31-Jul-2024

Gates Industrial Corp. Plc (GTES)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Gates Industrial Corporation Second 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'd now like to turn the call over to Rich Kwas, Vice President, Investor Relations. You may begin.

Rich Kwas

Vice President-Investor Relations, Gates Industrial Corp. Plc

Good morning and thank you for joining us on our second 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 will be followed by Brooks Mallard, our CFO. Before the market opened today, we published our second quarter 2024 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 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

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

Later this quarter, we will be attending with the Jefferies Industrial Conference and Morgan Stanley's 12th Annual Laguna 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. Also, please note that we have recast our adjusted EPS figures for 2023 and year-to-date 2024 using a normalized adjusted, effective tax rate. Historically, many non-recurring individual items have influenced our effective tax rate. To minimize quarterly volatility and better reflect our core operations, we've chosen to remove discrete items from our adjusted effective tax rate and recast historical earnings to provide an apples-to-apples comparison. We believe this approach will be beneficial to our investors and analysts, and please see the appendix for more information.

So, with that all out of the way, I'll turn it over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Rich. Good morning, everyone. We'll start on slide 3. Today, we reported solid Q2 results delivered through focused execution by our entire team of Global Gates associates. In the second quarter, we saw our revenues moderate 4% from the prior year on a core basis. First Fit sales decreased more than anticipated, reflecting the present underlying business conditions. As we anticipated, demand in our Industrial end markets remained somewhat soft. However, we experienced incremental demand weakness in Agriculture and in Construction applications.

Replacement revenues grew 1% with Automotive outpacing Industrial book-to-bill and is slightly below 1. We delivered a solid increase in our adjusted EBITDA margin while managing through a softer volume environment. Our adjusted EBITDA margin grew by 170 basis points. Strong gross margin expansion underpinned the improvement. Gross margin benefited from favorable channel mix compared to the prior year period, as well as continued progress with our enterprise initiatives. Our net leverage ratio declined to 2.3 times, a one half turn reduction relative to last year's second quarter.

During the quarter, we refinanced our term loans and unsecured bonds at attractive rates and extended our earliest maturity to the end of the decade. We are trimming our guidance due to the extended softness in our Industrial First Fit markets, particularly Off-Highway. Our updated revenue guidance is consistent with our historical seasonality. Brooks will provide more color and comments about our updated assumptions later in the presentation.

Of note, last week, our board of directors authorized a new $250-million share repurchase authorization that expires at the end of calendar 2025. The authorization provides us with an efficient tool to return capital to our shareholders opportunistically.

Please turn to slide 4. In the second quarter, we posted revenue of $886 million, a 4% decrease on a core basis. Replacement revenues grew slightly and outperformed First Fit revenues. The Industrial end markets primarily drove the decline in First Fit. At the end market level, Construction and Agriculture were most impactful to the Industrial First Fit revenue performance.

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Adjusted EBITDA was $202 million and represented a margin rate of 22.8%, an increase of 170 basis points. The increase was fueled by a 270-basis points increase in gross margin. The execution of our enterprise initiatives continued to deliver improved operating performance. In addition, the higher mix of replacement revenues, which generally carries above average margin relative to our corporate average, supported the increase in gross margin.

We also benefited from inventory builds related to our anticipation for gradually improving demand trends in the second half, as well as to support product line expansion with a new and existing customer. Adjusted earnings per share was $0.36, which represented a 6% increase. Higher operating income and lower share counts drove the growth.

On slide 5, we will review our segment performance. In the Power Transmission segment, our revenues were $542 million, which translated to 3.5% decrease on a core basis. The replacement channel grew 1% with Industrial Replacement growing modestly and Automotive Replacement being about flat. First Fit revenues decreased double digits, impacted by a mid-teens decrease in Industrial First Fit. Automotive First Fit was also down due to softer production trends in international markets. The majority of our end markets in Power Transmission decreased low to mid-single digits.

Personal Mobility revenues continued to decline, although the rate of change is starting to moderate. Energy and On-Highway revenues posted growth, led by solid expansion in our developed geographies.

