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Gates Industrial Corp. Plc (GTES)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to the Gates Industrial Corporation Q4 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 call over to Rich Kwas, Vice President, Investor Relations. Please go ahead.

Rich Kwas

Vice President, Investor Relations, Gates Industrial Corp. Plc

Good morning, and thank you for joining us on our fourth 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'll be followed by Brooks Mallard, our CFO.

Before the market opened today, we published our fourth 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 the slide presentation, each of which is available in the Investor Relations section of our website. Please refer now to slide 2 of the presentation, which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks

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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've described in our most recent annual report on Form 10-K and other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements.

Before I turn it over to Ivo, we are hosting a Capital Markets Day on the afternoon of March 11 at the New York Stock Exchange. Instructions to RSVP will be sent next week, and we hope many of you can join us for an informative session.

I'll now turn the call over to Ivo to review our results. 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 and review what we accomplished in 2023. I'm proud of what our Gates global teams achieved. Our team demonstrated resilience and fortitude through an uncertain macro environment and delivered strong margin expansion and cash conversion for the full year.

Our global teams worked diligently to service our customers and returned fill rates to pre-COVID performance levels, progressively meeting our customers' expectations across most of our product portfolio. Our team's collective execution enabled us to deliver a 180 basis points year-over-year expansion in adjusted EBITDA margin.

Importantly, the improvement was fueled by stronger commercial and operational execution, resulting in a 290 basis points increase in our gross margins. We believe this outcome demonstrates the resilience and quality of the business, as well as our team's ability to manage through a challenging environment. The full year profitability increase was an important driver of our nearly 20% growth in adjusted EPS. Furthermore, our free cash flow conversion measured 110% and helped drive a half a turn reduction in our net leverage ratio year-over-year. While we returned $250 million of capital to shareholders via share repurchases in 2023.

Our company-wide focused execution allowed us to surpass most of our initial financial guidance metrics for the year. We are in the relatively early stages of executing on our organically-focused enterprise initiatives that we anticipate will be delivering performance benefits and enhancing shareholder returns over a multi-year horizon.

Over an extended timeframe our business has demonstrated an ability to deliver strong profitability and cash flow generation. We are now focused on elevating the enterprise growth and enhancing profitability, while staying focused on improving shareholder returns. I look forward to sharing more details on these topics at our upcoming Capital Markets Day.

Turning to slide 4 and our fourth quarter highlights. Top line performance was about as expected. The demand environment remained choppy in the fourth quarter, and our end markets followed on recent trends as automotive outpaced industrial. Recall, we faced a difficult growth comparison from a year ago period where we were able to accelerate the conversion of past due backlog, creating a bit of an anomaly in seasonality.

Broadly speaking, our business demand has returned to normal seasonality, which in our view is a positive development. Our book-to-bill ratio in the quarter remained above 1. On the profitability front, we recorded strong adjusted EBITDA dollars and delivered a significant year-over-year margin increase. We've generated $186

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million of adjusted EBITDA, which translated to an adjusted EBITDA margin of 21.5% and represented a year-over-year expansion of 290 basis points. The increase in adjusted EBITDA margin was fueled by 440 basis points improvement in gross margins. The gross margin improvement was supported by benefits from our enterprise initiatives, particularly in our supply chain. Our performance was strong considering that volumes were down year-over-year and revenue mix was less favorable.

Our fourth quarter free cash flow was approximately $165 million, which was 158% conversion of our adjusted net income. Improved profitability and working capital management were the primary drivers behind the results. Our trade working capital as a percentage of sales decreased year-over-year, benefiting from improved cash collections as well as a normalized operating environment. The strong free cash flow performance helped us to lower our net debt-to-adjusted EBITDA ratio to 2.3 times, a half a turn reduction compared to the prior year period. We continue to make solid progress towards achieving our targeted net leverage goal of under 2 times.

Moving to slide 5. Fourth quarter total revenues were $863 million, down a little less than 5% year-over-year on a core basis, against the backdrop of the prior year's Q4 seasonality anomaly driven by an accelerated recovery in certain product lines in a prior year. Total revenues were down about 3% year-over-year, inclusive of favorable foreign currency effects.

Automotive increased low single digits on a core basis. The majority of our industrial end markets realized year-over-year declines globally, while energy and on-highway continue to post positive core growth versus the prior year period. At the channel level, demand in Industrial First-Fit declined double digits impacted by softness in North America, EMEA and South America. In China, Industrial First-Fit profit core revenue grew double digit year-over-year after experiencing general weakness over the past few quarters. Global Industrial Replacement channel core revenues declined low single digits versus the prior year period on normalization of lead times and associated channel inventories.

