Q4 2022 Earnings Call Transcript
Michael Roman and Monish Patolawala
January 24, 2023

Slide 1, Cover page
Bruce Jermeland, Senior Vice President, Investor Relations

Thank you and good morning, everyone, and welcome to our fourth-quarter earnings conference call.

With me today are Mike Roman, 3M's chairman and chief executive officer, and Monish Patolawala, our chief financial and transformation officer. Mike and Monish will make some formal comments then we will take your questions.

Please note that today's earnings release and slide presentation accompanying this call are posted on the home page of our investor relations website at 3M.com.

Please turn to slide two.

Slide 2, Forward looking statement
Bruce Jermeland

Please take a moment to read the forward-looking statement. During today's conference call, we will be making certain predictive statements that reflect our current views about 3M's future performance and financial results. These statements are based on certain assumptions and expectations of future events that are subject to risks and uncertainties. Item 1A of our most recent Form 10-K lists some of the most important risk factors that could cause actual results to differ from our predictions.

Please turn to slide three.

Slide 3, Note on non-GAAP financial measures
Bruce Jermeland

Please note, throughout today's presentation we will be making references to certain non-GAAP financial measures. Reconciliations of the non-GAAP measures can be found in the attachments to today's press release.

Before I hand the call over to Mike, I would like to take a moment and highlight a financial reporting change we are making starting here in Q1 2023.As we announced in our press release on December 20th, we will be exiting PFAS manufacturing by the end of 2025. As a result, we have decided to provide additional disclosure by expanding the scope of our non-GAAP measurement adjustments to include the exit of PFAS manufacturing.

For 2022, we have treated the Q4 PFAS manufacturing exit cost as a special item in arriving at results, adjusted for special items. However, beginning in 2023, we will expand the existing adjustment for special items to also adjust for the sales and estimates of income and associated activity of PFAS manufacturing. Therefore, our outlook for 2023 reflects this adjustment.

Today's press release, press release attachments and slide presentation provide information regarding our 2022 performance on our existing Q4 2022 non-GAAP basis along with some comparative information on the new 2023 outlook basis.

We will be providing a Form 8-K during the first quarter to reflect additional effects of this change in our non-GAAP measures and changes in segment reporting. We remain committed to providing strong transparency in reporting our financial performance, and of course, we are always here to address your questions. With that, please turn to slide four and I will now hand the call off to Mike.

Slide 4, Taking actions in a challenging environment to transform 3M for the future
Mike Roman, Chairman and Chief Executive Officer

Thank you, Bruce. Good morning, everyone, and thank you for joining us.

We continue to focus on delivering for our customers and shareholders in a challenging economic environment with slowing growth, inflation, and supply chain disruptions.

We posted organic growth of 0.4%, versus our expectation of 1%-3%, along with adjusted margins of 19%, and adjusted earnings of $2.28 per share.

The slower-than-expected growth was due to rapid declines in consumer-facing markets such as consumer electronics and retail – a dynamic that accelerated in December – as consumers sharply cut discretionary spending, and retailers adjusted inventory levels. We also saw significant slowing in China due to COVID-related disruptions, along with moderating demand across industrial markets.

As demand weakened, we took actions to adjust manufacturing output and control costs, which enabled us to deliver a $250 million inventory improvement. In addition to actions taken in the second half of last year, today we announced restructuring in our manufacturing operations as we expect the demand trends that we saw in December to extend through the first half of 2023. I will discuss this more later in the call.

With supply chains stabilizing, we are focused on improving manufacturing operations and driving working capital – these are our most significant opportunities to improve margins and cash flow.

As we navigate the external environment, we continue to position 3M for the future by investing in growth, productivity, and sustainability.

I will recap 2022, and our outlook for 2023, after Monish takes you through the quarter.

Slide 5, Q4 2022 operating margin and EPS
Monish Patolawala, Executive Vice President, Chief Financial & Transformation Officer

Thank you, Mike, and I wish you all a very good morning. Please turn to slide five.

As you will recall, we highlighted negative trends in our consumer retail and electronics-related businesses in late November. As the fourth quarter progressed, those trends accelerated. We also experienced significant slowing in China as COVID-related impacts resulted in a 17% decline in organic sales in December, and down 8% for the quarter.

Health care continued to be challenged in its recovery to pre-pandemic levels given labor shortages and hospital budgets being under pressure, while industrial end markets mostly remained steady.

Fourth quarter total sales were $8.1B, or down 6.2% year-on-year, which included headwinds from foreign currency translation of minus 5.0%, or $400M, which was better than the minus 7% we had expected. We also experienced a 1.6% decline from divestitures, or nearly $140M, largely from the third quarter divestiture of Food Safety along with the deconsolidation of Aearo Technologies.

On an organic basis, fourth quarter sales increased 0.4% versus last year. This result included an anticipated fall off in disposable respirator demand and the exit of our operations in Russia. These two items

combined negatively impacted organic sales growth by approximately $230M, or 2.6 percentage points. /Excluding this decline, Q4 organic sales growth was 3%.

On an adjusted basis, fourth quarter operating income was $1.5B, with operating margins of 19.1%. Adjusted earnings for the quarter were $2.28 versus $2.45 last year.

Turning to the components that impacted fourth quarter operating margins and earnings year-on-year performance.

We took a number of actions to navigate the fluid and slowing macroeconomic environment. Including managing selling prices to address inflationary pressures, reducing manufacturing output, maintaining strong spending discipline, and taking additional restructuring actions to streamline the organization and adjust to slowing end-market demand.

These actions delivered an underlying benefit to operating margins of 110 basis points and $0.19 to earnings. This helped more than offset headwinds from the sales decline in disposable respirators and Russia exit which negatively impacted operating margins by 70 basis points and earnings by $0.15 per share.

Inflation continues to impact raw material, logistics and energy costs. These pressures remain persistent and are broad-based. In Q4 raw material costs increased approximately $110M, or a negative impact of 1.4 percentage points to operating margins and $0.16 to earnings.

