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Gates Industrial Corp. Plc (GTES)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to the Gates Industrial Corporation Q2 2023 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]

I will now turn the conference over to Rich Kwas, Vice President of Investor Relations. Go ahead.

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

Good morning and thank you for joining us on our second quarter 2023 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 2023 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 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. 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 will be attending investor conferences later in the third quarter, including the RBC Global Industrials Conference and the Morgan Stanley Laguna 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 us today.

Let's begin on slide 3 of the presentation. Our global teams achieved solid results. We delivered Q2 revenue and profitability above the midpoint of our guidance, as well as strong free cash flow. Our nearly 4% core revenue growth was fueled by strength in our Automotive vertical across both the First-Fit and Replacement channels. The EMEA region led growth geographically with organic growth of high single digits year-over-year. Our China business experienced a nice rebound year-over-year with core growth in the high 20s of a COVID impacted prior year period. However, fell a little short of our expectations.

We continue to see solid demand for our products and our book-to-bill remained above 1 exiting the quarter. We see constructive demand trends globally from the automotive end market and somewhat more mixed picture across the industrial end markets. We realized strong margin expansion in the second quarter compared to last year.

Adjusted EBITDA margin expanded 120 basis points year-over-year and exceeded 21%. We delivered a high 50s percent EBITDA flow through on incremental revenues, compared to the prior year period. The EBITDA margin expansion was fueled by a 170 basis points increase in our gross margin. We experienced greater operating stability and benefited from a more normalized supply chain environment relative to the prior three quarters.

Our free cash flow generation and conversion were also nice highlights for the quarter. We generated $116 million of free cash flow for the quarter, which represented 114% conversion versus adjusted net income, a substantial increase versus the prior year period.

Working capital levels have stabilized and contributed to improved turns as our operations have continued to normalize. For the first half of the year, we delivered almost 90% of our adjusted net income to free cash flow, seasonally strong performance as the bulk of our free cash flow is usually generated in the second half of the calendar year. Our net leverage ratio finished at 2.8 times, a substantial decrease from the year ago period, while also returning $250 million to shareholders via our share buyback in May.

Based on our second quarter outperformance, we are increasing our adjusted EPS range to $1.18 to $1.24 from a range of $1.13 to $1.23. The updated range includes the benefit from a lower share count following our successful share repurchase in May.

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Moving to slide 4. Second quarter total revenue was $936 million, which translated to core growth of approximately 4% versus the prior year. Changes in foreign currency were a nominal headwind year-over-year. Our automotive growth was healthy across both the First-Fit and Replacement channels. Both channels realized double digit core revenue growth compared to Q2 2022.

The industrial end markets remain a bit choppy. Energy, construction and on-highway produced solid growth year-over-year, which was offset by softness in agriculture, diversified industrial and personal mobility. Adjusted EBITDA was $197 million and adjusted EBITDA margin was 21.1%, representing an expansion of 120 basis points compared with the prior year period.

Our margin improved compared to the prior year period, driven by favorable price realization and less operational headwinds due to greater stability in supply chain, a that is consistent with our expectations at the onset of the year. As previously mentioned, the year-over-year adjusted EBITDA margin improvement was driven by gross margin expansion.

We expect gross margin to show year-over-year improvement in the second half of 2023 as well. Adjusted earnings per share was $0.36. Higher operating income contributed to the EPS growth year-over-year, partially offset by increased net interest expense. The share repurchase was executed in May, provided approximately $0.01 of EPS accretion in the quarter.

On slide 5, let's review our segment performance. In the power transmission segment, we posted $574 million of revenue and core growth of 7% compared to Q2 2022. Currency was slightly more than 100 basis points of headwind. Automotive was the highest growth end market for the segment, with core growth increasing at a high teens rate year-over-year. The automotive Replacement and First-Fit channels grew at similar rates year-over-year. Construction and On-Highway generated double digit core growth, partially mitigated by softer demand in our diversified industrial and personal mobility end markets.

Power transmission's adjusted EBITDA margin increased 180 basis points year-over-year, and incremental EBITDA margin exceeded 50% compared to Q2 2022. Our team executed well and benefited from a less volatile operating environment.

