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Gates Industrial Corp. Plc (GTES)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. My name is Cheryl and I will be your conference operator today. At this time, I would like to welcome everyone to the Gates Industrial Corporation, Q2 2022 Earnings Conference 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] Thank you.

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

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thank you for joining us this morning on our second quarter 2022 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 second quarter results. A copy of the release is available on our website at 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 are available in the Investor Relations section of our website.

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Please refer now to slide 2 of the presentation which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed in or implied by such forward-looking statements. These risks include, among others, matters that we have described in our most recent Annual Report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements.

With that, I'll turn things over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good morning, everyone, and thank you for joining our call today. I'll begin on slide 3 of the presentation. I'm pleased with our team's performance which represents solid improvement from the first quarter in a very inconsistent operating environment. Underlying demand trends for our products are constructive across most of our markets and our backlog continues to grow with our book-to-bill remaining above 1. We generated near-record quarterly revenue despite the COVID lockdowns in China, the suspension of our business in Russia and incremental FX headwinds. These results are compared against the best quarter in the company's history in Q2 of last year.

Our profitability continued its trajectory of improvement as anticipated. While we have not seen inflation meaningfully abate, the significant pricing actions we have taken are gaining momentum and allowing us to be in a positive price/cost position. We continue to successfully navigate ever-changing operational dynamics. Raw material availability has improved. However, we continue to face inconsistent supply of certain petrochemicals we use across key product lines. Although we have seen some easing in container prices and port congestion, the reliability of intra-region freight and logistics is still spotty. We are comfortable with managing through these external challenges and have a number of initiatives underway to mitigate the impact of these issues as the year progresses.

With respect to our business in China, exiting June we begun to see a recovery from the significant impact of the COVID lockdowns. However, we expect it will take additional time for our customers and the local supply base to ramp-up their operations towards more normal levels. We anticipate this recovery will steadily continue but at somewhat lower pace than what we experienced coming out of the initial COVID lockdowns in 2020. Outside of the specific headwinds in China and Russia, we have not seen a degradation of business activity. We are experiencing more significant FX headwind and anticipate the operating challenges outside of our direct control will persist through the balance of the year beyond our prior expectations. This updated view is reflected in our revised full-year outlook. Our business is sound and our team's solid execution is focused on managing through the present operating environment to meet the end market demand and support our customers' critical needs while delivering the continued sequential revenue growth and margin expansion we expect in the second-half of the year.

Moving now to slide 4. Our total revenue was $907 million with core growth of 3.6%, offset by a 4.5% FX headwind. Core growth was led by the industrial end markets, where our initiatives are focused on capitalizing on secular tailwinds. Our Mobility business delivered another quarter of solid growth, as did our Diversified Industrial end market, where our products did drive efficiency improvements in fixed industrial applications are captured.

Rounding out our top-performing end markets where Off-Highway, which benefited from strong growth in agricultural applications; and Energy, driven by increased activity in North America and Middle East.

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Second quarter adjusted EBITDA was $180 million or a margin of 19.9%, representing sequential improvement of 230 basis points. This improvement was driven primarily by more favorable pricing, offsetting the negative impact from China and Russia, as well as operational inefficiencies from challenges associated with raw material availability.

Adjusted earnings per share were $0.32 in the quarter, representing sequential growth of 23%, primarily driven by higher operating income.

Moving to slide 5 and our segment-level results. Our Power Transmission segment had revenue of $543 million in the quarter, including a core revenue decline of 2% and a negative FX impact of 5%. The segment was impacted disproportionately by its much higher exposure to China and Russia, as well as a limited availability of certain engineered compounds used in products of this segment.

Looking at the segment in total, our Mobility business saw the strongest growth, followed by the Diversified Industrial end market.

As a result of the strong progress we have made with our growth initiatives over the past several years, we are bumping up against some capacity limitations in certain product lines. The targeted investments we are making to address these limitations are ramping up, and we expect them to come online in the second half of this year.

Our Fluid Power segment had revenue of $364 million in the quarter, including core growth of 14% and negative FX impact of 3%. We saw a solid performance across the board with double-digit quarter growth in all end markets. Our strongest performance came in, in our Automotive Replacement business which posted core growth in the low-20s. All of our Industrial end markets saw similar growth rates in the low-teens to mid-teens, benefiting from supportive demand across the industrial complex. Our new products also continued to perform well with core growth of over 40%, not all of which is incremental and include the replacement of legacy products, but at a more favorable margin.

With respect to profitability, our Power Transmission segment was impacted primarily by its exposure to China, Russia and raw material shortages. Despite the difficult operating environment and inefficiencies associated with the ramp-up of targeted capacity in support of our growth, the segment saw sequential margin expansion of 130 basis points.

Our Fluid Power segment generated strong margins in the quarter with much less exposure to China and Russia, as well as fewer material availability challenges. It converted its higher revenue growth into sequential and year-over-year margin expansion of 390 and 110 basis points, respectively.