As mentioned, foreign currency translation was a negative 5% impact to total sales. This resulted in a headwind of $0.10 to earnings per share, however, was a benefit of 10 basis points to margins.

Divestitures, primarily Food Safety, along with the deconsolidation of Aearo Technologies, resulted in a year-on-year headwind of four-cents to earnings per share in the quarter.

Finally, other financial items increased earnings by a net $0.09 per share year-on-year, driven by lower share count, partially offset by a higher tax rate. Please turn to slide six.

Slide 6, Q4 2022 cash flow and balance sheet
Monish Patolawala

Fourth quarter adjusted free cash flow was $1.7B, up 3% year on year, with conversion of 131%, up 18% versus last year's Q4. During the quarter we aggressively adjusted manufacturing production levels to end-market trends which drove a sequential reduction in inventory levels by $250M. For the full year, adjusted free cash flow was $4.7B with adjusted free cash flow conversion of 82%.

Capital expenditures were $506M in the quarter and $1.75B for the year, or up 9% year-on-year, as we continue to invest in growth, productivity, and sustainability. Looking to 2023, we expect capital expenditures in the range of $1.5B to $1.8B, which includes approximately $200M of investment in water stewardship related to our exit of PFAS manufacturing.

During the quarter, we returned $1.4B to shareholders through the combination of cash dividends of $820M and share repurchases of $540M. For the year, we returned $4.8B to shareholders, including $3.4B in dividends and $1.5B in share repurchases. In addition, we reduced our outstanding share count by 16 million shares via an exchange offer associated with the Food Safety divestiture. Having a strong balance sheet and capital structure remains a priority for 3M because of the flexibility it provides.

Net debt at the end of Q4 stood at $12.0B, down 4% year-on-year, with net debt to EBITDA at 1.4 times.

Please turn to slide 8 for our business group performance.

Slide 8, Business Group performance
Monish Patolawala

I will start with our Safety and Industrial business, which posted sales of $2.7B, or up 1.3% organically.

This result included a year-on-year headwind of approximately $165M due to the ongoing decline in demand for disposable respirators. Excluding disposable respirators, Safety and Industrial grew Q4 organic sales by 7.5%.

Our personal safety business declined mid-single-digits organically, primarily due to the decline in disposable respirator demand.

Turning to the rest of Safety and Industrial, organic growth was led by low-double digit increases in electrical markets, automotive aftermarket, and abrasives. Industrial adhesives and tapes, and closure and masking systems both declined low-single digits.

Operationally, the Safety and Industrial team drove strong execution during the fourth quarter. Adjusted operating income was $611M, or up 9% versus last year. Adjusted operating margins were 22.4%, up 2.7 percentage points as the team managed inflation with price actions, drove yield and efficiency, and exercised strong spending discipline while also investing in the business.

Moving to Transportation and Electronics, which posted sales of $2.1B, or up 1.4% organically.

Our auto OEM business increased mid-teens versus a 2% increase in global car and light truck builds. We continued to gain penetration on new automotive platforms while also benefitting from a favorable comparison due to last year's Q4 channel inventory drawdown.

Our electronics business declined 10% organically as it continued to be impacted by significant end-market weakness, particularly for smartphones, tablets, and TVs.

Turning to the rest of Transportation and Electronics, advanced materials grew organically low-double digits, while both commercial solutions and transportation safety increased low-single digits.

Transportation and Electronics delivered $366M in adjusted operating income, down3 % year-on-year. Adjusted operating margins were 17.8%, up 60 basis points versus Q4 last year. The team was able to more than offset manufacturing productivity headwinds and inflationary pressures with ongoing benefits from pricing, along with strong spending discipline and restructuring actions while investing in the business.

Looking at our Health Care business, Q4 sales were $2.0B, with organic growth of 1.9% versus last year.

Sales in our medical solutions business declined low-single digits organically. Fourth quarter elective healthcare procedure volumes were approximately 90% of pre-COVID levels as nurse labor shortages and strained hospital budgets continue to impact the pace of recovery. Oral care was up low-single digits despite decreased consumer spending on discretionary items. And finally, separation and purification organic sales increased high-single digits while health information systems was up mid-single digits.

Health Care's fourth quarter operating income was $421M, down 18% year-on-year. Operating margins were 20.6%, down 2.9 percentage points, with adjusted EBITDA margins of nearly 29%.

Year-on-year operating margins were impacted by manufacturing productivity headwinds, increased raw materials and logistics costs along with investments in the business. These headwinds were partially offset by pricing actions along with strong spending discipline.

Lastly, our Consumer business posted fourth quarter sales of $1.2B. Organic sales declined 5.7% year-on-year with particular weakness in the U.S. which was down high-single digits.

All businesses declined organically as consumers pulled back on discretionary spending and retailers aggressively took actions to reduce their inventories, particularly in the U.S. Looking ahead, we anticipate these trends to continue at least through the first half of 2023.

Consumer's fourth quarter operating income was $224M, down 24 % compared to last year, with operating margins of 17.9%, down 3.3 percentage points year-on-year.

The year-on-year decline in operating margins was driven by increased end-market weakness, higher raw materials/logistics and outsourced hardgoods manufacturing costs, manufacturing productivity headwinds along with investments in the business. These headwinds were partially offset by selling price actions and strong spending discipline.

I'll now turn it back over to Mike for a recap of our full-year 2022 performance.

Please turn to slide nine.

Slide 9, 2022 full-year performance
Mike Roman

Thank you, Monish.

2022 was a pivotal year for 3M. Throughout the year we took decisive actions that are foundational to our future, and at the same time maintained our focus on our customers. We addressed inflation through selling price actions, and proactively managed costs as demand softened throughout the year. To address supply chain disruptions, we did what was necessary to serve customers and reduce cycle times, including opening a new distribution center on the east coast.

We navigated COVID-related lockdowns in China, reached agreement with the Flemish government to restart operations in Zwijndrecht, and exited our Russian business. As always, we put 3M science to work to solve customer needs across our market-leading businesses.

