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Gates Industrial Corp. Plc (GTES)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to the Gates Industrial Corporation Q1 2021 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

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

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thank you, everyone, for joining us this morning. 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 first quarter results. A copy of the release is available on our website at investors.gates.com. Today's call is being webcast and is accompanied by a slide presentation.

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

Please refer now to slide 2 of the presentation which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking 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

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in our most recent Annual Report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements which may not be updated until our next quarterly earnings call, if at all.

I would now like to turn the call 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 first quarter earnings call. Before I jump into more of the details, let me begin with a few high level thoughts on the quarter outlined on our slide 3. We delivered another quarter of above-market growth, achieving a record level of quarterly revenue combined with strong operational execution.

Our business is off to an excellent start to the year. Economic momentum is building across most of our end markets, resulting in solid performance for the quarter that significantly exceeded our original guidance and the updated expectations we provided at the beginning of April.

Our substantial above-market growth is evidence of the accelerating success we have seen with our innovation investments and growth initiatives which are delivering solid share gains. We saw continued strength across the business as well as outstanding momentum in orders as we exited the quarter.

The exit from the pandemic and the resulting steady economic recovery we are seeing today have created a number of what we believe are transitory headwinds, from the rise in inflation and tight raw material supply conditions to scarcity in labor markets and availability of logistics capacity.

Operationally, our teams were agile and proactive successfully navigating these complexities as well as lingering COVID-induced inefficiencies. To drive productivity initiatives that contributed to our significant year-over-year margin expansion. As a result of our strong start to the year and the trends we are currently seeing in our end markets, we are raising our full year guidance, which Brooks will cover later in the presentation.

Finally, I would like to point you to the 2020 sustainability report we published last week. Gates is committed to doing our part for a more sustainable future, from efforts to minimize the environmental impact of our own operations to designing environmentally friendly products that improve the efficiency of our customers' applications.

The report highlights our focused initiatives related to corporate governance, community involvement, employee health and safety and diversity and inclusion. I'm energized by the employees' engagement across our organization on these key priorities outlined in detail in the report. I would encourage you to review it on our website for the full extent of our progress.

With that, let's move on to more of the detail on the results. Moving on to slide 4. Total revenue in the quarter was $881 million and included year-over-year core growth of 21%. This growth was broad based with sequential acceleration across all end markets, channels and regions. The most significant year-over-year growth came in the first-fit channel where we saw particular strength in the Diversified Industrial, On-Highway and Mobility & Recreation end markets. Sales into replacement channels improved substantially year-over-year with the most notable growth coming from industrial end markets. I will highlight that at this early point in the market recovery, we see no evidence of significant restocking.

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Our first quarter adjusted EBITDA was $196 million, representing growth of over 60% compared to the prior year and margin expansion of 530 basis points. The margin expansion was primarily driven by gross margin improvement, achieved through a combination of increased volume, benefits from our restructuring actions and strong operational execution. Our solid execution more than offset inflation, supply disruptions and COVID-19 costs as well as inefficiencies related to the Texas winter storm in February. Despite these additional costs, we delivered a core incremental margin of approximately 47% on a year-over-year basis.

Our adjusted earnings per share were $0.33 in the quarter, an increase of 57% compared to the prior year period. This increase was driven by significantly higher operating income, partially offset by higher income tax expense related to our higher pre-tax income in Q1 of this year and some non-recurring favorable items in Q1 of last year.

Moving on to slide 5 and the segment highlights. Both of our reportable segments delivered terrific results in the quarter. Revenue in our Power Transmission segment grew nearly 27% on a year-over-year basis including core growth of 23%. Our growth in Power Transmission was led by the industrial end markets, primarily diversified industrial, personal mobility and On- and Off-Highway applications. Sales were further augmented by execution on our initiatives which drove our estimated low-double digit above market growth in the segment. Sales across replacement channels showed strong growth but were outpaced by those into first-fit channels.