With regards to top, line opportunities during the quarter, we secured an agreement to extend our market presence with a national replacement channel partner that we anticipate will begin to meaningfully ramp early next year. The new business broadens our market reach for our mission critical products.

Power Transmission's adjusted EBITDA margin expanded 210 basis points. The margin improvement was led by contributions from our enterprise initiatives, as well as favorable channel mix, partially offset by lower volumes.

Our Fluid Power segment generated revenues of $344 million. Core revenues decreased 5%. Industrial First Fit declined mid-teens, driven by weaker activity in Agriculture and Construction. Industrial Replacement sales declined at about the same rate as the overall segment. Automotive Replacement was a partial offset, increasing low-double digits.

Similar to Power Transmission, we have reached an agreement to extend our partnership with one of our largest replacement channel partners to drive product conversions [ph] to Gates (00:09:50) mission critical components in an important US Geography. This is an exciting opportunity that broadens our ability to more efficiently serve our customers. Additionally, in the data center space, we are now specified with multiple customers and are in discussions with several servers and chip manufacturers to support their application needs.

I will now turn the call over to Brooks for additional comments on the quarter. Brooks?

Lawrence Brooks Mallard

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

Thank you, Ivo. Let's turn to slide 6, which shows our core revenue performance by region. In North America, core revenues declined approximately 4%. Industrial channel core revenues fell high-single digits, primarily due to a double digit decrease in First Fit. North American Industrial Replacement revenues increased slightly. Within Industrial, the Agriculture and Construction markets were our softest end markets while Personal Mobility was

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down double digits. Energy and Commercial On-Highway increased modestly. Automotive grew low-single digits, with replacement revenue growth slightly stronger than First Fit.

In EMEA, core revenues fell about 7%. Solid demand trends in the Industrial markets weighed on the region's core top line performance. Both Industrial First Fit and replacement core revenues fell double digits. Core revenues in Automotive were about flat, with Automotive Replacement growth offsetting a decline in First Fit.

China core revenues decreased modestly. Automotive experienced a decrease driven by First Fit applications. Automotive Replacement increased low-single digits. Our Industrial revenues increased modestly, supported by solid growth in our replacement channel. In South America, core revenues decreased slightly, with meaningful declines in the Industrial First Fit markets largely neutralized by growth in replacement channels. East Asia grew slightly, with Automotive growth more than offsetting an overall decline in the Industrial markets.

On slide 7, we lay out the key drivers of the year-over-year change in adjusted earnings per share. Operating performance contributed approximately $0.01 of growth and a lower share count represented another $0.01 of growth. Higher taxes were offset by lower interest expense.

Slide 8 has an update on our cash flow performance and balance sheet. Our free cash flow for the second quarter was $67 million, which represented free cash flow conversion of 70%. Our trade working capital in dollars increased slightly relative to last year's second quarter, primarily due to inventory build to support the new business and our channel partners Ivo highlighted earlier and to protect the service levels for our existing customer base. We intend to reduce our inventories in the second half of the year, in line with our normal seasonality. Our net leverage ratio finished at 2.3 times, which is one half a turn lower than the second quarter of 2023.

During the second quarter of 2024, we refinanced our term loans and unsecured bonds at an attractive blended rate that lowers our annualized interest expense. In addition, our nearest debt maturity is now 2029. Our trailing 12-month return on invested capital expanded approximately 250 basis points to 23.1% and was primarily fueled by higher margin. We believe our balance sheet is in solid shape and we intend to remain opportunistic returning capital to shareholders.

Shifting now to our updated 2024 guidance on slide 9, where we have trimmed our 2024 guidance. We have lowered core revenue expectations to a range of minus 4% to minus 2% from our prior range of minus 3% to plus 1%. At the midpoint, we now expect our core revenues to be down about 3% compared to a midpoint of down 1% previously.