Adjusted EBITDA was $186 million and adjusted EBITDA margin was 21.5%. Gross margin exceeded 39% in the fourth quarter. The year-over-year gross margin expansion was partially offset by higher SG&A spending. Overall, we are pleased with the improvement in profitability made in 2023 as we continue to advance our enterprise initiatives. Adjusted earnings per share was $0.39, up 56% year-over-year. Relative to last year, higher operating income contributed $0.07 a share augmented by lower interest and tax expense and reduced share count.

On slide 6, let's review our segment results. In the Power Transmission segment, we generated revenues of $533 million. Core revenues were down about 5% year-over-year against the prior year comp backdrop. Currency contributed about 100 basis points of growth to our revenues. In automotive, core revenue growth was in the low single digits with First-Fit and replacement generating similar growth. Industrial end markets were mixed.

Energy and construction both grew in the mid to high single digit range and on-highway grew low single digits compared to Q4 2022. The growth was more than offset by decrease in diversified industrial, agriculture and anticipated weakness in personal mobility. Personal mobility market continues to work through excess inventory and we expect a couple more quarters of weakness before growth reaccelerates. Our design win activity in this space increased about 20% in 2023 over prior year, and we are optimistic about delivering on our anticipated mid-term growth prospects.

Core growth in China industrial business was about flat, an improvement relative to last quarter. Global industrial replacement revenues stayed resilient in this segment, declining low single digits year-over-year and faring better than the first-fit market. The segment operating performance was strong and margin increased significantly year-

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over-year. Additionally, our enterprise initiatives are yielding benefits, including supply chain efficiencies as well as initial commercial traction from the first phase of 80/20.

Our Fluid Power segment produced revenues of $331 million. On a core basis, revenues fell about 5% year-over-year. Foreign currency contributed almost 2 percentage points of growth to our year-over-year performance. Automotive core revenues decreased low single digits compared to Q4 2022. Industrial end markets experienced a mid-single digit decline. Modest growth in energy was more than neutralized by softness in other end markets, most notably, agriculture and diversified industrial. Relative to segments overall core performance, industrial replacement outperformed while industrial first-fit was a bit weaker. Fluid power segment adjusted EBITDA margin increased 190 basis points versus the prior year.

On the heels of cost management and benefits from our enterprise initiatives. We remain focused on footprint optimization within the fluid power segment. We are in process of completing projects in South America and India that further expand our in-region, for-region manufacturing strategy. We anticipate these projects will result in lower fulfillment costs and increase throughput of our high velocity hydraulics and industrial hose product lines. We'll share more details about the enterprise footprint optimization strategy in March at our Capital Markets Day.

I'll now pass the call over to Brooks for further comments on our results. Brooks?

L. Brooks Mallard

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

Thank you, Ivo. I'll begin on slide 7 and discuss our core revenue performance by region, starting with a brief overview. Regionally, we experienced mid-single digit declines in North America and EMEA. The two regions most impacted by the highlighted difficult year-over-year comparisons. While down slightly versus prior year, our China business exceeded our revised expectations. We realized positive core growth in South America. In North America, we experienced similar year-over-year percentage declines in automotive and industrial. Trends in EMEA were more divergent with high single digit growth in automotive countered by an approximately 20% year-over-year decrease in industrial. In both North America and EMEA, the replacement channels performed better than first-fit.

China core revenues declined slightly year-over-year. Automotive increased mid-single digits and on-highway revenues expanded over 40% versus the prior year period, augmented by a favorable comparison. Diversified industrial remained soft, declining high teens compared to last year's fourth quarter. In general, we started to experience more demand stability in China as we exited the year. South America grew mid-single digits, benefiting from relative strength in automotive, energy and on-highway, while East Asia's revenues were relatively flat with the prior year on a core basis.

Shifting to slide 8, we show the adjusted earnings per share bridge to last year's fourth quarter. Of note, this quarter's adjusted earnings per share was a fourth quarter high for the company. Relative to last year, stronger operating performance contributed approximately $0.07 in earnings per share. Lower tax and interest expense were modest tailwinds. The contribution from other primarily reflects the benefit of a reduced share count.

