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Gates Industrial Corp. Plc (GTES)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. My name is Brianna, and I will be your conference operator today. At this time, I'd like to welcome everyone to the Gates Industrial Corp. Q3 2024 Earnings Call. Please note that this call is being recorded. At this time, all participants are in a listen-only mode. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I will now turn the conference over to Rich Kwas, VP, Investor Relations. Please go ahead, sir.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

Greetings and thank you for joining us on our third 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; will be followed by Brooks Mallard, our CFO.

Before the market opened today, we published our third 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 include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed in or implied by such forward-looking statements. These risks include, among others, matters that we have described in our most recent annual report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements.

Later this quarter, we will be attending the Baird Global Industrial Conference, the UBS Global Industrials and Transportation Conference, and the Goldman Sachs Industrials and Materials Conference. We look forward to meeting with many of you. Please – before we start, please note all comparisons are against the prior year period unless stated otherwise.

Now, I'll turn the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Rich. Good morning, everyone. We'll begin on slide 3. In the third quarter, our team continued to execute well and delivered solid profitability improvement, while encountering soft demand in certain industrial end markets. We experienced about a 4% decline on a core basis, primarily driven by weaker demand in the agriculture, construction, and personal mobility end markets.

Total replacement sales increased 1%, led by modest growth in automotive replacement, while sales to OEMs declined in the low double-digit range. Book to bill ended slightly above 1. We generated a 30 basis points increase in adjusted EBITDA margins. The improvement was fueled by a 110 basis point increase in our gross margin. Gross margin benefited from ongoing advancement of our various enterprise initiatives, which include pricing actions and productivity.

In addition, channel mix was favorable. These factors more than offset the impact of volume weakness during the quarter. Our net leverage ratio declined to 2.4 times from 2.6 times in the year-ago period, supported by a lower debt balance and improved profitability. During the quarter, we returned capital to shareholders via a \$125 million share repurchase. We have updated our 2024 guidance raising our adjusted EPS midpoint to \$1.35. We have maintained our full year 2024 adjusted EBITDA midpoint of \$755 million and narrowed that range. Brooks will touch a bit more on our guidance later in the presentation.

So, now, please turn to slide 4. In the third quarter, we produced sales of \$831 million, which was a 3.8% decrease on a core basis. Replacement sales grew slightly. We continue to see durable demand trends in our global automotive replacement business. OEM sales decreased, primarily affected by lower demand in ag, construction, and personal mobility. Our key Asian geographies and South America generated core sales growth, the bright spot in the quarter.

Adjusted EBITDA was approximately \$183 million, which translated to a 22% margin and an increase of approximately 30 basis points. The improvement was led by 110 basis point increase in gross margin, driven by efficiencies from our enterprise initiatives, as well as an increased mix of replacement sales, which carries higher margins compared to our fleet average.

SG&A was higher due to increased spending associated with investments in our strategic initiatives and unfavorable FX. We believe we are making appropriate SG&A investments to improve the enterprise growth algorithm for the long term.

Adjusted earnings per share was \$0.33, which was 8% lower versus the year prior. Operating income was approximately a \$0.03 headwind, which was impacted by the lower core sales performance. We managed our operations well in the weaker sales environment. The year-over-year decline in adjusted EBITDA compared to the year-over-year decline in sales measured 16%, better than normal performance, aided by our execution on a companywide enterprise initiatives.

On slide 5, we will review our segment performance. In the Power Transmission segment, we generated sales of \$513 million, which represented an approximate 3% decrease on a core basis. The replacement channel was up year-over-year, backed by the modest growth in automotive replacement. OEM demand stayed under pressure with both industrial and automotive experiencing decline in the low double-digit range. Broadly, we saw declines across our end markets in Power Transmission, diversified industrial, and automotive benefiting from good replacement activity were the most resilient end markets as both posted low single-digit decrease in core sales.

Ag and construction demand remained muted. Personal mobility remained a headwind for growth, but the sales base has stabilized, and inventories at the mobility manufacturers are trending lower. We expect inventory levels to normalize by year end and believe the business is well positioned for growth in 2025. Power Transmission's adjusted EBITDA margin expanded 30 basis points. Gross margins expansion drove the increase, led by contribution from our enterprise initiatives, as well as favorable channel mix, partially offset by lower volumes.

