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Gates Industrial Corp. Plc (GTES)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day. Thank you for standing by, and welcome to the Gates Industrial Corporation Second Quarter 2021 Earnings Call. At this time, all participant lines are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to Bill Waelke, Head of Investor Relations. Thank you. Please go ahead.

Bill Waelke

Vice President-Investor Relations, Gates Industrial Corp. Plc

Thank you for joining us this morning on our second quarter 2021 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 results. A copy of the release is available on our website at investors.gates.com. Today's call 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 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, which may not be updated until our next quarterly earnings call, if at all.

I would now like to turn the call over to Ivo.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Bill. Good morning, all, and thank you for joining us on our second quarter earnings call. Let me begin with an overview of our performance outlined on slide 3. I am pleased with our strong execution in the face of a challenging operational environment. Our business continued its excellent start to the year, delivering another quarter of above-market growth that resulted in record quarterly revenue and profitability.

The underlying demand and order trends across both of our segment are robust and our book-to-bill ratio remain above 1 exiting the quarter. The industrial end market contributed most significantly to our growth and our investments in innovation and organic initiatives are progressing nicely, resulting in further market share gains across our portfolio of products. These strategic growth initiatives are in their early stages, and the pipeline of new opportunities is increasing as is the potential to continue to drive growth moving forward.

The headwinds we highlighted on our last call remain present and have created quite complex operating conditions. Inflation persists throughout our supply chain, impacting not only raw materials, but also freight. We are not expecting the inflationary environment to ease in the near term and have been proactive in responding with broad pricing action, maintaining a positive price/cost position in Q2 and the first half of the year. In addition to inflation, the availability of certain raw materials, as well as logistics capacity, and labor in certain geographies remain tight. We have been agile and forward-leaning going to great lengths to navigate these operating challenges in support of our global customers' needs.

Despite these complexities, the execution by our teams was outstanding and drove our strong incremental margins. The combination of increasing profitability and free cash flow generation has allowed us to deleverage the business at an accelerated pace. As a result, our net leverage is presently in the range we previously set as our mid-term target. This, of course, provides us with increased optionality, particularly as it relates to future opportunities to accelerate our growth strategy. As a result of our performance to-date and the supportive trends we are seeing in our end market, we are again raising our full-year guidance which Brooks will provide further detail on later in the presentation.

With that, let's move into more of a detail on our results. Moving to slide 4. Total revenue of $915 million came in at the top end of the guidance we provided, up 58.7% year-over-year including core growth of 51%.This growth was broad-based across segments, end markets, channels, and regions. We saw particularly strong performance in the Diversified Industrial, Off-Highway, and Mobility & Recreation end market. Our Automotive OEM business also recovered nicely in the quarter. However, we continue to strategically reduce our participation in this channel, which was down to approximately 10% of total company sales in the first half of the year. Sales into replacement channels also grew significantly year-over-year with the most notable growth coming from industrial end market.

From the visibility we have, channel inventory levels remain low relative to the demand levels of our distribution partners I've seen. Our second quarter adjusted EBITDA of $216 million came in above the high end of our guidance, representing growth of 160% compared to the prior year and margin expansion of 920 basis points. The margin expansion was a result of productivity initiatives, continued benefits from our restructuring activities, and efficiencies from higher volumes. Despite the challenges associated with the volume growth, as well as significant inflation and the availability of production input, we delivered a core incremental margin of approximately 40% on a year-over-year basis. A strong result against the complex operating backdrop.

Our adjusted earnings per share were $0.42 in the quarter, a significant increase compared to the prior-year period, driven by our substantially higher operating income.

Slide 5 and the segment highlights. We clearly saw very strong performance across the board with core revenue growth of approximately 51% in each of our segments. Looking back at the second quarter of 2019, which is perhaps a more meaningful from a compare perspective, our current results reflect solid core revenue growth of 15.7% in Power Transmission and 4.6% in Fluid Power. Across both segments, our above-market growth has been driven primarily by new products, the performance of our organic initiatives, and secular trends in our end markets.