Our fluid power segment generated revenues of $362 million. Revenue declined slightly year-over-year on a core basis. Our industrial end markets were mixed and core growth in our Replacement and First-Fit channels both ended slightly down versus the prior year period.

The construction vertical was a relative outperformer posting solid core growth year-over-year. We are benefiting from growing infrastructure investments occurring in the US and elsewhere. With core revenue performance largely unchanged, operating leverage was limited, which resulted in only modest segment margin expansion compared to the prior year period.

With that, I will now pass the call over to Brooks for additional details on our results.

L. Brooks Mallard

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

Thank you, Ivo. Please turn to slide 6 and I'll review our core revenue performance by region. Core growth in the second quarter was led by China and EMEA. China core growth was 28% year-over-year as our business comped to the COVID-induced shutdowns that occurred in last year's second quarter. The On-Highway and

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Automotive end markets realized the strongest growth rates year-over-year, with the First-Fit and Replacement channels both delivering significant growth.

EMEA revenues expanded 9% organically versus last year. Automotive was the primary growth driver, with core growth exceeding 20%. Both auto Replacement core growth and First-Fit core growth increased double digits compared to the prior year. Industrial market performance was varied with growth in certain markets and declines in others. In aggregate, our EMEA industrial business core revenues declined low single digits compared to last year.

In North America, we experienced a modest revenue decline on a core basis compared to a record revenue performance last year. The Replacement and First-Fit channels saw similar levels of decline compared to the prior year. End markets were mixed with positive core growth in automotive, energy and construction and softness in diversified industrial, agriculture and personal mobility. East Asia and South America core growth rates were consistent with the company's overall top line performance. In aggregate, we delivered good organic growth in a variable demand backdrop, underscoring our end market and channel diversity and the resilience of our business model.

On slide 7, we provide an adjusted earnings per share walk from the second quarter of 2022. Improvement in operating income contributed approximately $0.06 per share of earnings growth. Higher net interest expense was $0.03 per share headwind. Other items, including the weighted average share count reduction, contributed a positive benefit of about $0.01 per share.

Moving to slide 8, we show a summary of our cash flow performance and balance sheet metrics. Our free cash flow for the second quarter was $116 million or 114% conversion of our adjusted net income. We benefited from margin expansion and more normalized trade working capital. On a trailing 12-month basis, our free cash flow conversion is well above 100%. Our net leverage ratio declined by 0.5 turn versus one year ago to 2.8 times.

We ended the quarter with the lowest net leverage ratio for a second quarter in our history as a publicly traded company. Our consistent, strong cash flow generation allows us to continue to strengthen our balance sheet, as we execute a balanced capital allocation strategy of investing in the business, paying down debt and returning capital to shareholders. Our trailing 12-month return on invested capital increased 250 basis points year-over-year, driven by margin expansion and disciplined capital management.

Now please turn to slide 9 to cover our updated 2023 guidance. We have trimmed our core revenue growth expectation to a range of 0% to 2% year-over-year from 1% to 5% previously. At the midpoint, we expect 1% core growth for the full year compared to 3% in our prior guidance. The adjustment largely stems from slower industrial demand trends in China and OEM stocking realignment in the personal mobility space.

We have maintained the midpoint of our 2023 adjusted EBITDA guidance at $725 million and narrowed the full year range modestly to $710 million at the low end and $740 million at the upper end. We expect greater gross margin expansion driven by operational productivity and a more stabilized cost structure to offset lower expected revenues from industrial markets in the second half.

We continue to expect variable incentive compensation will be an EBITDA margin headwind in the second half of 2023, predominantly in the third quarter. We have raised our adjusted earnings per share guidance to a range of $1.18 per share to $1.24 per share, which incorporates the benefits of May's share repurchase, partially offset by higher net interest expense. Further, we have adjusted our free cash flow conversion forecast to exceed 100% for the year, above our prior guidance of approximately 100% conversion.

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For the third quarter, we expect revenues to be in the range of $860 million to $890 million. Adjusted EBITDA margin is estimated to be flat compared to Q3 2022, as improvements in gross margin are offset by higher SG&A expenses related to variable compensation.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. On slide 10, I'll wrap up with closing comments before taking your questions. First, we are pleased with our results and the margin progress attained in the first half of the year. Our EBITDA margin expanded approximately 160 basis points year-over-year in the first half of 2023, led by improved gross margins.

