Q2 2024 Earnings Call Transcript
Bill Brown and Monish Patolawala
July 26, 2024

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

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

With me today are Bill Brown, 3M's chief executive officer and Monish Patolawala, our president and chief financial officer. Bill 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 Statements
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-Q lists some of the most important risk factors that could cause actual results to differ from our predictions.

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.

With that, please turn to slide 3 and I will hand the call off to Bill.

Bill

Slide 3: Solid Q2 results, significant opportunities ahead
Bill Brown, Chief Executive Officer

Thank you Bruce, and good morning everyone.

This morning we reported second quarter results with non-GAAP earnings per share of $1.93, up nearly 40 percent, with 1 percent organic revenue growth. Adjusted free cash flow was $1.2 billion with conversion of 109 percent.

I'd like to thank the 3M employees for all their hard work in delivering solid second quarter results. Monish will provide further details on the quarter, and then I'll wrap up our prepared remarks with guidance for the year before opening the call to Q&A

I've now been in the job for nearly 3 months and have been busy visiting a number of our factories and labs, as well as taking a fresh look at our strategy and how we're executing against it.

As you know, 3M has been undergoing a lot of change in the past few years following covid, most recently with the successful spin-off of the healthcare business, executing on a significant restructuring effort, and working to mitigate risks including discontinuing PFAS manufacturing by the end of 2025 and settling legal matters. You've also seen a number of changes to our organizational model, shifting from a geographic to a global business unit structure and centralizing our global supply chain activities under one senior leader.

Collectively, this has been a massive transformational change for 3M, and the team has executed really well. As a result of these efforts, you're seeing the benefits in operating margin expansion, strong cash generation, and a solid balance sheet with low leverage ratios and an incrementally more positive view from the rating agencies. Credit to Mike and Monish for their steady hand in guiding the company through these changes.

But my job is to look forward, and while much progress has been made, we have more to do … including navigating PFAS-related matters where fortunately we have a strong terrific team managing the exit and our ongoing legal matters.

As I see it, we're still in the early innings of our operational excellence journey, and we haven't yet cracked the code on organic growth which I know is essential to creating shareholder value. So my top priorities are #1, driving sustained top-line organic growth … #2, improving operational performance across the enterprise … and #3, effectively deploying capital.

On the first priority, I believe that the company has significant organic growth opportunities as we participate in end-markets with favorable secular trends and have a strong foundation and long history in material science innovation. However, as you well know, organic growth has been below market indices and peers over a several years, and up only about 1 percent year-to-date. Driving sustained organic growth requires both getting more out of R&D, as well as, improving commercial excellence.

As I've gotten into the details, what I've learned is that ex-Solventum, R&D investment for "core" 3M which is running about $1 billion per year, or about 4.5% of revenue, has been about flat nominally over the past 5 years and down on a real basis as the focus was on investing in and strengthening the Healthcare business. And within the lower spend, the amount we invest on new product development has declined even further as the company shifted more dollars to efforts to exit PFAS manufacturing and worked to reduce supply chain cost and resolve COVID-related sourcing constraints.

As a result of the decline in investment, along with a strategic shift to fewer but larger innovation opportunities, the number of and revenue from new product introductions has steadily declined over the past decade.

The simple fact is that our products are ageing. While we've been shifting our portfolio towards higher growth markets – like auto electrification, industrial automation, data centers and semis, climate tech and others – these efforts aren't material enough today to offset erosion in our core. They remain for the most part attractive growth platforms, and we need to continue to balance investing appropriately in markets that are evolving quickly while also investing incrementally to sustain the core products we have today.

But before we make any adjustments to our R&D budget, I want to first explore opportunities to get more from what we currently spend … for example, improving the velocity of our new product development process and increasing the effective "capacity" of our engineers by eliminating bottlenecks and non-value-added work, and over time, redeploying those currently working on PFAS exit activities to growth initiatives.

With enhanced data transparency and a more coordinated governance process, we can improve R&D effectiveness by deploying resources on the highest return projects. These efforts are essential to reinvigorating the 3M innovation machine but will take time to bear fruit.

So, in the near term, we have to focus on commercial excellence to sell more of what we currently offer, and that means better salesforce and distributor effectiveness, targeted marketing, optimized pricing and much better execution at the customer interface – in particular on-time-in-full performance – which is a key part of my second priority, operational performance.