Looking at Power Transmission, the Diversified Industrial and Mobility & Recreation end markets performed exceptionally well for us, supported by a number of positive secular trends. Specifically, the demand for our products in the Diversified Industrial end market is benefiting from accelerating industrial automation trends in manufacturing facilities, warehouses, and distribution centers; driven by an increasing focus on efficiency and uptime.

Our Chain-to-Belt initiative also continues to benefit from these trends with key design wins within the quarter in warehouse automation, chemical processing facilities, food and beverage applications, and e-mobility. We continue to see strong business performance for this initiative with revenue growing over 60% year-over-year.

In Fluid Power, which we believe is somewhat trailing the overall market recovery seen in Power Transmission, our focus on innovation is not only delivering significant growth but also driving key design wins across broad range of applications, including mining, agriculture, and pulp and paper to name a few. The strong growth we are seeing in this segment is driven by accelerating adoption of our new products, and we anticipate this trend continuing over the mid-term.

With respect to year-over-year profitability, we delivered adjusted EBITDA margin expansion of nearly 1,000 basis points in Power Transmission and 800 basis points in Fluid Power. Our current margins also reflect solid improvement over the second quarter of 2019 with Power Transmission recovering earlier and benefiting from higher volumes, as well as exit from some less profitable first-fit business.

In summary, we are seeing excellent performance in both of our segments while managing through the complexities of the present operating environment. Our teams are working tirelessly to support our customers and the demand they are experiencing.

With that, I will turn the call over to Brooks for additional color on our results. Brooks?

L. Brooks Mallard

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

Thank you, Ivo. Now moving on to slide 6 and the regional breakdown of our core revenue performance. We delivered strong double-digit core growth across all regions, with emerging and developed markets being very similar performance. In Europe, the strong growth was driven primarily by first-fit channels, particularly from Mobility & Recreation, Off-Highway, and Automotive applications. Sales into replacement channels also continued their strong growth trajectory with both Industrial and Automotive end markets delivering mid-double-digit growth.

North America growth was also led by first-fit channels, particularly in Mobility & Recreation, Off-Highway, and On-Highway applications. All of our Industrial end markets, including energy, experienced solid double-digit core growth. The Automotive Replacement channel continued to accelerate sequentially and posted high-teens year-over-year growth.

China, having experienced the most significant impact from COVID-related shutdowns in Q1 of 2020, began to return to more normalized year-over-year growth in Q2 of 2021 in line with our expectations. From an end market perspective, we experienced the most significant growth in Diversified Industrial and On-Highway applications with the Automotive Replacement channel also performing well.

Lastly, our businesses in South America and East Asia and India performed very well, while we managed through the impact of shutdowns across India for roughly half the quarter. We saw solid double-digit core growth across all end markets and particular strength in both On-Highway and Off-Highway application,s as well as in Automotive Replacement.

Moving now to slide 7 and some additional detail on key balance sheet and cash flow items. In the second quarter, we generated strong free cash flow despite the build in working capital from normal seasonality and the strategic procurement of raw materials.

Net leverage for the quarter improved to 3 times from 4.8 times at the end of last year's second quarter, placing us in our targeted mid-term range of 2 to 3 times. We also repaid an additional $70 million of secured debt at the end of the second quarter, with our total debt reduction now approaching $400 million since late December, all while maintaining a strong liquidity profile. Our return on invested capital was a strong 21%, representing a year-over-year increase of 630 basis points.

Moving now to slide 8 and starting with our updated full-year outlook. Based on the current healthy trends in our business, we are again raising our full-year guidance after a significant increase in our first quarter earnings release. Our updated expectation is for core revenue growth in the range of 20% to 22% and an adjusted EBITDA margin of 22.2% to 22.8%.

Our guidance includes the expectation that we will remain price/cost positive on a dollar basis for the full year and reflect strong incremental margins despite the significant inflation and challenges with material and logistics availability. We continue to expect CapEx to be in the range of $90 million to $110 million and free cash flow conversion to be greater than 80%, resulting in further improvements to our net leverage.