We anticipate our throughput and productivity rates will improve as the operating environment continues to normalize. We expect the benefits to build in the second half. As such, we maintained our 2023 adjusted EBITDA guidance at the midpoint and expect better margin performance for the year versus our prior expectation, while encountering a slightly less favorable demand environment in the second half.

Furthermore, we are in process of consolidating a facility in China into our existing footprint. We anticipate completing this project by the end of this calendar year. We have a number of actions and initiatives underway now that will enhance the long-term profitability of the company.

Second, we generated a significant amount of cash in the first half and are on track to exceed 100% conversion of our adjusted net income for the year. On a trailing four quarter basis, our free cash flow conversion stands at 135%. Third, our substantial free cash flow generation is driving net leverage reduction. We expect to end the year with a net leverage ratio of approximately 2.5 times, which would represent a decline from the year end 2022.

Notably, we intend to accomplish that while having returned $250 million of cash to shareholders via May's share repurchase. We plan to stay opportunistic, utilizing our excess cash and firmly believe that consistent balance sheet improvement will be accompanied by diligently returning capital to shareholders.

Before moving to your questions, I want to thank the 15,000 global Gates associates for their commitment and dedication, especially our North America team who executed a major ERP upgrade during the quarter without any disruptions to the business.

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

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment please, for your first question. Your first question comes from the line of Mike Halloran of Baird. Please go ahead.

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

Q

Hey. Morning, everyone. So...

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

A

Morning.

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

A

Morning.

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

Q

Just want to walk through kind of the markets you're seeing a little bit more stress at this point. Maybe just talk about inventory, inventory in the channel and how you think about the recovery curve as we get to the back half of the year.

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

A

Yeah, good. Good morning, Mike. Look the data would point out that the demand is still quite balanced out there. I'm taking first the inventory question and I'll come back to the demand. So the inventories are fairly balanced, and the point of sale data still indicates that the situation is actually in a reasonably good shape, with a reasonably solid underlying demand. So we're fairly constructive on what's happening with the channel.

Of course, we anticipate in the second half some industrial destocking. And we certainly believe that that's what's going to happen, particularly associated with the choppiness that we have been seeing in the industrial segment. I would say that for the channel destocking we see some destocking in applications associated with logistics and distribution and some fluid power applications like ag, as an example.

We also feel that as the supply chain is stabilizing and the lead times are shortening there is going to be a resulting movements in the channel to have our customers to normalize their inventories as well, just as we have been doing in our business. So right now, we are not seeing – in a nutshell, we are not really seeing any imbalances with sales of our business, our products to the channel and channel partners sells out. So maybe a little bit long winded, but a little more color in here.

And vis-à-vis what is happening with some of the end markets and some of the weakness that we have been seeing. Look, I'd say that most prominently we are seeing lower activity in ag, in ag OEMs, particularly on a smaller horse power equipment. And I think that that's been reasonably well-documented out there. There's an OEM stocking realignment in the personal mobility space. So we are seeing some of that. And then again, as I

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said, some of the warehouse automation space that has slowed down over the last kind of two to three quarters. So that's kind of how I would represent it. And, obviously our biggest business with industrials is in North America. And we are seeing some of it there.

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

Q

Appreciate that. And on the margin side of things, good performance in the quarter relative to where the revenue came in. I certainly understand the cadence you laid out in the prepared remarks more static sequentially for the puts and takes. A twofold question in light of that. One, could you help with the mix by segment and how you think that progresses? And then secondarily, how do you think the margins will track as we exit this year? How are you thinking about that exit rate? I know you're very positive about the ability to drive margin gains regardless of the demand environment. So maybe just a little bit of level setting and how you think that exit rate looks and the implications for next year?

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

A

Okay. Let me start with the second part of the question first. You know, we expect gross margins to continue to improve in the back half of the year. We called out that variable comp, especially in Q3, is going to be a headwind. So when you think about what our Q3 looks like, gross margin improvement 75 to 125 bps with that being offset by the variable comp and SG&A. And then in the back half of the year gross margins up about 150 to 200 basis points with SG&A up, again on variable comp, about 100 to 125.

