easier to electrify a motorcycle scooter and a bicycle, and we already see that, and we had a premium – premier player in those applications.

I would say that on the automotive side, we have bought Rapro a couple of years ago, three years ago and we are seeing good opportunities that we will be executing on as we move forward. And we are winning today programs in on-highway heavy-duty truck.

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So we are quite bullish actually about the opportunities that remain ahead of us. We are well positioned as you know. Despite the fact that there is an incredible amount of bullishness, we also have to maintain focus on managing our business that we generate revenue and profitability on today. And if I look at places like automotive replacement, we are building a very strong VIO coverage, vehicle-in-operation coverage, on the EVs that are on the market today. We've launched over 25 new products in the last couple of quarters. So we are building that very, very nicely, but it's a very small aged car park that that represents. And we are also focusing on the mild and full hybrids that we maintain will give us the opportunity to generate an incremental set of revenue generation opportunities kind of over the next 5 to 10 years.

So, very bullish on electrification, really delighted with the progress we made and I anticipate that at some times midyear when we will have our capital updates day again, we will spend quite a bit of time on giving you a really good purview of what truly this opportunity represents for us over many, many years to come in the future.

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

Hey, thanks a lot, Ivo. Best of luck.

Operator: We have no further questions at this time. I turn the call back to the presenters for closing remarks.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Hey thanks everyone for your time today. Thank you for your interest in the company and we look forward to updating you again on our progress in May.

Operator: This concludes today's conference call. You may now disconnect.

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