For Q3, we expect revenue to be in the range of $845 million to $865 million, and adjusted EBITDA to be in the range of $183 million to $196 million. This reflects continued strong performance and a return to more typical seasonality. The significant inflation notwithstanding our adjusted EBITDA guidance represents a year-over-year growth of 35% and margin expansion of 250 basis points at the midpoint. We currently believe the challenges in the balance of 2021 are manageable. However, the dynamic operating environment, in addition to the potential for worsening COVID situations in certain regions, has the potential to further affect us, our customers, and our suppliers over the balance of the year.

With that, I will turn it back over to Ivo for some final thoughts.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

Thank you, Brooks. Moving now to the summary on slide 9 and a few key takeaways. We delivered outstanding second quarter results in an environment that presented unique operational challenges. We anticipate a strong second half of the year, capitalizing on the underlying demand and favorable trends in our end market to drive further progress with our initiatives and new products. We are closely monitoring supply chain bottlenecks, as well as COVID-related challenges faced by our suppliers and customers. While the environment remains dynamic on a number of fronts, we are executing well, demonstrating strong business fundamentals and operational agility to support above-market growth.

We successfully managed the large increases in volume, navigated supply chain and label complexity, and offset inflation, delivering strong incremental margins. Our multiyear effort to focus resources on more profitable, higher-growth industrial end markets continues with our exposure to Automotive OEM applications now down to approximately 10% of companies total revenue.

Finally, our cash generation and increasing profitability has allowed us to continue to deleverage the balance sheet, providing more flexibility around opportunities to selectively accelerate our growth strategies beyond our organic growth targets. I am very proud of our teams and the effort they put forth globally to deliver this outstanding result, and I'm excited about the opportunities we have ahead of us as well.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from the line of Andy Kaplowitz from Citigroup. Your line is now open.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

Good morning, guys.

Ivo Jurek

Chief Executive Officer & Director, Gates Industrial Corp. Plc

A

Good morning, Andy.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

Ivo, so at the beginning of this year, you guide to Gates potentially outperforming its end markets by mid-single digits. But this quarter in Power Transmission, you recorded low-digits above market growth and on Fluid Power was high-single digits. So, can you give us a little more color on the biggest drivers of the above-market growth? And given you just said you think you are still early in ramping up your organic initiatives, do you actually think Gates could continue to drive above-market growth at these types of rates?

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

Yeah. Great. Thanks for the question, Andy. Look, I mean, we believe that the above-market growth is being driven primarily by the investments we have been making in our commercial initiatives, product innovations. And I've spoken about that for a while. And frankly, they are enabling us to take more share gain across both of our segments and end market. We believe that the underlying market conditions are also aiding the adoption of our new products, which supports the acceleration of our organic initiatives that we have highlighted a number of calls before.

Many of our initiatives and new products are focused primarily on applications in end markets that we have described having very strong secular tailwinds. The value prop is there. Our products are key in adapting those new technologies. I spoke about our focus on Chain-to-Belt. I spoke about the strong performance on personal mobility. I think that both of these came very, very strongly in Q2, and we believe they have a good runway for the future.

So, we are quite excited about the continuation of these positive trends, and we believe certainly that we can very consistently continue to not only outperform nicely in 2021, but over the longer term be able to demonstrate consistency of growing our business kind of 2% to 3% above the market as we have highlighted as our mid-term objective.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.
Q

Thanks for that, Ivo. And then can you give us a little more color into the puts and takes you're seeing that reflect your margin expectation going forward? It looks like you're still close to 40% incrementals for the year, maybe a little lower than Q3. You mentioned that you're still expecting the price inflation dollar for dollar. So, how much margin dilution is that versus the 200 basis point you gave us last quarter? And then, it does look like, at least at the high end of your margin range, you're assuming incrementals resume more of a normalized range in Q4 into that 40% range. So, does that suggest confidence to gauge should be able to deliver incrementals into that 40% range in 2022 even if inflation persists?

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

Hey, Andy. This is Brooks. So, we're very pleased with our incrementals overall. If you look at our normalized volume incrementals in Q2, so we're kind of in the low- to mid-40s range. So, think 43% to 44%. And then we had about 400 bps of incremental headwinds. About half of that came from increased SG&A for variable comp and different kind of customer-related accounts that have really recovered with the increase in volume. And then about half of that came from price/cost, and then FX dilution on the overall incrementals. So, even with the big volume gain, we were very pleased with the overall incrementals.