And so that's really in line with what we thought was going to happen maybe a little bit ahead on the gross margin improvement. And remember, Q4 was our toughest quarter last year in terms of gross margin, where we saw some of the highest priced inventory flow through relative to some of the supply chain disruptions we saw in the second half of last year. So we expect to see gross margin to continue to improve and then we expect to have gross margin opportunity as we move into next year.

On your mix question, let me see if I can – let me see if my answer is what you're looking for. So the softness we're seeing in the second half is going to be a little bit of a headwind on mix. When you look at some of the industrial softness and some of our higher margin stuff, some of the personal mobility stuff is our higher margin business. But overall, our operating performance continues to improve. So we're able to offset that and still maintain our EBITDA guidance and even get a little flow through to earnings per share. So net-net little bit of headwind on mix in the second half offset by better gross margin performance from an operating perspective. So we feel pretty good about where we are from a gross margin perspective. Did that answer your question?

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

Q

It was poorly worded on my side. I was – by mix, I meant when you look at the margin progression you've laid out for 3Q and then the implied 4Q, how does that break down by segment? Your answer is super helpful though but I was looking for some...

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

A

Well, we don't really give guidance by segment. We just lay it out in total terms so.

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

Q

Okay. Thanks for that. Appreciate it.

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

A

Yeah.

Operator: Your next question comes from the line of Andy Kaplowitz of Citigroup. Please go ahead.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning, everyone.

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

A

Morning, Andy.

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

A

Morning.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, could you give us a little more color on what you're seeing by region? You mentioned the 28% growth in China, but that was a little worse than you expected and part of the reason for the lower core guidance. So could you talk about what you're seeing on the ground there and your outlook for the rest of the year? And then you mentioned a difficult comparison in North America. Is it the personal mobility turned down there or anything else that sort of happened over there?

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

A

Yeah, no. Great. Look, on China, we had a terrific, terrific quarter, obviously, vis-à-vis second quarter performance kind of looking at what's happening out there around our competitors and some of the reporting companies. So I feel that the team is executing really, really well. But, we've anticipated, frankly speaking, that China recovery is going to take a little stronger hold than what we have seen. And if anything, I would say that it slowed down a little bit further as we were exiting second quarter. So now we anticipate that China is going to be kind of flat to low single digits up for the full year, which would imply that the recovery is not going to be as robust in the second half as what we thought.

And as you kind of look at the segments, I mean, obviously, auto in China is very strong, both on the OEM side as well as on the Replacement side of our franchise. I think that we see some very, very strong numbers there in terms of automotive performance. And industrial is a little bit weaker. But, again, I mean, it's you know, you take a look at some of the export data, some of the industrial activity in China, [indiscernible] (00:28:21) surveys. And I think that certainly our performance is more in line with what you see kind of externally reported.

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And on the question of personal mobility. Personal mobility is more associated with just the channel rebalancing. So we have seen some of the consumer weakness to roll in. There's lots of equipment that has been built over the last kind of 18 months. And that's creating some short-term headwinds in that end market. But I'll say that our design activity remains incredibly robust. We have a pipeline of opportunities that we are converting at very high rate that's at all-time high, nearly $400 million of those opportunities in the pipeline.

So, there is significant number of programs that we were awarded in Q2 and we are very confident in our ability to continue to deliver on our mid-term objectives that we've laid down for personal mobility. And I think I've stated that obviously there'll be ups and downs in some of the quarterly deliveries in mobility but it's very, very strong future prospects for that business.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Very helpful, Ivo. And then heading into second half of 2023 and into 2024, it seems like price versus cost is trending better than you thought, but could you confirm that? And then you mentioned a number of initiatives that could enhance Gates' profitability as you go forward. Maybe you can talk about some of these initiatives you're working on as you head into 2024.

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

Andy, it's Rich. Did you asked about price/cost in the first part of the question?

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Yes, exactly.

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

Yeah. Look price/cost remains positive. It was quite positive in second quarter, obviously. And it remains positive in second half, albeit more moderating. We're starting to see some level of deflation, but not to a significant degree. And we will obviously continue to price in accordance with the operating environment in terms of how inflation is going to be performing in the second half.

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

Longer term projects.

