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Gates Industrial Corp. Plc (GTES)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. At this time, I would like to welcome everyone to the Gates Industrial Corporation Q4 2022 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] Thank you.

Rich Kwas, Vice President of Investor Relations, you may begin your conference.

Rich Kwas

Vice President-Investor Relations, Gates Industrial Corp. Plc

Good morning, and thank you for joining us on our fourth quarter and full year 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 fourth quarter 2022 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 is available in the Investor Relations section of our website.

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

We'll be attending several investor conferences over the next month, including the Citi Global Industrial Tech and Mobility Conference, the Barclays Select Industrial Conference (sic) [Barclays Industrial Select Conference] (00:02:23); and the Evercore ISI Industrial Conference. We look forward to meeting with many of you.

With that out of the way, I'll turn the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Rich. Good morning, everyone, and thank you for joining our call today. I would also like to take this opportunity and welcome Rich to our team. He, as you know, has taken the lead position in Investor Relations here at Gates. He is a seasoned professional with many years of experience on the sell-side as well as in-house.

With that, let's start on slide 3 of the presentation. Our global teams delivered mid-teens core growth in the fourth quarter. Underlying demand was stronger than expected in North America and EMEA, especially during the second half of the quarter, and more than offset the COVID-induced slowdown in China. Growth was relatively consistent across our channels.

Importantly, our conversion of orders improved as supply chain inefficiencies eased in the latter part of the quarter, particularly in Europe. We exited the year in a more balanced position with supply, meeting the underlying demand. The weaker dollar exchange rate at year-end and better fill rates of aged orders in Europe benefited revenues by approximately 250 basis points year-over-year and contributed to the elevated sequential revenue growth. We are pleased with the progress our teams have made to enhance order conversion and believe activities should be more normalized as 2023 evolves.

Our profitability in the quarter improved nicely versus prior year and the resulting margin expansion was consistent with the guidance provided in November. While volume growth contributed to margin performance, we incurred incremental costs to convert past due orders, which modestly impacted the profit flow-through. Our global commercial teams continue to price effectively to preserve margin neutrality. Our improved performance helped to generate a 34% incremental margin.

Free cash generation was very strong in the quarter as anticipated. Free cash flow to adjusted net income was well in excess of 300% and benefited from the outline margin improvement, as well as higher working capital terms driven by inventory reductions. We are intently focused on increasing our working capital efficiency and boosting our free cash flow conversion as supply chain conditions moderate.

Moving now to slide 4, our total revenue was $893 million, which represents core growth of 16% versus the prior year period. Foreign currencies were approximately 6.5% headwind year-over-year. We experienced double-digit core growth in nearly all end markets led by personal mobility, which grew 41%, followed by our energy and off-highway markets, which collectively grew approximately 20% year-over-year. In general, we saw stable demand trends with improvements in our fill rates as we moved through the second half of the quarter.

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Fourth quarter adjusted EBITDA was $166 million, which translated to an 18.6% adjusted EBITDA margin and an increase of 150 basis points year-over-year. We executed well and the overall operating environment became more constructive. While we are not completely past supply chain challenges, we are encouraged by the stabilization experienced in the fourth quarter.

Adjusted earnings per share was $0.25. Our operating income was up significantly year-over-year, contributing approximately $0.10 per share. However, tax headwinds of $0.15 per share more than offset the improvement.

Please turn to slide 5 and our segment level highlights. The Power Transmission segment produced revenues of approximately $552 million in the quarter, driven by nearly 15% core growth year-over-year, offset by an 8% FX headwind. All end markets experienced healthy top line expansion. Similar to enterprise, personal mobility, off-highway and energy were the leading growth engines for the segment. Our opportunity pipeline in personal mobility grew about 50% in 2022. We exited the year with solid margin expansion and price/cost [ph] imbalance (00:07:58).

Our Fluid Power segment posted revenue of $341 million, including 18% core growth and negative FX impact of 3%. We realized solid growth in all end markets with automotive, off-highway and energy being the outperformers. Our innovation efforts continue to pay dividends with new products contributing to Fluid Power segment core growth and share gain in 2022.

As a result of investments made in 2018, our existing capacity is sufficient to support our growth aspirations via new product development and market expansion well into the future. Our segment profitability improved nicely, fueled by a 45% incremental margin on higher revenues and included improved price/cost dynamics compared to the prior year period.

I will now turn the call over to Brooks for additional color on the 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. We experienced double-digit growth in all our major geographic markets, with the exception of China. Our overall fourth quarter growth rate benefited from relative strength in North America and EMEA, our largest regions.

