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Gates Industrial Corp. Plc (GTES)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. And welcome to the Gates Industrial Corporation First Quarter 2024 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

I would now like to turn the call over to Rich Kwas. Please go ahead.

[Technical Difficulty] (00:00:38-00:01:18)

Sorry. It seems that we're having some technical difficulty at this time. Please remain on the line while we address the situation. Your line will be placed on music hold until the call resumes. Thank you.

[Technical Difficulty] (00:01:29-00:03:32)

Thank you for standing by. And welcome to the Gates Industrial Corporation First Quarter 2024 Earnings Conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

I would now like to turn the call over to Rich Kwas. Please go ahead.

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Rich Kwas

Vice President-Investor Relations, Gates Industrial Corp. Plc

Good morning. And thank you for joining us on our first quarter 2024 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 first quarter 2024 results. A copy of the release is available on our website at investors.gates.com. Our call this morning is being webcast as an 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 to now to slide 2 of the presentation, which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed in or implied by such forward-looking statements.

These risks include, among others, matters that we have described in our most recent annual report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update those forward-looking statements. Later this month, we will be attending the Wolfe Global Transportation & Industrials Conference, and the KeyBanc Industrials & Basic Materials Conference. We look forward to meeting with many of you. Before we start, please note all comparisons are against the prior year period, unless stated otherwise.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Rich. Good morning, everyone. And thank you for joining our call today. We'll kick off today on slide 3. We generated revenues above the midpoint of our February revenue guidance and within the range we provided at our Capital Markets Day in March. Globally, Automotive continued to outperform industrial end markets. Our global replacement revenues increased slightly with Automotive Replacement leading the way by delivering mid-single-digit growth. Broadly speaking, order activity improved as March progressed and our book-to-bill ratio finished at a higher level in March as compared to book-to-bill for the full quarter.

Our order fill rates and the associated service levels to our customers continue to trend up nicely as we continue to sharpen our operational execution on more efficient through-the-cycle performance. Our operating performance in the quarter was strong and resulted in significant margin expansion. Our adjusted EBITDA margin increased 330 basis points year-over-year to 22.7%. Our gross margin [ph] improved (00:07:30) 210 basis points, compared to the first quarter of 2023 despite encountering a volume decline in the quarter. We are making headway with our enterprise initiatives, particularly in material cost reduction and with [ph] 80/20 (00:07:48).

The higher replacement sales mix relative to last year also contributed to our gross margin expansion. In addition, our SG&A spending decreased year-over-year, which included higher than expected insurance policies. We made more progress with our balance sheet during the quarter. Our net leverage declined to 2.4 times from 2.7 times in the prior year quarter. We executed on the commitment we've made on our year-end 2023 earnings call to repay debt, reducing our outstanding term loan balance by $100 million. In addition, we used excess cash to repurchase $50 million of our shares in conjunction with Blackstone's secondary offering in February. Based on our strong profitability results in Q1, we are increasing our full year adjusted EBITDA guidance. We experienced a good start

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to the year and believe we are in a solid position to generate strong operating leverage as our industrial end markets progressively start to experience an anticipated demand recovery later in the year. Brooks will provide further color on our updated 2024 guidance later in the presentation.

Now, please to turn slide 4. First quarter total revenue was $863 million, which represented a 3.6% decrease on a core basis. The Automotive end market grew modestly, driven by mid-single-digit growth in replacement. The bulk of our industrial end markets experienced revenue declines on a core basis driven by the Industrial First Fit channel, which was down double digits. Core industrial replacement revenues decreased modestly.

Our book-to-bill remained above 1 in the quarter and expanded in March, led by an improving order cadence. I will also note that we have seen order intake greater than what we've experienced in Q1 of prior year, which signals to us the stabilizing market with pockets of specific weakness offsetting more solid performance elsewhere. We are encouraged by this activity. Adjusted EBITDA was $196 million and yielded a margin of 22.7%. EBITDA margin expanded 330 basis points supported by the key enterprise initiatives as well as increased mix of replacement sales, compared to the prior year period. Adjusted earnings per share was $0.31. Our operating income grew well over 30% and contributed $0.10 of adjusted EPS, which was partially offset by a higher effective tax rate in this year's quarter, as well as mix of other items.