In both segments, we managed pricing actions across all regions and channels in response to the significant inflation we experience. We expect the pricing momentum to continue and contribute to further sequential margin expansion in the second half.

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

L. Brooks Mallard

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

Thank you, Ivo. Moving now to slide 6 and the regional breakdown of our core revenue performance. Overall core growth was 3.6%, despite the headwinds from China COVID lockdowns, Russia, and continued material supply

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challenges. Improved pricing performance in every region and execution on our growth initiatives in the Americas and EMEA were the primary drivers of our revenue growth.

In North America, core revenue growth represented substantial acceleration from Q1. The growth was broad-based, with double-digit growth in all end markets compared to the prior year. Our Mobility, Energy and Off-Highway end markets had the highest growth rates, all in the mid-teens to 20% range.

From a channel perspective, we saw the largest growth in sales to OEM customers. Though order rates remain strong, supply chain headwinds did prevent backlog reduction and additional sales volume in Q2.

Our core growth in EMEA was 0.4%, with a strong pricing performance offset by significant revenue headwinds from Russia and specific petroleum-based material shortages. We had double-digit core growth in nearly all industrial end markets, led by Diversified Industrial, Mobility and Off-Highway, which more than offset a modest decline in automotive first-fit. Excluding Russia, growth was also balanced across the first-fit and replacement channels.

As we communicated on our last earnings call, it was a difficult operating environment in the second quarter for our business in China as a result of the strict COVID lockdowns. The lockdowns which overall created dislocation in both demand and the supply chain resulted in a core revenue decline of 31%.

One of our production facilities in Shanghai was completely shut down for approximately six weeks while others in the surrounding areas were impacted by the severely reduced movement of materials and finished goods. As the COVID lockdowns began to ease in June, our business slowly started to recover. The recovery continued in July and while we expect it to steadily improve, it will likely happen at a rate below what we previously anticipated.

Finally, our businesses in South America and East Asia and India had varied performance in the quarter. South America had another strong quarter with core growth of 18%. We saw good performance across all end markets led by On-Highway, Off-Highway and Diversified Industrial. In East Asia and India, demand remained steady and we saw solid growth in our Auto Replacement business and in the On-Highway end market. Given the specific regional challenges, we're pleased with our performance overall. The regional dynamics remain fluid and we were focused on maximizing our operational flexibility to meet the end market demand.

Moving now to slide 7 and some details on key balance sheet and cash flow items. Our LTM free cash flow of $108 million was impacted by higher investment in working capital, primarily inventory to mitigate the impact of supply chain and logistics reliability challenges. We're also being negatively impacted by higher cash taxes and temporary delays in collecting certain debt receivables partially due to changes in the regulatory environment. We expect all these items to normalize and improve cash flow in the second-half of 2022. Our net leverage at the end of the quarter was 3.3 times compared to 3.2 times at the end of Q1. The slight increase was driven primarily by lower LTM free cash flow and adjusted EBITDA. We had a solid 18.1% return on invested capital with a year-over-year decrease driven primarily by lower LTM operating income.

Moving now to slide 8 and our full-year guidance, we are increasing the bottom end of the range of our core revenue outlook. The demand environment continues to be constructive and we have additional capacity coming online to support growth in key end markets. We are updating our outlook to reflect the impact of FX and a slower rate of improvement in China as well as material availability and logistics challenges that we now expect to continue for the remainder of the year. A lower overall tax rate and minority interest are expected to partially offset these impacts. We are reducing our 2022 full-year adjusted EBITDA guidance range to $705 million to $755 million and our full-year adjusted earnings per share range to $1.15 to $1.25 per share. For the second-half, we

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expect more muted seasonality between Q3 and Q4 with the quarters looking similar in terms of overall sales and margins. We expect margins to continue to improve sequentially in the back-half of the year, as additional pricing and sales volumes materialize, resulting in a second-half adjusted EBITDA margin in the range of 100 to 175 basis points higher than Q2.

With respect to free cash flow, we expect improved profitability and reduced investment in inventory to drive good cash flow generation in the second-half. However, we anticipate exiting the year with elevated levels of inventory to minimize further disruptions from material availability and supply chain challenges. As a result, we have updated our guidance accordingly. We are pleased with the progress we've made with pricing to address the impact of inflation. And although mindful of the potential for higher energy costs, I believe we are still on track to achieve price/cost margin neutrality by the end of the year.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Brooks. Moving now to the summary on slide 9 and a few key takeaways. I would like to wrap-up by recognizing the determination and perseverance of our Gates associates around the world whose efforts drove our solid performance on the highly challenging macro conditions. While we expect the operating environment to remain volatile in the near-term due to geopolitical events, inflation, and poor reliability of supply chain globally, we have a strong management team in place to navigate in an uncertain market. Our business model is resilient and focused on delivering mission-critical, highly engineered solutions to our customers. Throughout the past several years, we stayed committed to investing in innovation and our growth initiatives, which are contributing to the strong order flow we are seeing. We expect our pricing momentum to continue and anticipate benefiting from the targeted capacity we are in the process of ramping up. Whatever market volatility we experience in the coming quarters, we are confident we are well-positioned to take advantage of fast-growing market opportunities for our advanced products and solutions and deliver on our mid-term growth strategy.