The majority of our markets have performed as we had anticipated heading into the second half of the year. However, Industrial First Fit demand trends have gotten softer in certain areas, most notably in Agriculture and Construction. In addition, while it's a relatively small end market for us, automotive OEM production trends have softened recently. We are now seeing more extended levels of summer shutdowns from the automotive OEMs.

We are reducing our adjusted EBITDA guidance to a range of $740 million to $770 million. The $755-million midpoint is $20 million lower than our prior guidance, with the headwind from lower volume and foreign exchange being partially offset by execution on our enterprise initiatives. Our adjusted earnings per share range is now $1.29 per share to $1.35 per share and incorporates our new tax methodology. Our guidance for capital expenditures and free cash flow conversion remains unchanged.

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For the third quarter, we expect revenues to be in the range of $825 million to $855 million. At the midpoint, we anticipate core revenues to decrease approximately 2% year-over-year. We estimate adjusted EBITDA margin to decrease about 40 basis points year-over-year at the midpoint.

On slide 10, we walk from our prior adjusted earnings per share guidance to our updated guidance. From left to right, we project about a $0.03 impact from lower operating income, with the unfavorable impact of lower sales volumes partially offset by enterprise initiatives. The costs associated with accelerated new business conversions is approximately $0.02 per share. We expect incremental growth and profitability from this investment to begin in Q1 of 2025. Unfavorable FX approximates about a $0.02 per share headwind. Lower interest expense, higher tax and other items net to about $0.03 of adjusted earnings per share benefit.

With that, I will turn it over to Ivo for some summary comments.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. On slide 11, I will summarize our key messages before we take your questions. First, I am pleased with our operating performance in the first half of 2024. Year-to-date, we have increased our adjusted EBITDA margin by 250 basis points year-over-year while encountering a 4% decrease in core growth. We are making good progress with our enterprise initiatives, particularly in the area of material cost reduction. Our heightened focus over the last couple of years on our resident material science capabilities has paid nice dividends for us.

We fortified our supply chain capabilities and reduced exposure to single sourced, highly engineered polymers. Also, we accelerated our ability to drive material savings through re-engineering of critical materials and components and expect more savings to come. Now, we are benefiting from our engineering focus in terms of developing new product lines that enable us to enter exciting secular growth markets.

From driving a change in the way Personal Mobility devices are designed and built to developing new fluid conveyance technologies that offer more efficient cooling solutions for hyperscale data centers, our focus is on opportunities to accelerate our organic growth while we are managing through the present macro environment.

Given how Industrial demand has unfolded this year, we have decided to pull forward our footprint optimization plans outlined during our Capital Markets Day and initiate a number of these projects in 2024. We anticipate the annualized savings associated with the actions will approximate $40 million, with about 40% of the run rate realized by the end of 2025 and the balance of the savings achieved by year end 2026. We intend to share more specifics on the program's execution plan and impact on the business on next quarter's call. We believe these actions will improve our manufacturing and logistics efficiencies long-term and enhance our ability to flex our operations to demand changes.

In our view, the enterprise initiatives underway and investments being made should position the company to generate stronger profitability from an already solid levels when the next Industrial upturn takes hold. Second, our optionality to enhance shareholder value continues to build. Our net leverage ratio is in the low 2s and tracking to the 2 times level by year end. We recently extended our debt maturities and lowered our annualized financing costs.

We remain highly focused on balance sheet improvements, which should enable us to more actively pursue inorganic growth initiatives over the mid-term. Last week, our board of directors approved a new $250-million share repurchase authorization, which replaces the $50 million left under our prior authorization. At our current

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valuation, we believe opportunistically deploying capital towards our shares is an attractive use of our excess capital.

Before taking your questions, I want to convey my gratitude to the almost 15,000 Global Gates associates for their commitment and dedication to achieving our business priorities and making our customers' expectations.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Mike Halloran from Baird. Your line is open.

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

Q

Hey. Good morning, everyone.

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

A

Good morning.

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

A

Good morning.

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

Q

So just some thoughts on the end markets where you're seeing some pressure. Maybe just talk through what you saw through the quarter if you're seeing stabilization, I mean, levels at lower levels here and maybe the outlook from your perspective on when you start normalizing some of those end markets.