On slide 5, let's review our segment performance. In the Power Transmission segment, our revenues came in at $533 million, which represented a 1.7% decrease on a core basis. At a channel level, replacement grew about 2%, fueled by Automotive Replacement, which grew mid-single digits. First Fit revenues decreased high single digits with industrial experiencing a double-digit decline and Automotive growing slightly. End market performance was mixed with Energy, On Highway, construction, and Automotive realizing low to mid-single-digit core growth, which was offset by declines in Personal Mobility, Diversified Industrial, and Agriculture.

Of note, the magnitude of the declines in these end markets began to ease relative to previous quarters and the Diversified Industrial end market in North America is showing signs of stability. Our adjusted EBITDA margin increased nicely, benefiting from contributions from our various enterprise initiatives, and a higher mix of replacement sales. Our Fluid Power segment posted revenues of $330 million. Revenues fell about 6% with core revenues posting a just under 7% decrease, partially offset by favorable foreign currency effects of almost 100 basis points. Industrial First Fit declined double digits, driven by weaker activity in Agriculture and Construction. Automotive Replacement was a bright spot, growing mid to high single digits. Fluid Power segment adjusted EBITDA margins improved 410 basis points, fueled by stronger operating performance that was supported by the ongoing execution of our enterprise initiatives.

I will now turn the call over to Brooks for additional details on our results. Brooks?

Lawrence Brooks Mallard

Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

Thank you, Ivo. Moving now to slide 6. And an overview of our core revenue performance by region. Most of our geographic regions outperformed the enterprise core revenue results. In North America, core sales decreased 3%, driven by weaker industrial trends. Industrial channel core revenues declined high single digits, primarily due to a double-digit decrease in First Fit. Industrial replacement fell low single digits. Agriculture weakness was the most impactful to our performance, followed by Personal Mobility, consistent with our expectations. We now anticipate the Personal Mobility destocking to abate as we exit Q2 and anticipate steady recovery in revenue generation from the second half of 2024 onwards. Additionally, we saw relative stability in Diversified Industrial where revenues were about flat with last year.

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Automotive increased mid-single digits with solid growth in both replacement and First Fit. In EMEA, core revenues fell 8% and was most impactful to our overall company core revenue decline. Industrial First Fit was down double digits and most of the industrial end markets in the EMEA region realized decreases. Automotive Replacement grew modestly and was a partial offset to the weaker industrial trend. China core revenues grew modestly and benefited from strong demand in the Automotive Replacement channel, which expanded in the high teens. Automotive First Fit was down while industrial grew slightly, with end market performance mix. In general, we observed overall demand showing more stability in China. Although our expectations are measured in the near term. East Asia and South America posted slight declines in core revenues, with Automotive outperforming industrial in both regions. In general, core growth was largely consistent with our expectations.

On slide 7, we show an adjusted earnings per share walk from the prior year quarter. Operating performance contributed approximately $0.10 per share and fueled the growth. The operating performance strength was partially offset by a higher than expected tax rate due to the booking of certain discrete tax items in the quarter and a mix of other items. The discrete tax items mostly involve changes in estimates around valuation allowances that we expect largely to be offset by other activity as the year progresses.

Slide 8 provides an update on our cash flow performance and balance sheet. Our free cash flow for the first quarter was an outflow of $39 million. This result is in line with our normal seasonal performance. Our net leverage ratio declined to 2.4 times, which was 0.3 times lower than the prior year period and reflected a $100 million reduction in our term loan. During the first quarter, we received a ratings upgrade from S&P. Additionally, late last week, Moody's bumped our credit rating one notch higher to be Ba3. Our trailing 12-month return on invested capital increased approximately 300 basis points to 23.1%, with the increase mostly driven by our strengthening profitability. At the end of Q1, we had $50 million remaining under our existing share repurchase authorization.

Shifting to our updated 2024 guidance on slide 9. We have increased our full year 2024 adjusted EBITDA guidance to a range of $745 million to $805 million. Q1's outperformance represents most of the increase. We are reiterating guidance for core revenue growth, adjusted earnings per share, capital expenditures, and free cash flow conversion. The higher adjusted EBITDA for the year is expected to be offset by a higher effective tax rate for 2024. For the second quarter, we expect revenues to be in the range of $880 million to $910 million. We expect a low single digit decline in core growth year-over-year as we expect industrial headwinds to continue through the second quarter. We estimate our adjusted EBITDA margin will expand approximately 50 to 100 basis points, compared to the prior year.

