

08-Nov-2021

# Gates Industrial Corp. Plc (GTES)

Q3 2021 Earnings Call

## CORPORATE PARTICIPANTS

### Bill Waelke

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

### Ivo Jurek

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

### L. Brooks Mallard

*Chief Financial Officer, Gates Industrial Corp. Plc*

## OTHER PARTICIPANTS

### Michael Patrick Halloran

*Analyst, Robert W. Baird & Co., Inc.*

### Nigel Coe

*Analyst, Wolfe Research LLC*

### Trish Gorman

*Analyst, Barclays Capital, Inc.*

### David Raso

*Analyst, Evercore Group LLC*

### Andrew Kaplowitz

*Analyst, Citigroup Global Markets, Inc.*

### Jerry Revich

*Analyst, Goldman Sachs & Co. LLC*

### Jeffrey D. Hammond

*Analyst, KeyBanc Capital Markets, Inc.*

### Damian Karas

*Analyst, UBS Securities LLC*

### Deane Dray

*Analyst, RBC Capital Markets LLC*

## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning. My name is Chris and I'll be your conference operator today. At this time, we'd like to welcome everyone to the Gates Industrial Corporation Q3 2021 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.  
[Operator Instructions]

Bill Waelke, Head of Investor Relations, you may begin.

### Bill Waelke

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

Thank you for joining us this morning on our third quarter 2021 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 third quarter results. A copy of the release is available on our website at [investors.gates.com](http://investors.gates.com). Our call this morning 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 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 will now turn things over to Ivo.

---

### Ivo Jurek

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

Thank you, Bill. Good morning and thank you for joining our third quarter earnings call. Let me begin with the overview outline on slide 3. I am pleased by the performance we delivered in the third quarter led by another quarter of above-market growth that resulted in record third quarter revenue and earnings. The underlying demand and other trends across both of our segments remained very supportive and were supplemented by share gains from our product innovation efforts and continued execution of our commercial initiatives. Our growth was led by our performance in the industrial end markets, which more than offset the significant near-term cutbacks in auto production that impacted our automotive OEM business.

We navigated the very difficult supply chain conditions with an unwavering focus on customer service and we undertook significant efforts to support the demand levels of our customers. That being said, demand for our products broadly exceeded our ability to satisfy [ph] all of (00:03:37) our customers in Q3, and our book-to-bill ratio remained well above 1. Operationally, we navigated this difficult environment to deliver strong margins and record Q3 earnings. During our second quarter call, we highlighted our concerns regarding the inflation, supply chain and labor challenges in the marketplace and our expectation that they would continue in the second half of the year. These challenges did continue with some of the headwinds worsening over the second half of Q3. While we maintain positive price cost position on a dollar basis with respect to materials, we were impacted by further escalation in logistics and distribution costs above what we anticipated.

We also faced additional operational inefficiencies from production disruptions related to COVID as well as the government-mandated power outages in China. These costs were magnified by some of the additional actions we took in the quarter to prioritize service levels and ensure we met our customers' most critical needs. We anticipate seeing the full impact of these cost headwinds in the fourth quarter, but view them as transitory as we expect to offset them in the first quarter with announced pricing actions that will take effect at the beginning of next year. We continue to see strong free cash flow generation and made additional progress on deleveraging the business, which further increases our flexibility around capital allocation priorities.

With that, let's move into more of the detail on slide 4. Total revenue of \$862 million came in at the top end of the range we provided, up 21% year-over-year including core growth of 19%. We saw the strongest performance in our industrial end markets across both first-fit and replacement channels with the most significant growth coming in Mobility & Recreation, Diversified Industrial and Off-Highway and markets. Our focus on mitigating supply chain disruptions and servicing our customers in Automotive Replacement resulted in that channel growing high-single digits, a nice offset to the mid-single digit decline in our automotive OEM business, driven by reduced production output across the global automotive OEMs.

In general, inventory levels in both of our replacement channels remain low with many of our distribution partners having difficulty keeping up with the end user demand. Our third quarter adjusted EBITDA of \$184 million represents growth of 31% compared to the prior year and margin expansion of 160 basis points. Price, volume benefits and GPS-based productivity offset inflation, SG&A investment and the incremental costs we incurred to support above-market growth. Our execution in the quarter resulted in an incremental margin of nearly 30%, a solid result given the outline operating challenges.

Our adjusted earnings per share were \$0.31 in the quarter, a 19% increase compared to the prior year period, driven by higher operating income which more than offset higher tax expense resulting primarily from our higher earnings.