In North America, we realized double-digit core growth in nearly all of our markets led by automotive and off-highway, which each grew more than 20% year-over-year. The EMEA region delivered the strongest growth in the quarter, with core revenues increasing 22% year-over-year. The off-highway and energy end markets each grew by more than 30% year-over-year. Our personal mobility business grew nearly 80%, the highest quarterly growth rate we experienced in 2022. Overall growth was solid and aided by an improved supply of raw materials and some catch up to customer demand.

Our China top line performance posted a year-over-year decline due to shutdowns related to rising COVID infections during the quarter. Finally, our markets in South America and East Asia and India performed well, delivering accretive core growth rates. In aggregate, we were pleased with the growth trends and improvement in supply chain fundamentals.

On slide 7, we show details on our cash flow performance and balance sheet. Our free cash flow was $226 million, which was 317% of our adjusted net income for the quarter. The stabilization of the supply chain and

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improved order conversion helped contribute to higher inventory turns year-over-year. Our net leverage declined to 2.8 times and represented a meaningful improvement relative to the third quarter.

During the quarter, we strengthened our capital structure by paying off our ABL revolver and issuing a new dollar-denominated term loan with a maturity in 2029. This replaced an existing loan set to mature in March of 2024. We remain confident in our ability to further improve our balance sheet in the future.

Moving now to slide 8 and our full year guidance and views on the first quarter, for 2023, we are initiating guidance for core growth to be in the range of 1% to 5% year-over-year. Within that framework, we have factored flattish volume versus 2022. We continue to see solid demand trends in the early part of the year, providing near-term visibility. That said we anticipate our customers will rebalance their inventory levels in the latter part of the year because of improved supply chain reliability.

Our initial 2023 adjusted EBITDA guidance is in the range of $700 million to $750 million. At the midpoint, this guidance implies about a 90 basis point increase in adjusted EBITDA margin year-over-year. Our adjusted earnings per share guidance is $1.13 per share to $1.23 per share. Improving working capital efficiency is a high priority for 2023 and we expect free cash flow to be approximately 100% of adjusted net income in the coming year.

For the first quarter, we anticipate total revenues to be relatively flat and in a range of $880 million to $910 million. We expect positive core growth to be offset by unfavorable FX. Our core growth estimate includes headwinds from the suspension of our Russia business and China COVID impact. We expect our EBITDA margin to increase approximately 100 basis points to 150 basis points year-over-year.

Next, on slide 9, we provide an adjusted earnings per share wall from fiscal year 2022 to 2023. Relative to 2022, our forecasted adjusted earnings per share is affected by non-operational items, such as higher interest expense and higher expected effective tax rate. Core growth and conversion should add about $0.06 per share. Productivity and an improved supply chain, which was a headwind in 2022, are expected to contribute nicely to our earnings growth in 2023.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Brooks. On slide 10, I would like to provide a brief summary view. Specifically, I'd like to highlight the following points. We were pleased with our execution in the fourth quarter, while managing through a challenging business environment. Our operating leverage on incremental sales improved to 34% and move closer to our typical performance. Free cash flow generation was a quarterly record. We are encouraged by the slowly improving operating landscape and cautiously optimistic that it will continue to heal over the course of 2023.

Our commercial team's efforts have been admirable. Price/cost is in equilibrium on a [ph] margin (00:15:34) basis, and we intend to protect our margins, should inflation trends escalate versus expectations during 2023. We anticipate customer inventories will begin to normalize as we move through the year. That said, we experienced solid order trends exiting Q4 and through January. We are cognizant of the risks in the global economy, but pleased with our execution and optimistic about the prospects in 2023.

Turning to slide 11, before we take your questions, I would like to review the opportunities we are focused on to enhance our performance and drive shareholder returns as we pivot to the future. First, we are intently focused on

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several productivity measures ranging from bolstering our supply chain to driving incremental efficiencies in our manufacturing operations. We are optimistic that we can continue to drive margin accretion across the enterprise with the improvement to reliability of raw material supply and the resulting effects it bears on our operational activities.

Second, we are accelerating the reduction of complexity across our enterprise by streamlining our product portfolio and minimizing customer complexity below and above the line as part of our 80/20 initiative. In the second half of 2022, we initiated projects in our auto replacement business and have begun to see early returns from the deployment. We expect to implement 80/20 across the rest of our portfolio over the next couple of years.

Third, we continue to invest aggressively in our highest growth areas. Our personal mobility revenue grew approximately 23% organically in 2022, and our opportunity pipeline is robust. We are expanding investments in new products and applications, especially in industrial verticals As such, you should expect our automotive OEM revenue mix to get further diluted as we continue to execute on our selective participation strategy over the next few years without affecting the overall growth profile of the enterprise.

Lastly, we are highly focused on delivering consistent free cash flow conversion in order to continue to improve our balance sheet. We believe a strong balance sheet is one of the primary avenues within our control to increase shareholder value.