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] Please limit yourself to one question and one follow-up. The first question is from Jerry Revich of Goldman Sachs. Please go ahead. Your line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone.

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

A

Good morning, Jerry.

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

A

Good morning, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

I'm wondering if you can just put a finer point on how the year-over-year cadence is tracking for your business in China? I know you mentioned it's below your prior expectations and it's rising sequentially. What about year-over-year and what does your guidance assume is the fourth quarter exit rate for the lines of business in China? Thanks.

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

A

Yes. So, Jerry as we have indicated, China was pretty tough right down mid-30s, a little worse than what we anticipated when we entered the quarter. We anticipated that we'll see maybe a month of shutdown in Shanghai and then things starts reopening. Clearly, that did not occur. Shanghai was shut down nearly through the month of June, significantly impacting the business activities there and across China as well. However, we did exit Q2 in a much better cadence than what we have experienced in April, May and June, so it was progressively better and clearly July half came in significantly better as well than June. So, we are seeing the progressive recovery, a really nice progressive recovery. But we just are being realistic that we don't feel that it will be as sharp of a snapback as what we have seen in 2020 when China just snapped back very, very sharply. So from our perspective, we anticipate that we will be probably somewhere in the high single-digits down in Q3 and kind of low single-digit to flattish exiting Q4 in China.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Got it. Appreciate the color. And then given that dynamic and all the moving pieces this year, I'm wondering if you expect your fourth quarter EBITDA margins to be the highest of the year which I think would be different than normal seasonality but given that production cadence as well as price/cost, it sounds like that might be the case this year. Can you just comment on that, please?

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

A

Yeah. Hey, Jerry, this is Brooks. So, look, I think that's pretty close. I mean as you know the way we're looking at it we think we're going to have more muted seasonality. Typically, you do see a little bit of a tick-down in Q4. But given the capacity we've got coming online and the additional pricing that's going to ramp through the year, we think it's going to be more sequentially even. So, I would say that's probably correct. Pretty close to Q3, if not maybe a little bit slightly up as we exit the year. And when you compare to how we exited the year in 2021, right, in significantly better shape; price/cost repair basically done and then now just getting after repairing the margin impact of some of these supply chain challenges and things like that. So, we feel pretty good about where we're going to be when we exit the year.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Appreciate it. Thanks.

Operator: Your next question is from Mike Halloran of Baird. Please go ahead. Your line is open.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Hey. Good morning, everyone.

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

A

Good morning.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

So kind of working off that last question but then demand seems fine across most of the verticals. Obviously, you got some China. You've got some capacity coming on. So, at what point do you think you're going to start working your backlog down and start moving towards whatever that more new normal looks like?

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

A

Yeah. Mike, look, we've anticipated in our previous guidance that that's going to start happening kind of in Q3. We now believe that we should start seeing backlog coming down kind of towards the end of Q3 into Q4. The incremental capacity that's coming on-stream is basically installed and we are now just ramping that capacity up. We're also working on a number of different alternatives to our – particularly and predominantly Power Transmission supply chain issues and raw material availability issues. And as you can probably appreciate, the conflict in Ukraine and Russia has significantly impacted further the availability of petrochemicals. So that's something that we are dealing with. And although we are not buying anything from there, the world's capacity, whatever minuscule capacity was available in the front-half of the year has completely evaporated and things became even more complex. But we have a line-of-sight on alternative solutions and we believe that we should start seeing backlog coming down as we exit 2022.

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

A

Excellent. And then on the demand side, you listened to the commentary and again excluding the challenges regionally in China and in the Russia side of things, it sounds like you're pretty confident in what the current demand trajectory looks like. Maybe just some thoughts by end market as you're thinking about back-half of the year into 2023? If there's any sign of – of cracks emerging somewhere or is there acceleration potential in other parts of the portfolio, just some puts-and-takes as you think about your demand?

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

A

Yeah. So, look, obviously, the known challenge is, right, China. I'm not going to spend lots of time on it. We have delineated that issue. Despite the fact that it's very challenging, again, it is getting progressively better. Europe is impacted predominantly for us presently through the loss of revenue that we have had in Russia, but all the industrial markets seem to be in a reasonably good shape. That being said, we are being cognizant of the fact that everybody is being nervous.

The situation with the supply of gas for industrial activities in Europe is something that we are thinking through and any potential impact either on supply or on demand. But so far, Europe is in a good shape. North America is very robust for us, as the numbers indicated, coming out of Q2. And we have significant amount of opportunities to be able to maintain a reasonably good trajectory of growth in North America.