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

On the longer term projects, yes. So, we have spoken about having a number of projects that we anticipate to bring to a foray in terms of more operational footprint realignment. We have long ways in executing that project in China. We anticipate it will be done by the end of the year. That's simply closing a facility in the Shanghai area, moving it into one of our existing facilities outside of Shanghai. So that's a good savings project.

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And we have a number of incremental projects that, as we are catching up to our demand. And as our capacity is more aligned with the underlying demand trends, we expect that over next 18 months we'll be in a position to be able to execute a number of incremental projects that are going to give us the opportunity to set the business to a lower breakeven point. And obviously, we've spoken on number of 80/20 initiatives that those are proceeding quite well. We anticipate that that is kind of a four, five year process where we believe we can continue to deliver and derive benefits in terms of profitability. So, we are reasonably confident that we can continue to expand our gross profit and ultimately have that translate into operating earnings.

Operator: Thank you. Your next question comes from the line of Julian Mitchell of Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. Good morning. Maybe just wanted to sort of focus on the sales guide looking out a bit. So I think your guidance implies organic sales in the fourth quarter are down year-on-year, maybe low single digits. Just wondered if you could confirm that. And then when we think about that in the context of history, I think the only downturn I've seen since you came public was about six, seven quarters long in terms of sales. How are you sort of advising us to think about the longevity of that next downturn starting in the fourth quarter? Thank you.

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

A

So, hey, Julian. That's a good question. It gives me an opportunity to level set. Remember, last year, was when we started to see the supply chain disruptions. And you really saw Q4, we were better than Q3 as some of those disruptions started to go away and we did better in Q4 and had a really strong Q4 in terms of top line last year. And so really, you got to think about the back half of this year and you're comping – you want to comp to the whole back half of 2022 because there was just some movement in between quarters that was more externally driven by some of those supply chain disruptions, okay?

And so when you look at the back half of the year, you're right on the low single digits Q4, a little bit more headwind in Q4 from a core growth perspective than Q3. But net-net we're guiding to around a 200 bps impact overall in the back half of the year. And that's split pretty evenly between industrial and personal mobility. And most of the industrial piece of that headwind is coming from, as Ivo said earlier, little bit lower expectations on how quickly the recovery is going to happen in China. The recovery is still there. It's just a question of how quick and the magnitude of the recovery through the back half of the year.

And then I'll let Ivo answer the question on the longevity of the downturn.

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

A

Look every downturn is slightly different. I would say that we continue to fortify our performance, I think, based upon the initiatives that we have executed. We should see more stability in Automotive Replacement side of our business. That business is performing well. There are some very positive trends, as we have discussed on other calls associated with the aging car fleet, growing, growing carpark of the aged car fleet. People are driving more. Fuel is reasonably affordable. So we certainly believe that as we move through, whatever the slowdown may be, we should have a little more robust performance than perhaps we have seen in the past.

When you combine that with some of our organic growth initiatives, I wish that I had a real good crystal ball for you. But when you look at the trend lines from some of the indices that we all track and you know, you do such a

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fine job, Julian, on publishing those indices should start reversing trend. And when they do reverse trend, that also generally speaking means that we should start seeing some bottom to the industrial activity.

So I know I didn't give you a clear cut crystal answer, but we feel maybe a little cautiously more optimistic about our ability to manage through whatever is in the future out there. Protect profitability, continue to drive our free cash flow. I think that our focus on both is starting to show early benefits. And yeah, that's kind of where we sit.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

That's helpful. Thank you. And then maybe just following up on a couple of smaller items. Just any sort of revised outlook for second half, interest expense and the tax rate. And then I think you said the CapEx budget's come down a bit for 2023. Any sort of firmer steer on the CapEx budget this year?

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

On the tax rate, we should be right around 20% to 22%. So we're trending down a little bit. We were lower in Q2. But for the full year pretty in line with what we had said earlier. From an interest expense perspective our total interest is going to be up year-over-year in the high teens. And that's kind of split evenly between when you're talk about net – I'm talking about net interest expense. And that's split pretty evenly between – remember, we refinanced our euro term loan in the fourth quarter of last year, and so there's the impact of those higher interest rates. And then there's the impact of the higher interest rates on our US dollar based term loan B and that's the other half of the impact. So the impact in the second half, I think is about half what it was in the first half because you kind of roll over some of those interest rates in the Q3 and Q4.