On page 10, we show an updated walk relative to the midpoint of the initial adjusted earnings per share guidance we provided in February. Greater savings contribution from our enterprise initiatives are being fully offset by the higher effective tax rate, which we expect to be 200 to 300 basis points higher versus the initial expectation we outlined in February. Please note that our adjusted earnings per share guidance does not incorporate any incremental share repurchase activity.

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

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you. On slide 11, I'll summarize our key messages before we take your questions. First, I'm pleased with our solid operating performance to start 2024. Our margin performance was healthy and we are gaining traction with our various enterprise initiatives, particularly in the areas of material cost reduction [ph] and 80/20 (00:20:13). [ph] Our material science (00:20:15) competencies are driving process efficiencies and material savings benefits.

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We see signs that industrial activity is beginning to stabilize, although we expect markets like Ag and Construction to stay soft for the time being. Core growth in our Diversified Industrial end markets was flattened – has flattened out over the last couple of quarters after a period of softness. And the order intake activity we saw in Q1 would suggest more stability in certain industrial markets. The improvements in March [ph] PMI (00:20:57) is encouraging, but we need to see a continued trend before we become more constructive on the near-term volume inflection for our business.

As such, we have maintained a pragmatic view of our top line growth expectation for the year. Second, we are executing on our commitments we have made to our shareholders. We believe we are effectively deploying capital and continue to strengthen our balance sheet, as evidenced by our two recent rating agency upgrades. We reduced gross debt in the first quarter in parallel with repurchasing shares. We are highly focused on achieving our 2026 targets outlined at our March Capital Markets Day. As we drive margin and cash flow improvements, our strategic optionality should expand and we intend to be opportunistic. I'll finish by expressing my appreciation to almost 15,000 global Gates associates for their diligence and dedication with a particular focus on execution of our key priorities, as well as commitment to meet our customers' expectations.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] The first question comes from the line of Nigel Coe with Wolfe Research. Your line is open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Thanks. Good morning, everyone. So hi. Hi, guys. Just wondering, in the context of Q1 realized growth. Q2, obviously looking at down 3.5% year-over-year. What is the pathway here to the plus 1% high end for the full year? What needs to go right in the back half? And obviously I recognize you got [ph] easier (00:23:28) comps. And maybe within that, just talk about what sort of price contribution we have coming through in the back half of the year.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Hey, Nigel. So for the second half of the year, we're staying in pretty pragmatic. First of all, the comps do get easier, right, because we started to see the industrial things trough last year. And then as we said in our prepared remarks, we expect Personal Mobility to stabilize and start to come back. And then it's just the rest of the industrial market, just starting to come back a little bit. Our Automotive Replacement business has been really good through the first quarter. So it's really the Personal Mobility stabilizing and then the industrial market starting to come back. And we just have to wait and see. We've seen some stabilization. We've seen some pockets of things getting better, but then we're seeing some pockets of things that really haven't turned yet.

Nigel Coe
Analyst, Wolfe Research LLC

Q

And there's no reason to believe the Auto aftermarket wouldn't kind of maintain at these levels through the year?

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

A

Not really. I mean, we anticipated – the underlying demand trends are very strong. The order flows are very strong. The book-to-bill is very strong. So we anticipate that the Automotive aftermarket will continue to outperform.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. And my follow-on is quick – quick follow-on on the 2Q guide. Unless I'm doing the math wrong, I think we're looking for a slight downtick in margins from Q1 to Q2. I think usually, we have – Q1 margins are a little bit lower than Q2. So just wondering what specific kind of dynamics we should be keep kind of paying attention to as we go from Q1 to Q2? Obviously, still very, very healthy levels of margin, just wondering why that Q1 to Q2 dynamic?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. The big thing is on SG&A, we had some kind of out of normal good news in Q1 related to some insurance things and some FX transactional tailwinds that we had, that we don't expect to happen through the balance of the year. And then we also have a little bit of uptick in terms of labor spending relative to SG&A, when the merit increases come in and things like that. So almost all of the kind of – as you'd say, I wouldn't say headwind, but the normal uptick you would expect from an EBITDA margin perspective is really related to SG&A and kind of some one-off benefits that we had in Q1.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. That's great. Thank you.