In the Fluid Power segment, our sales were \$317 million. On a core basis, sales decreased just under 5%. The replacement business grew modestly, led by automotive replacement which grew mid-single digits. Industrial replacement core sales performance was relatively flat. Industrial OEM sales declined mid-teens on a core basis, driven by continued demand pressure in ag and construction. Despite lower volumes, Fluid Power EBITDA margins expanded 20 basis points due to the progress with our enterprise initiatives and a higher replacement sales mix. Additionally, as a part of our footprint optimization initiative announced in March at our Capital Markets Day, we have commenced projects that will predominantly impact our Fluid Power business, and should be a nice contributor to profitability in 2025 and beyond, all else equal.

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

Lawrence Brooks Mallard

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

Thank you, Ivo. I'll begin on slide 6 and discuss our core sales performance by region. Our key Asian geographies and South America grew, but that was more than offset by demand weakness in North America and EMEA. In North America, core sales declined approximately 6%, driven by weaker OEM sales trends. Industrial OEM channel sales declined double-digits, with the agriculture and construction end markets most impactful to our performance, followed by mobility. We also experienced weakness in automotive OEM with sales down mid-single digits. North American replacement channel sales remained resilient, bolstered by low single digit growth in automotive replacement and with flat sales performance in industrial replacement.

In EMEA, core sales fell just over 6%. Overall macroeconomic pressure impacted the region's top line performance. Both industrial OEM and replacement core sales fell double digits, driven by declines in energy, construction, and diversified industrial. Automotive OEM sales were down double-digits, which was mostly offset by a mid-single digit growth in automotive replacement.

China core sales grew modestly and benefited from strength in the industrial end markets, which expanded double digits. Construction, diversified industrial, and personal mobility were significant contributors. The growth was partially offset by a high single-digit decline in automotive, driven by OEM demand softness. Automotive replacement declined slightly.

South America and East Asia and India both posted low-single digit growth in core sales. Automotive outperformed industrial in both regions, with industrial OEM sales down modestly. Replacement channels outperformed OEM channels.

On slide 7, we lay out the key drivers of the year-over-year change in adjusted earnings per share. Operating performance represented a \$0.03 per share headwind, driven by the year-over-year core sales decline. Favorable interest expense and other items including a lower share count offset a higher adjusted effective tax rate.

Slide 8 provides an overview of our cash flow performance and balance sheet metrics for the third quarter. Our free cash flow was \$88 million, which was – which represented 101% conversion to adjusted net income. Trade working capital increased on higher inventories and a higher mix of automotive replacement receivables. We built incremental inventory to support the new auto replacement business we announced last quarter. In addition, while industrial market activity currently remains subdued in our most important geographies, we believe we are nearing a trough.

Given our short cycle demand characteristics, we are positioning the business to capitalize on a potential recovery and support superior customer service levels. Our net leverage ratio was 2.4 times at the end of the quarter, which was a 0.2 times improvement compared to last year. The combination of a lower debt balance and improved profitability contribute to the result. We are well positioned to deliver our 2026 target of 1 times to 2 times net debt to adjusted EBITDA. As a reminder, as a result of our recent debt refinancing, we have no debt maturities until 2029. Our trailing 12-month return on invested capital was 22.3%, a 70 basis point increase and supported by the increase in adjusted EBITDA margin.

Shifting to our updated 2024 guidance on slide 9, we have increased our adjusted earnings per share guidance and narrowed our adjusted EBITDA guidance range, while reiterating the midpoint. We believe our full year 2024 core growth will be in the range of minus 4% to minus 3%, which is in the lower half of our prior guidance range. We have narrowed our adjusted EBITDA guidance to a range of \$745 million to \$765 million. The \$755 million midpoint is consistent with prior guidance. We have increased our adjusted earnings per share range to \$1.33 per share to \$1.37 per share, a \$0.03 increase at the midpoint. Our guidance for capital expenditures and free cash flow conversion remains unchanged.

On slide 10, we show our updated earnings per share wall for 2024. From left to right, we project about a \$0.01 per share benefit from operating income, which is offset by higher interest expense. Our lower tax rate and share count contribute \$0.03 of adjusted earnings per share benefit.

Turning to slide 11, we wanted to provide a brief update on our footprint optimization plan. Last quarter, we discussed achieving \$40 million of annualized savings over a multiyear period with savings beginning to accrue next year. To date, we have announced three closures of subscale facilities, which are all expected to be completed by year end. The footprint optimization plan is a global initiative and other rooftop consolidations are poised to enter the execution stage.

Savings are expected to build over the course of 2025 and 2026. As a reminder, we anticipate achieving 40% of the full savings run rate as we exit 2025 and intend to be at the full savings level on a run rate basis by the end of 2026. In aggregate, we believe the footprint optimization plan to contribute over 100 basis points to our adjusted EBITDA margin at maturity, which is at the high end of the range we communicated at our Capital Markets Day in March.