Our Fluid Power segment saw revenue increase 20% year-over-year including core growth of approximately 18%. Similar to Power Transmission, the growth in Fluid Power was led by our first-fit business, primarily in Diversified Industrial and Off-Highway applications. Sales into replacement channels also improved significantly from Q4 and showed strong year-over-year growth. Fluid Power revenues also benefited considerably from the very solid performance of our new products which helped deliver the segment's estimated high-single digit above market performance.

Segment adjusted EBITDA margins improved by nearly 600 basis points in Power Transmission and by over 400 basis points in Fluid Power with higher volume, restructuring benefits and operational execution, offsetting inflationary pressures. Across both segments, our above market growth was driven primarily by the performance of our organic initiatives.

In Power Transmission, our industrial chain-to-belt revenue grew approximately 50% year-over-year. While our personal mobility revenue increased over 80%, great progress from a meaningful base in applications that we believe provide a secular long-term growth opportunity for the company. In our Fluid Power segment, sales of our new products which we have continued to introduce increased nearly 90% year-over-year in Q1 with the most significant growth coming from replacement channels. These new products have been accelerating our penetration of new applications particularly in stationary end markets.

We had numerous design wins in both segments in key end markets such as intralogistics, food and beverage, chemical processing, rail, and industrial spraying to name few. While we did see a robust market growth in the quarter across many end markets, our growth initiatives continue to deliver meaningful performance over and above the base market recovery while our innovation and commercial organizations are delivering solid results.

So, to summarize, truly a great performance across both segments in terms of top line growth and margin expansion as well as new product and design wins to further support future growth.

With that, I will now turn the call over to Brooks for some additional color and the update to our guidance. Brooks?

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L. Brooks Mallard

Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

Thank you, Ivo. Now, moving on to slide 6, where we're continuing to show the regional breakdown of our revenue performance. We delivered strong double-digit core growth across all our regions with China and emerging markets in total significantly outperforming. Growth in China lapped the worst of the impact from the COVID shutdown last year and was driven by strength across the board. From an end market perspective, we experienced the most significant growth in China in Diversified Industrial and Automotive Replacement applications with both up approximately 100% year-over-year.

In Europe, solid core growth was driven primarily by a significant improvement in sales into first-fit channels, particularly for Diversified Industrial, ag and construction applications. Sales into replacement channels also continued on their strong growth trajectory with double-digit improvement in both the industrial and automotive end markets.

North America growth was also led by accelerating sales into first-fit channels, particularly in the Diversified Industrial and ag applications. All our industrial markets except oil and gas experienced solid year-over-year core growth. The Automotive Replacement channel continued to accelerate sequentially and posted high-single-digit year-over-year growth.

Lastly, our business in East Asia and India performed very well with double-digit core growth across all end markets and particular strength in both On-Highway and Off-Highway applications. We did not see any significant impact in the quarter from the worsening COVID situation in India. But are prepared for a range of scenarios should things continue to develop more negatively.

Moving now to slide 7 and some additional detail on key balance sheet and cash flow items. On an LTM basis, our first quarter free cash flow of $181 million represented 75% of our adjusted net income. For the first quarter, we had a normal seasonal cash outflow. Our strong sales performance drove higher receivables which increased our overall investment in working capital. We expect this to improve our overall cash generation for the year as those additional receivables are converted to cash over the balance of the year.

Our net leverage for the quarter improved to 3.8 turns from 4.3 turns at the end of 2020. Our current expectation is that we should be at our mid-term goal of between 2 and 3 times net leverage by the end of 2021. Our return on invested capital was a solid 17% despite investing in working capital to support our growth and represents an improvement of 170 basis points compared to Q4.