We still – I can tell you I'm still receiving more calls about supply availability than anything else even as we speak. And I would say that an incredible strength we see in Mobility and still Diversified Industrial. Those two end markets are real stand-outs for us. And both on the Mobility side, not only is our backlog growing, frankly, quite exponentially, but we see an incredible amount of design win activities.

So, yes, we are very cautious about what's ahead. And I think that we try to balance the caution in our prepared remarks, but we also are balancing that with a reasonably good situation that we see still with present level of demand for our products.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Thanks for that, Ivo. Appreciate it.

Operator: Your next question is from Josh Pokrzywinski from Morgan Stanley. Please go ahead. Your line is open.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good morning, guys.

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

A

Good morning.

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

A

Good morning, Josh.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Ivo, on some of these temporary costs that are kind of getting in the way, things like expedited freight. If you were to add up all of those, what do you think the impact is now? And then, how do you see those progressing over next kind of several months, quarters, whatever timeframe you have visibility over?

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

A

Yeah. So here's the way I would frame it. So the costs, I would say, are multiple, right? There's the freight cost. There's the cost of having your factory in place and ready to go, but the material doesn't get there, so you have these operating variances and things like that. And so, the way that I'll frame it up is as we progress through the year and we get to the end of the year and you can kind of see where our margins are going, you can do the math yourself and you look at how we exit the year.

When we think about getting back to where we want to be from a margin perspective in the short-term, right, we've got a medium-term goal of 24%, but first, you've got to get to 22% and then 23%. When you think about the difference kind of how we exit the year and where we want to get to is primarily those operating variances, and then, on top of that, kind of the additional missed volume by not being able to get that product out the door.

So as we exit the year, price/cost in very good shape. And then, we just got to get back to those other couple of pieces, and we'll be back where we want to be from a margin perspective.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And then, in terms of kind of the broader ecosystem you guys are operating in with some of your OEM customers, and it doesn't just have to be Auto OEM, but I'm guessing that you guys are not the ones kind of holding up the process. Any sense for what their inventory of your stuff would look like, or if they're giving you any information about kind of where some of the bottlenecks are? I guess the point here being if those guys do start to see a slowdown, are they sitting on more of your inventory and maybe there's a bit more risk there? I don't know if that's imminent, but just trying to gauge where you guys are fitting in that production schedule.

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

A

Yeah. Josh, I can tell you with certainty, maybe that's the only certainty that I have today, that we actually – that our OEM customers across the spectrum, from automotive to every industrial customer that we service, have no inventory of our products. If you wanted to buy several of our commodities today, frankly, it would take you a very long time to get them. And there are cases where we are truly holding our customers up with their ability to finish their products.

I mean our demand across – a good amount of our portfolio is very solid, but we're also balancing the issues that I have described in my opening remarks associated with the availability of couple of these resins, the highly engineered compounds that we use in numerous applications, particularly in Power Transmission. But there are

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also some Fluid Power product lines, particularly in engine cooling and battery cooling, that we are not as current as we would like to be.

So we're doing everything that we can to support our customers' most critical needs. But I would say that, presently, inventory across the OEM is not an issue that I am worried about at all.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Very helpful. Appreciate it.

Operator: Your next question is from Jeff Hammond of KeyBanc. Please go ahead. 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, 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

Just wanted to try to spike out a little bit this $50 million EBITDA reduction. Core growth is unchanged, but just how much is FX impact, how much is either price/cost taking longer, expedited freight, supply chain? And I don't know if there's a mix dynamic around China versus the offsets to the slower China?

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

A

Yeah. So, look, it's about 40% FX and the rest of it is the combination of supply chain challenges, slower improvement in China and the other things that Ivo has talked about. So about 60% of it is operational. All the different things we talked about; about 40% of it is FX.

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

Q

Okay. Helpful. And then just back to Josh's question around just – are you seeing any share shifts around, having availability or all your competitors are kind of in the same boat?

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

A

Right now, Jeff, I would say that the industry is in a reasonably same shape. Our Fluid Power, obviously segment is performing extremely well and we do have some availability across Fluid Power, just not in some of the

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secularly attractive lines that we are facing some constraint. So, I think it's predominantly Power Transmission. I think everybody is struggling there. But we feel very confident about our ability to not only maintain but to expand our market share, particularly as our capacity will come online.

I would note Jeff that the amount of designing activity that we see across both of the segment is very, very strong, maybe stronger than we have seen in a couple of years. So, we feel pretty good about you know what the future holds, not ignoring the facts about the uncertainty from the macroeconomics.

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

Q

Okay. Perfect. Thanks, Ivo.

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

A

Thank you.

Operator: Your next question is from Julian Mitchell of Barclays. Please go ahead. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Thank you. I just wanted to focus on the organic sales guide. So, I think you did about 4% growth in the first-half and in the second quarter. I just wondered in Q2 how much of that 4% was price? And then the second half you're saying will grow sort of low double-digit organically. Maybe help us understand sort of the price versus volume within that, please?