In Safety and Industrial: our new robotic paint repair system received multiple prestigious honors, as we continue to drive innovation in automotive manufacturing, an area we've led in for more than 100 years.

In Consumer: we launched Scotch Cushion Lock, a sustainable alternative to plastic wrap, which was recognized by Fast Company as one of its World Changing Ideas.

In Health Care: we advanced our leadership in wound care, which includes our negative pressure wound therapies becoming the first solution of its kind to surpass 2,000 peer-reviewed studies.

In Transportation and Electronics: we introduced new thermal barrier films to improve performance of electric car batteries – one element of our half-a-billion-dollar automotive electrification platform, which delivered 30% organic growth in 2022.

Companywide, for the total year we delivered organic growth of 1%, or 3% excluding the impact of disposable respirators and our Russia exit.

We posted adjusted EPS of $10.10, along with adjusted free cash flow of $4.7 billion, with an adjusted conversion rate of 82%. We strengthened our balance sheet and reduced net debt by half-a-billion-dollars, ending 2022 with a net debt to EBITDA ratio of 1.4. This enabled us to invest in the business and return $4.8B to shareholders through dividends and share repurchases.

At the same time, we took actions to position us for the long-term. We divested our food safety business, receiving $1B and reducing our outstanding share count by 16 million. We continue to progress in our Health Care spin-off, which will create two world-class public companies, better positioned to drive growth and value creation.

With respect to Combat Arms litigation, as last week's report from the chapter 11 co-mediators indicated, 3M continues to support Aearo Technologies in this ongoing confidential mediation process. We continue to address PFAS litigation by defending ourselves in court or negotiating resolutions, as appropriate.

We also announced we will exit all PFAS manufacturing by the end of 2025. Our decision is based on careful consideration of the external landscape, including regulatory trends, and changing stakeholder expectations. We simplified and streamlined our supply chain organization and advanced our digital strategies to better serve customers. We followed through on our sustainability commitments: we are ahead of schedule installing state-of-the-art filtration technologies in factories around the world – we now have capabilities up and running at all 3 of our largest water-using sites in the U.S., and in Zwijndrecht.

We supported employee health, safety, and well-being, including new flexible work arrangements and factory investments. And, we advanced diversity, equity, and inclusion, with each of our business groups now executing initiatives.

The steps we took in 2022, and the steps we are continuing to take in 2023, position us well as we look toward the future.

Please turn to slide 11.

Slide 11, 2023 outlook
Mike Roman

We expect market and macroeconomic challenges to persist in 2023. Based on this outlook, we expect organic growth of minus 3%, to flat, along with adjusted EPS of $8.50 to $9.00, and adjusted free cash flow conversion of 90% to 100%.

Our expectations reflect the slowing in demand we are seeing as we start 2023. Supply chains are improving; however, we still see headwinds from material availability and inflation, albeit at a lower level.

We are not satisfied with our progress or performance. We are taking additional actions, building on the actions taken in the second half of 2022 to reduce costs, structure, and inventory. We have implemented strict control of hiring and discretionary spending. Today we announced that we will reduce approximately 2,500 global manufacturing roles – a necessary decision to further align with adjusted production volumes.

In addition to the actions we are taking to respond to the macro environment, we are taking a deeper look at everything we do, as we prepare for the health care spin.

As we move through the year, we will take additional actions to improve supply chain performance, drive simplification, and bring us even closer to our customers. At the same time, we win in the market because we stay close to customers and continue to invest in innovation, even in the most difficult times.

We will continue to invest in growth opportunities in our businesses, aligned to global trends that take best advantage of our innovation. Automotive electrification, industrial automation, biopharma processing, and home improvement are just a few examples of large, fast-growing markets where we are investing, and where 3M innovation can make a difference.

We will continue to prepare for the spin-off of our Health Care business, which presents a tremendous value creation opportunity, while at the same time, preparing 3M for future success.

We will work to resolve the litigation we face, following through on the actions we initiated in 2022.

Underpinning all of our work will be the strengths of 3M: our people, our industry-leading innovation, our advanced manufacturing, our global capabilities, and our iconic brands. I am confident in our future. As we exit 2023, we will be a stronger, leaner, and a more focused 3M.

Monish will now cover the details of our outlook. Monish.

Slide 12, 2023 guidance
Monish Patolawala

Thank you, Mike. Please turn to slide 12.

The macroeconomic environment remains very fluid and uncertain. For 2023, we anticipate that GDP and IPI will continue to moderate with both currently estimated to be around 1.5%, or about half of 2022 levels. Therefore, against this backdrop, we feel it prudent to set our expectations to reflect this reality.

As Mike mentioned, we estimate our full-year adjusted organic sales growth to be in the range of -3% to flat. This includes selling prices up low-single digits, therefore organic volumes are expected to be down low-to-mid single digits for the year.

This range also includes an estimated 2 percentage point headwind from the ongoing decline in disposable respirator demand along with the impact of our exit from Russia. We currently expect our disposable respirator demand to be down to pre-pandemic levels. As the strength of the US dollar carries into 2023, we estimate a foreign currency translation impact to sales of -1% to -2%. And divestitures that were completed in 2022 will be a headwind to sales of nearly 1 percentage point.

Adjusted earnings are expected to be in the range of $8.50 to $9.00 per share. This range includes a combined earnings headwind of ($0.55) to ($0.80) per share year-on-year from the following three items.

First, the expected sales decline of disposable respirators and exit of Russia will be an impact of ($0.30) to ($0.45) Second, foreign currency will be a headwind of ($0.10) to ($0.20). And third, divestiture impacts will be a ($0.15). In addition, the 2022 carryover impact of higher raw material and logistics costs combined with energy inflation creates a year-on-year headwind of approximately $150M to $250M, or roughly ($0.20) to ($0.35) of EPS. And finally, non-operating items are estimated to be an impact to earnings per share of flat to minus ($0.10). This range includes a year-on-year increase in non-operating pension expense of $125M, a full-year adjusted tax rate in the range of 18% to 19%, and a lower year-on-year outstanding share count.