Now, I will turn it back over to Ivo for his closing remarks.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. On slide 12, I'll provide some key thoughts before we take your questions. First, our global Gates team is executing well, and we are delivering higher profit margins in a soft demand environment. Our team is effectively managing the operating variables that can be controlled in a challenging environment and produce a record Q3 gross margin for Gates since we became a public company. In 2024, we are on track to generate over 100 basis points of adjusted EBITDA margin improvement, with our core sales on pace to decline low to mid-single digits.

Second, we are positioned to drive meaningful returns for our shareholders over the next few years. Since 2016, on a core basis, our sales have grown at a 4% compound annual growth rate. We have multiple strategic growth initiatives in place, including driving a change in the way personal mobility devices are designed and built, developing new fluid conveyance technologies that offer more efficient cooling solutions for hyperscale data centers, as well as further increasing our relevance with existing customers and securing new customers in the automotive and industrial replacement channels.

As the industrial markets stabilize, we believe we are well positioned to drive attractive core revenue growth over the midterm. In addition, we believe the ongoing execution of our enterprise initiatives should enable us to deliver above average incremental margins on the growth we anticipate to achieve. We are making incremental investments across the enterprise to position the company to deliver higher organic growth and experience more organizational efficiencies over the next decade.

Finally, our balance sheet position continues to show steady improvement, and we anticipate having more avenues available to deploy capital over the midterm. We intend to be opportunistic, yet prudent in deploying excess free cash flows.

Before taking your questions, I want to extend my appreciation to the almost 15,000 global Gates associates for their hard work and determination to achieving our enterprise priorities and satisfying 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. [Operator Instructions] Our first question comes from the line of Jeff Hammond with KeyBanc. Please go ahead.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Hey. Good morning, guys.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Good morning, Jeff.

A

Lawrence Brooks Mallard

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

Good morning.

A

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Hey. Great. Great execution on the decrementals. It seems like a lot of the restructuring savings come in 2025, 2026, maybe just talk about what you're doing in the near term to kind of mitigate the decremental headwind here in this – in the short term soft period.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Yeah. Thank you, Jeff. Look. I mean, we have a ton on our plates associated with our enterprise initiatives. So, obviously front to back 80/20 execution is what we are focused on. And I think we have spoken in the last couple of calls about our focus on material cost reductions, optimized pricing through 80/20, and factory productivity. And I think that that's what's a bit unique about this cycle than maybe in a previous cycle. We feel pretty good where we sit and we continue to execute. Our teams executed well. And we are managing to expand our gross margins in a somewhat negative demand backdrop.

A

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Okay. Great. And then, it seems like your peers are putting up some pretty challenging numbers in China and Asia. And you guys kind of bucked the trend. And so, that really stood out. I'm just wondering what you think you're doing there. Is it share gain? Is it kind of where you play that's kind of driving that meaningful outgrowth?

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Yeah, Jeff. Thank you. I am very proud of what our China team has been able to execute. We've spoken for a while that we have had pretty significant focus for – in region for region, so that our business is really more dependent on the local macro environment. And as demonstrated, that's not been necessarily great. It's been challenging for some time, but we did see some green shoots in the industrial end markets in Q3. Our team has

A

been focused on expanding our market share, expanding our presence across various applications in the industrial space just as much as in the automotive replacement side of our business. And they have executed really well. And while we don't certainly see any benefits yet from the stimulus that the Chinese government is indicating that they will deploy, we feel pretty good about where we sit, the growth has been returning. And we anticipate that we're going to have kind of a mid-single digit growth rate for the full year 2024 in China. So, the team has done a really good job.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Okay. Appreciate it.

Q

Operator: Our next question comes from Nigel Coe with Wolfe Research.

Nigel Coe

Analyst, Wolfe Research LLC

Thanks. Good morning, everyone. Thanks for the question.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Hi, Nigel.

A

Nigel Coe

Analyst, Wolfe Research LLC

So, there's a lot going on this morning. So my head is spinning. I just wanted to just make sure that the message on page 11 is crystal clear. So, are you saying that by 2026 or for 2026, your kind of guidance was [indiscernible] (00:23:51) the high end of your medium-term EBITDA margin target? Is that the message?

Q

Lawrence Brooks Mallard

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

Yeah. So, I would say at the end of 2026, compared to 2024, that we will be at that \$40 million run rate of savings or 100 basis – a little bit over 100 basis points that we are committed to on the last call as we move forward. So, it'll hit incrementally as we move through 2025 and 2026 as we execute on the different projects, the different optimization plans. But if you look at it over a two-year period, by then is when you should see that 100-plus basis points of incremental EBITDA margin improvement.