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

A

Yeah. So, our price was a little north of 10% in Q2. And then we had all the headwinds that were really driving the offset of that which was the volume piece. You had the China lockdowns, you had the full-on Russia impact and then you had the supply chain issues that we've talked about which really impacted us, and then that was offset by some more – some actual secular organic growth that we had. So, I mean that's really the number. If you took the total core growth and took the 10% – a little bit over 10% off of it, that would give you the volume piece. And all those headwinds that we've talked about more than outstrip that volume piece that we talked about.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

And then, sorry, in the second half, you've got low-double-digit core growth guide. So is that kind of 10 points of price and then 2 points of volume, something like that?

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

A

No. We don't have as much price in the second half as we did with the first-half. So I would say it's certainly less than that.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

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Okay. But there's some volume growth dialed-in to the second-half organic growth guide?

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

Yes. There is. So, I mean there's some piece. Remember, right, we've got backlog reduction and then we've got – you kind of got normal seasonality and then you got the year-over-year impact that you're going to get from Russia and things like that. So, you kind of add all that up and we have a little bit of volume growth, and then most of it being priced. Maybe it's kind of – actually probably maybe more flattish on volume, flattish to a little bit up.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Okay and thank you. And then just my second question around the -free cash flow. So it sounds like the inventories are going to stay high through year-end. But I think you need, I don't know, something like $350 million of free cash flow in the second-half, after minus $120 million in the first-half. So I don't think the earnings is having a huge step-up half-on-half. So just trying to understand that swing in free cash flow of $500 million or something, where is it coming from if it isn't inventory liquidation?

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

Yeah. Well, look...

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

And when you do liquidate inventory, does that carry a big sort of – normally when companies bring down inventory dramatically, you get a marked gross margin headwind. Do you think you'll see the same?

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

No. Well, first of all, I'm not sure that profitability comment is 100% correct. We are going to see improved profitability in the second-half versus the first-half. So, there's really four things that are going to drive the improvement in cash flow. And you have to remember that we have pretty seasonal operating working capital normally through the business, right? So we have a build-up of working capital and then a bleed-off of working capital. But there's four things that are going to drive it, right? One is improved profitability; one is the collection of some of debt receivables that we had talked about that I talked about in my prepared remarks; the normal seasonality on working capital; and then the inventory reduction to more normalized levels. And so if you add all those up, that's really how you get there.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Got it. And as the inventory comes down, the fourth level you mentioned, does that have any gross margin impact or...?

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

No. I think our inventory has been more – I mean, the inventory reductions we're going to see are going to be more around raw material and how much work we hold in the business and not quite as much on the finished

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goods side. So, we're not overly concerned about that as we work through the back-half of the year. Remember, we've still got a lot of a pass-through backlog and so we're trying to be as efficient as we can in terms of what we build and how we build it and get it out the door.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Perfect. Thank you, Brooks.

Operator: Your next question is from David Raso of Evercore ISI. Please go ahead. Your line is open.

David Raso
Analyst, Evercore ISI

Q

Hi. Good morning. Thanks for taking my question. I apologize if I've missed this. What is the total revenue growth guide for the year? So, 7.5% organic, what's the currency now and was it the drag in the guide?

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

A

Hold on just a second. Let me grab it here. So, for the full-year, we're looking at FX kind of in the 3% to 4% range. Yeah. Headwind.

David Raso
Analyst, Evercore ISI

Q

Okay. Yeah. I'm just trying to figure then...

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

A

Closer to 4% actually. Yeah.

David Raso
Analyst, Evercore ISI

Q

Yeah. I mean basically if it's 3.5% or 4%, it's still sort of, hey, we took out $50 million of revs and took out $50 million of EBITDA. And I guess I'm trying to figure in the second quarter, you actually operated pretty well with a lot of the same negative dynamics you're speaking of for the second-half being in place. So, is it more a function of it doesn't get worse in the second-half; it's just not allowing you to improve in the second-half to where you previously expect it. Just to be clear because again in the second quarter, you operated relatively well. Is that all this is?

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

A

Yeah.

David Raso
Analyst, Evercore ISI

Q

There's not getting worse. It's just not allowing you the sequential improvement that you expected?

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

Yeah. No, I think it's right. We're not getting – I mean if you look at our guide, we're getting better in the second-half. We're just not getting as...

David Raso
Analyst, Evercore ISI
Q

I'm talking about the change in the guide though. Like basically the...

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

Yeah.

David Raso
Analyst, Evercore ISI
Q

...to take out $50 million revs and $50 million of EBITDA...

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

Yeah.

David Raso
Analyst, Evercore ISI
Q

...is a pretty dramatic decremental but the issues that are causing it were in place in 2Q and you actually operated it okay.