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

David Tarantino
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Good morning, guys. This is David Tarantino on for Jeff. Maybe just to start on the margin line relative to the raised outlook here, seems all around, the incrementals self-help. Could you give us some more color on where specifically that $0.06 of the incremental self-help is coming from? Is this pull forward or is it you're just finding more incremental opportunities versus what you initially identified?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. So I think there's – if you think about Q1, we did a little bit better on mix because the replacement business was a little bit better. We did a little bit better on the enterprise initiatives. Price, we're using 80/20 is kind of the underlying – underpinning infrastructure on a lot of the stuff that we do now and that helped with price a little bit. And then productivity came in a little bit better in Q1. And then, as you move through the year, we expect price not to be as helpful as it was in Q1, but we expect productivity to get a little bit better as we move through the year and a lot of that is driven by material cost productivity. As Ivo said in his – at the end of his comments, the material science work that we're doing on material cost out is coming to fruition and we expect that to continue

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through the balance of the year. So even with volumes being down, we're able to expand our margins. And so that's really a lot of the hard work we've done around material productivity and material cost out.

David Tarantino
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. And maybe just to follow-up on the comments around the improvement in order rates in the quarter, could you give some color on where you're seeing this and maybe just give some context, I mean, just relative sales were kind of at the lower end of the guide provided in March. So maybe just level set us on where you're seeing the more positive near-term trends and when you would expect this to show through.

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

A

Yeah. So look, I would say that on the order rates, we are seeing a little bit stronger order rates in Automotive Replacement. We're seeing a more constructive market backdrop in industrial replacement order rates, particularly in North America, as a reference to kind of prior year and maybe sequentially. So I would say that those were bigger drivers. We did see some blanket orders being placed as well for some of our longer project type businesses that we anticipate to ship through the year. When I take a look at what the distributors are selling through, which kind of is a very important indicator for us, I mean, we are seeing pretty good stability in the inventory channels. So the order rates now are more in line with what we would anticipate to ship out. And that being said, it's slightly offset by maybe a little more negative backdrop in Ag and commercial construction. So I've kind of tried to package every – both of your segments of your question into an answer. Hopefully, that answers your question.

David Tarantino
Analyst, KeyBanc Capital Markets, Inc.

Q

Yes. Great. Thank you.

Operator: The next question comes from the line of Steve Volkmann of Jefferies. Your line is open.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Hi. Good morning, guys. Thanks for taking my question. I'm curious if it's possible to sort of break down the benefits of the enterprise initiatives on margin relative to the benefits that sounded like you got on mix because of the Automotive aftermarket.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. So the mix impact in Q1 was about 50 basis points of gross margin expansion. And so then we had about 50 bps of inflation, [ph] some in (00:30:28) deflation and favorable FX and then the balance of it was enterprise initiatives offset by some volume headwinds.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Got it. Okay. That's helpful. And then, how should we think about the rest of the year. I guess I'm struck by the fact that you sound like things are sort of improving directionally and you sound fairly optimistic, but really didn't

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raise the rest of the year. Is there a mixed headwind as the rest of these businesses come back a little bit as the rest of the year?

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

A

Steve, I wouldn't say that there's a headwind on the mix. We just being pragmatic about what we are forecasting for the next three quarters. It's early in the year while we are seeing improvements. As I said, I feel it's more of a stabilizing market environment. There are some puts and takes. There are some end markets that are less constructive, like Ag and commercial construction. And while the PMI, we'll add a one positive month, we really need to see a validation that that's not just a [ph] head sake (00:31:41), but it's a real inflection in the underlying macros. And so as the year progresses, we certainly would feel that we would assess and reforecast if that's warranted, but at this point in time, we're just trying to take a pragmatic view of the rest of the year.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Okay. Understood. Thank you.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone. And nice quarter. Brooks, I am wondering if you don't mind just expanding on the deflation comment that you mentioned, the 50-basis-point tailwind in the first quarter, how much of that was from improved on time deliveries and efficiencies versus the lower freight costs? And what kind of momentum is there as the supply chain normalizes for you, folks? Can you just flesh out on what that might look like in 2Q based on the start so far?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. So as I've said, in Q1, it was inflation and FX. And it was probably a little bit more FX favorability than deflation. And really, what we're seeing is we're seeing a little bit of an uptick on inflation relative to freight because freight costs are going up. We're seeing a little bit of deflation on utilities. So utilities are a little bit better. And then materials are a little bit up and down, some things are better and some things are worse, but it's really – at the end of the day, it's maybe 20 bps. And so it's really not that big of a deal. We're just seeing kind of a stabilization of things across the board, so...