A

Nigel Coe

Analyst, Wolfe Research LLC

Okay. But not necessarily 2025, that's somewhat volume dependent. Okay. I understand that.

Q

Lawrence Brooks Mallard

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

Yeah.

A

Nigel Coe

Analyst, Wolfe Research LLC

Q

And then, just on – yeah. Okay. Okay. And then on the 4Q kind of buildup, I think at the midpoint, you're seeing a slight pickup, I think maybe 1% or so on revenues at the midpoint, the margin stepping down a fair amount. So we got revenues stable to slightly up, margin down, I think maybe 100 basis points plus Q-over-Q. So just want to understand those dynamics a little bit better.

Lawrence Brooks Mallard

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

A

Yeah. Well, the – that's driven almost entirely by – we talked about on the last earnings call that we had, one, this automotive replacement business and we were doing some rough credits as we put inventory in place. Those headwinds are higher than what we thought they would be because we're accelerating that activity in terms of shipping that business. And then, also that's predominantly happening in Q4 is where the majority of those credits are happening. So, I would say year-over-year, that's kind of a 75 basis points to 80 basis points headwind from an EBITDA margin perspective. And that's a onetime thing as we get the inventory in place for those new automotive replacement customers in the back half of the year.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

A

And, Nigel, one other question – one other comment real quick on revenues, just also for the full year, think about – I know you didn't ask this, but just helps shape up Q4. Think about close to a 1% headwind for the full year on FX. So, as think about the core sales growth, what's implied for the fourth quarter. So just want to make sure that everybody has that as a modeling piece.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Okay. Thanks, Rich. And then, just a quick clarification on the share count portion of the bridge. I know you don't break out share count, but that would embed the 3Q buyback, that wouldn't have any influence from the whatever Blackstone does the next couple of months?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

That's correct.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Yeah. Okay. Thank you. Thank you very much.

Operator: Our next question comes from Damian Karas with UBS.

Damian Karas

Analyst, UBS Securities LLC

Q

Hey. Good morning, everyone.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Hey, Damian.

Lawrence Brooks Mallard

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

A

Good morning.

Damian Karas

Analyst, UBS Securities LLC

Q

Yeah. Brooks, you had made a comment that you believe you're nearing a trough and are starting to position for a recovery. Just curious, maybe you could elaborate on what you're seeing and hearing that leads you to that viewpoint. And if that is in fact the case, how do you suspect that translates to growth range for the business in 2025?

Lawrence Brooks Mallard

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

A

Yeah. So, look, there's been a lot – several quarters, what, eight, nine quarters of negative PMI and volume, down volumes, particularly on the industrial side. And so, as we've moved through the year, there's a couple of things that we're really focused on, right? One is we talked about kind of labor availability and making sure that we have the ability to run our factories optimally, and then also making sure that we're in – we're positioning our inventory for superior customer service and then to be ready for the inflection. And so, as we move through the year, we've tried to make sure that – at some point we're going to come to the end of this negative PMI. You're going to see things inflect. And so, we just want to make sure that we continue to keep ourselves ready for that inflection. And so, when that comes, we don't know. We know there's certain parts of the business that we expect to inflect sooner rather than later. We would expect mobility to inflect a little bit sooner in 2025. Industrial, we'll see when that starts to happen. But we want to make sure we're ready and prepared for the inflection to make sure we can serve the customers and take advantage of the upcycle.

Damian Karas

Analyst, UBS Securities LLC

Q

I see. That makes sense. And then, regarding the footprint optimization, are there any further details you can share around the three facilities, like, where they're located? Any particular concentration in end market or product? And what's your confidence that you can maintain market share should we see a return to growth sooner rather than later with less facility capacity out there?

Lawrence Brooks Mallard

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

A

Yeah. So we try to play a little bit close to the – some of the location. It's primarily in the Fluid Power segment that we're seeing the footprint optimization activities so far. And we'll – and remember, as we talked about, we're not taking capacity out of our operational footprint, right? We are, in fact, making sure we have the same or more operational capacity and labor availability as we move through these footprint optimization plans. That's key for us. And if you remember, Ivo and I both talked about labor availability being one of the biggest drivers as we move through this footprint optimization plan. So, we actually feel better about where we stand from a capacity perspective as we move through the cycle. And we've thought through all of that as we thought about how we optimize our footprint moving forward.

Damian Karas

Analyst, UBS Securities LLC

Q

Understood. Thanks, guys. Best of luck.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

A

Thanks.