While there are a number of headwinds to earnings in 2023, ultimately our full-year performance will be driven by organic sales volumes, sustained progress in global supply chains and raw material availability, and our ability to drive improvements and reduce costs in our manufacturing and supply chain operations.

Finally, full-year adjusted free cash flow conversion is forecasted to be in the range of 90% to 100 %.

This range includes the continued healing of global supply chains, expected improvements in working capital performance, particularly inventory reductions, and full-year capital expenditures of $1.5B to $1.8B, which includes approximately $200M of investment in water stewardship related to our exit of PFAS manufacturing.

Please turn to slide 13.

Slide 13, Managing in a challenging macroeconomic environment
Monish Patolawala

Looking at our expected performance by business.

We see Safety and Industrial organic sales growth to be down low-single digits in 2023. This includes an estimated decline in disposable respirator sales of $450M to $550M, or a negative impact of approximately 4 percentage points as the business returns to pre-pandemic levels. Demand across industrial end-markets is moderating as customers remain cautious. Our Safety & Industrial team will also be monitoring the recovery of industrial production activity in China as we start the year.

Adjusted organic sales growth for Transportation & Electronics, excluding the impact of the exit of PFAS manufacturing, is forecasted to be down mid-single digits to flat organically. Looking across end-markets, automotive unit volume production is currently forecasted to be up nearly 4% year-on-year. We also expect automotive electrification trends to remain strong as we leverage our technologies and develop new innovative solutions for our auto OEM customers. Electronics, however, is expected to be down significantly due to weak end-market demand for TVs, tablets, and smartphones, along with the ongoing impact of display technology shifting to OLED from LCD.

Health Care's organic sales growth is anticipated to be up low- to mid-single digits versus 2022. We expect gradual improvement in healthcare elective procedure volumes as nurse labor shortages and strained hospital budgets continue to impact global healthcare systems. In oral care, we will be monitoring consumer discretionary spending and its impact on patient visits including orthodontic care. The healthcare team continues to create differentiated value and deliver strong margins for the attractive end-markets we serve.

And finally, organic sales in Consumer are estimated to be down low-single digits to flat as U.S. consumers remain cautious and retailers continue to aggressively reduce their excess inventory levels. Despite these near-term challenges, the consumer team remains focused on leveraging our iconic brands and accelerating new product launches in 2023.

Please turn to slide 14.

Slide 14, Q1 2023 outlook
Monish Patolawala

Before we go to Q&A, I want to walk through how we are seeing the first quarter.

First, three weeks into January we are seeing continued slowing in organic sales volumes as we start the year. This slow start is driven by the same weakening end-market trends that impacted the finish to 2022.

We expect soft consumer discretionary spending along with retailer destocking to continue into the first quarter.

Sales of electronic devices are forecasted to be down between 10% and 30% sequentially in the first quarter. While semiconductor end-markets and automotive builds are down mid-single digits sequentially.

Healthcare and oral care elective procedure volumes are expected to be at the same levels as Q4 and, as we have noted, industrial end-markets are mixed. And we anticipate the ongoing COVID-related challenges to continue in China and the geopolitical situation in EMEA to persist.

Therefore, taking all of these items into consideration, we estimate Q1 total adjusted sales in the range of $7.2B to $7.6B versus $8.5 adjusted for the exit of PFAS manufacturing, or down 10% to 15% year-on-year.

This anticipated year-on-year decline includes headwinds of 3 to 4 percentage points from disposable respirator sales decline and Russia exit, 3 to 4 percentage points from foreign currency translation, and a 1 percentage point impact from divestitures.

Taking these factors into account, we expect Q1 organic sales to be down low-single-digits to mid-single-digits. From an EPS standpoint, we estimate that first-quarter adjusted earnings per share will be in the range of $1.25 to $1.65. This range is impacted by the continued slowing of organic sales volumes, a pre-tax restructuring charge of $75M to $100M, or ($0.10) to ($0.15) per share, a tax rate of approximately 19%, along with normal Q1 items.

As you can see, the first quarter presents a tough start to the year. We will have our most challenging year-on-year comps related to declining disposable respirator demand and our exit of Russia. Ultimately, organic volume trends will be the biggest factor in determining how the quarter will turn out.

2023 is an important year as we work on progressing our strategies including preparing for the spin of Health Care, improving our manufacturing and supply chain operations, and taking actions to further streamline the organization. We are focused on creating the shortest path to the customer and providing innovative solutions to their most challenging problems.

We will remain nimble and take appropriate actions as we respond to changing market dynamics. And we will continue invest in growth, productivity, and sustainability to ensure the long-term success of our enterprise.

To wrap up, I continue to be bullish on our long-term trends. The large and attractive end markets we serve provide exciting opportunities for the future of 3M. We are not satisfied with our performance and the expected start to this year. We are working to aggressively address our operating performance in this challenging environment. We expect organic sales volumes will improve as consumer retail and consumer electronics markets stabilize, China works through its COVID-related challenges and, as our year-on-year comps ease. We also expect supply chains to continue to heal and raw materials and logistics cost headwinds to abate.

Therefore, we anticipate improvements in organic growth, operating margins, earnings, and cash flow as we progress through the year. As you have heard me say before, there is always more we can do and will do to improve our performance.

I want to thank our customers and suppliers for their partnerships, and the 3M employees for their hard work and dedication as they continue delivering for our customers.

That concludes my remarks. We will now take your questions.

Slide 15, Questions & Answers

Scott Davis - Melius Research LLC - Founding Partner, Chairman, CEO & Research Analyst of Multi-Industry Research

I was hoping you could walk us through, just perhaps logistically or opportunistically, how you exit PFAS. It's so kind of integrated with your product line, your manufacturing systems. Can you sell some facilities? Can you extract some value? Or is it -- or do you just have to kind of close -- lock up the facility and walk away? And how does that kind of work logistically?