We have a terrific ops leadership team in place executing on a number of opportunities, and I wanted to give you some color on what I'm seeing so far. I have been looking at our manufacturing and distribution network to understand our global supply chain and distribution capabilities. I see opportunities to reduce complexity, drive lean manufacturing and logistics, improve supply chain management, lower yield loss, and increase service levels with lower inventory.

While our network of 110 factories and 95 distribution centers have historically served 3M well, it is incredibly complex and inter-connected with most SKU's we produce touching multiple factories before reaching the customer. For example, a Command strip touches 5 factories and 2 distribution points before it hits the store shelf. This extends cycle times, increases goods-in-transit, and drives up logistics and freight costs.

In lean manufacturing and logistics, we're developing a consistent metric around operating equipment efficiency – OEE – to increase equipment utilization and rein in capital spending, and mapping "modes and flows" to lower freight and distribution costs.

In supply chain, we have significant opportunities to improve our sourcing effectiveness. We have more than 25,000 direct and indirect suppliers including nearly 4,000 contract and component manufacturers, yet more than 80% of our raw materials are sole-sourced. We haven't been holding our suppliers accountable to the same quality and delivery standards as our customers hold us to, and we're only beginning to leverage our scale to reduce cost.

Relative to yield loss, our raw material waste is running close to 5% of Cost of Goods Sold -- due in part to how we design and manufacture our products but also due to inefficient production scheduling and changeovers.

And finally, we have too much inventory at about $4 billion and 102 days at the end of Q2 and yet our service levels are only in the mid-80's. Our bottoms-up analysis indicates we should be closer to 75 days of inventory or lower, which would imply about a $1 billion cash opportunity over time while we drive on time in full above 90 percent.

My third priority is effectively deploying capital and our approach remains the same as it has been … investing in R&D and capex to fund organic growth, paying an attractive dividend which we just recalibrated with the spin of Solventum, maintaining a strong balance sheet, and using excess capital for M&A or share buybacks. We repurchased about $400 million of stock in the second quarter and have the capacity to do more in the second half and next year. While no acquisitions are on the near-term horizon, I will be taking a fresh, dispassionate look at our portfolio to determine if any assets have greater value owned by others, and along the same line, what assets might be a good fit for 3M. I don't have anything further to say on that today, but you can expect to hear more from me regarding portfolio prioritization as I deepen my understanding of our businesses and end markets.

So for the past three months its been pretty busy start with a lot still to learn. I think we have a good foundation to build upon and believe that this "focus on fundamentals", "back to basics" approach will drive value creation. I'm encouraging everyone at 3M – from top to bottom – to every day challenge the status quo and the way we've done things in the past, to act with speed and urgency, and to offboard those things that distract us from growing, innovating and executing for customers and shareholders.
And with that, I'll turn it over to Monish to cover the quarter and I'll come back to discuss guidance.
Monish

Slide 4: Q2 results driven by operational execution
Monish Patolawala, President and Chief Financial Officer

Thank you Bill, and good morning everyone. Please turn to slide 4.

I would like to take a moment to briefly remind you of a few items that we highlighted during last quarter's earnings call.

Beginning with the second-quarter, our results for business segment operating income includes prospectively the impact of the dis-synergies, or stranded costs, previously associated with Solventum. Therefore, for historical pre-spin periods presented the dis-synergies are reflected in Corporate and Unallocated.

In addition, we added a new operating category named "Other" for Solventum Transition Service Agreement activity. "Other" includes our Q1 costs associated with supporting the agreements for which 3M started to be reimbursed for in April.

And finally, Corporate and Unallocated incorporates the commercial agreements between 3M and Solventum that started on April 1st, and retrospectively picks up certain operations of the former Health Care business retained by 3M.

Turning to our second quarter performance, we posted solid adjusted results including sales of $6.0 billion dollars, operating margins of 21.6 percent, earnings per share of $1.93 … and free cash flow of 1.2 billion dollars.

We delivered adjusted organic growth of 1.2 percent, or up 2.4 percent excluding geographic prioritization and product portfolio initiatives. These results reflect the trends that we have previously discussed including strong growth in electronics, mixed industrial end markets, and continued softness in consumer retail discretionary spending.

