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Gates Industrial Corp. Plc (GTES)

Wolfe Research Global Transportation & Industrials Conference

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MANAGEMENT DISCUSSION SECTION

Nigel Coe
Analyst, Wolfe Research LLC

Good morning and thanks for joining us again at the Wolfe Transportation & Industrials Conference. We're continuing with Gates and we're very, very pleased to welcome CEO, Ivo Jurek. We'll again proceed with the Q&A session in a moment. But before I do that, I'll introduce myself. My name is Nigel Coe. I'm the firm's Multi-Industry analyst, and today is May 27.

So we've got a lot of topics to cover, Ivo, but I thought maybe it'd be a good opportunity to maybe just talk us through what you're seeing since you report a very strong 1Q, how you're looking into 2Q and beyond.

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

Thank you, Nigel. Good morning. Look, clearly we see a very strong momentum continue to build in our end markets after the most recent downturn that we've just exited. Let's remind ourselves of the fact that we've just exited the downturn.

Part of what has been changing since the beginning of the year for us is that we've reported very strong first three months of results and frankly we have continued to see increasing order rates exiting Q1, with our book-to-bill well above 1, so that there is a very strong underlying momentum that has built.

For us, look, we have repositioned our company over the past several years and we are now seeing also the benefit over and above the market momentum from the investments that we have made in our growth initiatives, in our innovation, new product introduction, and frankly that's been what has given us somewhat of a higher degree of confidence, taking into an account that this is a short cycle, short visibility businesses as you know. It has given us a little more confidence, taking into an account that momentum that we continue to see. When you combine that with the fact that we don't see any restocking or certainly we haven't seen any unusual customer behavior today where inventories continue to remain reasonably low at some end markets like the industrial channel side, we see inventory position almost being at all-time low where we sit today, and that all bodes well for what we what we believe is the mid-term future.

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Look, that being said, we also see a very strong underlying end market demand. So we don't believe that this is some artificial behavior. When we talk – when I talk to our customers and I talk to many of our major accounts quite frequently they see a very strong fundamental demand in their end markets and that's really good. But we also are seeing some real challenges that everybody is dealing with; whether or not those are challenges associated with material availability. There is quite a headwind for everybody and that brings a little bit of a dampening effect on the momentum that everybody sees. But that underlying demand is not going to go away. It just perhaps is going to be pushed a little bit into the future.

Look, coming back to our company and where we sit, I believe that we have managed quite well through these shortages. We have lean forward kind of at the end of Q3 of last year where everybody was still to a degree staring at an abyss but we felt that we are seeing positive turns and that we needed to reposition ourselves. And when I talked to our OEM customers, they already start seeing semiconductor shortages in Q3 and Q4 of last year and so it became a big issue in Q1. But it didn't quite sneak up on us as much as maybe on some of the end markets that you have seen throughout the Q1 reporting season.

So – and maybe the last thing that I would say on this point is that, look, and I think that from the industrial side and from the analyst side, you understand this well Nigel, the industrial companies have not had great 15 years, historically looking backwards, right? And so I think that we are perhaps in the early innings of a real sustained industrial upcycle. And I'm really excited about it. And I think that Gates is well-positioned. We have done a lot with this company over the last six years and I believe that we are going to benefit from the underlying fundamental strength that we see in the end markets today.

QUESTION AND ANSWER SECTION

Nigel Coe
Analyst, Wolfe Research LLC

Q

Ivo, I appreciate the fulsome, detailed response there. I want to get into some of the secular and structural growth drivers that you've got. But I do want to stick with the cycle because I think you raised a very good point. You haven't had a lot of help since you've become a public company in 2018. 2018, we had sort of high-yield market meltdown, we had 2019 very tough for short cycle markets, automotive end markets, et cetera; and 2020 we had COVID. So you've had three rough years. And generally speaking you're right. Since the GFC, we've had very weak industrial end markets.

You sound pretty confident we're in for a sustained recovery here. Again, just going back to your comments, what gives you that confidence? What gives you the confidence that this is a three-, four-, five-year recovery?