Moving now to slide 8, and starting with our updated full year outlook. Looking at the current trends of our business, execution on our initiatives and balancing the possible impact of COVID-19 in some regions, we anticipate demand will remain strong as economic activity progressively improves around the globe. As a result, we are raising our full year guidance. Our updated expectation for core revenue growth is 18% to 21%, an increase of over $200 million at the midpoint compared to the previous range of 9% to 14%. We now expect our adjusted EBITDA margin to be in the range of 22% to 22.8% reflecting strong incremental margins. We continue to expect CapEx to be in the range of $90 million to $110 million and free cash flow conversion to be greater than 80%.

For Q2, we expect our total revenue to be in the range of $885 million to $915 million and our adjusted EBITDA to be in the range of $198 million to $212 million, representing year-over-year revenue growth and margin expansion of 56% and 840 basis points, respectively, at the midpoint. We believe that inflationary pressures, while significant

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for the remainder of the year, are manageable and we remain confident that price will offset inflation for the full year.

The improvement in our outlook notwithstanding I don't want to overlook the aforementioned external challenges we are managing through. Limited availability of labor and certain raw materials, logistics concerns and worsening COVID situations in certain countries have the potential to further affect us, our customers or our suppliers over the balance of the year. While the operating environment remains challenging and dynamic, our ability to navigate it effectively to-date in addition to the constructed demand outlook, support our guidance update.

With that, I will turn it back over to Ivo for some final thoughts.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. Moving now to the summary on slide 9 and few key takeaways I would like to leave you with. We believe our business is positioned to deliver sustainable above market growth. The investments we have been making over the past several years are accelerating our growth in the market today. We are expanding margins through productivity improvements.

Our strong operational execution is focused on supporting the large increase in volumes and delivering strong incremental margins against a challenging operational backdrop. We are positioned to manage through the current operating environment complexities. We remained focused on execution throughout 2020 and kept our regional supply chains open to accommodate demand recovery, which we are now experiencing.

We leaned heavily on the Gates Production System tools for demand and supply planning early in the recovery which is now enabling us to better navigate supply chain issues. In our in-region, for-region business model and the investments we've made in our manufacturing infrastructure, will assist us in managing through the present set of global challenges. Finally, we continue to generate solid cash flow and are deleveraging the business ahead of our plan which provides some more optionality around future capital allocation.

I would like to conclude by thanking the Gates' teams globally for their continued perseverance and focus in delivering an outstanding quarter.

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

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Damian Karas with UBS.

Damian Karas
Analyst, UBS Securities LLC

Q

Hi. Good morning, everyone.

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

A

Good morning.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Good morning, Damian.

Damian Karas
Analyst, UBS Securities LLC

Q

So, I wanted to ask you about recent trends. Obviously, you mentioned order momentum through the quarter and you provided some nice second quarter guidance. But Ivo, maybe you could just give us an update, since the end of the quarter, the trends you've been seeing kind of across regions and thinking about the different end markets you play in?

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

A

Thank you for your question, Damian. Yes, I mean, we certainly saw a very broadly positive demand trends throughout Q1, as I've outlined in my prepared remarks. What we have seen in April, particularly in order rates, certainly reflects the continuation of the same trend. And we've contemplated that obviously in our updated guide, it has been quite broad across frankly from all of the regions. So, we continue to see that strength regionally. And frankly, we continue to see the strength in both of our reported segments.

But I do want to note as well that we will be dealing with some incremental headwinds, frankly, particularly associated with labor availability in the United States specifically and [ph] the decelerating out of OEM (00:23:47) demand as our customers are facing more challenging supply chain issues on their end and I think that the well reported issues in India associated with COVID. So, although I will – I'll reiterate the demand is very strong, we also want to make sure that we would remiss if we did not bring forward some of the incremental concerns that are out there in the marketplace.

Damian Karas
Analyst, UBS Securities LLC

Q

Got it. That makes sense. And you stated that – I think you haven't seen any evidence of significant restocking taking place. I know you don't necessarily have great visibility into this, but what's your sense on where inventory levels currently are? Would you say kind of normal or below normal for this level of demand?