We had another strong quarter of execution with adjusted operating margins expanding 440 basis points year-on-year and delivered adjusted free cash flow of $1.2 billion dollars with conversion of 109%.

Slide 5, Q2 2024 operating margin and EPS
Monish Patolawala

Please turn to slide 5.

On an adjusted basis, we delivered operating margins of 21.6 percent, up 440 basis points, and earnings of $1.93 cents per share, up 39 percent versus last year's second quarter.

Our second quarter year-on-year performance was driven by organic growth, productivity, strong spending discipline, and restructuring savings which combined benefitted operating margins by 310 basis points and earnings by 31-cents per share. In addition, income from the transition services we are providing to Solventum increased margins by 50 basis points and earnings by 5-cents per share.

These benefits were partially offset by stock-based compensation which was shifted into the second quarter due to the spin of Solventum this was in line with what we discussed during our first quarter earnings call. This change in timing negatively impacted operating margins by 200 basis points and earnings by 18-cents per share versus last year's second quarter.

Lower year-on-year restructuring charges were a benefit of 270 basis points to margins and 23 cents to earnings. For the second quarter restructuring charges were $44 million dollars which were lower than anticipated. For the full-year, we continue to expect pre-tax restructuring charges in the range of $250 to $300 million dollars.

Foreign currency was a negative 4 cents per share impact as a result of the stronger US dollar.

Acquisition and divestitures were a benefit of 10-basis points to margins and 3-cents to earnings year-on-year. This benefit is related last year's second quarter re-consolidation of Aearo Technologies along with the commercial agreements between 3M and Solventum.

Below the line items benefitted earnings by a combined 14 cents per share. This benefit was primarily due to increased interest income year-on-year on a higher cash balance due to in part by cash proceeds received from the spin of Solventum.

Taking into account our first half of the year performance, we now expect our full-year non-operating expense to be in the range of $50 to $75 million dollars versus a prior range of $75 to $100 million dollars.

A quick comment on Corporate and Unallocated and "Other" before moving on to cash flow.

Q2 Corporate and Unallocated sales were $86 million dollars with a $2 million dollar adjusted operating loss. Year-to-date, Corporate and Unallocated sales were $112 million dollars with an adjusted operating loss of $73 million dollars. This is in line with our full-year anticipated sales range of $225 to $275 million dollars with a forecasted adjusted operating loss in the range of $125 to $175 million dollars.

Our "Other" category had operating income of $37 million dollars, which reflects the level of activity and effort to support the successful spinout of Solventum. Year-to-date "Other" had an operating loss of $28 million dollars which is in line with our full year expectation of flat to a loss of $25 million dollars.

Slide 6, Q2 2024 cash flow and balance sheet
Monish Patolawala

Please turn to slide 6.

Second quarter adjusted free cash flow was $1.2 billion dollars. Our second-quarter performance was driven by strong operating income, lower cap-ex spending partially offset by higher working capital.

Adjusted capital expenditures were $250 million dollars in the quarter as we continue to invest in growth, productivity, and sustainability.

During the quarter, we returned a total of $800 million dollars to shareholders … split equally between dividends and share repurchases.

And finally, net debt at the end of Q2 stood at approximately $3 billion dollars.

These strong results build on our track record of robust cash generation. For the first half of the year, we have generated $2 billion dollars of adjusted free cash flow. Our strong capital structure continues to provide us the financial flexibility to invest in our business, return capital to shareholders and meet the cash flow needs related to legal matters.

Please note, that in the month of July, we will make total combined payments of $3.7 billion dollars related to the Public Water Suppliers and Combat Arms settlements.

Before I move on to our business segment performance, I want to highlight a couple of items for your awareness that were excluded in arriving at our Q2 adjusted results.

First, note that we reached settlements of approximately $120 million dollars with insurance carriers related to Combat Arms. We remain in discussions with multiple carriers and anticipate additional future recoveries.

Second, during the quarter we incurred a non-cash charge of approximately $800 million dollars related to a $2.5 billion dollar pension risk transfer on a portion of our U.S. defined pension obligation with Met Tower Life. This action helps to reduce risk and administrative fees related to our U.S. pension plan.

Please turn to slide 7.

Slide 7, Safety & Industrial
Monish Patolawala

Starting with our **Safety and Industrial** business … which posted sales of $2.8 billion dollars, up 1.1 percent organically.