I'll finish by thanking our customers and suppliers for their partnership and our global Gates associates for their valuable effort and support.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question is from David Raso of Evercore ISI. Your line is open.

David Raso
Analyst, Evercore ISI

Q

Yes, hi. Thank you for the time. The comment about the rebalancing by your customers of, I think you mentioned as inventory, given the improving supply chain, can you give us a little better sense of how you're quantifying that? It might even be where are inventory levels today at your customers versus where they'll probably want to move down toward with a better supply chain? And dovetailing that answer into the cadence of the organic sales growth for the year would be very, very helpful. Thank you.

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

A

Good morning, David. Look, from the inventory perspective, I would say that presently we continue to see the inventory levels to be in line with the underlying market demand. We've seen pretty resilient strength in the overall markets and we are very aware of the macro. We are very focused on staying and paying close attention to what's happening in the overall global macro. And so, we are monitoring the POS reporting from our largest distributors very, very closely.

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On the last call, I've indicated that we see somewhat uneven performance, particularly in the industrial replacement market. So we spoke a little bit about Europe. We've seen a little bit of that unevenness in North America in Q4. And while in one month, you may feel like you are finally starting to see some deceleration, the next month your order trends reaccelerate nicely.

So presently, we feel comfortable with the level of inventories there in the channel, but we are very aware of the fact that as supply chain stabilizes, lead times starting to shrink, we believe that the inventory level in the channel will start to be reduced. And so, our view is that we are likely to see that in the second half of the year and that is what we have taken into account in our guidance.

I'll turn it over to Brooks on the cadence of core growth.

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

Yeah. So, I think we have headwinds still in the first half relative to China and what's going on and then we also have the lap over of the suspension of our Russia business. And so we continue to have some core growth headwinds in the first half. And then in the second half, as Ivo said, that's when we expect to see more of the rebalancing of inventory. So I would expect the core growth numbers to be relatively balanced through the year. No big impact from one quarter to the next, but just different things that offset or different headwinds that kind of hit the core growth number as we move through the year.

David Raso
Analyst, Evercore ISI
Q

That's helpful. Thank you very much.

Operator: Your next question is from Michael Halloran of Baird. Your line is open.

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

Hey, good morning, everyone.

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

Good morning, Mike.

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

Maybe kind of start there, where you all left off. I certainly understand the inventory commentary. Embedding in that, is your assumption that the underlying end market demand softens through the back half of the year, Ivo? In other words, you guys are just trying to take a little bit more of a conservative approach to what the end markets look like in the back half of the year, given lower visibility and then maybe put that in the context of [indiscernible] (00:22:53) backlog normalization and timing?

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

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Yeah. Great, Mike. I think those are great questions. I mean, we have included in our appendix our view on what we anticipate the global end market trends to be. And while we are – obviously we are reasonably constructive on things like energy and automotive replacement, for the obvious reasons, I mean, people are driving more, low unemployment levels, people have plentiful of jobs. We believe that those trends will – and very aged car fleets. We believe that that bodes really well for an end market like automotive replacement.

We have started to embed, in particular, I may be being a little conservative on the second half of the year inventory activities and we believe that as the supply chains are improving, end customers in a natural way are going to try to ensure that they deliver a decent cash flow. So I think that that's been a tough spot in 2022 for everybody. And so, we are being pragmatic about what we anticipate in the second half. And I think that we are being reasonably open-minded about the end markets as well.

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

Q

Thanks for that. And a follow up question just on the margin side, obviously, it's encouraging to hear that there was more stability emerging on the supply chain side. It seems like you're saying by the time you're at the back half of the year closer to normal. Maybe just put that in context and then how you're thinking about the margin cadence into the year? Obviously, there should be some different dynamics on the volume side as you work through the year, but cumulatively, is the expectation for a little bit of a ramp to the year that maybe is a little bit better than the revenue trends might imply, given the supply chain piece, given some of the internal stuff you're working on and maybe just some thoughts on the cadence in there.

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

A

Yeah. Well, certainly, I think the comps, as you move through the year, year-over-year, Q1 is – of 2022 was a little bit tougher. And then as you move through the year, we had more of the headwinds in the second half of the year relative to some of the supply chain stuff. But as we move through the year, if you think about our full year guidance, at the midpoint, our gross margins will be up over 100 basis points, that will be offset then by SG&A, which has some variable comp element to it, which kind of gets us to that midpoint number of 90 basis points to 100 basis points of improvement year-over-year. It's relatively balanced through the year, as we move through the year, because the first quarter is the easiest comp for us. And so, that kind of gives a little bit more weight to the first half. And then the comps relative to the supply chain issues give us a little bit more easier comp in the second half. So it's relatively balanced through the year.

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

Q

Great. Really appreciate it, gentlemen.