Moving now to slide 5 and the segment highlights. We saw strong performance in both segments compared to the third quarter results of our business in both 2020 and 2019. In both segments, our above-market growth continues to be driven primarily by new products, the performance of our organic initiatives and positive secular trends in our end markets. Our Power Transmission segment had core growth of 15%, led by nearly 30% growth in industrial end market, offsetting the decline in automotive OEM. Diversified Industrial and Mobility & Recreation saw the highest growth rates. Our Industrial Chain-to-Belt initiative, combined with Mobility & Recreation, grew approximately 50% year-over-year. We secured key design wins in industrial robotics and semiconductor inspection equipment in Japan, textile manufacturing equipment in India, and additional warehousing and logistics applications in multiple regions, to name a few. We also finalized a significant win with a leading Asian scooter manufacturer on a new electric platform that is expected to fully launch in the first part of next year, further reinforcing the momentum we are seeing in our Mobility and Recreation business that we expect to continue.

In our Fluid Power segment, we saw core growth of 26%. The end market recovery trend is continuing and we anticipate it will take further hold as we enter 2022. We continue to see benefit from our investment in innovation with Q3 sales of our new products growing over 70% year-over-year, advancing our objective to deliver 20% new product vitality over the mid-term.

In an environment with significant supply chain headwinds, we believe the costs we incurred to support customers have resulted in share gains, particularly in Off-Highway and Energy, as well as Diversified Industrial applications, including forklifts and food processing equipment.

On the electrification front, we recently launched our next generation E water pump platform for hybrid electric and fully electric vehicles which have some specific patent pending features that we believe differentiate us from the marketplace and provide a solid opportunity to expand our sizable existing water pump business.

In the quarter we also began production of thermal management [ph] houses (00:11:23) for battery cooling on an electric heavy-duty truck platform in Europe, and are excited about the pipeline of additional opportunities we are [ph] boarding on (00:11:30). Our prospects with the electrification of transportation propulsion are strong and we remain optimistic about the size of our future potential business opportunity as these technologies gain further hold in the marketplace.

With respect to profitability, we delivered adjusted EBITDA margin expansion of 120 basis points in Power Transmission and 270 basis points in Fluid Power compared to Q3 2020 with similar levels of expansion compared to Q3 2019. We expanded margins in both segments not only while managing through supply chain complexities and inflation but also while investing in SG&A and innovation to build on the momentum we are seeing with our growth initiatives.

With that, I'll turn the call over to Brooks for additional color on our results. Brooks?

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

Thank you, Ivo. Now moving on to slide 6 and the regional breakdown of our core revenue performance. We delivered double-digit core growth in nearly all regions with developed markets outperforming. In Europe, our strong growth came despite the significant decline in auto production and was led by the Off-Highway and Diversified Industrial end markets. Our replacement channels continued to show solid improvement with both industrial and automotive end markets delivering double-digit growth.

Moving to North America, growth was led by first-fit channels, particularly in Mobility & Recreation, Diversified Industrial and Off-Highway applications. Nearly all our industrial end markets experienced solid double-digit core growth with the energy end market growing mid-single digits.

Our business in China has seen its percentage of sales into replacement channels increase meaningfully over the past several years, a result of the significant investment in our replacement channel presence while de-emphasizing our auto OEM participation, in line with our global strategy. We saw the benefit of this transition in the third quarter, with sales into replacement channels posting low-double-digit core growth, offsetting much of the decline in auto OEM.

Our total core growth in the quarter was impacted by a one-week shutdown of our facilities as a result of unplanned government-enacted power outages. While the potential exists for these disruptions to continue over the short term, we believe the investments we've made in China over the past several years in the replacement channels and our Industrial business position us well to capitalize on this large market moving forward.

Lastly, our business in South America and East Asia and India had strong performances in the quarter. We saw healthy double-digit core growth across all end markets, with particular strength in Diversified Industrial and Off-Highway applications, as well as in automotive replacement.

Moving now to slide 7 and some additional detail on key balance sheet and cash flow items, we generated strong free cash flow in the quarter with cash conversion on adjusted net income of approximately 90% and year-over-year growth of 116%.

Net leverage improved to 2.7 times, placing us firmly in our targeted midterm range of 2 to 3 times and providing further capital allocation flexibility. Our return on invested capital was a strong 22%, representing a year-over-year increase of 790 basis points.

Moving now to slide 8 in our updated full year outlook. We are maintaining our full year expectation for core revenue growth in the range of 20% to 22% with our Industrial growth initiatives expected to offset further deterioration of the automotive OEM business and additional headwinds in China. We are updating our adjusted EBITDA margin expectation to a range of 21% to 21.5%, which reflects margin expansion of over 300 basis points and incremental margins in the mid 30% range.