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

Damian, I think that we have actually a reasonably good visibility particularly in North America and also maybe Europe as well. And based upon the point of sale data that we track very closely, we have not seen and we certainly don't believe that we have seen any significant restocking that is occurring in the channel.

Look the macro data that's out there indicated inventories are quite low. Certainly that has been reported by some of the large end users. Commentary from our large OEM customers suggests that the inventory remains very low and that they are struggling to build inventory to support their own underlying demand pattern. So, I believe that the strength that we are seeing with orders and the business overall is driven by quite substantially significant underlying demand fundamentals and not necessarily artificial order pattern.

Damian Karas
Analyst, UBS Securities LLC
Q

Great. I appreciate the color. I'll pass it along.

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

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, Jeff.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc
A

Good morning.

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

A couple questions. One, the North America growth is a little lower and I'm just wondering how much that is, just kind of comp dynamics versus anything else? And then, just on – and you mentioned the first-fit kind of continuing to outpace or outpacing in the first quarter, is that what you're seeing in order rates? And maybe just give us – I mean, obviously, the incrementals are very good, but what's kind of the mix headwind as you think about that?

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

Jeff, the first-fit is indeed outpacing and it has outpaced a little bit in Q1, but it's going to be more pronounced in Q2 in particular as in Q2 of last year vast majority of the OEM started to shut down their production and we've certainly seen more favorable performance in Q2 of 2020 with our replacement channels than we have seen with the OEM channel.

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So, if you think about Q2 comps, I think that you're going to see much more substantial rebalance of first-fit being stronger in terms of growth and, frankly, in terms of mix than the replacement channels. That being said, I mean, obviously we are reporting extremely strong growth year-over-year, nearly 55%. So, I think that brings in itself sort of challenges to be able to support that.

In North America, we have had a very strong performance over the last quarter – last couple of quarters. We continue to see very strong growth in North America, and it's more driven by our ability to fulfill those orders than demand growth, Jeff. So, I think that as we are balancing our ability to support all of our customers we are prioritizing, making sure that our customers do get the products that they have ordered and I wouldn't necessarily be looking in the North America growth rate. That's still, frankly, was actually quite terrific [ph] with the mid, low-teens (00:28:35) performance year-over-year. And I think that the overall demand environment remains very strong there, as well.

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

Q

Okay, great. And then good color on the outgrowth. I'm just wondering how much is just purely – what you think is coming from differentiated product and some of the new product initiatives versus your ability to kind of fulfill demand versus your competitors in the near-term?

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

A

Thank you for that question. Look, my sense is that we have kept our operations going quite well through the pandemic. And I think that some of the outperformance that we are seeing is associated with the fact that we have been a reliable channel partner for our customers globally. So, probably some of it is more of a market share gain, [ph] through (00:29:37) reliability of supply and my sense is that that's more of [indiscernible] (00:29:40) market share.

On the new products, look, over last couple of years, I have been speaking on these on these earnings calls about a very substantial amount of design wins that we have had across broad-based very attractive end markets for us and end markets that we've prioritized to continue to drive longer term secular growth for our business. And with the more constructive end markets out there, we are starting to see that now show up in our numbers and we believe that we will continue to deliver a very nice outgrowth to the market recovery well into the future. So, we are very constructive about what we have been able to accomplish and now seeing that actually showing up in the P&L.

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

Q

Okay. Thanks so much, Ivo.

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.

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Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Good morning, Deane.

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

A

Good morning.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, was hoping we'd get some more color on your update that you'll be price cost positive for the year. Take us through both sides of the equation, what kind of price increases did you see in the quarter, what kind of pricing of your plan to put through? And then some more color on the supply chain side, labor has come up a couple different times. Do you have unfilled positions and anything about [ph] the RAS (00:31:22), like, the highlight in the industry about natural rubber being in short supply, some of those because of stockpiling, but just both sides of the equation if you could.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Sure. So, on the price side a lot of our pricing announcements went out in Q1 and really became effective at the end of Q1 and into of Q2. So, and that's kind of our normal cycle. We were able to pull some of those forward so we're able to get a little bit more price in Q1. But the balance of it will come for the full-year.