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

A

Thank you.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

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Yes. Hi. Good morning, everyone. Nice quarter. I'm wondering if we could just talk about the acceleration that you saw in EMEA in the quarter, which end markets drove that and is any of that momentum continuing into the first quarter?

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

A

Yeah. Good morning, Jerry. Thank you. Look, I mean, Europe was very strong performance for us, and it was predominantly driven by energy, off-highway and personal mobility. Personal mobility up almost 80% year-on-year, off-highway kind of in the 40s, but all of our end markets, frankly, in Europe are very solid. Our overall auto business was up in the teens, driven by automotive replacement – strength in automotive replacement. And so, there isn't really, frankly, any blemish in Europe. And so, it was a really terrific quarter.

Now, auto benefited somewhat from some catch up as I have discussed on my prepared remarks. We were able to secure little more raw materials and that gave us the opportunity to catch up to some aged backlog, particularly in the auto space on a PT side and so just a terrific quarter. The team has executed very well. And the end market demand remained very resilient and maybe [indiscernible] (00:28:06) follow up question, I mean, January, January was quite strong as well.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Super. And then in terms of the full year outlook, core revenue growth 3% at the midpoint, assuming flat volumes, can you just say more about the pricing cadence, because I think pricing alone should be high singles, low doubles in the first half of 2023, which in and of itself would get you above the midpoint of that range if volumes are flat? So, can you just unpack what's embedded in there a bit more if you don't mind?

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

A

Yeah. Well, look, Jerry, price is somewhat of a moving target, right? As you – as we see what's going on with inflation, as we see what's going on with our cost, the material cost and the energy costs, freight costs, things like that, I think you are probably a little hot on the price side. Certainly will be a little bit higher on price in the first half of the year as opposed to the second half, but we also are seeing some signs of moderation of inflation, where it's not quite a steep a ramp as we have seen. So, we expect price to be lower in 2023 than it was in 2022.

And then I think you also have to remember that in the first half of 2022, we also had the China and the Russia headwinds that are going to continue to be there. And that's going to affect the core growth sum as well from a volume perspective. But I would expect the price numbers to be lower than what you said. And you could kind of do the math if volume is flattish and then price is kind of in that low to mid-single digit kind of range.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. We'll take that over, but thank you. Appreciate the discussion.

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

A

Yeah.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Just wondered if you could parse out a little bit the free cash flow guide, so I think the guide embeds sort of net income not growing much in 2023, but free cash flow is up about $150 million and CapEx is up a bit. So it looks like that free cash $150 million is all working capital. Maybe any sense of the main drivers within that? Is it solely inventory coming down that much or something else? And how do you think about the liquidation of the working capital through the year? Is it kind of similar to your customers whereby it's more of a second half phenomena?

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

A

Yeah. So look, I think on the net income side, there are some moving parts in 2022, particularly relative to tax cash versus GAAP tax. So you've got to kind of strip that out. We certainly think we're going to see improvement in working capital year-over-year, primarily driven by inventory. So that's going to drive a significant piece of it. And then, everything else is kind of flowing through, but tax is a big piece of it. The GAAP tax versus the cash tax in 2022 versus the GAAP tax and cash tax in 2023 is a big part of what's generating the additional cash flow as we move from one year to the next, along with the inventory reduction.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

And is there any way to sort of quantifying it all of that $153 million cash increase, how much is that cash tax aspect?

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

A

Well, I mean, when you look – I mean, cash taxes, from a percentage perspective, is relatively unchanged year-over-year. And then you look at our effective tax rate for 2022 was kind of mid-single digits and then it's going to get back up to kind of 22% to 24% in 2023. So you can kind of do the math on that.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's helpful. Thanks very much. And then, I suppose, secondly, maybe one more for Ivo, but when you're looking at China, it was down for obvious reasons in Q4 and last year as a whole. Maybe help us understand how you're thinking about the volumes in China, the balance of the year? Is it sort of down again in Q1, up a bit Q2 and then sort of high-single digit in the second half? I just wondered what you're seeing and assuming there.

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

A

Yeah. It's a great point, Julian. Obviously, 2022 was very challenging in China with the second quarter shutdown, full shutdown in Shanghai, and then obviously the end of the year impact from first COVID restrictions and then reopening and the infections that rolled in. Look, January was very tough in China, firstly, the first couple of weeks pretty still, pretty significantly impacted by COVID, and then you rolled right into Lunar New Year. So, we have seen very little activity in January, but the activity is coming back.

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So, we anticipate that Q1 is still going to be down, I would say kind of in the high-single digits year-on-year, maybe 10% just for the sake of conversation. And then we anticipate that you're going to see a pretty strong rebound in Q2, predominantly because of the comps, obviously Q2 of last year was as I have indicated. So, the comp is going to be unusually hot in Q2 in China, but the second half of the year should normalize volume wise. And we actually anticipate that we will see a positive impact from China for the year. But we really need to see February before we can start getting more confident about how that's going to develop.