Operator: Our next question comes from Julian Mitchell with Barclays.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. I suppose just one I sort of double check, because you're talking about inventories being high, because of expected sort of demand inflection, but you're not seeing that inflection yet. And when I look at the inventories to say trailing 12-month sales, I think they're at 21% in September and inventories are up low double-digit year-on-year. Pre-COVID, your inventory to sales was 15%. So just want to understand, should we expect for the medium term your inventory to sales runs at sort of 20%-plus and that's the kind of sustainable go forward rate from here.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Yeah. Julian, great question. Look, couple of things. Number one, we've talked a little bit about taking incremental customers into 2025. I think Brook has talked about the ramp up that is happening actually in Q4 of those – of the new account. And we have pre-positioned some inventory to be able to fill the slew of initial orders and fill the order at certain rates that the customer is expecting. So I'll put that on one side.

On the other side, as these cycles inflect, historically, we have been in a position where we could not fully capitalize on some of the available business that was coming our way. And very quickly, we build up substantial amount of past due backlog. And so, what we have – when we take a look at the analytics on the business and we look at the same data that you very carefully monitor, the PMIs have been negative for over 24 months. While we are not calling the reversal of the PMI cycle, we believe that we have a lot closer to that inflection than perhaps we were thinking at the beginning of the year of 2024, if you recall.

And so, as we think about our business, we just want to make sure that we position ourselves well. We will run with slightly elevated level of inventory into the next upcycle. We believe that that will position us well to take more market share. And we have enough initiative on – to our disposals to be able to deliver on the free cash flow commitments that we have committed to the analyst community and to our shareholders. So that's kind of how we are thinking about it.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

That's really helpful. Thanks, Ivo. And just following up on your point on that, the cash flow aspect. So I think year to date you're running at about 40% conversion of adjusted net. Do we – in Q4, is the implication that there's some kind of sort of non-inventory working cap liquidation and that's what pushes you up towards the 90% for the full year? And when we think about uses of cash going forward, should we assume it's still sort of very much buyback is the focus at least for the next year given where the stock's valuation is?

Lawrence Brooks Mallard

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

A

Yeah. So, if you look back at our last 4 – Q4s from a cash conversion perspective, just – where we are right now to deliver the 90% cash conversion commitment is right at average. And so, the business typically does generate a significant amount of cash because of seasonality in Q4. And as Ivo talked about, some of that inventory is going to come out as we ship some of this automotive replacement business. We're going to see some normal seasonality, cash coming in both in terms of receivables and in terms of inventory drawdown and things like that. And so, we feel pretty comfortable and confident where we are from a cash conversion perspective.

From a capital allocation perspective, look, we still have to pay down some gross debt to get below \$2 billion. We – stock buybacks, we still have authorization on our stock buyback. And as our as our stock trades higher and our multiple looks better, the math on doing acquisitions is going to look better for us, right? And so, M&A is something we're definitely going to have it in the quiver as we look forward on capital allocation moving through 2025.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

And we will be very thoughtful about embracing the alternatives. And as you said Julian, stock is way too cheap based upon the financial metrics and the performance that we have delivered. And we believe that it's in the best of our shareholders interest to deploy capital in buying back our shares.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

That's great. Thank you.

Operator: Our next question comes from Deane Dray with RBC.

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.

Lawrence Brooks Mallard

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

A

Good morning.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Hey, just wanted to clarify on Julian's question regarding the inventories. If we look at the increase, how much of it was for this new auto replacement account, the channel fill, if you will, versus positioning I had of demand ensuring your fill rates and service level? So, if we just – if you could separate those two.

Lawrence Brooks Mallard

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

A

Yeah. I mean, I would say the inventory positioning for the new business is probably in the \$10 million to \$15 million range. And then, the balance is us working through optimizing our inventory using the 80/20 tools, thinking about when the inflection might come, what those demand signals might look like, and then how we make sure we take full advantage of the upcycle when it comes.

Deane Dray*Analyst, RBC Capital Markets LLC*

Q

Okay. That's good. And then, can you talk about contributions from new products and any update? I know it's still small, but any update on the data center initiatives?

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

A

Yeah. Sure. So, we continue to track towards the 20% of new product vitality index, Deane. So, we're very much on track to reach the level that we have committed kind of in that 2000 – 2018-2019 timeframe. So that – that's making really good progress. And as we anticipate the inflection in personal mobility, we will continue to see a nice contribution from those sales into the NPI vitality in addition to our fluid conveyance side of our business.