This updated guidance includes a price/cost neutral position for the year despite additional headwinds driven by higher inflation and operational costs incurred to continue to support our customers. It also reflects the decision to implement pricing in early Q1 of 2022 in line with our normal cadence which gave us better visibility into the magnitude of the increase needed. We believe inflation, increased supply chain costs and labor constraints are likely to continue for the foreseeable future. However, the rate of increase appears to be slowing.

For the fourth quarter we expect to see adjusted EBITDA margin dilution due to the timing of the aforementioned cost headwinds, which will be offset by our pricing actions effective in Q1 of 2022. We expect the unfavorable impact of these higher costs in the fourth quarter to be approximately 200 to 250 basis points. For the year, we expect CapEx to be approximately \$100 million and free cash flow conversion to be greater than 80%.

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 a few key takeaways. Our third quarter results are strong in this challenging operating environment. Our full year updated guidance suggests this will also be the case for the year, while navigating the present external challenges. We expect to deliver above-market revenue growth this year and a record top line performance. We believe our investments in innovation, in our growth initiatives, as well as supportive trends in our diversified end markets provides solid runway for the future. We are staying firmly focused on meeting our customers' needs and overcoming the present supply chain, logistics and inflation challenges, while expecting to deliver strong earnings growth.

Our innovation efforts and key growth initiatives are focused on higher margin products, which we believe in combination with restructuring benefits and ongoing GPS-based productivity initiatives provide additional margin expansion opportunity over the mid-term.

Finally, our business model has continued to demonstrate substantial free cash flow generation, which we expect to continue to contribute to deleveraging the business and increasing capital allocation flexibility. Our business is well positioned to take advantage of the secular market opportunities in core applications we serve and our global teams are firmly focused on keeping our customer's needs front and center. I'm grateful for the effort put forward by our global teams in delivering these results and looking forward to what we believe is a solid set up for 2022.

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

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] Our first question is from Mike Halloran with Baird. Your line is open.

**Michael Patrick Halloran**

*Analyst, Robert W. Baird & Co., Inc.*

**Q**

Hey, good morning, everyone. So...

**Ivo Jurek**

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

**A**

Good morning, Mike.

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

**A**

Good morning.

**Michael Patrick Halloran**

*Analyst, Robert W. Baird & Co., Inc.*

**Q**

So can we follow up then on the positive trajectory you're talking about for 2022? Obviously fourth quarter 200 basis point, 250 basis point headwind from all the supply chain inflation, etcetera, challenges out there. You got a price increase going in to start next year. How should we think about how that headwind starts abating? Are we at the point where we're at the same trajectory we would have talked about a quarter or two ago on the margin side early in next year? Or do you think it takes a little bit more time to play out?

**Ivo Jurek**

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

**A**

Thank you for your question, Mike. Look, we have decided to take our pricing actions early in 2021 and that put us ahead of the inflation that we saw and we were anticipating. And so we are price cost neutral obviously for Q3 and we forecast it will be price cost neutral for the year, which I think is a very strong statement right there. Being dollar for dollar cost neutral still gives you pretty significant headwind regardless on the margins taking into account how large those numbers are. But what we saw was accelerating inflation in the second half of Q3, particularly associated with logistics and material availability and all the expediting that you needed to do to support all of our customers. And since demand is so robust, we wanted to do everything that was in our power to support our customers and we've done that.

And so we've waited to scope the size of that inflation. And since it was so close to announcing our standardized price increases in Q4, we waited to do that not to disrupt all the price books and all the issues that come with rolling forward pricing. And so early in Q1 we anticipate to be again fully whole on price material economics, including the logistics that I've just discussed. And that being said, again, because those numbers are so large, you still are going to be facing some headwinds in the first half of the year associated with margin expansion itself. But we anticipate that 2022 is going to be a very good year. We'll continue to price our products in line with the criticality of the components and the services that we offer to our customers. And we feel we are in a good shape to be able to deal with all of the headwinds that we have expected.

**Michael Patrick Halloran**

*Analyst, Robert W. Baird & Co., Inc.*



So in other words, on an EBITDA basis, you get a lot closer to whole this time next year. It's just that the denominator makes it difficult on the margin side. Is that a fair interpretation?

---

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*



Yeah. That's exactly right. I mean, if you're going to be price cost neutral, you're going to get some margin dilution on the EBITDA line. That's just the law of math, right? But from a dollars perspective, we're going to be at least neutral for 2021 and at least neutral for 2022.