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

A

Yeah. Thank you for your question, Mike. Look, I mean, I think that the end markets have been developing more or less in line with how we have envisaged that it's going to play out. And as you may recall, we were reasonably muted about our expectations for any type of Industrial recovery. But as we went through the quarter, what we have seen is that particular in the Off-Highway applications in the Industrial First Fit business, again, I would say expressed by predominantly Ag and some commercial Construction applications. We have seen deceleration that kind of crept in towards the latter part of May and remained in June. And I'll note that it remains weak in July as well. And that would be probably the most notable change that we have seen.

I'd say that some of the auto OEMs have been layering in some reductions in car builds. And again, if I comment on July, I'd say that they have extended their summer shutdowns to be a little bit longer than we have seen maybe over the last four or five years. And so, those would be probably the most notable changes that we have seen. And frankly, I do not anticipate that this is going to reverse in second half. And that's why we've taken the

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proactive step and reflect what we believe is going to be the underlying environment, particularly in the Industrial First Fit.

Now, what's changed maybe from prior assumptions? Again, I would say that pretty much as we anticipated, Mobility we think has bottomed out in Q2. While we still anticipate that we're going to see negative core growth into second half, it's – the underlying market conditions are improving. We think the destocking has played itself out and we should start seeing reacceleration of growth into 2025. So, that again is playing out the way we anticipated. And maybe China Industrial Replacement performance was around the edges a little bit better than what we've anticipated, but that's not really a massive amount of revenue that had the opportunity to offset how we think about the market.

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

Q

Great. It's really helpful. And then on the margin line, if you look at the commentary for the third quarter, margins down a little bit year-over-year. I'm guessing that has everything to do with the demand environment and you're still very confident in the changes and the normalization you're seeing, the internal efforts. So, maybe as you look to the third quarter or the back part of the year, you can talk a little bit about confidence in that, trends and what you're seeing internally, and if there's any change in how you're thinking about some of these internal things in the short-term.

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

A

Yeah. Thanks for your question, Mike. No, I think – look, I think we're really – we feel good about our enterprise initiatives and how they're driving improvement on the gross margin line. I mean, we expect some headwind on EBITDA margins from SG&A just because it's kind of flattish or lower volume. But we expect to be able to maintain kind of our gross margin outlook even with lower volumes.

And as we take out a little bit of inventory and we look at some of the conversion costs that we have talked about for some of the new business wins, we expect the enterprise initiatives to be able to offset that as we go through Q3 and Q4. So, the enterprise initiatives are working on the material line – on material savings line, especially we're doing well. And so, we feel good about where we stand from a gross margin perspective in the second half of the year.

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

Q

So, no change in the internal confidence and the change initiatives that you're driving currently, and this is just demand related, correct?

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

A

That is correct. And I would actually say, Mike, that we're doing really well with our enterprise initiatives and as you could see in the gross margin and EBITDA margin performances. So, as the market start – I mean, the underlying market trends start to recover, we feel like we have – we're starting from an incredibly strong position, better than we have ever been historically. And I feel there's a high degree of confidence that – taking into account, again, we've been over 40% gross margin on a really negative market backdrop in Q2. So, I feel quite well that we are incredibly well-positioned to deliver on [indiscernible] (00:27:13).

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

Q

Makes sense. Appreciate it. Thank you.

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

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

Q

Hey. Good morning, guys.

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

A

Good morning, Jeff.

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

A

Good morning.

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

Q

Hey, maybe you could just unpack the wins you talked about with the major partner in each segment. Is that the same partnership? And just how is it getting broadened out and how much of an impact, if it's material, do you see it impacting 2025, I think you said?

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

A

Yeah, absolutely. Thank you for your question, Jeff. So, I would say that on the Fluid Power side, that is with one of our largest existing customers. We are just broadening out where we serve and how we serve them. And it's in one of the large critical geographies that we're going to become a prime supplier to them.