If you look at the full year, the full year, we're going to see about 900 bps of incremental dilution. So, our core kind of normalized volume incrementals are going to be in the high-40s, almost 50%. And then you've got that 900 bps, and it's kind of split evenly between FX, price, and inflation, and then the increased SG&A for variable comp and kind of the return to norm on some of those customer-based SG&A cost and logistics.

And so we feel really good about where our incrementals are coming in. We're kind of right in the middle of fairway on what we said with the elevated incrementals, and we feel good about 35% to 40% going forward. And then just real quick on Q2, you have to remember, we had really elevated volume growth year-over-year. And that also makes those incrementals a little bit tougher when you've got so much volume flowing through. And so in the back half of the year, those normalized incrementals are a little bit closer to those elevated numbers we talked about.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate it, Brooks.

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

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. I just wanted to follow up with that last question. So, when you define price/cost neutrality, are you wrapping in all the inflationary aspects, including freights and – or was it just the raw material aspect? There's just – there's no sort of clear definition of that. So, just – that would be helpful.

And then on the price equation, maybe just compare and contrast OEM pricing versus what you're seeing through the channel. And, again, spur the question I guess that oftentimes there's a lag on OEM pricing. So, just wondering if you're seeing a lag there.

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

A

Hey, thanks for the question. So, when we think about inflation, we think about really the overall per-unit cost, both for raw materials and for freight. Now, what we don't include is, we don't include labor inflation and we don't include maybe some of the inefficiencies you see in the supply chain with constrained freight and things like that. But we just look at the cost relationship of it year-over-year. So, materials, logistics rates, and then we compare that to price.

What was the second part of your question again? You got it?

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

A

Yeah. Nigel, I'll take the second part. And you're right, the OEM pricing activities, all those lags, a little more the distribution channel partners' pricing. But we are being pretty forward-leaning. We've seen the inflation, and we were worried about inflation. We spoke about it frankly from Q1 earnings call about the elevated inflation that is creeping in. And we have taken pricing into the OEMs as well. And we believe that we are reasonably well-positioned to be able to offset it, albeit it is lagging slightly behind the channel pricing that we have done.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thank you. And then, Ivo, you mentioned – you touched on channel inventories remain very low. Maybe just anymore color there, how low is low? Did they get lower during the quarter? And are you in a position where you can't fulfill demand, i.e., your partners want to restock but you don't have any because you've got supply chain constraints? Any color on that would be great.

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

A

Yeah. Right. I think it's a great question. Thank you, Nigel, for it. Look, based on the point-of-sale data that we have – and, again, I remind everybody that our point-of-sale data is most strongly correlated in North America at this point in time, which is also our biggest market – all of the indicators that we track would suggest that the inventory levels are quite low compared to the demand levels that the channel partners are seeing presently. All of the commentary that comes from our customers, again, whether or not it is commentary that comes from our channel partners on the distribution side, or frankly even from the OEMs, they all would like to have more inventory and they all struggle to keep up with the demand patterns that they have for our products from their customers.

So, I will tell you that everybody would like to have more inventory. We are doing the best that we can to keep up. I've also mentioned that we did have a very strong proof to bill for the second quarter in a row. We had terrific quarter again, very strong performance. We're not a backlog business, but we did build backlog; and that would indicate to you that people would like to get more than we can supply.

Nigel Coe
Analyst, Wolfe Research LLC

Q

I hate to ask one more question, but just on that point about building backlog and – does that maybe suggest the 3Q could be stronger than normal seasonality? I mean ,right now, your guidance embeds normal seasonality for 3Q, but just curious if that's a possibility.

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

A

It's a great question. Look, I mean, I think that what we need to take into an account is that we came in from a very strong baseline in Q2. It's a record level of revenue for us, very great result with strong incrementals. We are executing on our playbook, and there is more demand out there than we can fulfill. But I also want to remind everybody that there's tremendous amount of headwinds that we are still dealing with, and it's – particularly on our customer side just as much as it is on our side. So, although they like to have more products from us, if they cannot get semiconductors, I mean, they'll manage their bills just as much as they would like to build more products out there.