Mike Roman

Yes, Scott. So maybe I'll take you back to the announcement of the exit. We said we'll exit all PFAS manufacturing by the end of 2025. We also said we would work to discontinue use of PFAS in our products broadly across the company. That's both in our products but also in the manufacturing of our products.

And I think your question is really on our manufacturing part of that. And we said we will meet contractual commitments that we have to our customers, and we're working closely with them to manage that as we make this transition. But ultimately, also, I talked about that we are not planning and won't sell the businesses and that we will plan to shut them down as we work through the transition as we get to the end of 2025.

Monish Patolawala

Scott, just also a reminder, as we disclosed, we said we would take -- the exit cost of this will be in the range of $1.3 billion to $2.3 billion. And we took a fourth quarter charge of $800 million, that's included in that range of $1.3 billion to $2.3 billion.

Scott Davis

Okay. That's helpful. And then you talked about doing some further restructuring, perhaps help us understand the scope or scale, or at least are you talking about -- I think you mentioned 2,500 people. But are there rooftops and meaningful kind of cost out that you see in this plan?

Mike Roman

Yes, Scott. So the announcement we made today was 2,500 jobs in manufacturing, really is responding to the volume that we see, the outlook for the volume. And that's -- we're putting a focus on supply chain. We see an opportunity to continue to streamline our supply chain. We hope to take advantage of some of the tailwinds as supply chains heal, as Monish talked about.

We're taking actions ourselves, and we're looking at what additional actions we can take there. And we're looking deeper in the company as well as we work to prepare for the Health Care spin, we've been looking at 3M ParentCo as well, and how do we simplify, streamline and put our position ourselves closer to customers. So it's really looking deeper and broader. And I think taking actions, proactively taking actions against the outlook we have for our markets.

Andrew Kaplowitz - Citigroup Inc., Research Division - MD and U.S. Industrial Sector Head

Mike or Monish, you mentioned that industrial end markets are moderating, customers are cautious. I think, for instance, you mentioned industrial adhesives and tapes were down in Q4. Has there been a material change from conversations that you've had previously with industrial customers? Or is this just gradual moderation?

And then is the regional weakness that you're seeing in China just a function of COVID interruption and more consumer base versus end demand related? And how do you think that pans out in '23?

Mike Roman

Yes. Andy, back to Monish's comments, we're seeing kind of mixed performance in the industrial markets. We see strengths as we said, as we came through the quarter in areas like electrical markets and automotive aftermarket. We were seeing some moderation in specific end market segments.

And the comment about industrial adhesives and tapes and closure and masking is some of that is related to the electronics slowdown. So that's part of that impact. It's also impacted by China. So China has really got a couple of things that are part of the slowdown. One of them is COVID and the interruption in the markets in industrial production and GDP. It's also reflecting the importance of electronics to that market into our business there in China. And we see that continuing those dynamics that we saw in Q4 continuing into the start of the new year.

We saw some moderation in specific segments of industrial. We saw specialty vehicle construction markets. We saw some moderation coming through the end of the quarter. We're off to a slow start as we start the year. There's a couple of areas of destocking really related to those end market segments where we've seen nothing more broad-based than that. We had strong performance across some of those other end markets in industrial. But we're starting to see some moderating and, like I said, January is off to a slower start for industrial.

Andrew Kaplowitz

Mike, that's helpful. And then maybe could you give us a little more color regarding price versus cost expectations for '23. You mentioned the low single-digit price improvement you're seeing. You also mentioned supply chains are healing. Are you generally seeing pricing hold up for you despite some of this demand weakness across the portfolio? And then versus raw material and energy related headwinds, does that price versus cost equation getting increasingly green as you go throughout the year?

Monish Patolawala

Yes. So I think 2 different points in there, Andy. As you correctly pointed out, the carryover impact on what we have assumed right now in the guide is 2 pieces. On the selling price, we said approximately 2%. At the same time, the carryover impact of both raw materials and energy inflation is approximately 150 to 250. So when you just do that equation together, right now, it's positive.

I think what we'll see as we go through is how do supply chains heal and how fast can we get the cost out. But at the same time, it will take a little bit of time as we sell through our higher cost goods through our inventory, you're going to see some of that moderate, but it will start showing up as the year progresses.

The key question for us that we have to think through and that's what we are thinking through is, as deflation starts showing up in the economy, the discussion that's going to come up is the elasticity of price across not just our company but across all companies.

And what we have found over time, Andy, as you know, 3M so well that, our innovation ultimately drives the value that we add for our customers. And historically, we have been able to have a good price cost equation because of the value that we add for our customers. So seeing what we'll see in '23 will depend on supply chains and what plays out in the long run, we are very confident that the price/cost equation continues to be green just because of the value we add to our customers.

Andrew Obin - BofA Securities, Research Division - MD

Just a question. What are you guys just -- and if I missed it, I apologize, but are you sort of modeling an explicit recession in your forecast? What are your macroeconomic assumptions? I know you sort of said things are slow, but are you explicitly modeling a recession?

Mike Roman

Yes, Andrew, underlying our view of the year is -- the projection for the macro is part of it. And then we're talking about specific markets and dynamics that we're seeing coming through the quarter into -- coming through the fourth quarter into the new year.

So when you look at the macro global GDP, IPI in the 1.5% kind of range is the outlook for the year. You see U.S. softer than that. You see GDP below 1%. You see IPI even projected to turn negative as we get into the middle of the year. So those are kind of the macro dynamics that we're looking at.

We're also looking closely as we talked about in a couple of these market segments. Fourth quarter, we saw this 10% to 30% decline in the consumer electronics build and that is expected and projected. I would say, to continue as we get into first quarter and the first half of the year and consumer discretionary spending and the impact on the -- our end markets is -- that was in decline in Q4, I expect that to continue.