And on the Power Transmission, that's actually a new customer acquisition that we historically did not do business with. And as this ramps up kind of over the next 18 months, it's going to be reasonably material that will – we anticipate that it will add 100 basis points to 150 basis points of revenue to Gates Corporation. So, it's meaningful – two meaningful design wins. And we felt that it was worthwhile to go and pull forward some of the activities and get them into Q4 so that we can start seeing the benefits from 2025 onwards.

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

Q

Okay, that's great news. And then I think you said you're seeing some forward weakness on First Fit Auto, maybe just speak to the replacement trend and if you think there's any offsets as maybe people defer new purchases.

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

A

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Yeah. Look, I mean, we just see more extended shutdowns. So, I'm not going to be calling for what the production output is going to be on the auto OEM side on a forward basis. That has been more or less playing the way that we've anticipated. We just did not see that they're going to take an extended shutdown in July.

As to the replacement side of our business, the market dynamics are very, very positive there. The car fleet is getting older around the globe. It's growing at kind of that low-single digit rate. People still have high degree of employment, so they are driving a large amount of miles. So, the underlying market dynamics just even without the attribute associated with lower purchasing of new vehicles is very, very positive. And we believe that we are well positioned to continue to execute well in AR. And as you saw, it was a great driver of our growth for the last four, five, six quarters and we anticipate that that is going to continue well into the future.

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

Q

Okay. Appreciate the time.

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

A

Thanks, Jeff.

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

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone.

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

A

Good morning, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Good morning. Good morning. So, look, when you think about – obviously, you're still more or less within to your previous range, albeit at the low end. But when we think about where we were in April versus where we are now, what would you say is the biggest delta in your thinking? Obviously, auto production – Auto First Fit is clearly weaker than it was. But Off-Highway – would you say Off-Highway is the biggest move here or is it much broader than that?

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

A

Yeah. Look, I think – thank you for the question, Nigel. I would say that the biggest issue that we have seen was with the Off-Highway demand, particularly in Ag. I mean, Ag has weakened materially more than what we've anticipated. Look, we were not very constructive on Ag already in our original guidance. But what we are seeing is – we are seeing, again, extended shutdowns of plants, significant reduction in builds of new equipment by the ag OEs. And we just felt we needed to reflect that in our guidance – on forward guidance because it is – it's reasonably – I mean, it's a reasonably good amount of production that's come out.

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Outside of that, look, we didn't really anticipate that there's going to be a V-shape recovery in General Industrial. We are anticipating more flattening out of demand. And I think that's kind of around the edges what is happening there. I mean, it's choppy. There's some puts and takes. But overall, I would say is the Off-Highway incrementally worse. And I would say that some of the extended shutdowns of the other OEMs in July that we have seen we just did not really anticipate that that's going to be broader or deeper than what we have embedded in our original guide.

So, overall, while we are taking our revenue down, we are still anticipating kind of at the midpoint that even with reasonably kind of a low, mid-single digit drop in volume year-on-year for the full year, we are still anticipating at the midpoint to grow our earnings – our adjusted EBITDA by 100 basis points. And that's kind of the second year in a row that we are managing to do that on the back of very strong execution of our enterprise initiatives and drive to demonstrate the earnings power that this business has.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. That's great color. Thanks, Ivo. And then are we seeing – it certainly looks like replacement demand across your portfolio, Industrial, Auto, et cetera, is holding up really well. So, just want to make sure that there's no changes in conditions that you're seeing there. And then maybe pricing as well, are we seeing any pockets of price weakness developing with some of this incrementally weaker outlook?

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

A

Look, the rest of the business is more or less performing very much in line with what we anticipated. And again, I'll remind everybody, we did not really anticipate a second half recovery. We just did not anticipate it will be decelerating. And so, absent of the Industrial OE applications, it is playing itself out more or less as we have anticipated in our original guidance. And I'll let Brooks answer the pricing question.