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

Yeah. And let me kind of follow up on one thing on the cash flow too. I think what you also have to remember is over the past couple of years, we've seen a significant increase in working capital and that's what's driven the cash conversion below 100%. And so while we're going to get better on working capital certainly in 2023, I think just the fact that you're not increasing it as much as you have in the last couple of years is going to drive the most significant part of that improvement in conversion.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Great. Thank you.

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

Yeah.

Operator: Your next question is from Andy Kaplowitz of Citigroup. 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.

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

Good morning, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Ivo, last quarter, you still sounded reasonably pessimistic about supply chain headwinds clearing quickly, especially in terms of polymers supply. The polymers just start to clear up faster than you expected and I know you said that 2023 guidance bakes in gradually lessening supply chain inefficiencies and inflation. But is there a way to size the impact of these inefficiencies on you guys? I think last quarter, you mentioned 300 basis points to 350 basis points of headwind in the top line. What do you think that number came in at for Q4 and is there headwind still for 2023?

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

A

Yeah, Andy, thank you for the question. Look, Q3 was a really challenged quarter. I mean, we have really suffered from the supply chain as we have outlined on that call. Q4 has gotten definitely better, but we started very slow recovery of the raw material supply. October was very, very challenging still. October was more or less similar to what we have been seeing in Q3.

And as I said on the 3Q call, just look, our suppliers are actually able to make it more reliably, but we were not able to get it into our factories. And so, we were able to actually move the materials into the facilities in the second half of Q4 as we saw fit. It cost us little bit of money, as I've indicated in the prepared remarks, so the conversion flow through margin improvement was slightly impacted by that movement. However, we were able to get everything that we needed at that point in time, and that resulted in very strong performance, much more in line with the underlying market demand and what we have been able to do kind of in that Q3.

So, my anticipation, Andy, is that we are seeing improvements – gradual improvements in our suppliers' ability to make these highly engineered resins, but we are still somewhat cautious about having a real predictability in the first half of the year vis-à-vis getting it in the factories as we need to get them through the normal means of transportation. So, we still believe that there is going to be some limited impact, while we believe it's significantly better. I just don't anticipate that we're going to get normalized until we exit midyear of 2023.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

It's helpful, Ivo. And then you mentioned in your 2023 EPS walk that you have $0.08 of improvement from productivity and supply chain initiatives. Can you give more color into what your major initiatives are in these areas? And then last quarter, you talked about a, I think, a $45 million footprint rationalization plan. I think you said it would have limited impact in 2023, with bigger impact in 2024. But is there any benefit from this plan in your walk and could you elaborate a little more on what the plan might entail?

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

A

Yeah. Look, on the productivity improvements, I'll come back to kind of the performance that we are seeing in 2023. So, obviously when you are struggling getting enough raw materials to keep up your factories operating, it becomes very difficult to actually absorb all of the overhead in these facilities as you well know. But more importantly to be able to get any traction on your kind of standard, normalized productivity programs that you have, LEAN, Six Sigma, whatever the flavor is that you like to call, we call it the GPS system here.

And so we anticipated as the factories start operating much more normally, we can get pretty aggressively back into the kind of a normalized rhythm of driving productivity as we have demonstrated that we do in the past. And so, the headwind would give you actually the ability to kind of revitalize, if you would, your productivity efforts. So we are quite optimistic. We have a strong pipeline of productivity projects in the book and we are very intently holding our teams accountable and focused on executing on the biggest opportunities.

I would say that nothing's really changed from what we said on Q3 call about restructuring. We still anticipate some cash to be consumed on restructuring programs and the major benefits are not going to roll into our P&L from restructuring programs until 2024.

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Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Helpful. Thanks.

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

A

Thank you.

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

A

Thanks, Andy.

Operator: Your next question is from Nigel Coe of Wolfe Research. Your line is open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. Just wanted to go back to 1Q, the guide for 1Q in a bit more detail, maybe just looking at it from a sequential basis, it looks like sales are pretty flat at the midpoint versus normal history where we have a pretty pronounced uptick into 1Q with obviously the off-highway season. So maybe just talk about what you're planning for from a sequential basis? I mean, FX should also be a help as well. So I'm just curious if maybe the good news on supply chain and that backlog conversion we saw in 4Q, whether that's the offsets that I'm kind of asking about here?

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

A

Good morning, Nigel. I think it's a great question. Look, I would start with, as I've indicated, China, down about 10% and you have a full quarter of the Russia exit, that's a rather substantial headwind on organic growth on the enterprise that gets offset by the better performance and kind of the normalized seasonality that you would anticipate. So, I would say that those are the two biggest headwinds that we are counting on in our guidance.