So the macro is part of it, and we're looking closely at these key market segments and the indicators there. And I think it really says Q1 looks like Q4 and there are some areas of additional slowing. And then we kind of look at the total macro for the rest of the year as we shape up our outlook.

Andrew Obin

Got you. And then the question about pricing. Just historically, given -- and I know the way you report pricing is not necessarily how we think about pricing internally. I completely appreciate that.

But has anything changed in the market structure in terms of your ability to drive the pricing? I just would have thought for 3M, reported pricing would have been more of a tailwind into '23. But it is what it is, but are there any structural changes that you're seeing and that you're trying to address?

Mike Roman

Andy, there really is 2 parts to our pricing actions in the near term. One of them is what Monish talked about, we are always really looking closely at our price value in the marketplace. Our innovation delivers value to our customers.

We manage our pricing in the -- take advantage of that value and really make sure that we are getting that value through our broader market pricing. The last couple of years has brought in the inflation dynamic, and that's really been the driver. We are taking pricing actions to adjust for the input cost.

And so you've got a mix of our innovation as well as the inflation dynamic. And so as you look into 2023, you're -- we're confident we'll continue to position ourselves in strong price value based on our innovation. We are going to be managing inflation along with everyone else. How do we see that progressing, and what will we do with our prices, adjusting those if we see additional inflation and managing those as the -- I would say the elasticity in the market around inflation plays itself out.

Stephen Tusa - JPMorgan Chase & Co, Research Division - MD

What are you guys seeing on the inventory side of the -- of your more industrial businesses? I think you talked a bit about auto, but maybe just on the general industrial side, customer inventory behavior?

Mike Roman

Yes. Steve, I touched on a little bit of that. I would say as we began Q4, overall inventory looked to be in pretty good shape. And that was with the notable exception of Consumer. Everyone was working to reduce the inventory, and we saw a lot of destocking efforts in Consumer.

As I said, we're starting to see some destocking in industrial. I would say, Asia and China, where we are seeing weaknesses in consumer electronics driving some of that. And as I mentioned earlier, some specialty markets like construction and a few other areas like even packaging, we're seeing some reduction of inventory as we start the new year.

When you look at our transportation and electronics business the consumer electronics OEMs are reducing inventories. With that outlook for their demand, they're reacting to it. Automotive OEM inventory still remains low. It's improving, but it remains low as they're recovering from some of the supply chain disruptions.

Health Care, overall, looks pretty stable. We see oral care channel reacting to some of the consumer discretionary spending and slowing there in oral care that we saw really in the second half, and then it

comes back. The biggest move is in the consumer where retailers are still aggressively reducing inventory. So some dynamics reflecting some of the changes in demand in the end markets.

Stephen Tusa

Okay. And then you mentioned January was starting slow. I mean, can you give us a little bit of context? Is that -- is January or January -- is January organic kind of like below the low end for the -- of the annual range? Just roughly, just some color on kind of how slow January started for you guys?

Monish Patolawala

Yes, Steve. So back to January, yes, it is lower than the overall range. And partly, that's also driven by the toughest comps that we're going to have going into 1Q. As I mentioned, 7.2% to 7.6% -- $7.2 billion to $7.6 billion is the revenue range. It will be down 10% to 15% versus last year's adjusted. And you have to take revenue and adjusted for the exit of PFAS manufacturing, which would be around $8.5 billion. But embedded in that is 3% to 4% from foreign currency headwinds. So it's a Q4 carryover impact.

You've got 1% from divestitures, which is based on the closure of the Food Safety and some of the other transactions we did in 3Q. And then you've got a very large headwind from DR and Russia. If you recall last year, we had a very strong 1Q with the Omicron variant. Plus at that time, we had not announced the exit of Russia until mid-March. So that's another 300 to 400 basis points of pressure because you've got a comp. And therefore, overall, it's LSD to MSD is what we think right now is organic sales growth for 1Q. And what you'll find is as the year goes on, these comps start getting easier and that will start showing the growth on a year-over-year basis. Hopefully that answer your question.

Stephen Tusa

Yes. You weren't down double digit in January. Are you? Double digit?

Monish Patolawala

As of right now, we are somewhere in that range of where I told you.

Joseph Ritchie - Goldman Sachs Group, Inc., Research Division - VP & Lead Multi-Industry Analyst

I know we've talked a lot about the organic growth guidance for the year. I guess I'm just curious, when you think about the consumer specifically, it seems like you're embedding improvement as the year goes along. Is that just a function of inventories getting better? How much of that is China reopening? I just want to get an understanding of that business specifically.

Monish Patolawala

Yes. So on Consumer -- so you're right, Joe, I'll start with the summary, which is we are expecting that as things stabilize and as customers slow down their destocking, you will start seeing the comps get better in the year. The fourth quarter was extremely hard.

And as Mike said, we saw an acceleration of a trend in December. We continue to see that in January, and that's why the first quarter starts pretty soft. But our hope is that as things stabilize, as destocking gets better as consumer confidence builds into the year, we'll start seeing the consumer business starting to get better.

Joseph Ritchie

Got it. That's helpful, Monish. And maybe my follow-up question is a little bit of a longer-term question on the electronics business. So specifically, I think in your comments, Monish, you mentioned that this shift into OLED, I know there was an announcement about Apple making their own custom displays starting in 2024. Just trying to understand like how that will potentially impact your business beyond this year? And then is it already expected to impact your business in 2023?

Monish Patolawala

What -- I would answer, and then I'll ask Mike to join in. The way I look at this, Joe, is there are a couple of things. The company has always – has been looking at the LCD-OLED transition for a period of time. And that transition has been happening for a few years, and the team has continued to deal with that as it goes on.

What the team is working through is as new devices are coming on, what does that mean from a OLED to LCD ratio to mix. It definitely did have an impact for us in 2022. And then we are seeing what trends we are seeing -- as of right now, the trends we saw, we have predicted into 2023.

But with that said, the one thing about the electronics segment, and especially the display teams, is they always have a lot of innovation that is out there that helps offset some of these headwinds that come across. That business keeps reinventing itself as time has gone.