Moving to slide 9 and cash flow results and our balance sheet. Our free cash flow for the fourth quarter was $165 million or 158% conversion of adjusted net income. Q4 was our highest free cash flow quarter for 2023 consistent with normal seasonality. Strong margin performance and effective management of trade working capital supported the robust conversion.

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We delivered 110% free cash flow conversion on adjusted net income in 2023, underscoring the strong cash generating capabilities of the business. Our net leverage ratio declined to 2.3 times from 2.8 times in Q4 of 2022. We have authorized a new stock repurchase plan of up to $100 million. Given our strong cash position at the end of 2023, we intend to pay down a portion of our debt by the end of the first quarter. As our cash generation builds this year, we will look to apply it to further debt paydown.

Our trailing 12 month return on invested capital increased 300 basis points year-over-year to 23%. Our highest level since the end of 2018. We continue to make progress toward achieving our mid-term goal of 25%.

Moving now to slide 10, and our full year 2024 guidance and views on the first quarter. For 2024, we are initiating guidance for core revenues to be in the range of down 3% to up 1% relative to 2023. Within that framework, we have factored in lower rates of pricing as inflation abates, a slower first half demand environment and improving trends in the second half. There are pockets of inventory destocking and demand softness that we expect to impact our 2024 core growth.

Looking at our end market revenue exposure, we expect about half of our end markets to be down year-over-year in 2024. We anticipate demand trends to improve in the second half, but have taken a pragmatic view as we begin the year. Our initial 2024 adjusted EBITDA guidance is in the range of $725 million to $785 million. At the midpoint, this guidance implies about a 30 basis point year-over-year increase in adjusted EBITDA margin. Our adjusted earnings per share guidance is in the range of $1.28 per share to $1.43 per share. We anticipate our free cash flow to exceed 90% of our adjusted net income in 2024 after we delivered 110% conversion in 2023. For the first quarter, we anticipate total revenues to be in the range of $840 million to $880 million and core revenues to be down about 5% year-over-year at the midpoint.

Foreign currency is estimated to be a slight tailwind in Q1. For the first quarter, we expect our adjusted EBITDA margin to increase in the range of 40 basis points to 80 basis points compared to Q1 of 2023.

On slide 11, we show a year-over-year walk to our adjusted 2024 earnings per share midpoint. We expect the impact from that slight core revenue decline and headwind from non-operating items will be fully offset by benefits from our enterprise initiatives.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thanks, Brooks. On slide 12, I will offer a brief summary before taking your questions. We had a strong finish to 2023, and I'm proud of our team for their perseverance and ability to perform in an uneven economic environment. We were able to deliver a nice margin improvement, while encountering choppy demand conditions, benefiting from a mix of internal initiatives and the normalization of the underlying operating environment.

In a substantial way, our operations have returned to pre-COVID levels. In 2023, our team was able to showcase the underlying strength of our business model, which we intend to build upon moving forward. As we enter 2024, we are mindful of the underlying macro risks, but we believe there are many opportunities as well. We are taking a pragmatic approach to 2024, viewing the front half of the year as being more challenging due to normalization of business conditions, followed by a gradually improving business environment in second half. While we cannot control the timing of improvement in broad based business activity, we are firmly in control of improving our business operations for the long term. As such, we continue to build momentum of our enterprise initiatives in the areas of productivity, footprint optimization and 80/20.

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Moreover, we are thoughtful about making further investments in our business. As the business environment evolves, our priority is to stay close to our customers as a commercial front end, as well as maintain tight operational proximity to optimize service levels and fill rates of our comprehensive portfolio of highly engineered, mission-critical products. We are making investments in innovation, material science and process engineering to improve the competitive position of our portfolio, while equipping our people with better analytics and empowering them to ramp up the execution of our growth initiatives. We are focused on being good stewards for all of our stakeholders, investors, the communities we operate in and our employees.

On that note, most recently Newsweek recognized Gates as one of America's Greatest Workplaces for Diversity for the second year in a row. Before I take your questions, I would like to extend my gratitude to the nearly 15,000 Gates employees globally for their hard work and accomplishments in 2023.

And finally, as a reminder, our upcoming Capitals Market Day is scheduled for March 11 in New York, where we look forward to sharing more about our enterprise initiatives and business priorities.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We ask that you please limit yourself to one question and one follow up question. Thank you. Your first question comes from the line of Nigel Coe with Wolfe Research. Your line is open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone.

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

A

Good morning, Nigel.