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

No, not – well, yeah, but we're getting better. Remember, we're going to see 100 to 175 basis points of incremental margin improvement in the back-half versus Q2, okay? So we are getting better from Q2.

Now, what changed from the guide was the China COVID lockdowns are going to be more exacerbated but probably the bigger issue – definitely the bigger issue is the impact of the raw material shortages and then the supply chain issues on our operating reliability and on our operating efficiency. And so that's really what changed from the guide but let's not lose sight of the fact that we are calling for 100 to 175 bps of profitability improvement over Q2.

David Raso
Analyst, Evercore ISI
Q

Yeah. No. I appreciate it. But given you raised the core revenue guide, it still seems like you're getting the material at least enough to raise the guide on organic. It's just costing you more to get it. Is that the idea, right, that you – that's why the decrementals so bad on the revenue change; it's so high.

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

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Yeah. Well, I would say that there's a pricing element in there too, right? And so it's not just the volume piece. So, there's a pricing element in there too. But, yeah, it's costing us more to I think make it. I think the operational, these supply chain efficiency issues are greater than anticipated.

David Raso
Analyst, Evercore ISI

Q

And then when it comes to the additional capacity, I'm sorry, can you give us a little more color on how much is being added and where? And I know like I shouldn't be asking the question I guess does it help at all with the key polymer availability and the cost to produce with the new capacity coming on or is this more of a – we still need the rest of the supply chain to do their part but when they can we will have incremental capacity to ramp-up.

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

A

So there are a couple of things Dave about the incremental capacity. First and foremost if the incremental capacity is going to give us an opportunity to fulfill the order flows that we are seeing for particularly Mobility, Industrial chains or belt and several of our industrial and automotive specialty belt lines. So, that's where the capacity is coming in. Those specialty belt lines, the last piece is also going to give us an opportunity to ultimately, sometimes in the future, be in a position to potentially do some restructuring activities with less efficient operations. So, we're kind of adding two pieces of capacity: One is incremental capacity that's going to give you simply growth and the other one that's going to give you, over a longer term, an opportunity to produce product more efficiently. Where...

David Raso
Analyst, Evercore ISI

Q

So it's very high-margin capacity coming on given the type of products that you just discussed what's coming on-stream?

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

A

It's an accretive margin capacity that is coming online. Yes.

David Raso
Analyst, Evercore ISI

Q

Yeah. And it sounds like your...

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

A

That being said...

David Raso
Analyst, Evercore ISI

Q

And it sounds like [indiscernible] (00:46:29) older inefficient cost. Can you quantify a little bit what the impact might be? Just a sense of is this adding an extra 5%,10% of capacity across the whole company, be it in high-margin products, but your revenue thought process?

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

I would probably tell you that somewhere maybe in the 5% plus or minus. That's probably the right number to think about that.

David Raso
Analyst, Evercore ISI
Q

Okay. Thank you.

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

The – coming back to your original question about the polymer, the issue with the polymer is not something that we manufacture it. This is a raw material input that is highly engineered, that is in an extreme constrained supply. And so two things are happening: Number one, the price continues to escalate for that polymer, traditional supply and demand type of situation. And two, there's just simply not enough of it around the world, taking into an account how much capacity came offline through the conflict in Russia and Ukraine. So that is an issue that we are trying to address. We have a line-of-sight of being able to address it. We are doing a couple of things: One, we are qualifying other sources of course that we have a long-term partnerships with; and two, we are also engineering alternatives around that raw material supply. We believe that we should be in a position to start seeing some level of relief in Q4, particularly through that engineered solution but we're just not accounting – taking into an account everything that's happening in the world. We have not really been able to depend on lots of certainty over the last 12 to 18 months. So, we just want to be realistic about our ability to ramp everything up and be in a situation to take advantage of both incremental capacity on one side and two the solution to that raw material input.

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

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.

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

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey. Just want to follow-up on where we left off there. And it relates to Josh's question, too, where, Ivo, you said that you've had some challenges with not being able to supply some of the OEs. Is that related to this raw material availability of these resins? And have you just left the OEs in a lurch, or are they getting sourcing elsewhere? Is there any market share loss or everyone's in the same boat; can't produce that particular product?

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

A

So, Deane, everybody is in the same boat because this is a reasonably common polymer that is used in the products that are impacted. So I think that the OEMs, they are getting what they need, but they're getting it similarly to kind of what we are getting our raw material. It's just tough to be timely and it's tough to fulfill perhaps all of the demand that they would like to if they were interested in building a little bit of a buffer. There's just no ability to build any buffer because the raw material is just simply not available.

So I would tell you that we have not – certainly, we have not been notified, nor we have seen any loss of market share through an order flow. And I apologize, but I – kind of the front-end of that question escaped me.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

No. You addressed that, Ivo. And then, second question, for Europe, are you factoring in any risk of energy rationing in any of your manufacturing plants?