For example, Ashish and his team have launched products that are used in AR and VR technology, which also hopefully is a growth market in the future, and that's what -- that business is very good at looking at these trends, working these headwinds and then finding innovation to offset that as time goes. But right now, we have embedded what we think is the trend in LCD-OLED shift into our 2023 guide.

Mike Roman

Yes. And Joe, I would add we've been managing that transition and that trend for some time. It's -- and it's part of our innovation that we're doing with our customers, too, innovating on both sides of that, the OLED displays. And as Monish said, the other higher growth segments in electronics, historically, our electronics business has been overweight to consumer electronics.

And as we've talked about over the last few years, our strategy is continue to innovate there, and we're working with our customers multiple generations ahead, whether it's OLED displays or other applications, we're really working with them to innovate and drive value and opportunity for 3M in that consumer electronics.

At the same time, we recognize the big growth drivers are some of these other higher-growth segments. And Monish talked about AR/VR now emerging as one of those opportunities. Automotive electrification, of course, is the largest of those right now.

There's other areas like factory automation, and even into electronic into semiconductor manufacturing kinds of processes. So we are innovating in those spaces and at the same time, looking ahead and managing through the next display technologies and the next mobile device technologies and consumer electronics.

Julian Mitchell - Barclays Bank PLC, Research Division - Research Analyst

Maybe just wanted to start on the operating margins. So sort of backing into what you've talked about, are we right in assuming that the guide embeds sort of 19% operating margin for the year and sort of mid-teens in Q1?

And then on that Q1 aspect, very heavy decremental margins sequentially even without the restructuring charge. Is there a lot of sort of under production going on at 3M to clear out inventory, for example? Just trying to understand why that Q1 margin is so light. I think it's like a 50% decremental or something excluding the restructuring.

Monish Patolawala

Yes. So I've always said, Julian, first is volume gives us the best leverage. And what you have seen in Q4 continues into Q1. As we have said in Q4, we took some aggressive actions on making sure we rightsized our manufacturing facilities to help control inventory. Our plan is we will continue to aggressively manage production as a way to -- manage production as a way to manage cash at the same time so we're not building unnecessary inventory. So that's number one.

I think number 2 is, as I mentioned, there's continued pressure on a year-over-year basis on foreign currency between 3% to 4%. If you look at it versus fourth quarter exit rate, it's pretty much, I would say, flat to what fourth quarter exit rate was. And then the other item, you mentioned the restructuring, but we also have other normal 1Q items that we have from an accounting basis that we take which is normal in every quarter.

And that's why the start to 1Q is slower. But as you accelerate or move through the year, volume and the supply chain healing are the 2 factors that will continue to drive us to get these margins better. And if we're looking at it on a year-over-year basis, it's all driven by the comps that we had last year, which impact us heavily. So it's lower volume in Q1, that's a big driver and volume will be the big determinant on what we think Q1is going to be.

Julian Mitchell

And Monish, is that roughly right on that sort of mid-teens operating margin Q1 and 19-ish for the year in your guide?

Monish Patolawala

Yes. Yes, it's -- we're actually close there. It's close enough, Julian.

Julian Mitchell

And then one quick follow-up on that for Mike. Mike, you've announced a restructuring program today. I think it's the first kind of formal discrete one since fourth quarter of 2020. And you had the business transformation savings program prior to that. Just wondered sort of when you think about the scope of the current restructuring plan, what kind of savings run rate we should expect annually when do you get to that? And how do you assess the kind of scope of this being enough to get margins back on track as you had those prior restructuring programs, but margins have sort of stayed under pressure?

Mike Roman

Yes, Julian, the way we're thinking about it. And like I said, this is certainly taking on what we see in the markets and in our performance and the supply chain dynamics that we're facing, all of that's part of what

we're focused on as we look at these actions as we go through the year, adding to what we've already announced.

And then we are thinking and getting ready for the spin of Health Care. We're taking a deeper look, as I said, at everything we do. There's opportunities to streamline what we do as a company in the face of those end market dynamics and then in our operations. And we're learning from the changes that we've made to this point.

So we'll continue to work on that. In terms of giving you a view of the impact of that, that's something we'll come back with as we make decisions and announce those actions, those additional actions as we go through there.

Deane Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

Thank you for all the '23 planning assumption details and also for providing first quarter guidance, I know that's not a typical practice but given all the moving parts, we appreciate that. So my question relates -- it's come up a couple of times on the Health Care spin.

Can you remind us the timing that you're expecting? There was some noise about the potential challenges in the courts. Where does that stand? And on the separation costs, how much is this impacting '23? Or is that all excluded and stranded costs? How quickly would you be able to address those?

Mike Roman

Yes, Deane, maybe I'll talk a little bit about just the spin now. Monish can talk about the separation cost model. We have a dedicated team working and building the execution plans. We're making very good progress. We talked about our expectation that we would be completing the spin by the end of '23, early '24 and that's kind of the focus for the teams as they work to execute this.

You commented on there had been some -- actually, there was a suit in the marketplace around the spin of Health Care and again, would we be able to complete that spin. And that was something that was dismissed. And so there's nothing from that dynamic that's impacting us. It's really about our teams working to execute the spin. And as I said, they're making very good progress. We're confident that we're moving in the right direction and moving ahead at pace.

Monish Patolawala

So as regards to the guide, Deane, as we had disclosed when we announced the spin of Health Care, we currently do not -- we are thinking of counting it as a special item, so that will be excluded from our ongoing operations. We are unable to predict how much of that will show up in 2023, so we haven't put that in our guide.

But when we had announced the transaction, we had given you a framework that our transaction cost of spin-off will be somewhere in the range of $1 billion to $1.5 billion, which is a mixture of CapEx and OpEx. The teams are continuing to work that as they go through right now. We've now been at this for the last 4 to 5 months.

So as we get better estimates around that, we will definitely keep you posted. And then as regards stranded cost, as Mike mentioned, and we had also mentioned it in the last quarter, this is an opportunity for us to look at everything that we do as we are getting ready for the spin.