So, yes, demand is strong. Supply chain challenges, labor challenges, logistics challenges. And frankly, although we want to move beyond COVID, COVID is still here. It's problematic. And we dealt with it in Q2 in India. It was by far worse than what we've anticipated. I've highlighted that although our automotive [indiscernible] (00:30:01) business did a great – posted a great result in Q2, it was frankly a little worse than what we've anticipated with our conservative guidance. So, there's still lots of uncertainty taking to an account the seasonality, I believe that we have taken that into account, and we have a very strong guidance for the second half of the year.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thanks, Ivo.

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

A

Thank you.

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

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, one of the positive surprises in the first half has been your debt leverage getting paid down faster and hitting your target, really, six months ahead of time. Is there an element in your capital deployment that you can now pivot to more playing offense? Is this M&A opportunities? What's the funnel look like? And are there internal growth investments that you might be able to step up as well? Thanks.

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

A

Thank you for your question, Deane. Absolutely. But, again, I remind everybody that our priority remains deleveraging, balanced with frankly doing the right thing for the company over the long term and supporting over the long-term growth for the company. We have very strong set of organic opportunities, as I have highlighted on last – past year and a half or so. And we're excited about those opportunities, and we will be prioritizing funding those projects. They, generally speaking, return the best investment on – the best returns on that investment that supports those.

That strengthening balance sheet, of course, does create optionality to accelerate our organic strategies through M&A. The pipeline of opportunities out there is pretty active. However, I don't think that it will surprise you. The seller expectations in general are pretty stretched, and we will be very disciplined and selective in adding capability to our portfolio through M&A. But those opportunities remain very strong. They are all on the table, and we will be – we will be very focused and very disciplined in creating long-term shareholder value.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. And then just second question, it's another one of these positives happening fast, or is this whole Chain-to-Belt conversion, maybe I was guilty of thinking this was going to be a on-the-horizon secular trend, but it's really happening near term. And is there any – and it's becoming a needle-mover. Is – can you size for us like what it could contribute in your mix next year maybe on a percent?

And just to clarify, does Chain – the Chain-to-Belt wins, does that show up in new product introductions? And is it part of your share gains calculation as well? Thanks.

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

A

Thank you for that question, Deane. Of course, we are very excited about our Chain-to-Belt opportunities, and I think a couple of years when I shared with the investment community the opportunity, we felt that it's a very strong opportunity for us to try organic growth over a very long period of time, despite the fact that we are doing really, really well and it's becoming a nice addition to our revenue generation and market share gains, particularly in Power Transmission. We believe that it will take more time, and it is a long-term opportunity for growth. And, again, I'll remind everybody, we believe that that has added kind of $4 billion to $6 billion to our TAM in a very near adjacency to what we do for our customers and how we solve our problems.

We believe that it will be adding some incremental opportunity for us to deliver a strong 2022, but we will come back to 2022 during our Q4 earnings call during our normal life cycle. And it does show, Deane, in the Diversified Industrial and personal mobility in particular. And I think that both of those are growing very nicely and performing very nicely for us. So, clearly, great opportunity for the company. It's supporting our growth anticipation short-term, but it will be a very long trajectory of runway that we see for us to continue to execute on

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Just to clarify, does it show up in your calculations of new product introductions?

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

A

It does. It does, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Yeah. I would think it would. I just wanted to be sure. Okay. That's all real helpful. Thank you.

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

A

Yeah. Thank you for the question.

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

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

A

Good morning.

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

Q

So, following up a little bit on an earlier question, obviously [indiscernible] (00:35:26) talking about good internal momentum. Inventory is still low from a channel perspective. That balancing out or normalization doesn't seem to be embedded in the guidance currently. Maybe just some thoughts when you talk to your channel partners or you look at your own supply chain, when do you think that starts balancing out and normalizing a little bit, and just how you think demand cadence is here and into next year?

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

A

Hey. It's a great question, Mike. Look, I mean, there's still an incredible amount of challenges that we are dealing with, predominantly associated with some labor availability in specific regions, particularly in North America, in US. And raw material supply is very, very challenging, [ph] whether or not (00:36:10) it's resins, high-precision steel, to name probably the two of the most challenging sources of raw materials for us.