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

A

Look, a lot is happening in – fundamentally, a lot is happening in our end markets. You can go in and you can talk to somebody like John Deere, right? They have almost an 18-month visibility for demand of their products. Look, I mean it's almost hard to say, is it a fundamental visibility that is different from the past? But in my six years, I really don't hear the customers to be that forward-looking with that much sustained visibility.

But Nigel there's also some really interesting secular trends that are happening. Look, we all talk about the Amazon impact, right? But there is a peripheral benefit from the Amazon impact for our business. Not just that it

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opens a different channel but it also drives consumption of heavy-duty trucks, medium-duty trucks that the goods need to be delivered from manufacturers to the Amazon warehouse or they – whether or not they use an airplane or FedEx, UPS, USPS; not to leave anybody out there. They all use industrial devices to move goods. That's really good for our business.

As these warehouses get built out, again we don't know if this is a lot of distribution center that is built by Walmart or Amazon, they need industrial automation. Industrial automation is a big driver of our industrial products like our transmission belts as well as hydraulic hoses. And I can just go on and on and on, what's happening with the electrification of personal mobility? That's a secular trend leaning into a recovering consumer confidence. Those are all fundamentals that frankly, as you pointed out very astutely, frankly in my six years as the CEO of Gates, I really haven't seen that. I have seen the vast majority of my time at the company dealing with some natural or unnatural headwind that came our way.

So I remain very bullish. I remain very optimistic about what's happening in these markets. Look, there are going to be different starts, of course. That always happens. But I think fundamentally I am much more optimistic than maybe I have been in five or six years, and I'm really excited that the demand for our product is going to be there for an extended period of time. And the innovation that we have done and the refocus on benefiting from secular tailwinds, ESG, reduction of power consumption, elimination of hazards in factories. Look, we are front-and-center of that process. Whether it's robotics or it is a heavy-duty truck, you will find Gates products with a large content in all of those applications. So very exciting time for us.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Absolutely. So when CEOs are confident, they tend to invest. They tend to hire, spend on innovation. Ivo, at this point where you can go out and do lots of acquisitions that tends to be another kind of function as well. What are you doing in terms of hiring and organic investing? Are you stepping up in investment spending here?

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

A

Look, we have hired a very substantial amount of folks since we've bottomed out in Q2 of 2021. Look, we had to. I mean you certainly saw the reported numbers. We've generated a record level of revenue for the corporation in its 110-year history, so we couldn't do anything other than hire people. But also let me remind you, we have been kind of maybe out of cycle with our investment. We've put our investment in that frankly didn't make me look very smart in 2019, right? But these investments are long-term investments. They take time to be put in the ground. And we've put three new factories between 2018 and end of 2019.

We are benefiting from that investment today. We have great cash flows. They give us opportunities. Cash flow gives us an opportunity to invest in organic initiatives. We have a huge runway in organic initiatives. We have put the major investments behind us but we still invest about 3% of our revenue in CapEx. About 1% goes into maintenance and 2% goes into things like high returns generating organic initiatives. So we are investing in those to support ourselves. And then as you said, look, we got balance sheet flexibility. We're going to be reaching 2 to 3 times net leverage in 2021 taking into an account a midpoint of our guide for 2021. So we feel really good where we sit. And this company is a high-quality asset with high recurring cash flows generation. We got opportunities to do what we need to do, whether or not it is organic or inorganic.

Nigel Coe
Analyst, Wolfe Research LLC

Q

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Okay. So we spent a lot of time talking about the cycle and we view as when cycles are expanding, you typically will have [indiscernible] (00:11:43) and then obviously when cycle is down, turning [indiscernible] (00:11:44). But we're in a good position right now but can we talk about maybe some of your organic initiatives? And you're one with the Chain to Belt kind of transition.

And the second one would be the [ph] EV (00:11:58) content mix-up. So, maybe just talk about industrial Chain to Belt. I think you talked about the growth last quarter if I'm not mistaken about 50% growth, industrial Chain to Belt. How do you see this transitioning over the next two or three years?