And as we see additional inflationary pressures come out both on the material side and on the logistic side, we're looking at additional price increases to make sure that dollar for dollar that we're – offset the inflationary pressures that we see. When you think about our full – kind of our full year guidance and what we've given, what I would say is without getting into specifics on price and everything, when you look at our incrementals we're going to see about 300 bps of dilution overall on our incrementals than what we would normally see just because you're getting price and inflationary dollars offset dollar for dollar but you're not getting any follow through on that additional revenue. So, that's kind of how I would lay it out.

In terms of supply, we've been able to manage through material supply constraints pretty well overall. Of course, there's a little bit of cost associated with that as you expedite things and you move things around. Probably the bigger issue that we've been dealing with and Ivo alluded to this earlier, is labor availability in the US. And so, that's kind of the one that we're managing through right now probably the biggest one that we're dealing with. Ivo, I don't know if you have any additional color on that.

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

A

Yeah. I think that's well said. But Deane, I think the way that I would bring that maybe to the part of the question that you have had, the biggest inflation that we have frankly seen has been in metals and in chemical components, so, resin, carbon black. And on the chemical side, we've seen – we've been particularly hit with,

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frankly, the Texas storm in February that has driven more havoc into the supply chain. But we certainly believe that that's going to start normalizing in the second half of the year as all of those facilities will get back up and operational.

So, we think that we are well-positioned. We certainly believe that we were forward leaning with taking pricing announcements into the market and we continue to be very focused on ensuring that the business will continue to demonstrate the strength of our brand and our ability frankly on top of that strength to offset any inflation in raw materials with pricing.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's really helpful. And as Brooks in his answer when he said dollar for dollar on the price increases to the inflation [indiscernible] (00:35:00) about what happens because you do get some margin dilution there and you already sized it. So, I appreciate the precision in the answer there and it's perfectly understandable.

All right. So, second question for me is on the growth in belt from chain this conversion hitting 50% in the quarter. Was this more of – we're reaching this critical mass, this momentum now, is that meaningful? Was it just an easier comp? Just a perspective on how meaningful this because it is a big jump here and we have been waiting for it. I just want to make sure that we have it in context. Thanks.

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

A

Yeah. Thank you for the question, Deane. Look, we have been highlighting for a while since we introduced this initiative that there is a very significant available market out there for alternative power transmission technologies such as chains, gearboxes and cables. That's the fundamental out there. Our products have significant value propositions that we have discussed, look, reduced maintenance, more quiet, they are safer, they are lightweight, they are more efficient. And when you combine that with everybody's desire to focus now more on ESG initiatives that's kind of a sweet spot for us to drive these conversions and maybe even accelerate them.

With respect to the progress and coming back to the heart of your question, there are several secular drivers out there, increased automation, not only to improve operational efficiency, but also to help address challenges that we all are seeing around the world's availability of labor. Look e-commerce is accelerating demand for warehousing and logistics and that is a real sweet spot for supporting some of these underlying trends in these markets.

If you layer in the product introductions on the top of what we have been able to do simply with the design wins, we have been talking about some of this design wins for a couple of years now. That is what is driving the acceleration of this initiative. And frankly, it's not from a small base. It's from a reasonably good base that we have been able to build on. Again, I don't anticipate that we will see 50% incrementals in terms of growth every quarter. But certainly, the long-term opportunity for our business is very robust with this initiative. And frankly, that's what's going to help us to deliver our stated goal to deliver growth well above the base of the industrial market growth rate.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great to hear. Thank you.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi .Good morning, and thanks for the context on chain-to-belt just now. Maybe just looking at the guidance for the second half of the year, just wanted to better understand what's informing that revenue guidance in particular. I think it's implying sort of sales are down mid-single-digit plus half-on-half, up maybe mid-high-single digit year-on-year in the second half. Doesn't seem like you are seeing kind of excess ordering or pull forward in the first half. So, maybe help clarify what's behind that second half assumption? Is it something to do with what's going on among auto OEs? Because when we look back historically, there isn't an obvious kind of seasonal pattern for Gates revenue wise first half second half.