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. And then in terms of in your conversations with your distributors as you get ready to set expectations for pricing in 2025, can you just talk about conceptually, how are you thinking about normalized inflation going forward, considering the outsized inflation we've seen over the next couple of years as you set the initial expectations on what distributors should expect in 2025?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

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Yeah. Well, 2025 is a long way away, Jerry, so I'm not going to try to predict what's going to happen that far out. I can tell you a couple of things. One is we're always going to be able to, we believe, get price to offset the inflationary pressures we've seen, right? Even with the extraordinary inflation that we saw over the past three years, we were able to get EBITDA margin neutrality with our pricing. In addition, as we continue to work through 80/20, we're going to be more strategic around some of the pricing things that we do in terms of using the 80/20 tools to do the best we can relative to pricing. And then, we'll look at what's going on with materials, we'll look at what's going on with freight, we'll look at what's going on with utilities, and then we'll make that judgment when we get to 2025.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And what kind of lead time do you need to provide?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Typically two to three months.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

All right. Super. Thank you.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Thanks.

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

Damian Karas
Analyst, UBS Securities LLC

Q

Hey. Good morning, everyone.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Good morning, Dam.

Damian Karas
Analyst, UBS Securities LLC

Q

Thanks for all the thoughts on kind of the guidance and your pragmatic approach to the margins as the year progresses. So maybe just take a step back, ask you a little bit about potential growth drivers. Data centers is obviously very topical right now. I know you guys have mentioned you've got capabilities in the space. I was wondering if there's any numbers or thoughts you could share around activity you've been seeing and just that opportunity more generally. And I'm presuming we see any such activity kind of show up in your Industrial First Fit category.

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

A

Yeah. Sure, Damian. I think as we stated during the CMD about a month ago, it was five weeks ago, we view the data center as an emerging, rather significant opportunity to drive incremental growth through the next three to four years. We have a reasonably decent portfolio to be able to participate with our electric water pumps and with our fluid conveyance products. That being said, we are also in process of launching fully refreshed fluid conveyance product that's specifically going to target the data center applications that is more tailored for what's needed in those particular hyperscale data centers.

So I wouldn't anticipate that we're going to see any meaningful ramp-up in 2024, but I would say that it should be an expectation that we start talking more about it in 2025. And as we go in 2026, these projects are specked early and the revenue ramp-up takes some time as these data centers get built out. So that's kind of how I would say you should think about it. And as to the other drivers, I would certainly say that we still feel extremely constructive about our [ph] Chain-to-Belt initiative (00:37:25).

And as particularly, the end markets are stabilizing, particularly on the mobility side, as I said in my prepared remarks, I think Brooks may have said that we now anticipate that the Personal Mobility destock should play itself out in the first half of this year. And while we don't expect any hockey stick type recovery in Personal Mobility space, we do believe that in the second half, the market is going to be more constructive. And then in 2025, we should start seeing really nice uptick again in our growth rates, in Personal Mobility, lots of projects we're involved across a very significant number of design wins. So we are quite constructive on that. And then as we have been demonstrating, we are doing a rather good job in the Automotive Replacement side of our business. And we still believe that there are some positive drivers over the mid-term and that should be constructive for us. So we do have lots of vectors to continue to drive growth in the future. But that being said, I would ground everybody and we need to see – we need to start seeing some stability in the underlying market environment, which we believe we should start seeing into the second half of this year.

Damian Karas
Analyst, UBS Securities LLC

Q

Okay. Great. That makes sense. And then, could you just maybe elaborate a little bit on your expectations for China? And I know you said still choppy trends, but it was nice to see kind of the positive growth inflection. So what makes you think you can't kind of just continue to grow from here and just maybe talk about what's giving you a little hesitation and the expected choppiness. Thanks.

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

A

Okay. I would say more pragmatic view of what is happening. I would say that fundamentally, there are still lots of headwinds in that economy. We are growing really nicely Automotive Replacement business in China despite all of those headwinds. We start seeing that particularly on the industrial replacement side, it's becoming less bad in China. So one could anticipate some degree of inflection into second half of the year there. Commercial construction is stabilizing. So I mean, you could come to conclusions that things are getting better, but they are also choppy and I would say that our Q2 comp in China in particular is going to be challenging because that was the best quarter in China that we had last year. So while the underlying market environment may be stabilizing or is stabilizing, again, we just try to be pragmatic rather than getting way over our skis here.

Damian Karas
Analyst, UBS Securities LLC

Q

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Thanks, guys. Best of luck.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc
A

Thanks.

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

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Hey, guys. How are you?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc
A

Hey, Andy. How's it going?