Industrial adhesives and tapes posted mid-single digit organic growth driven by strength in bonding solutions for consumer electronic devices.

Personal safety, and automotive aftermarket grew low-single digits. Electrical markets was up slightly while roofing granules was flat due to unplanned customer manufacturing challenges.

And finally, we experienced year-on-year organic sales declines in abrasives and industrial specialties.

Geographically, industrial markets grew low-single digits in the U.S. and Asia Pacific, while EMEA was down low-single digits.

Overall, industrial end market demand continued to be mixed in the quarter as end user and channel remain cautious.

Adjusted operating income was $623 million dollars, with adjusted operating margins of 22.6 percent … up 40 basis points year-on-year. This performance was driven by higher sales volume, benefits from ongoing productivity and restructuring actions and lower year-on-year restructuring charges. These benefits were partially offset by the timing of stock-based compensation and cost inefficiencies due to the spin of Solventum.

Slide 8, Transportation & Electronics
Monish Patolawala

Moving to **Transportation and Electronics** on slide 8 … which posted adjusted sales of $1.9 billion dollars, or up 3.3 percent organically.

Our electronics business outperformed the market, up low double-digits organically, as we continued to gain spec-in wins on consumer electronics devices and in semiconductor manufacturing.

Our auto OEM business increased nearly 5 percent in Q2 versus a half-a-point decrease in global car and light truck builds. Looking at the first half of the year, our auto OEM business was up 9 percent organically versus a flat global build rate of cars and light trucks as we continue to gain penetration on new platforms.

Looking at the rest of Transportation and Electronics …
advanced materials grew mid-single digits organically and commercial branding and transportation was down low single-digits year-on-year.

Transportation and Electronics delivered $426 million dollars in adjusted operating income, up 16 percent year-on-year.

Adjusted operating margins were 22.3 percent, up 250 basis points year-over-year. The team achieved this result through strong leverage on electronics volumes, ongoing benefits from productivity and restructuring actions, and lower year-on-year restructuring charges.

Partially offsetting these benefits were the timing of stock-based compensation grants and cost inefficiencies due to the spin of Solventum.

Slide 9, Consumer
Monish Patolawala

Turning to slide 9, the **Consumer** business posted second quarter sales of $1.3 billion dollars.

Organic sales declined 1.4 percent year-on-year with continued softness in consumer discretionary spending … this included a 2.7 percentage point impact from portfolio and geographic prioritization.

Home improvement grew mid-single digits … consumer safety and well-being grew low-single digits … packaging and expression declined low-single digits, while home and auto care declined mid-single digits organically.

Geographically, the U.S. was up slightly, Asia Pacific was down mid-single digits, and EMEA was down high-single digits.

Consumer's second quarter operating income was $219 million dollars, down 7 percent compared to last year … with operating margins of 17.4 percent … down 80 basis points year-on-year.

Operating margin performance was driven by lower volume and the timing of stock-based compensation grants along with cost inefficiencies due to the spin of Solventum. Partially offsetting these headwinds were benefits from lower restructuring charges.

Before I turn it back over to Bill, I want to take a moment to thank the 3M team for the tremendous progress they have made positioning the company for success.

I am very proud of the relentless focus our teams have brought to create value by driving performance through our improved productivity and efficiency, spinning out of our Healthcare business, and reducing risk and uncertainty by managing legal matters.

I am confident that under Bill's leadership the team will continue to build on this momentum to create consistent value for our people, our customers, and our shareholders in the years to come.

I would also like to thank all the analysts and investors for our rich discussions and engagements over the last 4 years.

With that, please turn to slide 10 and I will turn it back over to Bill for an update on our guidance.

Bill…

Slide 10, 2024 full-year earnings guidance
Bill Brown

Thanks Monish.

Given the strong operational execution in the first half of the year, we're raising the bottom-end of our full year adjusted earnings guidance by 20 cents to a range of $7.00 to $7.30, versus $6.80 to $7.30 previously … now up 16 to 21 percent year-on-year. Full-year adjusted operating margins are now expected to be up 225 to 275 basis points.

Full year adjusted organic growth remains unchanged at flat to up 2 percent, with expectations for second half organic growth in line with first half performance at the mid-point.