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

A

Sure. I mean, terrific question. Thank you for asking it actually because we are very excited about these opportunities. Look, over the past several years, I have been consistently talking about a really nice set of change to Chain to Belt design wins in attractive, large end markets and applications. Let's remind ourselves that what we are doing in Chain to Belt and the opportunity for Gates is frankly adjacency to our core. This isn't something that we have done in the past.

So, as you said, this is maybe an $8 billion market opportunity for us where we believe we are the only differentiated Gates – I mean belt provider that has the opportunity to replace roller chain. Frankly, look, there hasn't been a quarter over the last eight quarters or so that we haven't talked about some exciting – some exciting design wins. We are seeing accelerated momentum from this very great foundation that we have built over the last several years, supported by a new and renewed focus on ESG that is frankly front-and-center now for industrial manufacturers, not like us but all of our partners that we do business with. Our teams are very focused. They're really energized by the breadth and the momentum of the design wins that we are delivering and they are very attractive end markets for us; markets that we have not always had a great presence in food and beverage, right? I mean we all need to buy food and we consume Coca-Cola, beer, whatever is your drink of choice, pharmaceuticals, logistics and warehousing that I have spoken about and industrial automation to name some of these examples where we are able to penetrate. And we are able to do that both in new applications and convert existing applications.

So think about it as brownfield, greenfield-type design wins. Look, the margins are very strong in those applications. They are above fleet average that we generate. And, look, this is something that we believe we can continue to track well into the future. We are in an early inning. This is what gives us the opportunity to drive our growth well above that global industrial PMI that we kind of like to benchmark ourselves to. And we feel that we are very well-positioned. Now, every quarter is not going to be a 50% core growth quarter. But we think that this is an opportunity that's going to give us some legs well; well into the future.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Are you confident that the customers are receptive to this transition?

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

A

Absolutely. Look, we offer incredible benefit. We give them energy consumption reduction. We give them substantially improvement in uptime. We eliminate the hazards from these factories. And I'll tell you an example. I have spoken with our team that has brought in an incredible blue-chip customer design win in food processing; something that all of us are purchasing from that food manufacturer today. And they consume 1 gallon of grease

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a day to be able to grease their chain that is powering their manufacturing equipment. We've eliminated all of that. So, yeah, it is a grease that is used. It's a full-grade grease. It's very expensive, by the way, but we eliminated any need for it.

So there are some real tangible benefits. And as people, all of us are focused on sustainability. We want to drive energy consumption reduction and we want to make a safer environment. Look, grease is dangerous. The number one source of accidents in industrial facilities is slips and falls, right? So if you put grease on, it has a tendency to spill on the floor and if you're an employee and associate, you walk around, you fall, and you hit your head. Not a good thing. So our products, people now believe it, see it, and they are very excited about the benefit that they get.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Great. And the other one I want to touch on Ivo is the EV opportunity. I know you've really – Gates has really migrated the portfolio away from its legacy automotive background to first-fit down to about 10% – 10%, 11% of sales right now. But EV content opportunity is much higher given the cooling requirements and heat measurement requirements for an EV power unit. What are you seeing today in terms of build wins in the EV and is that content uplift story playing out? Are you seeing that in your [indiscernible] (00:17:12)?

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

A

Yeah. Sure. Let me kind of start from a little different angle, if I can Nigel because I think, look, it's not really well-understood. When folks take a look at our organic growth performance over the last three years as a public company, they look at it and say, hey, look, you kind of a little bit underperformed that growth curve.

But what is very little understood is we actually feel really good about how we have performed vis-à-vis growth. When you take into account that since the IPO, we have reduced, in a focused manner, we have reduced our automotive OEM participation from about 18% of our total revenue at the IPO to about 10% of revenue today. And that has not necessarily dampened our growth dramatically but it's a significant reduction of exposure to an end market. And we have done that in a very focused and strategic manner. And I want to remind ourselves of that when people take a look at comps, right?