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

A

So, from an inflation perspective, it's a little bit of a mixed bag material. Pretty – pretty flattish from an inflation perspective, a little bit better on utilities, a little bit worse on freight. Labor is kind of sticky. But between our normal pricing actions and then the additional 80/20 work that we've done in terms of strategic pricing and optimized pricing, we don't see – we see the pricing environment remain stable to slightly constructive as we move forward. So, we don't see any headwinds from that.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. That's great. Thank you.

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

A

Thanks, Nigel.

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

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Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Yes, I realized that the 2024 guidance adjustments, we can see that clearly from the likes of [indiscernible] (00:35:28) and so forth. But I wondered more for 2025. What's your perspective either on the sort of the slope of recovery we should expect in some of these weaker areas like Auto First Fit or Off-Highway First Fit or General Industrial? And I guess one reason I'm asking is you've pulled forward this $40 million of savings program, a chunk of those savings, $15 million to $20 million or so coming next year. Is that reflecting the fact that you don't assume a sharp cyclical recovery is likely as you look across the business into next year?

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

A

Yeah. Look, I'm not going to get to the specifics of 2025. I mean, clearly, we are having some lack of clarity even on some of the shorter trends that are happening. But the way that I think about it, Julian, is we have seen reasonably extended deceleration in manufacturing activity over the past couple of years. I mean, that's been pretty prolonged. When we all look at the [ph] PMI rates and manufacturing PMI rates (00:36:45), they have been quite extended at 18 to 20 months range, which is highly unusual. And if you kind of think about that, you would anticipate that you are at or near the bottom of the cycle. And while I'm not clearly here to predict what's going to happen vis-à-vis the Industrial activity, we do believe that we are probably somewhere near bottoming out.

My anticipation on the Industrial First Fit, particularly on the Ag side, is that you will see some degree of more prolonged weakness. And frankly, we have had a number of our restructuring programs on a book ready to be executed, and we are taking the opportunity to do that right now. We have represented, I think, a pretty good outline of the structural opportunities that we believe exist for us vis-à-vis footprint optimization at the Capital Market Day update. And we clearly had that playbook ready to go and pull forward and that's what we are doing presently.

And we are not taking really capacity out. We're just optimizing how we will service our customers, try to get to locations that have a better access to direct labor, optimize our efficiency of distribution, and deliver rather meaningful improvement to our operating profitability when these projects are executed.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's helpful. Thank you. And then just maybe my follow up, one is just wanted to drill a little bit down into that margin element again. EBITDA margin, I think you guided down about 100 basis points year-on-year in the back half after a 200-basis point-plus increase in the first. And the revenue trajectory year-on-year doesn't look that different.

So, is there something in – I think mentioned SG&A investments, but just wondered if there was anything else moving around in terms of mix or price/cost dynamics. And maybe something tied to that to sort of free cash conversion, I think in the teens in the first half, what's the confidence in the step up to get to 90% for the year?

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

A

Yeah. So, on the – well, let me unpack the first one first. There's kind of three elements I think in the margins. One is FX. FX has been a bigger headwind as we move through Q2 and it's now a bigger headwind in the back half of 2024 than we had anticipated.

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And then, I think the other two pieces that we had already talked about is, one, we are going to draw down some inventory in the second half of the year. We had built up some in anticipation of some of these business wins and also to make sure we could take care of our customers, and now we're going to make sure we align our inventories. As we exit the year, that's obviously going to weigh on production. That's going to weigh on our fixed cost absorption and things like that.

And then the third part is the new business win conversions. I mean that's a cost. There's a merchandising cost. There's an inventory change out cost, and there's going to be a headwind year-over-year as well. So, those are the three elements, really.

On the SG&A side, it's really more of just a volume versus SG&A perspective. I don't think SG&A is going to be that different year-over-year. There's going to be less volume. So, it's going to be – it's going to weigh on your margins a little bit from a percentage perspective.

From a cash conversion, we're actually not that far off when you look at 70% conversion in Q2. Historically speaking, we have really strong cash conversion last year, right? Historically speaking, that's not that far off between kind of the seasonality of some of the cash flows coming in, particularly with the higher sales in the first half and collecting the cash on that in the second half. And then the inventory drawdown that I talked about, we feel confident that we'll be able to deliver that 90% cash conversion in the second half.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks so much.