And obviously, if China suddenly gets dramatically better [indiscernible] (00:41:49) we anticipate that volume would get better, but I haven't seen it in January. And I think it's very difficult to predict that suddenly you're going to see a V-shaped recovery in China. So I would say that those are the two pragmatic issues.

And then, as I said, we are still facing a little bit of supply chain issues and we are probably a little bit gun shy on being able to declare a victory in supply chain until we see that stability to become repeatable throughout, certainly, couple of the first quarters of 2023.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Just to be clear, the Russia and China. I mean, maybe China is going to be a little bit worse Q-over-Q, but Russia would have been an impact in 4Q as well, correct?

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

A

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Yes.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Yes. Okay.

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

A

But as I said in my prepared remarks, Nigel, we had a really nice catch up to some past due orders...

Nigel Coe
Analyst, Wolfe Research LLC

Q

Yeah.

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

A

...that we have delivered on in Europe in Power Transmission and that's kind of would have given us a little bit of an outperformance in Europe in particular. So while order flow remain very robust and the book-to-bill remain above 1, I would just caution for everybody to extrapolate exactly what happened in Q4 in Europe because of the catch up.

Nigel Coe
Analyst, Wolfe Research LLC

Q

No. That's very clear. And then my follow-up is really around capital deployment. I mean, if you get to that 100%-plus conversion, you got the kind of "problem of capital deployment", which is a good problem to have. But in your plan, are you deploying capital? I mean, are you assuming de-levering with the cash flow? And then do you see opportunities to maybe buy back stock during the year?

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

A

Yeah. Yeah. So, look, we've made a commitment in the mid-term to get to 1.5 times leverage. We were below 3 times as we ended the year. We want to continue to de-lever the business. And so as we continue to generate cash, we're going to lock in some of that lower leverage by continuing to pay down debt, reducing GAAP interest, reducing cash interest, certainly over the short term.

This business generates a lot of cash. The capital allocation for us, we're always going to look at different opportunities and figure out what is going to pay back the shareholder the best. We do believe we need to continue to pay down debt though and reduce not only our leverage, but our gross debt as well. And so I think in the short term, that's what we're focused on.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. That's helpful. Thanks.

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

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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.

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

A

Good morning Josh.

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

Q

I apologize if I missed it, but can you just walk us through what book-to-bill was? You mentioned strong orders I think a few times. Maybe just put a finer point on that. And how you stand today on kind of the total past due backlog? You mentioned you worked that down. Just is any remaining and sort of what's the order of magnitude.

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

A

Yeah. So, a great question. Thank you, Josh. Look, we've trimmed some of our past due backlog in the quarter, particularly in Europe and we've taken a pretty nice chunk from the aged backlog there. Interestingly enough, in January, past due backlog start jumping back up on the strength of order flow.

So, Q4 book-to-bill was approximately 1.05. So it remained [ph] above 1. We've written (00:45:43) the past due backlog slightly down. It continues to remain elevated. And we just got to see a better flow through of raw materials to ensure that we can keep up properly with not only with the flow of orders, but also recover some of the aged backlog that we owe to our customers.

Clearly, as a book-to-bill business, not only we not like having aged backlog, but we really don't like to have an elevated backlog period. So both of these remain a reality still for us. We still have challenges to work through.

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

Q

Got it. That's helpful. And then, I guess, just on kind of the surge that you've seen in the fourth quarter, the supply chain improvement, the solid orders. I'm just wondering if there's anything anecdotally or qualitatively, you've had discussions within your customers that some element of this is kind of the supply chain bullwhip effect, right? So like you're able to get more product out the door. Presumably your customers are as well. Like, is the strength that you're seeing on the order side sort of representative of, hey, everyone can get more supply. So they're pulling back – pulling through more product through the supply chain as a whole, but like demand never really changed. Like, I guess, are you seeing any sort of demand volatility up or down, or is a lot of this just kind of dictated by what we've been through on supply chain? Again, hard to quantify, but like any comment there would be helpful.

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

A

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Yeah. This is really frankly the crux of the situation that I think we are all dealing with. And I spent quite a bit of time talking to our customers, particularly at this point in time with the volatility and, obviously watching the macros and watching all the indices that are out there and being very cognizant of the trends that we are seeing. But the general feedback that I am receiving is reasonably positive. The order trends at our customers still remain quite robust but it is varied by the region.

And so when we kind of talk about underlying market demand, we just want to make sure that folks understand that we are looking at it globally, not just from North America perspective. And so, while you may have very strong demand trends in ag, construction and on-highway in North America, that may not be the case in places like China, as an example, and those are large markets, right?