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Good. Brooks, I just want to start out with free cash flow. Start of the year, you had negative, which seasonally is not, it's kind of normal, but last year, I think you had positive free cash flow. So can you maybe discuss what happened in the quarter, I know you didn't change the outlook for the year, so should you turn to a nice cash in Q2?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc
A

Yeah. Well, I mean, I think last year was more of the outlier and this year is more of return to normal. And so we build inventory through Q1 and Q2 because that's typically a little bit busier. And then also, we had more variable comp payout in Q1 of this year. So that was a pretty significant year-over-year change and that also impacted Q1 of this year. But I would say Q1 of this year was much more normalized than Q1 of last year.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Okay. And then, Ivo, I just want to follow-up on Diversified Industrial and Personal Mobility. What is driving Diversified Industrial stabilization? And then you kind of mentioned in a previous question, you think Personal Mobility gets better in the second half. What kind of run rate does it have to get to? Because I think at the Investor Day, you talked about potentially double-digit growth in 2025. So what's the visibility toward that sort of inflection in Personal Mobility?

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

Look. So the Personal Mobility was impacted over the last kind of five or six quarters, particularly by the destock and kind of the overbuilds during the COVID era. But we are starting to see now – you're starting to see some real inflection, I think, in the market demand. Look, we haven't seen order expedites in a very long time. You are now starting to see customers kind of calling you and saying, oh, please, would you please expedite this order for me. And that would give you an indication that we are kind of approaching the trough of the inventory destock. And if you take a look at the underlying market build, so the end unit builds, they've stabilized. So as we are looking on

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forward going basis, we believe that the channel destock is kind of coming to an end and we should see Q2 being the bottom of it.

And then because they said a more stabilizing end market demand in the Personal Mobility space, we believe that that will start slow and steady recovery with perhaps more normalization as we get into 2025. Now, what gives us a degree of confidence that we will start seeing some of the growth rates that we were discussing at the CMD? Look, we continue to grab quite a bit of share in conversions. They do take time to ramp up as the new equipment is being built and being offered for sale in the season, that is as usual. So we actually feel quite, quite positively that we have reached a bottom in the Personal Mobility in the first half of this year. Now, on the industrial replacement side, look, things are just less bad. I wouldn't let you read my words as things are off to the races. But all of the indication, all the indicators are pointing towards more stabilizing demand.

Reasonably, I mean, reasonably positive, broad improvement or reduction of negative order rates that we have seen for kind of three or four quarters there in industrial replacement. So we believe that this is on a trajectory of kind of a steady recovery, very much in line with what, frankly, the industrial PMI is starting. It is just getting less bad. So it will mirror the performance of the indices.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks very much. Good morning. Maybe, Ivo, just going back to your point on the sort of the broad environment in industrial because I guess at the Investor Day, it felt like things were sort of getting better, maybe more quickly, and then maybe the tone, it seems, is a little bit more balanced or measured today. Is that a fair sort of characterization? Did you see any notable kind of slowdown or change in trend in the last month or two? And again, totally understand it's a very uneven environment. We see that just less than an hour ago with the PMI going back below 50 again and also on new orders. So that's just the nature of the environment, but just wondered, was there any particular region or market that you feel more tepid on now versus, say, at the CMD?

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

A

Yeah. Look. One of the things that I would point out while we anticipated that the Easter holiday was coming in into March, which was a little bit earlier than it was prior years. We have seen little more choppiness at the second half of that month. And I would say that it was – the weaker performance was reasonably muted. I mean, it was less than half a day of sales. If you kind of – want to kind of scope it, what was the impact. And I would more associate that with the Easter coming in earlier. And then – but on the other hand, I would say that some of the [ph] off highway (00:46:45) builds are getting weaker, and I would anticipate that that's going to continue to be a headwind into kind of the rest of the year. I don't anticipate that Ag is going to be recovering.

My sense is that the commercial construction equipment space is going to be somewhat challenged as well. But that probably is going to be offset by a more constructive AR, more constructive IR, some recovery in Personal Mobility in the second half. So I wouldn't say, Julian, that anything has really changed. I would just say that March maybe came in half at a below what we kind of anticipated that we are going to see. And again, I would probably say it's more on the back of that Easter holiday coming in a little bit earlier than prior year and probably impacting us little more than what we've anticipated.