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

A

Deane, we are pretty forward-looking about our ability to look at alternatives to the energy that we use, particularly natural gas. So we are putting contingency plans in place to be able to continue to operate our facilities in a reasonably constrained environment from that energy input. So we feel okay about having that alternative. But, obviously, time will tell how severe it may be. And we have, I think, taken a pragmatic view of what it will do to Europe in the second half.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. And just last one for Brooks on guiding to the low end of the previous CapEx range, is there anything that's been pushed out on particular projects? Anything you can share there? Thanks.

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

A

No. Nothing's been pushed out or anything like that. It's just a matter of getting projects done and completed. So...

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

A

Deane, I would probably add that similar to your ability to secure raw materials, it is as difficult to secure some components of key capital equipment to be able to complete these projects. So a lot of these projects are stretching out. And I would say that that's one of the headaches that you have if you have been adding capacity presently in this environment. There's just a level of uncertainty with being able to get some of these critical components, whereas you can get variable speed drives, so controllers and so and so forth. So all of that has an impact, not just on your ability to produce products, but also on your ability to produce some of these larger capital projects.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

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Yeah. We've heard a number of companies say exactly that, Ivo. So that's completely understandable that that also gets reflected in lower CapEx. So I appreciate that color. Thank you.

Operator: Your next question is from Andy Kaplowitz of Citigroup. Please go ahead. Your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Good morning, everyone.

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

A

Good morning, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, could you talk about the resiliency that you expect of Personal Mobility and Diversified Industrial ,as we know you've been focused on investing in those businesses. Obviously, you told us they've been strong, but do you have any concerns about Personal Mobility's exposure to consumers? And then, as you go out into 2023, are these end markets for Gates going to be big enough, where assuming they hold up, they can materially improve the trajectory of the Gates' organic growth?

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

A

Yeah. Look, I mean, I think that Personal Mobility, right, yeah, I mean you can take kind of two takes on it. Why? Consumer gets impacted and then – could that impact their business? And our view is that probably not because they're such in early stage of penetrating those markets with belts that replace chains. And as the electrification of Personal Mobility scales up, we just see a very robust demand for a decade-plus that could represent an opportunity for us to offset maybe some other headwinds that you may have in more challenged economic environment. And business is starting to get pretty meaningful. Obviously, three years or so it was less than $20 million, and it's going to approach a couple hundred million dollars in 2022. And it could be bigger if we had a supply.

We just, as we discussed, trying to ramp up that supply as soon as we can. And the backlog is very robust, particularly on Mobility and it's quite substantial. So we are very excited about what can happen there. We believe that a similar opportunity exists in industrial chain to belt, particularly as folks are much more focused on efficiency in operating industrial assets. We all have to do better reducing CO2 footprint, and that bodes well for this initiative for Gates Corporation for a very, very long time.

So although I can't clearly be able to tell you what will happen in 2023 vis-à-vis macroeconomics and all of the end market demand, we continue to be focused on executing what is within our control; keep making investments in both new product development, new product launches and capacity expansion in support of these more secularly impacted opportunities for us and we believe that that's a great future that lies for us well into the end of this decade.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

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Very helpful, Ivo. And then I think you mentioned Auto Replacement in the low-20% growth range, which obviously is still quite strong. So if you could talk about what you're seeing in that business? And then with the understanding that Auto first-fit continues to be a smaller part of your sales, maybe you could talk about your expectations now given that's still a pretty difficult Auto production environment?

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

A

Yeah. Look, the Auto Replacement in the 20s that I mentioned was in the Fluid Power segment of our business, Andy. So it's in – on the engine cooling side, kind of the battery cooling side, the electrification piece that we have spoken about in the past. So, that's an area that has gone very, very fast for us.

On the Automotive first-fit, look, the Automotive first-fit and you know – I think that as you recall I have been very, very negative on Auto first-fit because we just didn't believe that there is an opportunity to recover that quickly from the supply chain shortages, and we remain very cautiously – maybe cautiously negative. We believe that it will take much more time for the supply chain to heal for the Automotive OEMs. They are making calls every day about what vehicles they are going to build, and we don't anticipate a very significant increase in volume growth in the second-half of this year.

But that being said, they're just not building lots of cars. So what will happen if the economy flips upside down? Is there kind of the traditional significant downside to it? I would say that probably not so. I think that you will see maybe more muted impact on the Auto OEM side than maybe historically. So, it's kind of a – it's a tale of two stories and we believe that there's not an upside in the second-half for Auto OEM and we also believe that there's probably not a dramatic downside even as you extrapolate what potentially the economy may look like in 2023. They are staying very good. Unfortunately, most of our AR business in – I mean, most of our business in Russia was AR. So, from comps perspective, comps are very difficult when you take into account the Russia situation. But outside of Russia, the business continues to do quite well.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate it, Ivo.

Operator: Your next question comes from Nigel Coe of Wolfe Research. Please go ahead. Your line is open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. So...