I would say that maybe on the data centers, in September, we've announced the launch of a new Data Master, data center cooling house that we anticipate will start shipping this quarter in Q4. It's a product line that is very specifically designed towards data center application. It does have better – maybe increased compactness for the application, allowing a much more efficient assembly and routing in very tight footprint in those data centers. And there's also some features, very specialty compounded type materials that ensure cleanliness throughout the system limiting any contamination opportunities and downtime through engineering and deploying our material science into this product line. So, there'll be more on the new product side of the data centers.

And then, we working very closely with our partner CoolIT on a number of applications on our water pumps. We are also expanding the portfolio of these water pumps from about 100 watts up to 4 kilowatts. And we have a number of new accounts that we are working on design wins with globally and frankly, predominantly between North America and Asia. So that's proceeding quite well. Again, it's very early on. And there's lots of interest and lots of discussion about companies that are booking ton of new business, lots of the new business is coming on the chip side. And then, on the infrastructure side, there are some customers that have a longer cycle infrastructure type builds. And our products are more consumable that go into these type of applications. And so, we anticipate that our stacking is going to be more on the latter part of that project cycle. So, we're very excited about what we are doing. The opportunities are quite nice out there and we have substantially scaled up the reach of the type of customers that we are dealing with, both from kind of the hardware side, all the way through the infrastructure side.

Deane Dray*Analyst, RBC Capital Markets LLC*

Q

That's a great update. Thank you.

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

A

Thanks, Deane.

Operator: Our next question comes from Mike Halloran with Baird.

Michael Patrick Halloran

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

Hey. Good morning, everyone.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Good morning.

A

Michael Patrick Halloran

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

Two here. One, just as you think about the stressed end markets that you're seeing today, are you at the point where you're starting to see sequential stability in those markets or is there still deterioration? I suppose more broadly, when you think about the cumulative portfolio at this point, is this just more stable at softer levels or is it more variable than that by end market if I'm just thinking about it on a sequential basis?

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Yeah. Look. Our – the algorithm or the thesis about Gates has been that with our large presence in replacement markets, the replacement market should give you a better stability as you move through the cycles. And so, I think that you're kind of seeing that playing itself out. Our replacement markets have been performing significantly better and the replacement markets have been slightly up on a much larger base of revenue. And the first fit side of our business, which is much smaller, has been rather substantially impacted predominantly by the negative end market environment with off-highway. So I think at commercial construction. There's a nuance on personal mobility, but it's just an overhang from a super cycle that was occurring during COVID.

A

And on that end market, we do start to see stability. We are starting to see the inventories in the channels. Personal mobility channel has stabilized rather nicely. And we certainly anticipate that as we exit Q4 into 2025, the personal mobility will start to nicely accelerate and start getting more a trajectory of growth rates that we have seen historically, and that we feel good about that not only because we are the leading brand in those applications, but also we have a ton of new design wins that we have prosecuted over the last couple of years.

And when I take a look at more traditional markets, look, I mean, our industrial replacement market has behaved much more constructively in Q3. While it hasn't accelerated into a growth position, it has stabilized. It's kind of flat lined, which is good to see from where I sit. Our replacement markets in the automotive side of our business are performing quite well, and that's after two years of really nice sustained growth. And again, we spoke – Brooks spoke a little bit earlier about the ramp up of the new account that we have in North America that will be very nicely accretive in 2025.

And so, the replacement market is doing exactly what we thought it's going to do when we brought the company public. It's providing more stability. And I think that bodes well for the future. Again, I'll put a plug in there, right? I mean, we have had a couple of years of negative core growth, and we have grown our gross margins, and EBITDA margins nicely over the last 24 months. So, we feel quite good about what this business capacity is when we start actually getting some operational leverage on incremental revenues.

Michael Patrick Halloran

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

Q

That makes sense. And follow up, just – I certainly understand the answer to Julian's question earlier about buyback prioritization. As you think about the shift to M&A over the next few years here, how aggressively are you working on the cultivation today? Do you feel like you have the right team in place? And then, what kind of opportunities are you seeing out there when you look at things that are coming your way or that you're working in?

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

A

Look, we have a good team – small team, but a good team. Our first priority was to repair our balance sheet or get our balance sheet to a point where we can start thinking about deploying excess free cash flow into incremental M&A. While that was happening, we were not inactive. We are active out there. We are cultivating relationships. We have pipelines of opportunities where we participate in a number of discussions. But at this point in time, again, our stock is cheap. And I probably get more rewarded by generating rewards for our shareholders by buying back stock than deploying and trying to buy companies at much higher multiple that is greater than where we trade. But I think that as we rerate and as things start normalize, we continue to execute.