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

A

Good morning, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Really good margin execution and cash flow production. So congratulations on that. Maybe just fill in the gaps. I mean I think, Brooks, you mentioned half of the end market is expected to be down in 2024. So I'd be curious, where are you' seeing the down end markets? And then any thoughts on sort of the impact of inventory adjustments during the quarter? The sell-in versus sell-out dynamic?

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

A

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Yeah. Good morning, Nigel. Let me take this. Look, I think we have put in the appendix a view of the anticipated 2024 end market conditions. And we feel kind of predominantly, we see predominantly that the industrial on-highway and the industrial off-highway will be more challenged in 2024 than it was in 2023. Obviously, ag has been challenged for a while internationally in the second half of the year in the US as well. We've managed through quite well, but we anticipate that in 2024 ag is going to remain weak globally. On-highway had terrific run of a couple of years. And it's more or less just normalizing in terms of demand. But we are seeing some strength in China in on-highway as well. And that has been quite negative for a while. So some puts and takes in there.

And then on diversified industrial, diversified industrial has been quite weak. I mean, whether or not it is logistics and distribution, automation, the kind of discrete automation. It's been quite choppy over the last year and we certainly don't anticipate that improving until sometimes into the back half of the year. So we've taken a reasonably muted view of that end market, but there are some positives as well. I mean, the automotive replacement market end market remains quite robust. The market dynamics are quite strong. The [ph] H. Carpark continues to grow, H. Carpark (00:25:48) in China continues to grow. So the underlying demand drivers remain positive.

And then, obviously, energy and resources, oil and gas, mining and such, we remain quite optimistic about the underlying conditions of the market. Maybe on the last note, in personal mobility, the underlying market is actually reasonably okay. You still see a very significant amount of new design wins coming to the forefront, particularly as in some of the developing economies, you start seeing electrification of [indiscernible] (00:26:31) personal mobility get stronger. And we have had very strong amount of design wins. But the underlying largest I mean, the broadest exposure that we have presently is in the bike market and that has been dealing with post COVID kind of overhang of inventory. And that we believe is going to work itself out as well, kind of in the front end of the year. And sometimes as you are exiting kind of latter parts of Q2, maybe in the middle of Q3, we believe that we should start seeing that overhang to start dissipating and then market should start growing for us as well.

So puts and takes not a fantastic backdrop. But we are managing through quite well and we believe that we are well-positioned to deliver what would be presented in our guidance for 2024.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks, Ivo. That's great. And then, I guess, my follow up question is, on the margin bridge on slide 11, the $0.07 from enterprise initiatives. And you provided a little bit of color in terms of some of the cost initiatives. So just wondered if you could maybe just build that out in terms of kind of what's driving that $0.07 and any sort of cost to achieve that we should think about as well.

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

A

Yeah. Hey Nigel, this is Brooks. So this has been driven entirely by gross margin improvement, right. And so if you remember right, so I'm going to give a little history. We talked about, since COVID, we've talked about the challenges related to the polymers and the resins and getting those and those were challenged because there were governments that were trying to get their hands on them for different reasons. And then there were other people that were getting out of the business and stuff like that. So it's a little bit of a challenge in terms of getting some of the raw materials that we needed, and that caused us some operational efficiencies and some gross margin headwinds.

And as we work through those and we've stacked the enterprise initiatives on top of them, we've really seen our gross margins progressively come back through 2023 quite in line with what our expectations were. And so if you

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think about 20 – if you think about the fourth quarter, the normalization piece was probably about 250 bps of gross margin tailwind. We probably had between volume and mix a couple of hundred basis points of gross margin headwind. And then the balance, which is about 400 basis points, really comes from our enterprise initiatives around productivity, material cost out, freight cost out, 80/20 and some of the strategic pricing stuff that we've done.

And so just a combination of things that have happened over the course of 2023 that have helped drive those gross margins in the direction that we want to.

Operator: Your next question comes from the line of Julian Mitchell with Barclays Capital. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe just wanted to look at the seasonality. So you've got some commentary on slide 10 about the half and so on. So I just wondered any sense of kind of how much of the EBITDA or the earnings we should expect in the first half as a proportion of the year? And sort of related to that, perhaps, I think you'd mentioned more muted price assumptions, which is very understandable. So just within the core sales guide, what is the price tailwind versus last year?