---

**Michael Patrick Halloran**

*Analyst, Robert W. Baird & Co., Inc.*



That's great. And then a follow-up on the book-to-bill commentary and the strength of the underlying demand. Obviously, really strong growth, really healthy underlying demand even though you have a couple of stress points that hopefully should get better in the next year. Could you maybe talk a little bit about what the visibility looks like as we sit here and how far this backlog seems to be stretching out and you're not typically a backlog oriented business? And so what is the underlying commentary, say, about the trajectory in the next year?

---

**Ivo Jurek**

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



Yeah. Mike, a great question. Again, as you've said, we are not typically a backlog business. But the order intake is very strong. And despite all the headwinds that we have seen in Q3 associated with the [ph] weak out of (00:24:45) production and the headwinds that we have seen in China, our book-to-bill is very, very solid, way north of 1. And frankly we are just struggling to be able to keep up with the needs of our customers, taking into account how strong their performance is. And so our backlog has grown. We've talked about building backlog on a Q2 call. The backlog continues to grow through Q3. And we feel that the demand is very solid in the marketplace. When you combine that with the initiatives that we have been executing on, the issue really for us is not the strength of the end markets, it's ability, frankly, to secure enough raw materials to be able to keep up with the demand that we see.

---

**Michael Patrick Halloran**

*Analyst, Robert W. Baird & Co., Inc.*



Makes sense. Appreciate the time. Thank you.

---

**Operator:** Our next question is from Nigel Coe with Wolfe Research. Your line is open.

---

**Nigel Coe**

*Analyst, Wolfe Research LLC*



Thanks, good morning. I just wanted to dig a bit more into Q4 sales. I mean, I think the Q-over-Q dollar number is stepping down quite a bit more than we would expect. I'm just curious if there's some constraints on your ability to supply. You mentioned, Ivo, in your prepared remarks that you're not able to ship everything you would want to. So just curious what constraints you've seen on sales. And then as part of that, I noticed that you call it a mid-single-digit decline in auto OEM, obviously a lot better than global production. So I'm just wondering if there's some element of catch-up in the auto OEM channels.

A

## Ivo Jurek

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

Good morning, Nigel. Thank you for your question. Look, a lot to unpack but I would start with the constraints that we are seeing. The biggest constraints frankly are associated with the availability of resins and chemical additives. That is probably the biggest challenge that you are dealing with. And when you secure them, being able to position them in a facility that consumes those resins or additives, is the other complexity that we have dealt with, taking into account the challenges that you see with logistics globally and the impact that you see in these various ports, it's just put tremendous amount of strain on our operating team globally, and they have managed that really, really well. So I'm very pleased with what we have been able to do in Q3. But we anticipate that these short-term impediments are not going to improve in the Q4, and we're just trying to be pragmatic about what we are seeing there in terms of the availability of these resins and additives in particular. Some of the other raw materials that the issues have – we have been able to manage through them quite well. But the resins and chemicals is probably the biggest issue.

Now, coming back to your question about automotive, what I would say is that we are the global leader in electric power steering, as an example. We are seeing ramp-up in the right mix. We have spoken quite a bit over the last couple of years about our desire to be much more focused on the new energy applications in automotive. And despite the car production decay, we have been able to be in the right mix. And so although it is a headwind, it's not as big of a headwind as maybe others have seen.

That being said, our automotive replacement side of the business is performing extremely well. The demand is very strong and we continue to prioritize our customers and do everything that we can to be able to service them and the needs of their customers.

Q

## Nigel Coe

*Analyst, Wolfe Research LLC*

Great. Thank you. That's great to hear. And then I just wondered if we maybe could dimension the price actions in January and you called out the 250 basis points of impact in 4Q. Are those price actions enough to offset that 250 basis points?

A

## L. Brooks Mallard

*Chief Financial Officer, Gates Industrial Corp. Plc*

Yeah. So the price actions that we're taking for next year take into account what we've seen up until the time we calculated them. And as I said before we expect to be price cost neutral for 2022. I won't into a lot more detail than that. But I will tell you that if we see further acceleration as we did in kind of midway through 2021, we can roll out additional price increases next year to make sure that we stay on top of this price cost dynamic. And I think there's one thing that we're all pretty confident in and that is that we can go get price as needed to offset the supply chain disruptions, material inflation and labor disruptions that we're seeing in the environment right now.

Q

## Nigel Coe

*Analyst, Wolfe Research LLC*

That's great. I'll leave it there. Thank you.