That being said, look, we have very early innings of that shift to that electric propulsion. But we are developing very differentiated products; from electric water pumps and various number of ranges from 50 watts to 1.4 kilowatts to give ourselves an opportunity to have a coverage, not just on passenger vehicles but as well as take the opportunity as heavy-duty truck manufacturers are coming and moving in that direction in small steps.

Now, I've spoken about an opportunity Nigel I think on my Q4 earnings call with heavy-duty truck OEMs, leading truck manufacturer or a global truck manufacturer, they're frankly starting a production in a very near-term future. And the content on the truck for us is over $600. I can tell you I have no $600 content today on a heavy-duty truck with the present products that we manufacture in digital application, nowhere near that. So we see that opportunity being tangible. We are there. We are winning those opportunities.

Now, I'll tell you this is something that's going to take time. This is something that is early innings of a shift in propulsion. And we are focused on not only building the new technology that we can support our OEM customers with but we are also very much focused on building out that vehicles in operation content for cars that are on the street today. And as you know, we are a predominantly automotive replacement-focused company in the auto space. We are really not that focused on the OEM piece.

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But in this space our sweet spot is something that is 7 to 11 years in age. And we believe that even with electrics that will be the sweet spot for our cars, maybe not 7 to 11, maybe 5 to 10 as we see these vehicles shift. But we have a leading coverage of vehicles in operation and we are in a very good position. And we believe that as the time is going to move forward towards those shifts, we're going to be there. We see that as a tangible opportunity for our company and we are very confident that it will be a net benefit for our franchise.

Nigel Coe
Analyst, Wolfe Research LLC

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Great. Thanks, Ivo. You mentioned earlier on that maybe investing $160 million in CapEx back in 2018 perhaps wasn't the smartest move in hindsight. But, with that said, you now have a lot of capacity to absorb. And where I want to go with this is really as we come back up on the volume curve, are you confident that as you absorb that capacity that incremental margins can be very attractive here even with inflationary pressures and even with some investment spending, do you think [indiscernible] (00:21:38) margins can be sustained here?

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

A

Yeah. So, look, when I speak about our incremental margins, we kind of have – we have a number of levers, right? One lever is just improving absorption in these facilities. But it also gives us the opportunity to drive incremental growth and support those customers which is a very big benefit. So, as those – as the capacity gets absorbed, you get benefit.

We have a second lever that is innovation. Innovation of new products gives us pretty significant improvement in our cost of goods manufactured. We don't put a different label and call it a new product. I mean we are revolutionizing the industry where we participate. And generally speaking, that gives us the opportunity to make these products more cost-effective.

And the third attribute is price and our franchise is we are top three market shareholder globally in the two product line segments that we participate, across about 80% of everything that we do. And it gives us a reasonable amount of confidence that we can offset inflation. So, if you put it all together, our guidance was for 40%-plus in incremental margins in the second-half of the year and that takes into an account the very significantly elevated volumes that we've guided, and the dilution that we see obviously from offsetting inflation with price but not necessarily getting a margin accretion. So, we offset the inflation dollar-for-dollar but we get a bit of a dilution into the incrementals on the incremental revenue. But that's taking all of those factors into an account, we still feel comfortable with 40% plus in the second-half.

So, we will not get 40%-plus incrementals day-in, day-out so we believe that the sustained level of restructuring that we have driven and the opportunities that we have with innovation that we are putting in the marketplace, our sustained incremental margins should reside in that 35% to 40%. And we feel quite good about that neighborhood. Look, we are a high-gross margin business as you know and we ought to be levering up in that 35% to 40% to – frankly, we want our customers to deliver the gains that we believe we can deliver over time.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. And the pricing power, maybe to comment on that, to touch on some of the pricing actions you've taken; customer receptivity. I'm sure the channel is happy to pass along the price but what about the OEM channels?

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

A

Yes. So we have a number of OEMs with contracts where we have [ph] escalated the quality spend (00:24:36) so that conversation becomes obviously a lot easier because you can see it in inflation of steel, aluminum, carbon black, name it. It's out there. So that's not an incredibly difficult conversation. It's never an easy conversation. I'm not going to tell you that; that it's easy but it is much easier. And then frankly there's also supply and demand set of issues. And customers have been much more reasonable than in the past cycles.