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

A

Yeah. So, first question first, I mean, typically from an EBITDA perspective, from a sales perspective, we're a little bit more front end loaded. It tends to be kind of 51/49 from a seasonality perspective, first half versus second half and then EBITDA is more 50/50 historically speaking. Those numbers kind of hold in terms of the comparison.

I mean, we think from a sales perspective, it's going to be more of a 50/50 split. So a little bit more back end loaded because we do expect things to get progressively better throughout the year. And then from an EBITDA perspective, maybe kind of a 49/51 split, which follows kind of the 50/50 that we just -- that I just talked about on the sales side.

So not meaningfully divergent from what we see historically, but there is a little bit of a follow on pattern where we're going to see a little bit more sales in the second half than we would normally expect to see from a seasonality perspective.

From a price perspective, look, the kind of the inflation based pricing is really rolling over as inflation normalizes on materials and you actually start to see a little bit of deflation on the freight side. So we expect, low single digit pricings as we move through 2024. Having said that, a lot of the work that we've done around 80/20 is really around, value pricing and strategic pricing in terms of our high velocity items versus our low velocity items.

And so we'll continue to look at opportunities to drive margin improvement by value pricing all the different SKUs that we make. Remember, we make hundreds of thousands of SKUs throughout our network. And we still will look at that as a lever to drive margin enhancement as we move through 2024. But it's definitely going to be muted compared to what last kind of 8 to 10 quarters have been.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

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Thanks very much. And then just my follow up around the margin year-on-year. So you've I think it's up, 60 bps at the midpoint in first quarter, up I think similar-ish for the year as a whole in your guidance. So just wondering, if you get that better volume leverage through the year as the destocking fades and so forth, why wouldn't we see the margin expansion accelerate or increase as you go through the year as well?

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

Well, look, we've taken a pragmatic view of volumes for 2024, right. I mean, we've seen -- as we've talked about the volumes decline in the back half of the year. We've got these different models that kind of – that tell us what we think is going to happen in terms of volumes and so we've taken a pragmatic view of that. Look, if volumes accelerate, if things get better we expect to be able to stack that margin fall through on top of the enterprise initiatives, right. The enterprise initiatives we're working on are largely volume agnostic. So we feel pretty good about that. And so the business will inflect and it will drive additional gross margin, additional profitability as volume comes back.

Operator: Your next question comes from the line of Deane Dray with RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Thank you. Good morning, everyone.

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

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Hey, maybe we can start with China. This quarter, there has been such a mixed range of performance in the country. Everyone seems to want to paint it with the same brush. But it really depends on what end markets you're exposed to. And as long as it's not real estate, but you all have definitely shown the best sequential improvement in China and to kind of take us through that, what did you see? It was still down modestly, but just some color there on how you think it plays out over the near-term?

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

Yeah. Thank you, Deane. Look, we're pretty well connected in China, we have a great business in China, and we like our business in China and we're optimistic about it for the long term. We have seen a gradual recovery in 2023 and we certainly are not forecasting that it's going to go from a gradual recovery as to [indiscernible] (00:35:07). So we're quite sober about what we anticipate is going to happen there, and I think that the continuation of the gradual improvement is probably right.

Auto is doing really well. [indiscernible] (00:35:22) OE or auto replacement our auto replacement franchise is terrific in China and continues to deliver really nice growth rate for us even with the challenges that you have seen there, we still, there will be kind of a mid single digit growth in Q4 and for the year. So that remains quite robust.

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We are starting to see steady recovery in on-highway which has been very much challenged in 2023, construction equipment is stabilizing after two really terrible years of excavator output in China and diversified industry is stabilizing. So again, some puts and takes, auto doing well and we anticipate that we're going to continue to see a slow and steady performance out of our team in China, which is a great team.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Yeah, that's great to see. And then second question, just it's a broader question regarding CapEx and you've demonstrated the ability consistently strong free cash flow, you've done the debt pay down and you're making some more CapEx investments here. And I know you're going to talk more about it at the Analyst Day. But just broadly at a high level, this enterprise footprint optimization project, just as you just kind of share with us some of the key inputs when you look at where and how you may deploy our resources for these facilities, is there an IRR analysis on each project? What are kind of the inputs that you have and the assumptions that you're making? Again, I know you're going to -- it's going to be more detail at the Analyst Day. But just broadly, if you could share some of that thinking here this morning.