Was there a third question? I got tax and I got interest. Was there a third one?

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

And the third question referred to the CapEx.

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

Oh, yeah, yeah.

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

I can maybe answer that question. Julian, we don't fundamentally believe that we're going to be dramatically reducing our CapEx. It's more aligned with our ability to secure some of the new equipment. Some of the lead times are still somewhat extended, and we just don't believe that we're going to spend the full $100 million, but we're going to be within striking distance on that number. So it's not an issue of reducing CapEx dramatically.

Operator: Thank you. Your next question comes from line of Josh Pokrzywinski of Morgan Stanley. Please go ahead.

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

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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

Ivo, I'd like to maybe just approach the cycle question slightly differently. What are you seeing on volume versus price trends? And I guess maybe the context of where are volumes today versus say, pre-pandemic levels? Are we higher or are we fairly close? Like, I know there's decent amount of price in there. So I'm trying to level set on really just how far away from the last kind of fundamental slowdown we really are volumetrically.

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

Yeah, look, I mean, just on Q2, our volume was modestly down for the quarter. And I would – it's an interesting question that you ask. I haven't really thought at that completely thoroughly. But we are somewhat at lower volumes than prior peak. So fundamentally, I think that you certainly have Automotive First-Fit and that is very dramatically lower globally as that industry is coming from the pandemic. I would say that's probably the biggest, most impacted industry out there. And the rest of that is kind of – it's kind of a mix, if you ask me. I mean ag has been performing quite well, and I think it's slightly lower now than the rates that we have seen kind of prior year. Prior year was very, very strong. So we see some of the rates moderating.

Look, on the construction equipment that business continues to remain quite strong and I think it's quite supported on some of the infrastructure investments that certainly we're making here in the United States as well as elsewhere. Mining and oil and gas is significantly lower in units and activities than prior peaks. So I think it's a mixed picture, Josh. I wouldn't say that there is a – that there's any specific industry that has – that is peaking at this point in time. I think that the underlying activities have moderated over the last 12 months. And I think that I'm cautiously optimistic that as you start seeing the trends reverse in with ISM and, you know, PMI, that that maybe actually an indicator that things are bottoming out.

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

Yeah, that makes sense. And I guess maybe where I'm going with that on the volume versus price side is that it sounds like most of the revenue revision here is really related to channel, not necessarily a sellout phenomenon or at least not a particularly pervasive one. And you're not having to give back price, like – or is that a fair representation because I guess otherwise like volumes not overheated, pricing sticky and we'll work through the normalization, but otherwise things seem pretty stable.

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

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Yeah. I think that that's fair. I mean, I think that you have the phenomena of reducing lead times, obviously, that basically is impacting kind of normalization of what's happening in the channel. I mean, I see very still actually quite positive trends in sell out of our customers activities. So I think that that that's a correct assertion, Josh. I would say that China industrial activity is I mean weaker and you obviously see weaker volumes there particularly on the industrial side. But auto is again remaining very buoyant and reasonably robust there.

I would say that Europe industrial activities kind of muted. So I would say there's definitely some volume here and of course as we said, the channel activity in terms of kind of the personal mobility side of the business. So, again, I think it's puts and takes. It's not really deceleration in pricing. It's really more of realignment to what we are seeing in terms of the underlying trends, again, China industrial, some of the personal mobility and then kind of puts and takes. I think the rest of it is more in line with what we've anticipated at the onset of the year.

Operator: Thank you. Your next question comes from the line of Jeff Hammond of KeyBanc. Please go ahead.

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

Q

Hey, 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.

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

Q

Just clarification on the destock. Is it fair to say you got – you saw destock in personal mobility in 2Q and then kind of the rest of it is more prospectively or was it more prevalent in 2Q? I'm just trying to understand how much happened in 2Q versus how much is to come.

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

A

Yeah. So no, so Q2 was relatively muted. We have a pretty good outlook in terms of what our customers want on the personal mobility side and what they've got in inventory and things like that. And it's really almost entirely the second half and it's really managing with our customers, how much inventory they have both from a end users perspective and in their warehouse with our product and kind of managing through the supply chain aspect of that as they work through that inventory. So it's almost entirely prospective.