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

A

Good morning, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Yeah. Good morning. We've sort of really attacked the second-half guide I guess. We've gone through it in more detail. Just obviously I think we're forecasting – this is a question for Brooks, roughly level sales in dollar terms versus second quarter. And typically we see a drop-down – quite significant drop-down in the second-half of the

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year. So, I'm guessing China is part of that. But also you talked about shipping backlogs. So I don't know if you've given the dollar backlog number, Brooks, but if you could just maybe just give us a little bit of color in terms of where that backlog sits today versus normal levels, that'd be helpful.

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

Nigel, the backlog is that all-time high. I will say unfortunately, because as you know we are a book-and-ship business not a backlog business, but the backlog is over $100 million. And just for reference, it's kind of 2x what it was during the peak of 2018. So we've built quite a bit of backlog; lots of the backlog is coming from Personal Mobility and lots of the backlog is coming in from some of the more constrained lines; some of them in hydraulics and some of them in engine cooling. So, it's very robust and I cannot tell you that I am looking extremely towards the day that the backlog drops. And I will not look at that as a negative. I will actually look at that as an incredibly positive situation because we will be more in balance with the underlying market demand.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Okay.

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

And one thing I would remind you of too is we are going to get significant pricing tailwinds in the second-half versus the first-half as well as all the pricing that we've put in place comes online. So, that's going to be a benefit as well.

Nigel Coe
Analyst, Wolfe Research LLC
Q

So, higher dollar price but lower year-over-year price because of the comps. Okay. I understand it.

And then just a quick one for you, Ivo, on Europe with the potential for gas rationing and I'm just wondering how are your customers thinking about that or preparing for that? I don't know the eventuality or potential of it. Is there any preproduction going on ahead of that or is it just a case of let's see what happens. What do you seeing out there?

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

I wouldn't say it's just let's see what happens. I think that there's a tremendous amount of anxiety, Nigel. I think that everybody is thinking about how they will operate should that eventuality come to fruition. And just like what we are doing right, I mean, we are looking at what optionality we have for our industrial assets and we do have some optionality in some of the larger plants and we are enacting on those contingency plans.

I just think that the problem that we are facing right now is there's just simply no capacity. And so even if you were willing to carry more inventory, it is very difficult to be able to build that inventory up ahead of any potential disruptions. And I wish that I could give you a better answer than that but I just don't see any build-up. Certainly, I see no build-up in the OEMs and I do not see build-up in the replacement channels presently.

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Nigel Coe
Analyst, Wolfe Research LLC

Q

No, that's very helpful. Thanks, Ivo.

Operator: Your next question is from Jamie Cook of Credit Suisse. Please go ahead. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi, good morning. Just a quick follow-up. Can you comment on whether the cadence of sales changed throughout the quarter and sort of the trends that you're seeing in July. I know you said China – you commented on China, some of your peers noted that Europe got better snapback in July so what you're seeing basically in July.

And then just a clarification, just on Julian's question on the cash flow. Can you just – sorry. Where exactly do you expect inventory levels to be as we exit the year? Thanks.

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

A

Yes. So, look, China much better; Europe, I mean we actually had a pretty solid performance in Europe absent Russia in second quarter and we kind of maintain the purview that it's more of a status quo. Nothing is going off the rails. And I cannot also tell you that anything is snapping back because we just didn't see a significant decay. I mean absent of Russia, I mean our business in Europe was kind of high-single digits in Q2, which is pretty good.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Did that continue into July because other people were saying that July – were mentioning strength in July. So I'm just trying to figure out how the trend is post the quarter?

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

A

Yeah. And Jamie, as I said, I mean I think that it's kind of a status quo for us. It remains very positive still, I mean I think positive I would say. So no change to trajectory in Europe. Of course China is changing trajectory. So China is healing. Again, we haven't put lots of backend recovery in China but there's potentially a situation out there that China could perform a little bit better than certainly what we anticipate, absent of any additional incremental shutdowns that they may – they could potentially instill.

The answer to inventory, we believe we will start eating into our inventory as we exit 2022. Again, we are not baking in any dramatic change in our finished goods inventory but we start seeing that we will exit at a lower point than we have been operating over the last 18 months. So, we are again not taking any production offline. We can't do that at this point in time. Demand continues to exceed our ability to supply but we are balancing what we make. We are balancing the use of more of the WIP that we have on-hand and the raw material that we have been able to secure, so the net effect is a lower inventory level.

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

A

Yeah. And just a little bit more color on that. We'll be down year-over-year fairly significantly but we won't be back to our normal inventory levels. We'll still be carrying elevated levels of inventory over what we normally would.

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Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you. That's helpful.

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

A

Yes.

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

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

Thank you everyone for your time and interest. As always, the team here is available for any follow-up questions or discussion. Otherwise, we look forward to updating you again after the third quarter. Have a good day.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.

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