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

Q

**Trish Gorman**

*Analyst, Barclays Capital, Inc.*

Hey, good morning. This is Trish Gorman on for Julianne. So just on the backlog and you guys said it began building in Q2 and book-to-bill remains solidly above 1 times. So just wondering kind of within that backlog, do you guys have any sort of repricing mechanisms or escalators to protect margins as it comes through to revenues just in light of the current cost environment?

A

**Ivo Jurek**

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

Thank you for your question, Trish. Yes, we price upon shipment. So, as Brooks just outlined, we are repricing our price book starting early Q1 and all of our shipments that are going to go out in Q1 will be based upon new pricing through the distribution channel. Now, obviously, it's a little different dynamic with the OEMs. With the OEMs, we are approaching them one by one and we are raising prices as needed and as negotiations come to fruition, but 54% of our revenue comes through distribution channel. So, those are much more predictable.

Q

**Trish Gorman**

*Analyst, Barclays Capital, Inc.*

Thank you, it's very helpful. And then just maybe a quick follow-up on inflation in Q3, both segments saw very impressive margin expansion. So just wondering if you expect inflation to be more acute in one of the segments versus the other as we think about Q4 dynamics? Thanks.

A

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

No. Both segments use basically kind of the same underlying bills of material in terms of resin and compounds and things like that. So we don't expect to see one seeing more outsized inflation than the other.

Q

**Trish Gorman**

*Analyst, Barclays Capital, Inc.*

Perfect, thanks so much.

**Operator:** Our next question is from David Raso with Evercore. Your line is open.

Q

**David Raso**

*Analyst, Evercore Group LLC*

Hi, thank you. The decision around the pricing action, you just mentioned the repricing of the backlog Jan 1. Was that sort of the business decision there where obviously it's a little uncomfortable repricing a backlog, but at the same time you ended up taking a hit in the fourth quarter by not pushing price more quickly for 2021? Is that sort of the dynamic we should think about that obviously the channel's not going to love repricing of backlog but at least you didn't push an increase through, say, October and then hit them again in January? I'm just trying to get a sense of the decision why to wait?

A

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

No. So the reason we waited is our typical – it typically takes about 90 days for us to push our price increase through the channel. And so typically our normal pricing mechanism for the beginning of the year price increases

is we will announce the price increases in October to be effective early in Q1. And so as we started to see inflation accelerate toward the end of Q3, what we decided to do was take the next six weeks or so, make sure we size the price increase appropriately and then communicate it at the normal times to minimize the disruption to the customer and to give them their normal time to get all their prices updated in their catalogs and their systems and things like that.

And so for us it just made a lot of sense that, hey, at this point in time in Q4 we're going to be a little bit upside down on price cost, but we're going to recover it in Q1. And then we're going to continue our normal methodology in terms of how we get rolled price out to make sure we're able to offset the inflationary pressures we're seeing.

**David Raso**

*Analyst, Evercore Group LLC*



And given the benefit of your model having so much replacement channel sales, I'm curious if that was the thoughtful decision of let's make sure we know the magnitude and then price accordingly. And I know it's easier said than done, but why are you then pricing only to offset costs? I mean, the benefit of [indiscernible] the mature replacements (00:34:39), I would think to be able to – unless you fear some demand destruction from trying to price where you can maintain margin on price costs. I'm just curious what's your take on that?

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*



Yeah. So, look – so, look, I would say that at a minimum, right, we always make sure that we're going to price to offset costs. Now, that doesn't mean that we're not looking at our whole portfolio, particularly in times of this kind of accelerating demand environment we're in and not looking at things that are margin challenged where we may be able to do better. So what I would say is at a minimum we're always looking to be neutral on price versus cost, but we're also looking for opportunities to optimize the portfolio and improve our margins as well.

**David Raso**

*Analyst, Evercore Group LLC*



Okay. That's helpful. And then I know it's a hard question, but when we think about margins year-over-year, even if you pull out the 200 bps, 250 bps hit in the fourth quarter, it's still implying down year-over-year even if you add that back. So I don't know if that's a mix issue or something else to discuss. But when would you expect the margins year-over-year to return to growth? Is that a second half 2022 issue or could it be as soon as 2Q? I'm just trying to frame it a bit as you approach this pricing decision.

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*



Yeah. So I would say that the other part of the margin equation there is you have to remember last year we were still going through some of the COVID stuff. And so our SG&A in Q4 of this year is higher than it was last year. Now, some of that is variable comp, but most of it is just a return to the norm on things like marketing programs and co-op with customers and different things like that as we get back to a normal rate of spend. So I think as we roll over into 2022 and the comps get more normalized you'll see that more normalized margin comparison start to come through.

**David Raso**

*Analyst, Evercore Group LLC*



All right. That's helpful. Thank you very much.