While significant macro uncertainty remains, our business segment end market trends are largely playing out as expected.

Year-to-date Safety & Industrial organic growth is approximately flat versus a full-year expectation of flat to up low-single digits. We expect that industrial end-markets will remain mixed as channel partners and end customers continue to remain cautious on overall demand trends.

On an adjusted basis, Transportation & Electronics is up nearly 5 percent organically in the first half, versus a full-year expectation of up low-single digits. Strength in the first half was due in large part to consumer electronics along with automotive. We continue to monitor auto build rates along with consumer electronics demand trends for the back-to-school and holiday season.

And finally, Consumer is down nearly 3 percent organically through the first-half of the year versus a full-year expectation of down low-single digits. We continue to expect that consumer retail discretionary spending on hardline goods to remain muted in the balance of the year.

Before we open it up for your questions, I would like to take a moment to recognize and thank Monish for all of his contributions and impact on 3M over the past 4 years. While I've had only a short time working with him, he has been a strong partner and has helped me get up to speed on the company, and I've enjoyed working with him. I appreciate everything that he has done to navigate through a number of challenges and to make 3M stronger along the way.

With that, let's open the call to your questions.

Slide 11, Q&A
Jeff Sprague – Vertical Research Partners LLC – Analyst

Hey, Bill, thank you very much for that very thorough and detailed kind of deconstruction of the history on organic growth and the like and I appreciate your comment that it will take some time to kind of get after these things. But are you actioning some of these ideas already? Can you give us a sense of how some of these changes on the front end of the business as it relates to organic growth may be kind of put in action?

Bill Brown

So good morning, Jeff, and thanks for the question. So as I mentioned in my remarks, there's two major thrusts here on driving organic growth. One is certainly to spur innovation and driving innovation to turn the top line up, drive organic revenue. And so part of it is, we've got to sort of bottom out on how much we're spending on new product development and start to turn the ship. The first half of this year we launched about 75, 76 new product introductions. This year we'll do probably less than 150. And as I reflect back over the last 8 or 9, 10 years, at one point in time we did over 1000. So we've really got to turn that around. It's going to take some time to do that. We continue to invest some of our precious R&D dollars on cost reduction and PFAS exit, stabilizing our supply chain. I made a comment about 80% of our raw materials coming in a sole source. We've got to qualify other vendors to be able to reduce costs over time. So that's going to take some time.

What I'm really working on as well in R&D is ideas for how we can offload non-value add activities from our researchers. It really comes in two, three themes. One is both efficiency as well as effectiveness. I think there's an opportunity to drive effective capacity of our engineering team. I think we have an opportunity to drive velocity through the new product development pipeline. We have an opportunity to think differently and how we govern differently on R&D, where we place our precious dollars so that they can move across the company to the highest ROI investment. So that's what I'm focused on R&D. But again, it's going to take a little bit of time. So we've got to sell more of what we have on the market today. That's simply commercial excellence. I'm digging into a number of different factors.

We've got a sales force today it's just over 5000 people. We know over the last four or five years it's down about 25%. That's partly because of the export model we've moved to. But we have an opportunity to take a look at our coverage, our incentives, our training around our sales force. I think there are some opportunities there. We distribute to almost 30,000 distributors. I think we have opportunities there.

There are probably some opportunities in pricing at a high level. We've done a very good job at the covering inflation and we'll see some incrementally positive pricing this year. But when you get down to a granular level there's some disconnects between pricing and discounts and margins to the volume or size of the customer and we have an opportunity to take a harder look at that. We're looking very hard at advertising and merchandising. It's a lever that's important in our consumer business. We were down quite substantially from where we were before relative to consumer packaged goods type companies, we're down. So we have an opportunity to think differently and very tactically around advertising and merchandising.

I think lastly we're looking at cross selling. There are certain examples, certain places where we sell products into a distributor or into a customer, but those customers, they should be buying a different product from us, but they don't. For example, for customers that do buy surface conditioning products to polish metals and woods, you always use a respirator to do that. You want to look at our customers. There's a bunch that don't buy the respirators from us, so there's an opportunity there.

All of those things are levers that we're going to be pulling here in the short-term, Jeff, and we'll keep updating analysts and investors as we learn more about how do we really drive the top line, which is so crucial to driving value creation at 3M.