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

A

Yeah, absolutely. Look, our guidance for 2024 CapEx is still very much within the frame of what we guide for the long term, which is 2% to 3% of revenue. So, we're not anticipating that we're going to be breaking through the ceiling of our investments. We are very much focused on ensuring that while we're investing in NPI and material science, we are also investing in manufacturing, process engineering and equipment. That gives us the biggest opportunity to leverage driving productivity forward. So as you said, IRR is obviously a very important on any project that we do. And generally speaking, this IRRs are in excess of 30%. So those are really good projects.

Now when we talk about optimization of footprint that I have highlighted in the prepared remarks. Look, there's a great set of opportunities that we have ahead of us in India. We are very bullish on what is happening in India, the infrastructure builds that are happening in there and the demand that we see for heavy duty equipment, which is very positive. And so we believe that over the mid-term, we want to be ready to ensure that we capitalize on the India opportunity, just like we have done in China. Brazil in similar vein has very unique set of operating dynamics. You've got high tariffs and the opportunities that we see there are quite robust and we feel that being in close proximity to our customers with local manufacturing is the right thing to do. So those are kind of maybe couple of projects that we've highlighted out there. But I would say more broadly, we want to be very pragmatic about making sure that we stay contemporary with our manufacturing processes and we can leverage the NPI and then ultimately position ourselves to a situation where we can accelerate our organic growth, which, as you know, has not been insignificant. We have delivered organic growth very much in line with the high multiple premium industrial peer set.

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

A

The one thing I'll add to that is if you remember, I've said this multiple times before, even as we're working on some of these enterprise initiatives and these bigger footprint optimization projects, they still fall well within the 2% to 3% guidance that we give on CapEx every year. So, we don't feel the need to ramp up CapEx to an abnormal level in any given year. We can handle all these investments and all these enterprise initiatives well within the framework of what our capital spending is in a year-on-year basis.

Operator: Your next question comes from the line of Andy Kaplowitz with Citigroup. Your line is open.

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Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey, good, 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.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo or Brooks I just wanted to flush out the enterprise initiatives a little bit more in terms of how they ramp up in 2024. They're kind of linear. And then, you obviously just talked about factory optimization. You've talked about 80/20 in productivity. Is it kind of equally split when we look at that $0.07? And do you have even more of an impact as you go into 2025, for instance than 2024.

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

A

Yeah. So let me I'm going to be a little bit careful here. As there's a lot of moving parts here. First of all, in 2024, I think our enterprise initiatives will definitely lean more towards the material cost out side than some of the more factory productivity side. And we'll be working through the footprint optimizations and I think those are definitely more 2025, 2026 type things. And so we definitely lean more towards the material saving side. The factory productivity in a down volume environment is tough, right? I mean, it's a tough nut to crack. We're going to get some. But as volume comes back, that's when the factory productivity will really start to stack up. And then the 80/20 work we're going to do in terms of strategic pricing and in terms of, going out and driving better value demand from our end customers is going to be a big driver as well. So I would say, kind of the summary of that is definitely more weighted toward material cost in 2024.

On the enterprise initiative side,

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

A

I mean, 2025, you should start seeing some benefits from some of the footprint optimization. And we'll be talking more about obviously -- we again, as Brooks said, lots of moving pieces on the footprint optimization, notification of employees and and so on and so forth. But we have number of terrific projects that we are quite bullish about. And we have stated 2025 should be a beneficiary of the restructuring there.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Very helpful, guys. And then I just want to go back to the seasonality question again for like if I look at historically, Q1 is almost always up decently sequentially versus Q4. At the midpoint, you guys have a kind of flattish, I think, global auto production is supposed to be down in Q1 versus Q4. But you guys are, as you know, are not big in

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first-fit anymore. Is there anything else sort of going on or is it just sort of this pragmatic view around destocking in Q1, and you already mentioned that keeps you, where your guidance is for Q1?

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

Yeah, well, I mean, I think there's a nuance here as you move from Q4 to Q1. We have a -- we're taking a pragmatic view on volume. So we have volumes down and that's partially offset by FX because FX is a little bit of a tailwind as we move from Q4 to Q1. And so it's really more of a pragmatic view based on how we think the demand environment is going to play out through the first half of 2024. And so that's really the best visibility we have right now in terms of what's going to go on with demand.