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

Q

Okay. And then, Ivo, you made a couple of Europe comments, but just wondering how you're thinking about the second half for Europe. We've heard about a little choppiness there. Do you see some of this auto strength continuing?

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

Yeah. So first, Jeff, let me start with second half of 2022 for Gates, Europe was a real standout outperformer. We had a very strong performance there. So I would say that we have a very difficult comp in Europe in second half. So starting with that, auto continues to be quite strong. And again, we believe that the underlying trends with used vehicles are kind of as I've outlined and the auto OEM business continues the trajectory of improved output from the OEMs. So auto we feel is in a reasonably good shape.

And then most of kind of our caution if you would is more associated with the industrial activities that continue to be choppy. And I'm sorry for continuing to use the word choppy, but it really is. I mean, you can have couple of months that are less than trend line and then you can have one or two months that are nicely above trend line. So there's no real straight line consistency up or down and so we remain pretty cautious about what we are seeing in Europe, particularly on the industrial side.

Operator: Thank you. [Operator Instructions] Your next question comes from the line of David Raso of Evercore ISI. Please go ahead.

David Raso
Analyst, Evercore ISI
Q

Hi. Thank you. One quick modeling question before my real question. Currency for the year, what's the updated view on currency impact for the full year?

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

So in the back half, it's going to be a favorable, very low single digits in the back half, mostly in Q4, because Q4 is when it starts to roll over, but very modestly.

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

Hey, David, think about flat for the year.

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

Flat for the year, it's very slightly favorable in the back half.

David Raso
Analyst, Evercore ISI
Q

What I'm trying to understand though that to get to the revenue for the full year, the fourth quarter needs probably even a little less currency help than the third quarter, so we can talk offline the exact math. But what I'm just trying to understand with the fourth quarter, with the organic implied down 4%, where do you see when it comes to the segments that impact the greatest. And given that's the quarter you're seeing the weakest core, how does that influence our thought on pricing to start 2024? Thank you.

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

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Yeah. So look, I mean, like I said earlier, I think you got to think less about Q4 as a comp year-over-year and you got to think of it more in the back half, because remember, Q3 was seasonally weak in 2022 because of the supply chain headwinds and some of the issues we had getting product out the door. And then we started to catch up in Q4 and I believe the Q4 was a record revenue quarter for us in 2022.

And so it's really not that much about the expectations for, I think, 2023. I think 2023 we're kind of seeing a return to normal seasonality. When you look at the sales split, when you look at the EBITDA split, you look at all those things on the first half versus the second half, it's a return to normality. I think Q2 was more of an outlier where you just saw all these disruptions. So I don't think there's anything to read into the kind of lower core growth number that you're seeing in Q4. It's more a function of Q4 of 2022 than Q4 of 2023.

Operator: Thank you. Your next question comes from the line of Deane Dray of RBC. Please go ahead.

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.

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

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, I joined a little bit late, but I wanted to circle back on the comments about lead times. I know it's hard to kind of homogenize across all your product lines, but if you could just highlight where you stand on lead times now versus 2019, because that's an important part of the calculus on destocking, because the more the lead times compress, the more your customers have confidence about burning off buffer inventory. That's what we're seeing across multiple industrial verticals. But just some perspective on lead times to start with.

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

Yeah. I would say that the fluid power lead times have normalized for us, Deane. And in power transmission we still have a reasonable amount of our portfolio where we have extended lead times. We're still trying to work down reasonably good amount of past due backlog that that we hold. And we don't anticipate all of the lead times in power transmission will normalize by the time we exit 2023.

We still remain I guess nicely constrained across a number of our power transmission lines as well, despite the fact that we have added capacity. So it's kind of a – it's a mixed picture, Deane. Some of the lines are where they need to be and some of the lines will remain reasonably constrained all the way through 2024.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

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That's helpful. And then just as a follow up, any commentary about outgrowth expectations, anything you'd call out in terms of competitive dynamics? Because like in PT, if competitor lead times have shrunk, that can also change some of the destocking. So just any competitive and outgrowth commentary would be helpful.

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

Yeah. Look, I would say that we – the business continues to perform very nicely in terms of our automotive vertical, both on the OEM as well as on the AR side. So we not only are keeping up, we have increased our output nicely there and that's paying nice dividends. So, I'm not going to indicate that we are not taking market share. But as we indicated, auto came in mid-teens for the quarter. And so that's quite strong.