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

A

Good. Good set of items, Julian. Thank you for the question. Let me kind of start with we are certainly anticipating that we will see more seasonally normalized year in 2021. And frankly, I can't even believe that we are talking about normalized seasonality which I think is a good thing. But I also believe that we are in very early stages of the market recovery and there is a terrific macroeconomic backdrop to what we see presently.

We are seeing very positive trends in the end markets across all of the regions that we participate in, the channels, and as I've said there's really no evidence of restocking that is occurring in the face of some of the COVID challenges that I think most are still facing, us included.

We are seeing acceleration of sales related growth due to our initiatives and we certainly anticipate that those will continue throughout 2021 and beyond. The orders had been very robust. Of course, there had been challenges but we continue to navigate through those challenges quite well and we anticipate that we will manage all of these challenges through 2021.

Coming back to your auto question. Look, what we have embedded in our guidance, Julian, is frankly a deceleration in automotive OEM business because I certainly do not believe that we will break through all of the semiconductor challenges that the car companies are dealing with in 2021. I think that they will get better, but I don't anticipate that they're going to get all solved in 2021. And I think that that end market is going to probably become the end market that is most challenged in 2021. I think I hit everything to do that you had an interest in.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Yes. Thanks, Ivo. And maybe my second question on the balance sheet outlook, so, I think you'll be sort of 2 to 3 times maybe 2.5 times net levered at the end of this year. That seems to embed free cash flow being up for the year after that declining Q1. But maybe when we look at the uses of cash now that you've got more optionality, how full of an M&A pipeline do you have and what sort of returns are you targeting on acquisitions?

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

A

Yeah. Let me start with the M&A and the optionality out there and then I will pass it on to Brooks maybe to give you some additional color on cash flow. Although, I will start again with it's nice to see more seasonal performance. And seasonally, generally speaking in the past, we consume cash in Q1 and then as the year

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progresses we are able to convert our receivables into cash in the second half and we certainly anticipate the same thing is going to [indiscernible] (00:43:06) in 2021.

And on your point, yes, we have consumed cash in Q1, but let's also remind ourselves we have seen over $170-some-odd-million of growth in the first quarter year-on-year. So, that naturally increased receivables quite a bit. So, with that, if I take a look at the priorities on deleveraging the balance sheet and what it means for the long term for the company, look, we do have a significant number of organic opportunities that we will continue to execute on. But we also have a very solid pipeline of M&A activities out there.

We will be very disciplined. We are in a very good shape to continue to hit our organic growth targets and we are hitting them on all eight cylinders, cylinders no pun intended here. So, we feel very good about what's happening organically with the business. And we're going to be very disciplined to make sure that whatever potential M&A that we can go after is one that we don't overpay for. As you know, the multiples presently are quite lofty and we've got to be able to generate decent returns on any inorganic activities so that we reward our shareholders over the long term. So, the pipeline is very robust. But I also believe that we want to make sure that we are very disciplined here and we will be.

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. And just to follow on there. Look, we've made it very clear that we're going to deleverage the business both in terms of paying down debt and through growing earnings. If there's good M&A opportunities out there at the right prices, those are certainly an option. But we like the idea of continuing to pay down debt, that helps improve our cash interests, that helps improve our earnings per share and it really sets us on the path of where we want to be which is in line or better than our peer group from an overall debt and leverage perspective. And then it creates optionality of course in the future in terms of how we want to allocate capital. So, we've got a great set of opportunities in terms of what we do with the cash from the business.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

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

Ashok Sivamohan
Analyst, Goldman Sachs & Co. LLC

Q

Hi. This is Ashok Sivamohan on for Jerry Revich. Can you talk about how you're thinking about operating leverage from here if the recovery were to continue into next year? Are there any headwinds to your typical 30%-plus incremental margins that we need to keep in mind?