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

Yeah. And Andy, I would also, probably suggest that people start thinking about as the operations have recovered and normalized. And again, as I said on the call in the prepared remarks, we're pretty much back to pre-COVID level of operational cadence. Our customers are taking advantage of the fact that we're are much more predictable and how we fulfill demand. Our lead times have been normalizing. And we want to ensure that our service levels remain high and that just gives everybody an opportunity to really just order more in line with what the underlying demand is. And that's kind of how you should think about it.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Yes. Hi. 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.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

I'm wondering, if you could just talk about a little bit more on the capital deployment plan for this year. Obviously, stock buyback, over $100 million is in the works. But can you expand on that because you're set to generate pretty significant free cash flow and with EBITDA growing leverage just naturally coming down? Would love to hear more, Brooks, if you don't mind.

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

Yeah. So, look, we -- as you just said, I'll take the words out of your mouth. As you just said, we generate substantial free cash flow, year in and year out, right. And so we are going to continue to pull the levers that move us toward our medium term goal of 1.5 times leverage, right. Which means we're going to continue to pay down

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debt. And that's going to be our primary vector for capital deployment here in the short to medium term. Having said that, because we generate a substantial amount of cash while we want to make sure that we have all avenues open to us in terms of deploying capital to reward our shareholders. And so we took out the stock repurchase authorization for $100 million.

And we'll use that also as a vector to help reward shareholders here through the short and medium term. But I would say we're still primarily focused on debt reduction, debt reduction, profitability improvement as a way to improve -- to get to our medium term leverage target of 1.5 turns. But we want to make sure that we have, all avenues available to us in terms of capital deployment.

Jerry Revich Q
Analyst, Goldman Sachs & Co. LLC

And Brooks, I didn't hear you mentioned M&A within that context. How attractive is it today versus the bolt on M&As we saw you folks grew in the last cycle?

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

Yeah, look, I mean, we always look at opportunities, but we feel that presently kind of in 2023, we've made some commitments about getting our balance sheet to be very much in line with what our premium industrial peer group looks like. There are significant benefits in a lower interest expense, and that can generate more free cash flow. And our stock is so inexpensive that we believe that that's the best way of deploying capital. And so those would be the two levers in the short term. And I think that none of that should be surprising to what would we have signaled and communicated to the markets over the last kind of 12 months? So we'll stay true to that.

And some great opportunities appear and we feel that we would be able to generate very substantial returns going out to the markets and doing some M&A. We generate enough cash to be able to do that. And our leverage is coming down pretty dramatically as we said. So we're in a very good shape to be able to now start thinking about all three of these avenues of potential capital deployment.

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

Right. And I would say, too, that as we focus on debt paydown as our primary lever to get to 1.5 turns, that also leaves us maximum flexibility in terms of dry gunpowder to do whatever, to deploy capital in whatever way is going to best reward our shareholders.

Operator: Your next question comes from the line of David Raso with Evercore ISI. Your line is open.

David Raso Q
Analyst, Evercore ISI

Hi. Thank you very much. Sorry, if I missed this, but I'm so trying to make sure I understand the cadence of the organic sales year-over-year. So the down one for the year, is that if I could sort of maybe play this out, it looks like it's a down five in the first quarter is second quarter. The idea of, down three in the back half of the year is up two. I'm just trying to get a sense of the cadence for my first question.

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

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So, look, we're not going to -- we're not forecasting second quarter quite yet. I would say, if you look at we expect there to be a progression of things getting better throughout the year. And so, we've given our first quarter guidance. Second quarter, does it come in minus three? Minus two, remains to be seen, how quickly things inflect. We think we've taken a pragmatic view from a volume perspective. And so if things get better faster that's good for us. Margins will improve faster and things will get better. But we think we've taken a pragmatic view and we'll continue to update as we move through the year.

David Raso
Analyst, Evercore ISI

Q

But to be clear, though, the second half of the year, do you expect the return to growth to be in the third or fourth quarter? Because I'm thinking about the personal mobility comment earlier that destock continues beyond the first half. So I'm just trying to level set, when do we think we will return to growth? And then the follow up, if you can give us some sense between the business segments which one do you think will be kind of above the company guide and which one below? So just trying to get a sense of perspective on the business segments and the cadence. Thank you.

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

A

Yeah, David, we anticipate a modest growth in the second half as we have outlined in our prepared remarks. I mean, it's natural taking into an account where we are guiding Q1. And I'll leave it at that. And I did state that we anticipated the personal mobility should start recovering in the second half of the year after about four or five quarters of rather significant inventory destock. So that's really where I would probably leave it with you. And we've provided you with a framework on the end market performance, and that's probably good amount of outlines that should give you an ability to take a look and develop your model.