We have a tremendous platform that can deliver truly accretive organic growth rate over the next three, four, or five years. And so, we believe that we have low risk of ramping up, scaling up our business. We are deploying SG&A towards those opportunities. We have done a good job in balancing our capital deployment across our factories. So we are well-positioned to deliver on nice organic growth rate as the market starts to stabilize. And I don't think that that's a year out. That's probably a lot closer than that.

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

Q

Thanks, Ivo.

Operator: Our next question comes from Jerry Revich with Goldman Sachs.

Q

Hi. This is [ph] Clay (00:46:06) on for Jerry. Just one question for me. How has the price cost trended throughout the year as material cost have slowed? And then, how does this inform how we think about pricing for next year? Thanks.

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

A

So, look, there's really two components to our pricing. We have always maintained and always – I think we'll maintain – we have pretty strong pricing power. And we'll always offset material freight inflation with price. And I think the second component is the 80/20 pricing as part of our 80/20 enterprise initiative. And that's been nicely accretive – not hugely accretive, but nicely accretive as we move through 2024. And we haven't fully deployed 80/20 across all of our regions and all of our product lines yet. And so, we're continuing to roll that out. And we think there's still some runway relative to the 80/20 pricing and some accretion there. But we're confident whichever way inflation goes, we'll be able to price for inflation and we'll be able to make sure we maintain our margins irrespective of how inflationary the environment is.

Q

Thanks. I appreciate it.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

Thanks, [ph] Clay (00:47:30).

A

Operator: Our next question comes from Nigel Coe with Wolfe Research.

Nigel Coe

Analyst, Wolfe Research LLC

Yeah. I've got another question, so sorry about that. So, I just want to come back to the data center opportunity. I mean, I know it's very small right now, but [indiscernible] (00:47:51) has sized the TAM at potentially \$2 billion by 2028. And I'm just wondering if that's kind of the scope of the market you see as well. Just any thoughts there would be helpful.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Yeah. Nigel, I think during our Capital Market Day, I've talked about kind of \$1 billion, \$1.5 billion. So, we are in a very similar vicinity as what [ph] Parker (00:48:16) has outlined. They may have some other products there. But, for us, between our hoses, couplings, and water pumps, we believe that that's plus or minus similar number.

A

Nigel Coe

Analyst, Wolfe Research LLC

Okay. And then, just a quick one on the return to growth, because it seems that you are seeing a bottom in the market. And I think any sort of reasonable view on seasonality as we go from 4Q, 1Q has you growing in 1Q 2025, just want to make sure that's not out of whack with your thoughts.

Q

Lawrence Brooks Mallard

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

Well, we're not prepared to talk about 2025 quite yet. But if you were to look at normal seasonality through over the course of the last three years, one would expect you move from growth as you move from Q4 to Q1. But in our next call, we'll roll out our 2025 guidance and what we're thinking about volumes and margins and everything. And so – but assuming normal seasonality, one would think you would return to growth.

A

Nigel Coe

Analyst, Wolfe Research LLC

Okay. Fair enough. Thanks, guys.

Q

Operator: Our next question comes from David Raso with Evercore ISI.

David Raso

Analyst, Evercore ISI Institutional Equities

Hi. Thank you. There have been a lot of calls. So if this was answered, I apologize. The ag, construction, and personal mobility softness, is there any sign of a bottoming in those particular markets? Sort of dovetailing on the

Q

prior question about trying to think of resumption of organic growth, are those businesses a big part of that or is that something that we don't yet really know when the bottom is on those markets?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Yeah, Dave, good morning. Thank you for your question. I would – I think I stated that a couple of minutes ago. We definitely believe that personal mobility is stabilizing. So while it may still be somewhat negative in Q4, the inventory – channel inventory and inventory at our customers is bottoming out and normalizing. So we anticipate that personal mobility will resume growth in 2025. I would say that ag and commercial construction is still reasonably negative. And you probably know it better than I do. But my sense is that there's probably somewhat more pain maybe that's going to be layered in over the next couple of quarters in ag particularly before we start seeing some stability in those two end markets.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

And anything on construction in particular?

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

No. I would say that construction is kind of similar to ag. It's reasonably negative globally. I think that you're probably not going to see any stability until maybe latter part of next year.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

And lastly, the plant closures, the facility closure, any reason? I mean, it's easier for me to ask than you to execute, I appreciate that, especially trying to serve customers. But any reason we can't pull forward some of the closures? I mean, unless you think the market...

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Well, we did.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

[indiscernible] (00:51:23).