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

A

Thank you for your question. Look, we are very pleased with our incrementals in Q1. As we said, they are on the top of very significant increase in revenue and we've managed it quite well. The core incrementals, again to remind ourselves, were over 47%. When you consider the unanticipated energy surcharges that we absorbed in Q1 associated with the February storm, our core incremental average was approximately 50%. So, right on the target that we have targeted our business to deliver.

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Our global teams have done an excellent job with keeping our restructuring programs on track, managing price to balance the inflationary environment as well as managing through some of the significant global logistics challenges. So, very proud of what we have done in Q1.

So, moving on to kind of the Q2 and the rest of the year. Look, in Q2, we expect to be – to be dealing with some of the most challenging quarter when you consider the very sizable increase in revenue year-over-year as well as some of the headwinds that we've talked about the remaining COVID-19 impediments, the rising inflation and so on so forth. So, in 2Q, the revenue again is going to be up over 55% kind of midpoint of our guide.

The way we think about incrementals here is more in line with our normalized incrementals that we expect to be kind of in that 35% to 40% as we have discussed that that's what we are targeting with the restructuring and the rebuild of our business that we have done kind of over the last two years to three years. And so, we anticipate that taking into account the large revenue increase, when you take into an account the restructuring savings, the price inflation that will offset dollar for dollar, we anticipate to deliver core incrementals of approximately kind of 40% in 2Q.

For full year, we anticipate the incrementals to be kind of in the low- to mid-40s, once again driven by the significant volume increase that we have updated our midpoint of our guidance and that is right in the middle of the expectations when you take into account that we are seeing again, as we discussed earlier, about 300 basis points of dilution each from the higher volume expectations and, frankly, from the pricing expectation that is offsetting inflation but getting no meaningful pull through with the higher gross margin business like ours.

So, we are very, very bullish about delivering very strong incremental margins in 2021 and kind of in the 2022 timeframe and beyond, although we are not going to be providing any guidance here on the call, we anticipate that we will be delivering that mid- to high- to low-40s (sic) [mid- to high-30s] incrementals as we get out of 2021.

Ashok Sivamohan
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Understood. And following up on the capital allocation discussion. Can you talk about how you're thinking about the high end of your leverage range if the right assets were to come along?

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

A

We really haven't provided any guidance on how we would think about that. Look, we are comfortable with the profile of our business. The business is very cash generative business. Leverage is really not an issue that we worry much about. That being said, we do feel that it is very important for us to get kind of to that 2 to 3 times leverage that we have discussed. We plan to do that earlier than we have anticipated. And when good opportunities for potentially any larger scale M&A would come, we would think that through and ensure that we can generate the right returns, the right level of ROIC and the right level of IRR. And we would then decide whether or not that is something that we would like to undertake.

Ashok Sivamohan
Analyst, Goldman Sachs & Co. LLC

Q

Thank you for the color.

Operator: Your next question comes from the line of Josh Pokrzywinski with Morgan Stanley.

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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.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Just to follow up on the free cash flow guidance, just reiterating kind of the 80% conversion, just wondering if you had to put any more precision around that, if free cash flow dollars should be higher than kind of the prior plan. Just because the growth is higher I would imagine that requires some working capital commitment and, obviously, you guys have talked about supply chain tightness. And then if the percentage conversion, wherever that falls and kind of better than 80%, is that something that you would think would sort of be at similar or below where you would've thought prior?

L. Brooks Mallard
Executive Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Yeah. So, from a dollars perspective obviously with the higher growth, we're going to generate more cash dollars, I won't go any probably – I won't go into any more detail than that. I would say I think a lot of us are dependent on how the volume equation evolves over the year. I mean we felt confident in the 80% and being above the 80% number. But clearly that's going to be somewhat driven about how the volume evolves through Q2 and through the balance of the year. At a minimum, we'll be able to be at 80%. If things break our way, could we be a little bit higher than that? Maybe.