And also, look, I mean, I frankly visited the Port of Long Beach to try to understand what's going on, and there's a pretty significant congestion there as well. So, on occasions where you can get the raw material, you got it from point A to point B, you can't quite get it from the ports to your source factories. So, we believe that it will take some time to work itself through. We certainly believe that those challenges will remain front and center with us through the second half of the year. And we anticipate that maybe 2022, we should start seeing some easing of those impediments.

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

Q

Thanks for that. And then a follow-up, you look at the auto OEM exposure, decent trend certainly, but you went out of your way multiple times to talk about how you keep seeing that reduction here as a percent of total revenue. So, kind of a twofold question here.

One, does the strength that you're seeing in the broader businesses as well as in that specific segment, does that give you greater optionality in the short term here to maybe be more aggressive on reducing exposure? But then, secondarily, is there a point where you think that balances out? And how should we think about the timing around that, or maybe some sort of other kind of indicator that we should look at?

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

A

Yeah, Mike. I think that I would like to address this – next time we get – in depth next time we get together, and we provide the investment community and the analyst community with an update on – kind of a capital base update. So, we will address them in – more in depth and breadth. But, look, we've taken a pretty strategic pivot to reduce our exposure to the OEM segments of Automotive. We have been executing on that for over three years since we became a public company.

That exposure is down from about 15% of total company revenue during the IPO to about 10% now. That being said, we're also quite excited about some of the electrification trends that are going on. We have had a number of new design wins again in the quarter. And so we're not in a bad place. But we believe that over the long term, Automotive first-fit is going to remain kind of in a maybe high-single digits as a percent of total company revenue.

And we are pivoting towards being much more focused and continue to execute well on our replacement side of the Automotive business, and that's where we are making substantial investments. We are building strong portfolio of EV coverage of the VIO, the vehicles in operation coverage. And so overall I think that we like where we sit, and we will be measured in how we continue to execute on the desired outcome of where we sit with Automotive OEMs.

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

Q

Appreciate the help, as always. Thanks.

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

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

Q

Hey. Good morning, guys.

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

A

Good morning, Jeff.

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

A

Good morning.

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

Q

Hey. I just wanted to pick on a couple trends that I see. One, it seems like Europe is recovering a lot faster than North America, and I just wanted to kind of get a little better sense if it's just a more robust recovery or more outgrowth or better supply chain dynamics. And then if you can just frame how you're thinking – how you see, like, the PT recovery versus 2019 versus the Fluid Power, it seems like PT is running ahead. I don't know if that's just where we are in the cycle or if there's anything else to read into that?

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

A

Yeah. Great set of questions, Jeff. Let me try to get through all of them. Look, we're very pleased with how our Europe business has performed. We believe that our execution leaning forward frankly as early as Q3 of last year in prepositioning ourselves with raw material availability and staying operating has [ph] played (00:40:56) dividends and has accelerated our growth there with market share gains. So, we are very, very pleased with that performance.

Going back to your second question about FP not growing as quickly as far as Power Transmission versus the 2019 comp, look, we view that our Fluid Power business is still in the very, very early stages of recovery. We are seeing very nice improvements in recovery across the end markets. But frankly, not all of those markets are recovered fully yet. I can maybe list one being energy as an example which, although improving, it is still quite significantly below 2019 levels. And from that chart that we shared I think at the beginning of the year, that energy was about 7% or so of our total company revenue. So, it was not de minimis in size.

So – and from all the data that we see, we are still seeing that, again, very early innings of the impact that the innovation is bringing to [ph] foray (00:42:20). What we – from everything that we see, we believe that we are taking a nice amount of market share, and markets are poised to continue to recover in FP.

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

Q

Okay. Great. And then the last one, I think you called out labor availability is a bigger issue in the US, and I think your hope was you'd start to see some improvement there. Is that starting to get any better, or is that still a big problem for you?