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

A

Thanks, Julian.

Operator: Your next question comes from the line of Deane Dray from 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 Vice President & Chief Financial Officer, Gates Industrial Corp. Plc

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, Ivo. I might have missed this. I joined a little bit late. But can you just talk through the thought process of moving up the pull forward of the repositioning, restructuring actions? That's typically a good sign to – if you have

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the plan go ahead and start to implement it. And in your answer, does 80/20 provide any of the insights in terms of what changes that you'll be making?

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

A

Thanks for the question, Deane. Yeah. So, look, we've represented during the March Capital Market Day that we have a good solid plan, that we are ready to execute and we just feel the – two attributes. Number one, we are ready to go and pull forward the optimization activities, and so we are doing that. Those programs are ready to be executed and ready to be put in place. And we are putting them in place as we speak.

We are really pulling those activities forward by about two quarters. So, it's not like we have pulled them forward by couple of years or anything like that. Some of these programs are longer term, reasonably complex projects, and we ordering equipment and doing things of that nature so that will – that's kind of the attribute that's necessitating the completion of this project kind of by 2026. So, from that vantage point, we are in a good place.

On the 80/20 question, I mean, we look at the 80/20 more as a kind of a separate set of programs that are giving us the opportunity to optimize how we think about manufacturing, scheduling and optimizing output within the plants. And I think what that's doing for us, it's giving us also an opportunity to become significantly more efficient as we move forward. So, those are kind of complementary processes, not necessarily one leading the other. They're just complementary in nature. And so, [ph] we're executing them both (00:43:51).

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good to hear. And just a couple updates, I know it's still a small piece of the business. Anything new on the data center front in the water pumps and any new developments on chain-to-belt?

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

A

Yeah, thank you. On the data centers, look, this is really quite an interesting, I mean, space from our vantage point. First of all, very, very early on, lots of changes. People are still trying to figure out what is the most efficient technology to deliver a cooling to these very, very expensive apparatus that is being deployed in this environment. And presently, we are actually in process of launching some really interesting new fluid conveyance technology that specifically targets this application but also lead itself to be deployed across pretty broad set of other industrial fluid conveyance applications. It is very exciting what we are able to do

The specific actions there are rather difficult, right? You have to be metal free. You have to be halogen free in your construction, which is not a trivial set of things to accomplish in the space that we participate. We've been able to develop a new technology that is based on engineering new polymers that give us the opportunity to eliminate nitriles and deliver real differentiation in this space. So, it's quite exciting.

We are presently working with significant number of server manufacturers and chip makers to get specified in the space as their preferred partners. We have very close coordination with our partner in CoolIT. We are extending our abilities to offer other solutions beyond the cooling pumps. And we have been able to get specified with a large manufacturer that we anticipate we will be ramping up some incremental volume towards the latter part of this year and early into next year.

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So, lots happening. A lot is changing there. We are right in the middle of dealing with the major players in cooling. I think that our solution is targeting very efficient and good price point entry in the marketplace. But we also believe that this is going to be a game that's going to be played over several years as these folks are truly understanding the extent of the power, how to remove the power from this service and these chips, and how to protect that equipment. So, very, very exciting stuff.

Coming back to the second part of your question, I'll start with Personal Mobility in particular. Personal Mobility has been impacted by pretty significant destock. Put that aside for a second. That plays itself out. And as I indicated in my prepared remarks, that is playing itself out the way that we anticipated, and then we believe that kind of on the onset of 2025 we will start seeing reacceleration of our growth. We continue to get very strong print position with the manufacturers of these various two-wheel applications [indiscernible] (00:47:47) scooters. It's electrified or non-electrified, we're getting very strong print position across the bike market segment, both with electrified application and non-electrified application. We're now starting to penetrate more broadly in North America, starting to enter more mid-price bikes. And that's really exciting for us.

So, we have a very high degree of confidence that that business is going to start reaccelerating and continue to deliver the growth that we've anticipated kind of from 2025 onwards. So, that's a really nice secular opportunity for us as well.