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Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's helpful. Thank you, Ivo. And then a more prosaic question maybe for Brooks around tax rate. Clearly, that increase has sort of offset the higher EBITDA margin guide for this year. So is it sort of a 25% type tax rate in the adjusted P&L for the year? And when we think about beyond 2024, does the tax rate we should use, is that more like the sort of low 20s type range?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. So yeah. I think for the year, we've seen – we had these discrete items and as I said in my remarks, largely, they're going to be offset. What we are seeing too is a little bit of a tick-up in our statutory tax rate based on the mix of income in the jurisdictions that are coming in from. And so that's a little bit of an uptick for the year. I think going forward, 22% to 25% is going to be in this range and it's going to be impacted again, like I said, by the mix of income and where it's coming in. And then obviously, there's other things going on with the [ph] pillar (00:48:59) tax and different things like that that may affect that a little bit here and there, but 22% to 25% is where we think we ought to be kind of for the midterm.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's great. Thank you.

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

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

Q

Hey. Morning, everyone. So I just kind of want to kind of put all these pieces together here because a lot of markets, a lot of different trend lines. If you net it together, is the guidance more or less assuming stability and relatively normal sequentials for your overall business for the remainder of the year?

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

A

Yeah. I think that that's the right way to think about it, Mike. I think that stabilizing demand is probably the right way to think about that with some puts and some takes, right? So off highway, maybe weaker and some of the other segments, maybe performing a little bit better, AR, IR recovering. So that's a good way to think about it. Puts and takes and more stability.

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

Q

And then could you provide an update on the operational improvement initiatives internally? Probably a little bit more geared towards how the organization and teams are accessing it and how quickly you think you can start seeing some significant benefits. I know we just had the Analyst Day not that long ago. So more curious about the internal momentum in how the adoption curve is going.

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

A

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Yeah. I think it's a great question. Thank you for asking that, Mike. Look, we're doing better. I think that the organization is much more comfortable and much more confident in its ability to execute on the vision that we have set in the targets. And on the internal – on the internal expectation, I would say that, if you're thinking about that, right, we've really not upgraded or updated our revenue guidance for the year. But at the midpoint, we have taken up our EBITDA margin guidance throughout nicely and we are forecasting that we will continue to see gross margin improvements which will drive the EBITDA margin improvements in a lower volume environment. And so we are executing quite well. We are doing probably slightly better than what we've anticipated at the beginning of the year. Some things are happening right as we've anticipated. And if you think about it, we're going to be delivering in 2024 kind of margin performance both on the EBITDA and gross level – gross margin level, kind of at a historical high during an end market or volume trough.

So that's providing us with a very positive setup as we enter a more constructive volume environment kind of in the 2025 and 2026. So we are laser focused on executing on our 2026 commitments to our shareholders. We're making good progress. And based upon where I sit today and what I see from the organizational execution, I would feel much more confident that we're going to be highly capable to deliver on that objective that we set up at the CMD.

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

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

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

A

Good morning, Deane.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. Maybe just want to circle back. There's been a lot of discussion about like the tone of business and the stabilizing demand and so forth. And you've given lots of good color there. And just maybe if you can make a distinction between the demand that – on aftermarket versus First Fit. And just the idea, when you look at the slides, you're down First Fit industrial in both segments and also down First Fit industrials, North America and EMEA. So just maybe you have to dig deeper into the individual verticals, Ag, commercial construction, and so forth and just saying First Fit is not specific enough, but just how do you reflect on the First Fit all being down at this stage in a stabilizing environment?

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

A

Yeah. I would say that the First Fit is predominantly impacted by Ag, commercial construction, and Personal Mobility. Those three verticals are thriving, I would say, 95% of the First Fit performance while the replacement business is up low single digits globally. And I would say that that's driven by a very, very solid performance in AR

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in the Automotive Replacement side. So up mid-single digits and stabilizing performance in the industrial replacement, which is down, I would say, low-single digits. So you're right, you need to take a look at the puts and takes. And if you recall what I stated, I believe that the off highway is going to continue to be a headwind throughout the year. But I also believe that we can maintain strong performance in Automotive Replacement and that we will start seeing improving trends as we work through the year in the industrial replacement side of our business.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. That's helpful. And then I might have missed it, but when you talked about cadence in the quarter, how did April start off and did you – any of that Easter holiday early impacted, was that recouped noticeably in April?