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

A

Gosh. Yes. Labor markets remain very, very tight. But I don't think – I think that you guys may be sick and tired of hearing it from all the reporting companies and – but we are staffing to the best of our abilities, and we're having some success in being able to do that versus where we perhaps sat in kind of April-May of the past quarter. We have undertaken very significant recruiting campaigns to fill our vacant positions. And I think that this is going to remain as long as I think the COVID conversation is front and center. I think lots of the states are already dropping some of the supplemental benefits out there. So, we should start seeing a little bit less of a headwind from those. But I think that the COVID conversation is still impacting people's willingness to come back to work, particularly in the US.

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

Q

Okay. Appreciate it, Ivo.

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

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone.

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

A

Good morning, Jerry.

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

A

Good morning.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Ivo, I'm wondering if you can talk about how much capacity you folks have to ramp up production into 2022. Obviously, big changes in the manufacturing footprint. If we're looking at just your ability to ramp up and your supply chains, how much could supply of your products increase 2022 versus 2021 assuming semiconductors and other areas are not a constraint for your customers? Just so we can get a sense for the manufacturing footprint today versus the last cycle.

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

A

Yeah. Jerry, I will stay away from 2022. Again, I think that we will provide a better update on our standard cycle in end of Q4 – on the Q4 earnings call about 2022. But, look, we've made pretty significant investments during the last cycle. We feel good where we sit with capacity. We also anticipate and are hopeful that we will see the raw material supply chain shortages kind of worked themselves through.

As I discussed, most of these are in the resin and precision steel areas, that's the biggest impact on us, and on our manufacturing. And both of these are significant components, particularly on the Fluid Power side where we believe that, working through the second half of this year, we should hopefully start coming out of the situation on that. And that would position us reasonably well for taking advantage of what 2022 brings to [ph] foray (00:45:49) for us. And we're very constructive on the end markets.

We really don't control some of the other raw materials that our customers are managing through. And, again, I believe that all customer are more in a boat of feeling better about 2022 than they have so far in 2021.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And even maybe to ask about it in a different way, is it fair to say that across your footprint, you're pretty much running at two shifts today. So, if we're talking about ramping up production, we need to get more production out of the same shifts in the next year or beyond?

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

A

Jerry, you know that we generally speaking do not comment on our capacity utilization because of the complexity of various plants, the locations, geographies, labor availability, and so on and so forth. But we are running in a good place, and we feel optimistic about the market recovery as it progresses.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. And lastly, your margin performance this year is really impressive in a challenging environment. You might essentially get to a new cycle of high and just to your one of recovery. I'm wondering as you folks think about the opportunity to expand margins cycle over cycle, how concerned are you with parts of the footprint essentially overheating kind of like the overruns that we saw at the tail end of the last cycle? How confident are you that we can sustain, I think, 35% to 40% incrementals even as we're getting to a pretty high level of demand in parts of the footprint?

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

A

Many components there, Jerry, so hopefully I can capture all of them. But let me start with, look, we've done lots work since becoming a public company in realigning our footprint, building around innovation, and frankly positioning the company to being able to manage decrementals and incrementals and arranges that we have discussed, right? So, we've spoken about the decrementals being in the 30 percentile level and the normalized incrementals kind of at 35% to 40%. And certainly, we're delivering on the incremental side despite the very significant challenges that we are dealing with. And that should reinforce the set of opportunities that we see ahead of us and hopefully give investors a level of confidence that our strategy is taking hold.

I would probably stay away from trying to address what's going to happen in the future. It's very, very difficult, very dynamic operating environment, I think, for everybody. I think that we are well-positioned. Our operating and commercial teams are doing an outstanding job in doing everything that's possible to support our customer needs and delivering strong returns for our shareholders. So, we feel quite good about that.

And maybe the last piece that you have had in there, look, we – a while ago, we have put a mid- to long-term objective of kind of delivering that $4 billion, 24% EBITDA target out there. And we still believe that we are on a target to be able to deliver that over the mid-term future.

And so we're quite optimistic about what we have done with the business. We're quite pleased with how our teams are executing, and we'll continue to report as we progress through into the future.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Appreciate the discussion. Thanks.

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

A

Thank you.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks a lot. So, maybe just trying to keep my questions a little focused. China growth I think was the high-teens in Q2 after low-70s in Q1. Maybe help us understand what are you seeing across the two segments there right now in Q3 and what you're dialing in for China growth in the second half of the year within your overall global guidance?