I think that PT is doing well. But again, full disclosure, right, last year we were getting impacted most significantly with the polymer supply in PT. And so I think that the comps that we anticipate are going to be somewhat favorable across a few of the lines. But I just think that the lead times will probably remain somewhat elevated on PT.

Operator: Thank you. Your next question comes from the line of Jerry Revich of Goldman Sachs. Please go ahead.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Yes. Hi. Good morning, everyone.

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

Morning.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

I'm wondering if you folks – hi – can you talk about the impact of supply chain on margin performance this year? Was that still a drag because it's pretty impressive that year to date, your gross margins are up on down volumes and I'm just wondering is there another tailwind we should be thinking about 2024 versus 2023 because the supply chain is getting better, but it doesn't feel like it was completely clean in the first half of the year. Would love to hear your comments on that.

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

Yeah. So the first half of the year we saw things get progressively better. They were better in Q1 than they were in the back half of 2022. They were better in Q2 than they were in Q1. And then they're better in the – we anticipate they'll be better in the back half of 2023. And that's where, if you remember last year, we talked about some of the gross margin drag that we had. Certainly, in the face of a little bit of a core growth headwind and maybe a little mix headwind in the second half, the stabilization of the operating environment, better supply chain performance and then more normalized operational performance in the second half is what's driving our gross margin improvement. So we expect it to continue see it getting better in the second half of the year, hopefully returning to complete normality and then pivoting to gross margin expansion with the initiatives that we've talked about as we head into 2024.

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Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Super. And, Brooks, can I ask you just on your prior comment regarding returning to normal seasonality? Normally your first quarter top line's up low to mid-single digits from the fourth, which would I think would translate to a year-over-year organic growth. But it feels like there's going to be some tough comps just given the stocking that we had seen in the first quarter of 2023 in North America. I'm wondering if you can just comment on that cadence. Obviously, we're not talking 2024 outlook yet, but we're hoping you'd comment on the first quarter comp.

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

A

It feels like you're trying to get me to talk 2024, Jerry, so I'm going to stay away from that. I think, look, the top line is largely developing like we thought it would in the second half, but for a little bit longer recovery in China and in the mobility. I think as you see inflation moderate, you'll probably see pricing moderate some, which really won't impact gross margin. So as you kind of move through the next few quarters, you'll see that pricing moderate. But we expect to see gross margin expansion as I said before, from some of our initiatives.

I'm hopeful we'll return to normal seasonality cadence and everything gets back to normal in 2024. But we'll have to wait and see. And we'll be sure to make sure we let you know when we roll out our 2024 guidance.

Operator: Thank you. Your next question comes from the line of Jamie Cook of Credit Suisse. Please go ahead.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. Most of my – just one follow up. Obviously, the cash flow projection is strong for the year. But I'm just wondering, as you look at your inventory with supply chain sort of starting to normalize, how you're thinking about the opportunity on the working capital front in terms of inventory or do you sort of, over the longer term would keep inventory at higher levels versus history just as supply chain in the world start to change? Thanks.

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

A

We're already starting to take inventory out, particularly on the raw material side. And so as our supply chains normalize, we're adjusting our raw materials. We continue to adjust our finished goods, based on customer demand. But on the lead time side, we're already seeing some improvement on the raw material side. And we would expect as again, as supply chains normalize to see some additional improvement.

But let's not forget, if you look at our trailing 12 months, we're a 135% cash conversion. So as we've rolled over some of the step up in cost and then receivables on inflation and the comps are more normalized, the cash generating aspect of this business is starting to flow through again. We're over at a 100% cash conversion for Q2, which I believe is a record for Q2 as well. So no, we were already some favorability, some improvement from an inventory perspective. We would expect to see a little bit more. But then all in, we expect to see cash generation continue to return back to normal.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

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Operator: There are no further questions at this time. I'll now turn the call over to Rich Kwas for closing remarks.

Rich Kwas

Vice President, Investor Relations, Gates Industrial Corp. Plc

Thanks, everyone, for participating. If you have any follow up questions, please feel free to reach out. Have a great rest of the day and a great weekend.

Operator: This concludes today's conference call. You may now disconnect.

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