And our goal is to reduce stranded costs as much as we can, and we'll keep working it as we go through it. And we'll definitely let you all know as we figure this out. But the teams are actively working. The teams are staffed and they're doing an amazing job keeping the program on track.

Nigel Coe - Wolfe Research, LLC - MD & Senior Research Analyst

We've covered a lot of ground here. But I want to go back to 1Q '23, perhaps Monish. We calculate a 15% margin, which is kind of similar to Julian's mid-teens. I don't think we've ever seen a margin that low. I think the GFC, we saw 17% and change margin. So just wondering why margins will be so low. And I understand supply chain is a factor here, but why 15%? What's going on?

And as part of this sort of question, the kind of the coverage of the full year plan even at the low end of the range is still really, really low. So I think it's about 17% to 19% coverage, making a very, very back-end loaded year. So I know you said volume gets better, but what gives you confidence and what can give investors confidence is enough capture in the back half of the year?

Monish Patolawala

Yes. So I think 2 different questions and both great ones. So I'll try to answer the first one, similar to what I told Julian. Volume gives us the best leverage. And when you just look at it even sequentially and you adjust for FX, which helped us versus a guide that we had given, volumes are going to be flat.

We have started very low in the month of January, and that puts tremendous pressure on our fixed cost, number one. Number two, we have a restructuring charge. And then number three, our tax rate is 19%. And then, of course, we have some another normal 1Q items from an accounting basis that we take.

So when you put all that together, I would say, Nigel, it comes down to volume. Volume is down 10% to 15% on a year-over-year basis. And so that's number one. This is the toughest comp and you have DR and the exit of Russia, both of which we have disclosed in the past. When you apply them at company margin, which is at 46%, that puts pressure also on a year-over-year basis.

When I go through the remaining quarter year and as you correctly asked the question, what happens on margins, as you start thinking about -- we exit some of these comps that are difficult, 1Q being the toughest, volumes will start -- our comps will start getting better.

The supply chain efficiencies, the actions that we have announced also in 1Q and some of the actions we took in 4Q will all start showing up in the remaining of the year. Again, as I mentioned, some of these items, including cost out from raw materials take a little bit of time as we work through our higher cost of inventory through the system.

If you also look at external data, and that's what we can look at because none of us are able to predict what we can in the future, external data says the second half gets better. It gets better in China; it gets better globally. And that's another reason why we are hopeful that as volumes come back in the second half, we should see our own margins go up and our own revenue go up.

But with that said, at the end of the day, we control -- we don't control the markets, but what we definitely control is our own actions. And so continuing to drive supply chain efficiency, continuing to make sure that we are being as nimble and agile as we can.

Using Mike's words, we are looking at everything. We're being very careful and discretionary in hiring. And 2023 is an important year. It's a year that we plan to execute on a lot of our strategies over the last few years, including the spin of our Health Care and improving our supply chain operations.

I just want to end with your question, Nigel. we are not satisfied with where we are. We're going to continue to look at this. We're going to continue to be nimble and agile as the volume plays itself out. And our goal is to keep building from where we are right now.

Bruce Jermeland

Nigel, I just want to correct one thing Monish said. Our total sales for Q1 are going to be down 10% to 15%, not volume.

Monish Patolawala

I'm sorry. Yes.

Bruce Jermeland

Organic sales growth is forecast to be down low single digits to mid-single digits.

Nigel Coe

Okay. I was going to follow up on that. So thanks for that clarification, Bruce. And I know I've asked 2 questions there, but I do have one for Mike. You said everything's on the table in terms of your reorganization and things about new ways of doing things, 5 or 6 years ago, 3M went through a sort of pretty big centralization of supply chain and business support functions. In hindsight, has that left the organization a bit too rigid? Was that the right move? And could you unwind that civilization?

Mike Roman

Yes, I would say that, Nigel, that the change is that -- there's a couple of different changes that we made to the supply chain maybe that you're thinking about. One was, we did take actions on some of the structure and really looking at factories, our footprint of factories a number of years ago. And then we moved to -- when we announced the change to our business group led model, we went to a common supply chain model globally. And we made some additional steps in that in last year, really to continue to drive more flexibility, greater streamlined performance end to end in our supply chain. So we see it really more as an opportunity to build on the changes we have made and drive simplification, streamline, more productivity, reducing our costs, delivering more directly to customers.

So it's continuing to build on some of those changes. I think those actually have positioned us to be more flexible as we go ahead. And there's an expectation that supply chains will continue to heal. So we want to be able to take advantage of those tailwinds that we hope to see as we go through the year.

At the same time, we control what we control, and that is making additional changes based on what we've learned to really execute our performance in our supply chain. It's the biggest opportunity we have to improve margin and cash flow as we go through the year.

Daniel Rizzo - Jefferies LLC, Research Division - Equity Analyst

This is Dan Rizzo on for Laurence. I don't know if I missed this or not, but you mentioned that free cash flow conversion is 90% to 100% this year. Is that a long-term goal. Can you maintain that? I mean, as things kind of, I guess, will get less volatile in the out years?

Monish Patolawala

Yes, it's 90% to 100% for 2023, just to be clear, that was the guide. For last year, we ended at 82%. As I've said multiple times, the opportunity for 3M's cash from a working capital comes from inventory management and EP. And to answer your question, is it sustainable? Of course, it will ultimately depend on the income that we generated depends on how supply chains behave and the capital.

But if you just look at the ability for us to use data and data analytics to help drive inventory and working capital clearly exists. In the fourth quarter, the teams did an amazing job to take inventories down, got it down by nearly $250 million. And as supply chains start to heal, this is clearly an opportunity for us, and we're going to keep driving that.

Mike Roman

To wrap up, we are focused on creating value for customers and shareholders in a challenging environment. We will continue to take actions to improve our performance, control costs and drive simplification, while building 3M for the future. Thank you for joining us.