Jeff Sprague

Great, thanks for that and maybe just one other quick one. Well, maybe it's not a quick one. I appreciate the detailed answers. On kind of the operational excellence side of the equation and a lot of these KPIs that you're speaking to on delivery quality and the like, does this require sort of a heavy lift on restructuring? The company's gone through a lot of restructuring recently, including just coming to the end of a big program or do you kind of view these as just more kind of process improvements and things of that nature?

Bill Brown

So you're right. We've been through and are actually getting through a very substantial restructuring program, we're about 75% complete. It will drag into 2025. I think the team is executing very well on that. A lot of the things I'm talking about in terms of improving OpEx, they're incremental pay-as-you-go type of opportunities. You almost get the savings as you're covering investment. There are potentially over time some bigger bites. If you think about the complexity of our broader network, a few years out there could be additional restructuring, but can't size it today. Right now, the opportunities that I'm seeing are almost pay-as-you-go. Reducing waste and inefficiency in factories are things you can do and just execute against without substantial charges to get there.

Nigel Coe - Wolfe Research, LLC. - Analyst

So I think you might well have answered my question, but I do want to just kind of ask about the plants and the distributions at the footprint. I think you mentioned 105 plants and 95 DCs -- 110 plants and 95 DCs. So are we talking here about, over time, a significant shrinkage in that footprint, or is it more a reconfiguration to reduce the complexity of the product velocity around that network?

And then thinking about the opportunities around sort of investing to drive growth versus efficiency, how should we think about margins beyond '24? Are you confident we can still grow margins beyond '24, even though it sounds like you're going to be investing?

Bill Brown

Okay, so a couple of good questions, and I'll try to hit on them pretty quickly. You're right, 110 factories, 95 distribution centers. The fact is, if you go back in time, the team here has actually been reducing the number of factories, the number of DCs in our network, and there's some inflight in the restructuring program we have today.

Looking forward, we don't think we necessarily need 110. I can't decide what it exactly is and when that cadence might happen, but we're taking a hard look at it. But it's not just factories, it's also cells within factories. When you look at what we have in assets and cells within these factors, we have 250 coating assets that are spread almost through half of our factories. And you have to sit back and ask, as we drive operating equipment efficiency, do we really need all those assets in all those factories, or do we have an opportunity to increase effective capacity.

So these are things that we're working on. Peter Gibbons and then team are doing a great job at this. This is going to happen over time. I can't really size how many factors of the restructuring that's required to get there.

Relative to margins, the team has done an outstanding job. You can see in the first half of this year, up almost 500 basis points. So the margins have come up quite substantially. We've got more we can do here in terms of just basic blocking and tackling productivity. Volume clearly -- as it comes back, volume clearly is going to be a high leverage ratio for us. So where they can go from here, I can't size it today. Certainly, as we get to the balance of the year into '25, we'll give you some more outlook on that. But there's lots of levers here, including driving organic volume.

Nigel Coe

Great. Thanks Bill, that's great color. And then Monish a quick follow-up on the insurance recovery. That's obviously great news on the Combat Arms recovery. Can you just disclose how many carriers are you negotiating with on Combat Arms? And maybe just bring us up to speed in terms of what's the opportunity within the water settlement?

Monish Patolawala

Yeah, so Nigel, as you know, there's a tower insurance here, so we are dealing with multiple insurance providers. We were pleased with what Kevin Rhodes and the legal team have done on getting the 120 this quarter. And as I've mentioned in my prepared remarks that we believe that there is more to be had here and we'll definitely keep you all informed as these things happen.

Scott Davis - Melius Research LLC - Analyst

Bill, I don't want to read too much into this, but is it your view that 3M is just too diversified and needs to kind of narrow down even a little bit more than what we've already seen with the Solventum spin?

Bill Brown

Well, I'm not sure I would say that today, Scott. In fact, as I think about it, it's a big business, a complicated business, a lot of different end markets, different business segments, different ways of going to market. A lot of the stuff that we make goes across all of these factories. So there's a lot of interconnection across the business. But as I've done in my past, I'll do the same thing here, which is take a fresh, hard look at what businesses that we're in. And as I said in my prepared remarks, dispassionately do that. Really look hard at what is better owned by us and we'll make some determinations over time on that. At the same time as we think about the kind of business that we want to be in over time, are there assets that aren't owned by 3M that are better owned here? And we'll take a hard look at that piece there as well.