Operator: Your next question comes from the line of Jeff Hammond with KeyBanc. Your line is open.

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, Jeff.

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

Q

Hey, EMEA was one of your better growth markets. It seems like, there's maybe some broadening weakness there. Just speak to how you're thinking about Europe and into 2024.

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

A

Yeah. So Europe, the anticipation, Jeff, is that ag is going to continue remain weak as this construction end market, auto remains kind of flattish 2 plus LSV, diversified industrial still reasonably negative core growth and all the news flow from places like Germany and Italy is not necessarily terrific.

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So who am I to predict that it's going to get dramatically better short term? So we anticipated that's going to remain somewhat weak and maybe as the second half progresses, start getting less bad. And on-highway, we anticipate, it's going to be down versus 2023. So Europe, I think, is dealing with more fundamental slowdown than perhaps any other region that we participate in.

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

Q

Okay. And then I was just supercomputing and saw some of your hoses on some liquid cooling applications and certainly an area of strength in conversation. Just wondering, if you can speak to that opportunity. I'm not sure if it's a rounding error or if something we should get excited about. Thanks.

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

A

Jeff, I get excited about every opportunity. When you sit in my chair, every opportunity is a great opportunity. But we will speak actually a little bit more about the hyperscale of data centers and the liquid cooling in those. We actually have a couple of really interesting technologies that I will share more about both on the electric water pump side that helps to provide efficient cooling and on leak free applications for conveyance of the fluids that cools these datacenters. So yeah, we're actually excited about it. I'm not prepared to size the opportunity for you at this point in time. It's early stages. But we are excited that we have lots of the -- actually have lots of really interesting technologies that are being adapted in what I kind of termed the new economy. So from hyperscale to broad based electrification and industrial automation. So we'll share more on March 11 in New York.

Operator: Your next question comes from the line of Mike Halloran with Baird. Your line is open.

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

Q

Hey, good morning, everyone.

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

A

Good morning.

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

Q

Couple of questions. First on the just on the guide one last time here, I look at this, the normal sequentials and it kind of gets you into the middle part of the range. Normal sequentials doesn't necessarily imply anything better from here from an end market perspective. So you've commented on gradual improvement in the back half of the year. I'm just kind of curious what that means from your perspective and if that's even really required to hit the midpoint of the range versus just kind of float along at current levels?

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

A

Yeah, Jeff, I think that, I would say that certainly the back half of the year has significantly easier comps as well, right. So that's going to be part of it to be quite frank. And we kind of feel that, Q1 is frankly a continuation of what we have seen in Q4 in terms of the demand dynamics. And then, just steady normalization of demand as inventories have normalized, as the underlying purchases are very much aligned to the underlying demand for the

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products and the applications that we service. So it really doesn't, again, we're being very pragmatic, but we don't believe that we will require any significant improvement in the end markets to be able to deliver the guidance. And again, it's in the early guidance. That's why we are quite forefront and [indiscernible] (00:56:04) about making sure that we have put a pragmatic view of what we believe the world's economy is going to do.

Michael Patrick Halloran

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

Q

And then on the M&A side of things, how developed is that pipeline at this point? You've been out of the market for a bit focused on other areas of capital usage, and I certainly understand your comments about how inexpensive your stock is and that makes it a priority. But if the opportunity comes up how invested or how in the market are you on the M&A side to be able to identify and go after some of these areas?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Yeah. Look, because we don't necessarily talk about it front and center doesn't mean that we don't develop strong pipeline. We have a good pipeline of opportunities. But again, the issue is that our stock is so undervalued. And we just believe that that is just -- it's just tough to compete. We're generating strong returns on deploying that capital. And we believe that it's in the best interest of our shareholders to go further reduce our debt and opportunistically deploy capital through share buybacks.

And that's going to put the company in the strongest and very forward leaning footings as the time move forward. So the next, kind of four or five, six quarters, you're going to be in a situation where you can start thinking about maybe better, bigger deals if that's what you ultimately want to do, getting the stock and valuation normalized because, again, I certainly feel that the stock is quite undervalued. And we've got to do everything that we can to take advantage of that.

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

Rich Kwas

Vice President, Investor Relations, Gates Industrial Corp. Plc

Thank you, everyone, for participating today. If you have any follow-up questions, please feel free to contact me. Thanks and have a great day.

Operator: This concludes today's conference call. We thank you for joining. You may now disconnect your lines.

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