And although you never want to reach out and have these significant discussions with them, I think that folks actually understand that the inflation is real. And by the way, they see it in everything that they do. They see it in inflation of labor. They see it in purchasing steel for their own products, so I don't think that you're coming into – you're an outlier and just saying well, gee, nobody has talked to me about inflation. What's going on with you?

So, again not an easy conversation but it isn't one that they don't anticipate. And you look at results, many of our end users and customers they themselves are raising prices, right? I mean inflation is here and we will manage through it. We are well-equipped. We have a strong pricing team. And frankly, we feel that we need to get compensated for the mission critical products that we offer to the marketplace and our customers.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Fantastic. We've got two or three minutes remaining. If anyone has got any questions in the audience, please feel free to pass this along but I've got two more to [indiscernible] (00:26:16), Ivo. One would be free cash conversion. And three of the four years, we've take out – if we ex out that CapEx investment cycle, you converted at or above 100% free cash conversion. But with still a tepid demand environment, working capital as a proportion of sales is definitely towards the high-end of our coverage. What is the opportunity to re-optimize trade working capital and then particularly inventories as volumes pick back up again?

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

A

Yeah. Look, in general, the profile of the business is such that the free cash flow conversion profile for our business has been at 100% as you noted. And nothing really has changed from our commitment to continue to convert at that rate. But when you take a look at 2021 and our guide for free cash provision of about 80%-plus, look, we have a very substantial growth that we are seeing across our business which frankly we have to support with working capital. That's actually not a bad thing because the working capital is actually a certainty that you have that will turn into cash. It's just somewhat delayed as you are building up to support that volume.

But we expect working capital is going to improve throughout the year, particularly as the receivables are being collected. And, look, I mean we believe that there are opportunity to continue to drive an improvement. I mean our Gates operating system is focused on driving improvement to the inventory turns. We are developing new products that give us an opportunity to simplify our supply chains that give us an opportunity to buy more raw materials from larger accounts and manage our payables more effectively. So we believe that we still have work to do.

Our working capital, certainly on the incremental revenues, should be meaningfully below 25% as a percent of sales. So we think that there is an opportunity but we also believe that in a sustainable way, 100% cash conversion of net income is certainly what we anticipate to deliver year-in, year-out with the exception of maybe a dislocated year like this one. We have such a huge growth.

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Nigel Coe
Analyst, Wolfe Research LLC

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That's understandable. But it does sound like that the pathway is small towards capital efficiency as we get deeper into this recovery.

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

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Absolutely.

Nigel Coe
Analyst, Wolfe Research LLC

Q

And then my final question, Ivo, is really on the balance sheet. And based on EBITDA recovery and free cash production, debt reduction, your leverage doesn't come down pretty dramatically based on our model over the next 12 to 18 months. Do you see scope to transition toward capital allocation as opposed to delevering over the next 12 to 18 months? And right now if you have the choice given where your multiple is right now, would you be buying back stock as opposed to acquisitions?

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

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I think it's a great question, Nigel. My view is that there's tremendous opportunity to look at where we get the best benefit to generate returns for our shareholders and that's what we will do.

Look, my job first and foremost was to delever the balance sheet. [ph] And everybody knows our (00:29:40) significant skepticism about how fast we can get there. We will be below 3 times – at 3 times at the end of Q2 of this year. We will dramatically delever over the next 12 to 18 months as you have pointed out and that gives us that opportunity. So, whether or not this is a buyback, it is – and more accelerated M&A, but look we are going to be very focused on not overpaying for assets. We don't need the M&A to accelerate our growth. We have a tremendous amount of organic opportunities and we will use that cash to do the right thing for our shareholders.

Nigel Coe
Analyst, Wolfe Research LLC

Okay. Ivo, very clear. That was a great discussion. Thanks for that. We're out of time. We're going to be kicking off again in five minutes with JCI. Hope you can join us for that but again Ivo thanks for being here. Thanks for supporting us and we'll catch up soon. Thanks very much.

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

Thank you very much.

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