So at this point in time, I would say that we are very watchful at what is happening in the diversified industrial in the industrial replacement channel. Again, I said it a couple of times, Josh, that that's choppy, it's uneven. You may have a weak month and then you may have a very solid month. But I'm just very, very focused on ensuring that we don't miss some trend line and we end up calling it wrongly. But so far, it's been reasonably positive in general.

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

Q

Got it. Appreciate it. Best of luck.

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

A

Thanks, Josh.

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

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

Q

Hey. Good morning, guys.

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

A

Good morning, Jeff.

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

A

Good morning, Jeff.

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

Q

So really, if I do the math, it seems like incremental margins are high-40s. Just wanted to understand really how much of that is around the confidence and this kind of supply chain issue getting better versus something else in there. And I think we had quantified maybe a $40 million headwind in 2022 from the polymer issue and I'm wondering if that is the right number and how much of that reverses in 2023 in the guide.

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

A

Hey, yeah. So as Ivo said, there were some encouraging signs, I think, as we worked through Q4. But we're not out of the woods yet. If you think about our margins as we move from 2022 to 2023, core growth at the midpoint is 3%. We would expect to see less fall through on that as it's mostly price/cost. And we've said that we're trying to maintain EBITDA margin neutrality as we move through. And then, we expect to see significant improvement from supply chain improvements and from the productivity initiatives that Ivo talked about. And that'll be partially offset by some higher SG&A expenses related to variable comp.

So I think you're thinking about it the right way in terms of the gross margin improvement, not only from the supply chain improvements, but from productivity as well. And then that will be partially offset by some higher SG&A as we move through the year.

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

Q

Okay. And then just back on this, the down low-single digit from market for industrial, the industrial and diversified industrial and I think, Ivo, you mentioned choppiness. Maybe just talk, one, about outgrowth. And two, just if you're seeing it equally between the FP and PT side. Thanks.

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

A

Yeah. Look, Jeff, I think the best way to really reference it is just an uneven demand, right. Again, it's one month and maybe down next month and maybe up, up maybe more than down next time. So, right now, what we see is that the sell through from our customers remains very, very robust.

I think that everybody is somewhat concerned about working capital. And as people start getting more comfortable with lead times, I think that you will see some movements in order flow, not necessarily driven by weaker demand. And again, we have not seen weaker demand yet from the POS reports. But I think people are just making sure that on one side they don't hold too much inventory, on the other side, they don't have too little. And so, there's a continuation of rebalancing what is happening in the market – in the channel. So I would say that that's probably the one area that we are very, very intensely watching.

But that being said, there's also an opportunity as people are getting more raw materials that also could result in higher demand generation because people are simply able to just get everything that they need, which wasn't the case throughout 2022.

So, we are reasonably balanced in our view as to what we anticipate throughout 2023, particularly in the industrial replacement market. And while we don't want to call it down dramatically, we also don't want to be in a situation where we miss any potential uptick that maybe should the market conditions remain robust. And there are lots of positives that one should like, right? I mean, you have the infrastructure investment and you need lots of construction equipment. You are going to be building lots of industrial automation equipment. And those are all really good markets for Gates Corporation.

So, we are optimistic about the underlying trend line, but we also want to be realistic about what is happening with ISM and with some of these indices that are being reported on. So, that's kind of what I would say that our perception is.

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

Q

And just maybe speak to the outgrowth assumptions. I know mobility has been something that you've called out, but [indiscernible] (00:54:41) opportunity on the industrial side.

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

A

Yeah. Yeah. Thank you. So, look, I mean, I'm not going to spend much time on mobility, but I think this is a perfect example of how we are driving an organic evolution of our portfolio. Again, I'll remind everybody that in kind of in 2019, it was kind of a $25 million business. And we kind of exited that – we exited the year kind of on a $200 million run rate. So, growing at kind of 10x in 3.5 years.

Now, we don't expect to be growing at 10x over the next 3.5 years. But we are very optimistic about continuing to deliver kind of mid-20s growth rates in mobility and pretty quickly catching up to the size of our end market contribution that we generate in the auto OEM space as an example.

Industrial [indiscernible] (00:55:41) continues to build very strong pipeline of opportunities. Obviously, I've spoken about our Fluid Power business, our innovation, available capacity continues to give us an opportunity to outgrow the end markets. But those underlying markets just are also very robust. Certainly, in North America, ag, construction, heavy duty are very robust markets. And I have highlighted that we've had a very strong growth in our automotive business with Fluid Power as well. And that's an area of where we participate with electrification. That's an area where we predominantly participate in the replacement side of the business with Fluid Power.

So it's – generally speaking, we are very confident about our ability to outgrow the market. And we have demonstrated over the last five years, three years and certainly over the last couple of years that we are capable of outgrowing our underlying end markets globally. So we – maybe a longwinded answer, but maybe providing a little more color.

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

Q

Very helpful. Thanks.