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

We did. We've just announced – sorry. We did, David. We've just announced three that we're going to – we announced them in the second half of 2024 and we just stated that we will complete those closures by end of this year. And we did say that our policy is that we will tell you when we are executing when we are well on execution side and we have more that we anticipate to execute into 2025. And when we are ready to go and delineate exactly the impact, we will come up and we will provide an update. We have provided incremental update in our deck on page 11. And we have – we are on track to execute those.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

And of what's been announced, how much are those already accounting for part of the \$40 million in full savings, just so I can get a scope of how many – maybe more need to be executed to get the \$40 million?

Lawrence Brooks Mallard

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

A

Yeah. Look, I mean, I think as we – we want to be really careful in terms of how much we roll out, how much detail we give based on the timing of when things roll out. We're going to stick with – well, by the end of 2026, we're going to be at \$40 million of incremental EBITDA margin, over 100 basis points of incremental EBITDA margin. And the split is kind of 40%, 2025; and 60%, 2026. And as we move through things and we start to realize things, we'll be a little bit more, I think, discreet in terms of counting out what we've achieved versus what we have to go. But right now, we're going to stick with that overview and we'll give you updates on that overview as we progress through the different phases of the footprint optimization.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

A

And David, that's the run rate for 2025 and 2026. So the 40% gets you to a number that we're – that's run rate not realized savings in 2025.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

[indiscernible] (00:53:21) the full year, it's run rate [indiscernible] (00:53:24) by the time you exit.

Lawrence Brooks Mallard

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

A

By the end of 2025. Correct.

David Raso

Analyst, Evercore ISI Institutional Equities

Q

Helpful. Thank you so much.

Lawrence Brooks Mallard

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

A

Yeah.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

A

Thanks, David.

Operator: Our next question comes from Andrew Kaplowitz with Citi.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, guys.

Lawrence Brooks Mallard

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

Hey. Good morning.

A

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Ivo, I think you said that diversified industrial is one of your most resilient end markets in Power Transmission, which I think is kind of the opposite of what you were seeing earlier in the year. So maybe you can give us more color on what's going on there overall.

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Yeah. Look. We are starting to see some more stability, particularly in the replacement channels. So, I think that people still need to repair their apparatus. They may have been deferring some maintenance. You can't defer maintenance forever. I think that the inventories have been depleted rather significantly. And while we don't – we are not forecasting any significant rebound in inventories over the near term, we believe that we have reached kind of the trough of the demand destruction that we have seen over the last couple of years. So, the demand – diversified industrial end market was basically flat year-on-year, which is the best performance we have seen in several quarters.

A

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

And Ivo, like auto OEM has become a small part of your business and continues to be somewhat volatile, but like auto replacement seems quite stable and even arguably healthy. Is it benefiting from auto OEM volatility? And if you have good visibility going into 2025 in the auto – global auto replacement business?

Q

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Look, we are very constructive on the global auto replacement business from couple of different venues. One is that we are taking market share, which is nicely accretive to our business. And, two, if you take a look at the underlying market dynamics, the car fleets continue to age, people are driving, the unemployment is very healthy both in the developed world, as well as reasonably healthy in the developing world. We manufacture products that are not discretionary. If something breaks that we manufacture, it's not nice to have. You will have to replace it. And so, that gives us more optimistic view that that market continues to be reasonably accretive to what we do in 2025.

A

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

And, Brooks, you probably already talked about this, but just sort of my own [indiscernible] (00:56:13) I know you spoke about some startup costs last quarter as you ramped up some customer wins. Were those costs just lower than you expected in Q3? Can you flesh out what you saw?

Q

Lawrence Brooks Mallard

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

No. I wouldn't say they're lower in Q3. I would say probably – that we – we've accelerated some of those [indiscernible] (00:56:34) and shipments relative to the new business that we won. And so, we're expecting

A

probably more headwinds than originally anticipated. I would say most of those headwinds are coming in Q4, which there was an earlier question about the year-over-year margin impact. And so, that was like 70 basis points to 80 basis points margin impact year-over-year of that accelerated activity with the new replacement customer. So, no, I mean, I think in – all in all, it's good, we're moving faster, we're performing better, we're getting the product on the shelf where it belongs. And we're going to have, I think, a good footprint as we move into next year.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Appreciate it, guys.

Q

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

Thanks, Andy.

A

Operator: We have no further questions at this time. I will now turn it back to Rich Kwas for any closing remarks.

Rich Kwas

Vice President, Investor Relations and Strategy, Gates Industrial Corp. Plc

Thanks, everyone, for participating. If you have any follow-up questions, please feel free to reach out and have a great rest of the week. Take care.

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

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