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

A

Thank you, Julian. Good morning. Look, our China business is performing extremely well as well, and we are executing on our growth playbook. The industrial markets are performing well there, particularly on the On-Highway and Diversified Industrial applications, which have been a very significant area of focus for our teams then for initiatives. We continue to see very strong growth in replacement channels in both the Automotive and Industrial end markets.

So, we are quite pleased with what's happening in China. And I'll remind everybody that China came into COVID first and came out of COVID first. So, the normalization of our growth rate in China is good to see frankly. I know that perhaps everybody would like to see strong numbers. Those are very strong numbers that we have printed, taking to an account more normalized performance. And for our second half implied performance for China is normalized growth rates in the high-single digits to low-double digits.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks very much. And then, just a second one, the tax rate sort of embedded in the adjusted EPS calculation moves around a fair amount. Maybe help us understand what's the second half adjusted tax rate we should expect, and any sort of medium term color on that adjusted tax rate, please?

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

A

Okay. Hey. This is Brooks. So, yeah, we had some favorable adjustments in Q2. I think that's going to lower our overall tax rate that we're thinking for the full year, more to the 19% to 21% range as opposed to typically we'll see kind of 22% to 22% or low 20s. For the longer term, we expect that low 20% rate to hold, so 20% to 22% for the longer term. But we will see a little bit lower rate this year based on those onetime items.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

Operator: Your next question comes from the line of Josh Pokrzywinski from Morgan Stanley. Your line is now open.

Gustavo Gonzalez
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good morning, everyone. This is actually Gustavo Gonzalez on for Josh. Thanks for taking my question. So, just to go back to the inflation topic, can you sort of frame up the order of magnitude of price/cost spread in the first half? And how does that sort of compare to your expectations for the second half?

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

A

So, for the year, from a price perspective, we expect to be just north of 3, and that was what it was in Q2 as well. So, just north of 3. Now, the comps get a little bit tougher as the volumes went up in the back half of 2020. So, even though the price percentage year-over-year is the same, it's more price dollars. From a overall kind of EBITDA perspective, we're slightly flat, maybe plus or minus 10 bps in terms of the overall EBITDA percentage. But then, as I've said before on the incremental side, that is a little bit of a headwind for the full year. So – and kind of back into the math on that.

Gustavo Gonzalez
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then just one last follow-up, so you're kind of closing a pretty solid top line growth this year. But that reiterated CapEx, is this sort of more of a reflection of past investments in capacity or should we expect CapEx to kind of ramp from here? Thanks.

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

A

Hey. This is Brooks again. So, just real quick, we've got a lot of great investments that we can make organically. Our organic investments are typically the highest rate of return investments that we can make. It's really just about the timing and the execution and how much stuff you can get through the pipeline. And so that's why, in normalized environment, that $100 million, $110 million of CapEx gives us a lot of opportunity for growth CapEx, a lot of opportunity for investment that's going to drive both the top line and the bottom line. And so that's really all it is. It's just kind of a normalized – this is what we can get through the system.

Gustavo Gonzalez
Analyst, Morgan Stanley & Co. LLC

Q

All right. Got it. Thank you so much.

Operator: Your last question comes from the line of Jamie Cook from Credit Suisse. Your line is now open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. Most of my questions have been answered. I guess just one, the Power Transmission margins were quite impressive during the quarter. So, just any color on the sustainability of that or were there onetime [indiscernible] (00:55:40) sort of help that? And then, over what time period do we think we can get the Fluid Power margins closer to Power Transmission? Thanks.

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

A

Morning, Jamie. We are quite proud of the execution on Power Transmission. And, again, I would suggest that the performance has been delivered primarily on the volume growth, and frankly the innovation and new products that coming through and showing through the result. On the Fluid Power, again, we are reasonably early in the recovery, Jamie, as the market starts going through more fulsome recovery. We anticipate that our margin is going to continue a trajectory up, and, again, taking normal seasonality into account.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Operator: There are no further questions at this time. Presenters, you may continue.

Bill Waelke
Vice President-Investor Relations, Gates Industrial Corp. Plc

All right. Thank you, everyone, as always for your interest, and we look forward to providing you with another update in November.

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