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

Damian Karas
Analyst, UBS Securities LLC

Q

Hey, good morning, everyone.

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

A

Good morning.

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

A

Good morning.

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Damian Karas
Analyst, UBS Securities LLC

Q

Good morning. So I appreciate the underlying market assumptions that you've laid out for this year. Given that automotive is pretty significant for the business, could you perhaps just provide any further color on how you're thinking about the outlook for auto? I guess, just a key assumption. Maybe headwinds or tailwinds that are worth pulling out. Yeah, it'd be really helpful if you can kind of give us a walk around the globe for auto and what you expect this year.

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

A

Yeah. So as you recall, our automotive OEM business is less than 10% of our revenue presently and so, look, we anticipate that the overall production is going to be slightly net positive. I certainly don't fall into the category of individuals that will cause significant increase in auto OE output globally. We are thinking more in line of maybe 2% to 4%. Certainly some recovery in North America where we have very little presence, similarly improved production output in Europe. But you also have to take into account some of the challenges that folks are going to have buying new automobiles when you take into account the increases in prices of new vehicles and frankly the interest rates.

So while the carmakers may be more capable of producing, will you see some decay of demand in the end market because of the affordability index, that I don't know. I'm not an economist, but our view is that globally, you should see auto OEM builds up kind of low- to mid-single digit.

And then our bigger business [ph] is in automotive (00:59:07) replacement. And frankly, we anticipated we should see low-single digit end market growth, positive dynamics in North America, obviously very aged car fleet, high miles driven, high levels of employment bodes well for folks maintaining their vehicles. Very similar trend in Europe. People are certainly driving more miles. We believe that China is going to rebound very strongly. I think you can see it in some of the reports already that people are starting to drive significantly more than, frankly, they have driven over the last two to three years at an expense of even public transportation. So the setup for automotive replacement business is very strong for 2023, as the situation normalizes, particularly in a supply chain, this should be a net positive for Gates.

Damian Karas
Analyst, UBS Securities LLC

Q

Understood. Appreciate all that additional color. And then, a follow-up call on the distribution inventory normalization that you're expecting later this year. Sorry if I missed it, but could you quantify how much of a headwind you've baked into guidance related to that? And is that something that would likely bleed into 2024 or do you view it as more of a [indiscernible] (01:00:43) transient adjustment?

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

A

Yeah. Damian, I think it's very difficult to forecast firstly when and/or if it's going to occur, is it going to occur in second half or is it going to spill into 2024. Again, I will repeat that we are very intently focused on monitoring all the trends. We certainly are very focused on monitoring our POS. The POS trends remain positive, but we are being cautious with our approach for the year and certainly, one should anticipate that as the supply chains normalize, you probably should anticipate that folks will be optimizing their working capital levels. And to us, we have embedded our view in our guidance and I'll probably just leave it at that.

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Damian Karas
Analyst, UBS Securities LLC

Q

Right. Thank you.

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

A

Thank you.

Operator: Your last question is from Deane Dray of RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone, and special welcome to Rich.

Rich Kwas
Vice President-Investor Relations, Gates Industrial Corp. Plc

A

Thanks, Dean.

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

A

Good morning, Dean.

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

A

Good morning.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. Covered a lot of ground here. Just a couple of quick ones. First, Ivo, you didn't mention it, but I was hoping you have good news about your operations in Turkey with the impact of the earthquake.

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

A

Yes. Thank you for asking. Obviously, our prayers are with the folks in Turkey, devastating event. We are very fortunate. All of our operations are not in the impacted area. We are actually in İzmir, which is a reasonable distance away from the epicenter of the earthquake. And so, none of our facilities nor our suppliers have been impacted. But thank you very much for raising that and asking that question, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good. That's great to hear. Thank you. And then, just lastly, you mentioned share gains in Fluid Power. Just broadly, can you talk about the contribution from new products and what's embedded in the guide?

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

A

Yes. So as we have discussed, we continue to drive our contribution of new products as a percent of revenue up. We have exited 2022 in Fluid Power with over 25% of vitality in Fluid Power. So as you will recall, we have highlighted that our aspiration is to get kind of to 20% NPI vitality by 2023 across our portfolio. We've certainly surpassed that objective in Fluid Power. And maybe the follow-on question, so where are you in Power Transmission? In PT, we're kind of in the mid-teens. So we still have ways to go in PT and as I've highlighted in the past, we are now very laser focused on revitalizing our portfolio in PT and we are making good progress on there as well.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you.

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

A

Thanks, Deane.

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

A

Thank you.

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

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

Thank you very much for joining us for our Q4 2022 earnings call and we look forward to seeing some of our shareholders during the next couple of conferences in Miami. We're welcome any follow-up questions as the time progresses. Thank you. And we'll speak with you on our next call.

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

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