And then on the Industrial side, we are doing really well with robotics in Asia, with some food processing equipment in Asia. And we continue to work on broader set of conversions in United States. And we are making some investments in the front end. We believe that it is critical for us to be a real major player with the MOEMs, both in the US and in Europe. And that investment is being made us as we speak.

So, very positive developments on our end. Some of them, again, will play themselves out kind of over that 2025 onwards. But we have a very good set of confidence that this is an opportunity. Both of these opportunities are kind of opportunities for the next 10 to 20 years.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

It's a great update. Thank you.

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

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, everyone.

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

A

Good morning, Andy.

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

A

Good morning, Andy.

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Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, can you give us a little more color into what you're seeing by region and specifically China? China shifted back to a year-over-year decline. I think you said led by First Fit, but you mentioned the double digit improvement in Industrial Replacement. So, can you help us make sense of what's going on over there? Does Industrial Replacement picking up tell you that First Fit can't be far behind?

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

A

Yeah. So, thank you for your question, Andy. And look, I mean, I think I also said in my prepared remarks that China remains choppy. I mean, it's been really interesting to see how uneven the environment is. And frankly, it's not just in China. It's globally, right? I mean, you have seen really kind of nice rebound in March into April and then you see some of the trends to reverse themselves. So, it's a very, very uneven and almost less predictable type behavior.

But specifically to China, let's say, that's what's happening. It's reasonably uneven. AFFO is down reasonably well for us in China in Q2. And the forecasted production in the Auto space for China is still reasonably negative, high-single digits down for the second half. So, we anticipate that that's kind of the way it's going to play itself out. Maybe around the edges could be a little bit worse than that.

But for us, we did see rebound in Industrial Replacement side of our business, not necessarily enough to offset the diversified – sorry the Construction side and Ag in China. While those are reasonably small, overall, Industrial was kind of less positive, I guess, than what you would anticipate. But the replacement side of the business is doing quite well. AR in China is still doing well. The market dynamics are quite positive. And we don't really see a trajectory of change in AR for our business in China.

So, China is probably not going to be the massive engine of growth that it has been historically. I mean, the economy has matured. And [indiscernible] (00:52:17) cycles that everybody else is seeing. And as they start figuring out what they want to do to stimulate the economy, things should be on better footing at some sometime in the future.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Ivo, I wanted to follow up on your comments that maybe we're sort of bouncing along the bottom in terms of Industrial. Maybe you could talk about inventories in the Greater Industrial channels and what your channel partners are saying. I'm sure you would say that Ag and Construction probably still doesn't look great in terms of inventory, but what about the other Industrial markets? What are you seeing there in terms of channel inventories and conversations?

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

A

Andy, you gave me your answer. That's exactly what I would say. Look, I mean, we believe that the Ag and Commercial Construction inventories are going to be probably somewhat impacted, taking into account the slowdown that you see. But the rest of the inventories, we believe are pretty reasonable. We don't really anticipate that you're going to continue to see any further destock taking into account that these markets have been bouncing kind of around the bottom for an extended period of time and folks have been reasonably proactive in in

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destocking for an extended period of time. So, absent the Ag in particular, we think that inventories are well positioned.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate the color.

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

A

Thanks, Andy.

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

Q

Hi, guys. It's [ph] Clay (00:54:03) on for Jerry. Just one quick one for me and apologies if I missed it. But on the previously outlined 2% benefit from material cost reductions, how much of that have we been able to realize so far and what's the time line to realizing those benefits moving forward? Thanks.

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

A

I don't believe that we have we have clarified what exactly is the extent in terms of percent of improvement. I would just say that we continue to execute well on material cost savings, and we don't anticipate any changes to our ability to go and continue as we move into the future.

Q

Thanks. I'll pass it on.

Operator: And that concludes our question-and-answer session. I will now turn the call back over to Rich Kwas for closing remarks.

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

Thanks everybody for participating. If you have any follow up questions, feel free to reach out. Have a great day.

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

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