**Operator:** Our next question is from Andy Kaplowitz with Citigroup. Your line is open.

**Andrew Kaplowitz**

*Analyst, Citigroup Global Markets, Inc.*

Hey. Good morning, guys.

**Ivo Jurek**

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

Good morning, Andy.

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

Good morning.

**Andrew Kaplowitz**

*Analyst, Citigroup Global Markets, Inc.*

Ivo, I think you had talked previously about expecting normalized growth in China in the high-single digits to low teens in the second half of 2021. And obviously you mentioned the power outages basically caused the one-week shutdown for you. Was that mostly the difference versus your previous expectation as well as some of the auto first-fit weakness? And then are you seeing – or are you seeing more of a macro slowdown in China? And how concerned are you about that as we go into 2022?

**Ivo Jurek**

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

Yeah. Andy, thank you for the question. And I would – real briefly, we believe that absent the power outages that came, frankly, without really much notice, we would have seen kind of the mid-single-digit growth, taking into account the auto production in China has decelerated quite substantially. But, as we said we have spent from a strategic perspective significant amount of time and effort to build out our Industrial business there and frankly broaden our presence in replacement channels as well and that is bearing quite a bit of fruit for us.

So we see the benefits of our strategy. And absent the power outages, we would be kind of in the mid-single-digit growth in Q3. So my expectation for kind of mid- to high-single-digit growth for China would have been intact absent the power outages there. And yet I don't anticipate that those are going to go away at least until the Beijing Olympics are over with. And so we don't anticipate that it's going to get better, but we are very optimistic about what we have done in China about the size of our opportunity there and the fact that it will continue to drive nice amount of growth once they start stabilizing in terms of making more power available to industrial sector.

**Andrew Kaplowitz**

*Analyst, Citigroup Global Markets, Inc.*

[ph] And so, hopefully, though, (00:38:59) and then Fluid Power growth exceeded Power Transmission, I think, for the first time since Q2 2019, if I'm looking at this right. So I know you've said that Fluid Power is a bit behind Power Transmission into recovery, but is it now right to think that Fluid Power is caught up and maybe even a stronger growth momentum than Power Transmission going forward? And related to that, I think you mentioned energy turning the corner up mid-single-digits. Do you see that end market accelerating moving forward?

**Ivo Jurek**

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

**A**

Yeah. Look, my sense is that Fluid Power is on a trajectory that we have outlined a gradual recovery to very nice rate of return of growth. So we clearly have demonstrated that that is what is happening. I'll point you to a very nice amount of growth associated with our new products. So we believe that we are taking market share from others as the market continues to recover. Yes, energy markets have finally turned a corner and we see acceleration there. There also, we have a number of significant new innovations that we have launched over the last 12 months and we continue to launch and we believe that we are benefiting incrementally in addition to that end market recovering. And when you combine that with the government finally passing the infrastructure bill, we actually remain quite optimistic about the potential of our business in Fluid Power over the mid-term.

**Andrew Kaplowitz**

*Analyst, Citigroup Global Markets, Inc.*

**Q**

Thanks for that, Ivo.

**Operator:** Our 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.

**Jerry Revich**

*Analyst, Goldman Sachs & Co. LLC*

**Q**

I'm wondering if you could just talk about – hi, Ivo. I'm wondering if you could talk about the production cadence as you folks went through the quarter and through October. What was the period of peak disruption just from a material availability standpoint? And as we look at the implied fourth quarter guidance, I believe the core growth outlook implies sequentially revenues down in the high-single-digit range or so, which is worse than normal seasonality. So maybe you can just comment on whether you saw a deterioration into October in terms of supply chain availability and our other key inputs into the ability to produce? Thanks.

**Ivo Jurek**

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

**A**

Yeah. Thank you, Jerry, for the question. So, remember, seasonality impact in Q4, as you mentioned, you feel that it is worse than seasonally. We actually had a record Q4 in 2020. I want to remind everybody of that fact. So we had a terrific Q4 last year, saw comps are getting a little more difficult. And we are being pragmatic about the raw material shortages, Jerry. We still don't see any dramatic improvements getting materials through the port and we just feel that it makes sense to be pragmatic about getting materials in our factories.

**Jerry Revich**

*Analyst, Goldman Sachs & Co. LLC*

**Q**

No, that's very clear, Ivo. And to be clear, it's not as if you observed that deterioration into October. I just want to make sure that's the case.

**Ivo Jurek**

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

A

No, we have not seen deterioration into October.