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

A

So the March month was not really impacted from an order intake on the Easter side of the holiday or the Easter holiday side. It was more the shipments that were more impacted in Europe, particularly Europe and North America about – think about it again, maybe half a day of sales. So it wasn't significant, but we kind of came a shade under what we have anticipated at the midpoint at the CMD. In April, look, we continue to see choppiness.

Again, I would probably repeat myself. Commercial construction, Ag, IR came in kind of as we anticipated, steadily improving, not – no hockey stick improvement. AR remains solid. So continuation of what we have seen. So the market environment is choppy. That's the best way to describe it. You can have several weeks – [ph] and I wrote it up (00:56:17). They are very good and then you may have a very weak week of order intakes and shipments. So it's pretty much playing itself out as we are anticipating in our forecast for Q2.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you.

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

David Raso
Analyst, Evercore Group LLC

Q

Yeah. Hi. Just a couple of quick clean-ups. I don't think I heard a currency guide for the year. I'm just curious, where your head is on currency now for the year.

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Well, we don't really forecast currency, David. I mean, we just take the current rates and we use those for the balance of the year. And so I mean, I'm not going to try to predict what's going to happen with FX. That's for sure. So that's how we look at that. So whatever the prevailing rates are, when we kind of put, roll up our forecast, that's what we use for the balance of the year.

David Raso
Analyst, Evercore Group LLC

Q

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I mean, [ph] given the slightly negative (00:57:13) in the first quarter, is it drag? Is it just safe to assume that's a little bit of a drag for the year? And I mean, obviously...

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc
A

It's a drag. It's a drag to the first three quarters and then it kind of gets positive toward the end of the year, but it's a drag overall for the year, about 30 bps from the top line perspective.

David Raso
Analyst, Evercore Group LLC
Q

Okay. On the footprint optimization, can you give us a quick update where we stand with those and which are the ones that particularly when they get across the finish line, should make a difference?

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

Well, we have not quantified those at the CMD. As you know, we have a number of projects that are ongoing and we will update you at a time of completion, just like we did in China with our China project last year. But I would not think about substantial benefits until latter part of 2025, early 2026.

David Raso
Analyst, Evercore Group LLC
Q

Okay. And then lastly, I think you said not just book-to-bill above 1, but actually orders up year-over-year, right? I know the revenue's down, so book-to-bill can be above 1 and orders still down. But if I heard you correctly, you said your orders were actually up as a company year-over-year in the first quarter, is that correct?

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

That's correct.

David Raso
Analyst, Evercore Group LLC
Q

So the idea of organic being down 3.5% in 2Q, is I mean, obviously, I don't think if it was a long lead time company. It just goes back to your comment. Yeah, maybe the orders were up in the first quarter, but it's choppy enough, we can't count on converting up orders in 1Q into even flat organic for the quarter. I mean, that sort of the idea? Like the orders are moving around enough week to week, it just sort of where...

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

I think, Dave – yeah, Dave, I think that that's the right way to think about it. Look, some of the outperformance in Q1 versus prior year has been driven by some of the longer cycle projects. Think oil and gas and mining that will fill in 2024 over the next two to three quarters. Half of that was driven – half of the outperformance was driven just simply through to the shorter cycle businesses, but then you kind of see incrementally little more weakness in Ag and commercial construction. So we're just trying to balance that out. And again, I would restate that we believe that the end market environment is stabilizing, but we are not prepared to declare victory and say, hey, look, there's an inflection. And we anticipate that now that will meaningfully impact our ability to deliver top line growth

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above what we are envisaging at this point in time. Again, it's early. We are off to a very good start and we believe that the backdrop is a little more positive, but we are very pleased with where we sit presently.

David Raso
Analyst, Evercore Group LLC

Q

Well, I have a one quick one. The interest expense, I know you used your revolver a lot in 2023, so that not repeating should enable, right, your interest expense to be down. But the first quarter did come in even a little lower than I thought. Can you give us some help with how you're thinking about the full year interest expense?

Lawrence Brooks Mallard
Executive VP, Chief Financial & Accounting Officer, Gates Industrial Corp. Plc

A

Yeah. I mean, it is going to be down year-over-year. We're thinking about $150 million interest expense – GAAP interest expense for the year.

David Raso
Analyst, Evercore Group LLC

Q

Okay. Helpful. Thank you so much.

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

A

Thank you.

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

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

All right. Thank you, everyone, for joining. If you have any further questions, feel free to reach out. And otherwise, have a great rest of the week. Thank you.

Operator: Thank you. That does conclude our conference for today. Thank you all for joining. You may now disconnect.

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