Irrespective, as Ivo said, this business generates a lot of cash. It's not overly capital intensive. We're able to manage through our working capital fairly well and we're confident in the ability to generate cash in this business as we move forward. So, we feel good about where we are today, normal seasonality returning, we have some cash outflows in Q1 but historically that has been the way the business operates and we feel confident about our ability to generate cash through the balance of the year.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then I guess on the general industrial strength that you've pointed out, clearly some wins out there in the marketplace. Any more that you can talk about in terms of end market applications or kind of first-fit versus replacement, obviously chain-to-belt would be more of a replacement phenomenon that would maybe add some context on what you're seeing out there within that market?

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

A

Josh, let me point out that the chain-to-belt opportunities are actually across both channels. Most of – we have had a number of design wins that go through the OEMs so we are now starting to see [ph] design wins (00:54:07) with OEMs. You should think about all the personal mobility and recreation as an OEM set of applications not replacement market applications. And clearly, we have an incredible momentum in personal mobility and recreation over and above as well very robust performance on the industrial applications.

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But if you go back to some of the calls that we have had over the last couple of years, we have highlighted areas such as food and beverage, pharma, chemical processing, to name a few, as intralogistics as markets that are very robust for us particularly on the industrial side. And even for those, we see an ability to generate revenue not just through replacing the existing applications, but we also see design wins and conversion of equipment that is in stages of design that goes through OEMs not just through the conversion channel.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thanks. I'll leave it there.

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

Q

Hi. This is [indiscernible] (00:55:38) on for Andy. Good morning.

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

A

Good morning.

Q

So, it's encouraging to see recovery in Fluid Power progressing during the quarter. Can you discuss what your percentage of capacity utilization was for this segment? And given recently added capacity, how much room for further margin expansion is there as utilization improves?

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

A

Thank you for the question. Look the capacity utilization is very quickly rising. I think that we're still bringing up all of the capacity that we have put in place during 2018, early 2019 timeframe. So, we feel good about where we sit in terms of capacity utilization and how much room we have available. In terms of margins, again we're not going to provide a specific guide on reportable segments. But we certainly do believe that we have a room to run and certainly an opportunity to continue to drive further expansion from what we have reported today. I would also remind you that we have increased our midpoint of EBITDA margin for the year by 90 bps at the midpoint and we certainly embedded our opportunity to further expand [indiscernible] (00:57:09) margins in that.

Q

Thank you. That's helpful. And during the prepared remarks, you called out strong order momentum throughout the first quarter. So, realizing your short cycle business, has there been any backlog build driven by strong customer demand or supply chain constraints and do you have any increased visibility versus normal?

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

A

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Yeah. So, again, we are not at backlog business, but I will say that we have increased our backlog in Q1. There's certainly incremental visibility to what we normally have. And I would again point you back to our prepared remarks, order rates have been very strong. We have applications that certainly are in the early cycle as well as the mid cycle and the latter cycle businesses such as oil and gas and some of the industrial automation businesses that they are starting to ramp up in earnest. And we feel quite optimistic about what we see in terms of the market recovery momentum across frankly across the globe.

That being said, again, as I mentioned, there are some headwinds. Certainly, regions like India, Southeast Asia, we've got to pay more attention to those regions as well as what I said about the automotive OEM business that we anticipate is going to continue to face challenges for the remainder of the year but despite those challenges we have taken our midpoint of our guidance up over $200 million.

Q

Thank you for fitting me in. I'll pass it along.

Operator: And there are no further audio questions at this time.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

All right. Thank you everyone for your interest in Gates. As always, the team here is available for any follow-up questions. And we look forward to providing your next update on the second quarter. Have a good day.

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

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