**Jerry Revich**

*Analyst, Goldman Sachs & Co. LLC*

Q

Okay. Terrific. And then as we think about the pricing opportunity over the course of [Technical Difficulty] (00:42:42-00:42:48)

**Operator:** Mr. Revich, it appears that we've lost your audio. Are you still there? We'll move on to the next question for now, which is from Jeff Hammond with KeyBanc. 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, Jeff.

**Jeffrey D. Hammond**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Hey. Just kind of the – keeping the service levels up and that enabling kind of share caps or just maybe speak to how you're approaching your customer about permanent share gains versus kind of these temporary availability - driven gains?

**Ivo Jurek**

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

A

Yeah, and great question. Look, we've stated that we believe that in 2020, in the second half of 2020, we started to take some temporary share gains through product availability. We believe that we're converting those share gains into more permanent share gains. We have very strong performance across all of our businesses to gain with demand significantly exceeding our ability to supply. And many of our product lines, frankly, not only have raw material driven capacity issues, but they have product lines like in engine cooling and battery cooling for new electrics where our capacity is also limited by our planned machine capacity. So we are looking at further expansions there as we are developing, frankly, product that is highly differentiated and from what we believe and what we understand is best-in-class. So it is translating into very robust forward demand. And we just got to get through the raw material shortages that I think not only Gates but I think all of the industrials are seeing presently.

**Jeffrey D. Hammond**

*Analyst, KeyBanc Capital Markets, Inc.*

Okay. And then it doesn't sound like you want to quantify your 2022 price increase, but maybe you can speak to what the magnitude is versus, say, a normal year. Is it 2X or 3X normal? Thanks.

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

Yeah. So I really don't want to get into sizing anything for 2022 yet because 2022 hasn't played out, right? And so it's going to be, we think we've sized it appropriately now but could there be additional inflation and we have to roll out additional price increases? If we do, we will. So I'm going to stay away from sizing the price increase for next year. I will say the magnitude is significantly higher than what you would normally see and we'll just leave it at that.

**Jeffrey D. Hammond**

*Analyst, KeyBanc Capital Markets, Inc.*

Okay. Thanks, guys.

**Ivo Jurek**

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

Thank you.



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

**Damian Karas**

*Analyst, UBS Securities LLC*

Hey, good morning, guys.

**Ivo Jurek**

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

Morning, Damian.

**Damian Karas**

*Analyst, UBS Securities LLC*

Thanks. Morning, Ivo. Thanks for all the color around supply chain and the demand environment. Was wondering if maybe you could help us think a little bit about 2022? I know obviously you're not in a position to give us guidance but how should we be thinking about free cash flow and what that should look like next year? And would you kind of expect to continue to naturally drive your leverage down below 2 times, or would you anticipate maybe start deploying capital allocations sooner rather than later?

**L. Brooks Mallard**

*Chief Financial Officer, Gates Industrial Corp. Plc*

Okay. So I'll start with the cash flow and then I'll kick it over to Ivo for the capital allocation question. So from a cash flow perspective, look, we went out with above 80% conversion this year. We knew as we were going through the year, we were going to be making a pretty significant investment in working capital as things return to normal. We're sticking with the over 80% of adjusted net income for this year. As we move forward and working

capital stabilizes, our target is always going to be at above 100% cash conversion on adjusted net income. And I'll just leave it at that for now, barring – and when we give guidance, we'll obviously update that. But we knew we were going to be lower this year because of the investment in working capital. Going forward, our target is always going to be 100% of adjusted net income. I'll kick it over to Ivo for the capital allocation question.

#### Ivo Jurek

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

A

Yeah. Thanks, Brooks. So, Damian, I think that as Brooks say, we are making really good progress on deleveraging. And frankly we have achieved our mid-term leverage goal much sooner than we anticipated, which is a great kudos to our operating team and our commercial team and everybody at Gates. So we're very delighted with that outcome.

What I typically say and I'm going to be pretty consistent in here, maybe boring, but consistent, we have terrific amount of organic growth opportunities ahead of us that we are very excited about and we'll continue to prioritize funding those projects. And as we said, as we pointed out over several quarters, we are delivering terrific outsized market growth rate. So we will continue to do that. Our M&A pipeline is actually quite active and quite busy, so we have lots of opportunities to add bolt-on acquisitions to our company to accelerate our growth, to help us to deliver on our vision, to significantly capitalize on opportunities in electrification. And frankly, on Diversified Industrial end markets opportunities. And you know, lastly, I'll say that we have a significant amount of cash on hand. And all of the options are on the table and we are very much focused to stay clearly front and center focused on creating long-term shareholder value and that means that we are considering everything that would result in our shareholders getting rewarded.

#### Damian Karas

*Analyst, UBS Securities LLC*

Q

Understood. Thanks, guys. I'll pass it along.

#### Ivo Jurek

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

A

Thank you.

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

#### Deane Dray

*Analyst, RBC Capital Markets LLC*

Q

Thank you. Good morning, everyone.

#### 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, Deane.



**Deane Dray**

*Analyst, RBC Capital Markets LLC*

Hey, covered a lot of ground here, just had a couple of follow-ups. Ivo, when you said demand exceeded your ability to ship, can you quantify for us how many revenues were missed in the third quarter?



**Ivo Jurek**

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

Deane, I think that I stated that our book-to-bill ratio was significantly north of 1. Again, that's a continuation of string of quarters where we have book-to-bill above 1. So, what's happening with our business is very, very positive. Demand is very strong. And again, demand frankly across all of the markets, end markets and across both channels, even taking into account the demonstrated weakness in automotive OEM, we have outperformed the declines in production output there. So we are quite optimistic about what we see with the demand. And we are very well-positioned into 2022. We are extremely laser focused, both on our commercial side, to be able to price, taking into account what's happening in the marketplace and we have a high degree of confidence to be able to do that again in 2022 as we have done in 2021. And our operating teams are doing a yeoman's job to get the raw materials positioned in the factories that need them the most without significant manufacturing output disruptions. So that's really what we are focused on and we feel pretty positive about how the team is operating.



**Deane Dray**

*Analyst, RBC Capital Markets LLC*

All right. For follow-up, can you remind us how many price increases you put through in 2021 just year-to-date? And is there any thought that there might be some pull-in since you are signaling this increase in January that there [ph] wouldn't be (00:51:50) any pull-in until the fourth quarter? And if that were to happen, I'm not sure you'd be able to ship incrementally more but just what are the dynamics?



**Ivo Jurek**

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

Thank you, Deane. That's a great question. We have done a couple of major price increases to the channel this year and we have approached and negotiated price increases with just about every OEM that we do business with in 2021. And so we have gone multiple times stood up to the market with incremental pricing. Now as to pooling of demand, you are absolutely right. We are frankly having difficulties to be able to keep up with the present demand. We just have no capability to be able to support any pull-in demand that we would frankly do everything that we absolutely can not to allow anybody to pull in demand, even if we had the capability to do so.



**Deane Dray**

*Analyst, RBC Capital Markets LLC*

Got it. Have you had cancellations?



**Ivo Jurek**

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

No. We have not seen any cancellations. We have seen lots of pull-out with the various customers because as you can imagine we are not the only company that is causing some shortfall with providing products to end users in particular. That is basically a nature of the business today. You've got to be very flexible and you have to be able to support the customers' ever changing reactions to what they can build based upon the product that they have available.



**Deane Dray**

*Analyst, RBC Capital Markets LLC*

Got it. And just you might find some comfort in this, that we have two other companies in our coverage who because of their business model and relationships with their distributors and OEs purposely are delaying price increases into January. We've seen this before. So we understand the sensitivity about price books and so forth. And just last a quick question. You clarify on Chain-to-Belt up 50%, is that, those are sales and what is the backlog and the orders book look like?

---

**Ivo Jurek**

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



Yeah. Thank you, Deane. I mean, I appreciate your understanding of how the business model works again, we want to make sure that we scope the right size of pricing. We want to be least disruptive with price increases to the channel. And so that is a decision that we have made and we believe that that was the right decision to do regardless because we have a better, better chance of going in with a price increase that is sizable enough to be able to offset the headwinds that we are dealing with presently.

Now coming back to Chain-to-Belt, Deane, a terrific performance again, another quarter of very strong sales performance. With our Chain-to-Belt, our backlog continues to grow. And more importantly, our opportunities that we quote on and a pipeline of opportunities and design wins continues to grow very nicely. So, my view is that we have quantified our opportunities, particularly with Personal Mobility & Recreation over the last couple of quarters in what we believe we can deliver. We're certainly very much on a trajectory to be delivering kind of the 250 million of revenue in Personal Mobility & Recreation over the next 18-plus months.

---

**Deane Dray**

*Analyst, RBC Capital Markets LLC*



Great. Thank you.

---

**Operator:** We have no further questions at this time. I'll turn the call over to Mr. Waelke for any closing remarks.

---

**Bill Waelke**

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

Thanks, everyone again for your interest in Gates. As always, I'm available for follow-up questions. Please don't hesitate to reach out. Otherwise, we look forward to updating everyone again at our next results announcement in February.

---

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

**Disclaimer**

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2021 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.