So I wouldn't draw any specific conclusion from my remarks other than we're going to take a hard look at it. And if we determine that something is better owned elsewhere, then we'll move forward in that. It's all about value creation for owners.

Scott Davis

Fair enough. And I guess when I looked at your list of priorities, operational excellence, all these things are kind of basic. I don't want to minimize, but this is, it almost feels like you're walking into a situation where a lot of things weren't done right. And I don't want to point fingers, but just point being is, what was the fail? Was it just compensation and kind of where people's priorities were placed and you need to change a compensation plan? Was it just that a lot of these things like lean manufacturing were just not seeded or seeded early enough? I'm just trying to get my arms around.

I have followed 3M for a long time and we've had a number of different CEOs who have come in and had kind of a similar tick list that we want to fix this, this and this, but have struggled to kind of get there. And I'm trying to just get my arms around, what do you think was the main fail that kind of led us to where we are today?

And is there kind of one main thing that you can kind of tick the box first and work on kind of through the list? I know that's a little bit of a tough question, and again I'm not trying to point fingers, just saying that it's a pretty heavy lift. I think some of these things, a lot of people try pretty hard to fix, thanks.

Bill Brown

Look, I'll just say it's not about fail or success or right or wrong. I come in with a different set of experiences, different background, fresh look at the way we do business from the things that I've done in the past. I think the team here has done a marvelous job in managing through a lot of complex situations. I was a CEO of a company through COVID, and what we dealt with is well short of the challenges that 3M has faced, and you bring on top of that, a lot of the liabilities that Mike and the team have managed through, the structural changes. There's been an enormous transformation effort. And as I said, they launched the restructuring program. We're 75% complete. It's gone very, very well and you can see that in the margins. That's gone very well.

I come in, I just look at it the way it is today with sort of looking at the cold hard facts, and it's a back to basics focus on the fundamentals approach does sound “basic”, but at the end of the day, I do think that there's a lot of value that can be created from the raw materials that we have here. Just focusing on just how do you turn the business to top-line growth through the things that I've talked about, commercial excellence, driving growth from R&D, and driving a real culture of operational excellence through the company, and move at these things with speed and with urgency.

I've been in situations like this before. It's easy to fall into a trap of this is the way things have been done. And as I said in my remarks, I'm encouraging people to challenge the way we've done things in the past every single day. That's what continuous improvement is really all about, and that's what I'm encouraging people to do. So I'm looking from here forward and I see a great opportunity for value creation.

Julian Mitchell - Barclays PLC - Analyst

Maybe just the first question around the reinvestment point and organic growth. So Bill it sounds as if you can reinvest sufficiently in the business in the medium term to get growth moving, but still see reasonable margin expansion. I just wanted to confirm that that is what you're saying.

And then on that growth rate point, I wondered sort of what your initial thoughts were on the growth entitlement for 3M. Maybe what you think it's addressable. Markets are growing at, how you view the growth rate of its aggregate peer set. Just the context I suppose is 3M has grown around 1% to 2% the last five to 10 years ex-Solventum. I wondered what you thought the market growth rate was versus that?

Bill Brown

So a couple of good questions. I mean first, we do expect that we have some capacity in the back half to incrementally invest in the business. I think Monish and Mike have talked about this in our guidance model. We still see some opportunities to incrementally invest. We'll talk more about where that might be in the back half. But we always said with the savings that we're generating from restructuring, some of that savings would be reinvested back in the business. That's been the case so far and we see some additional opportunities in the back half of the year.

My comments around sales force, my comments around advertising, merchandising, at least a couple of different items. I can't say much about R&D today. I want to look harder at how do we free up capacity of the investment we make already today, and can that be more streamlined and redeployed effectively on top line growth? And that's really a big focus of mine.

In terms of entitlement growth, certainly we should be growing better than we have and we were guiding 0% to 2% midpoint of 1%. We know there's 1% headwind because of exiting certain geographies and parts of our portfolio, but still on an adjusted basis, 1% to 3% organic. It probably should be a bit more than that. GDP is in the 2.5% range. IPI we think this year is around 1.7%, 1.8% or thereabouts. We should be growing at least at the level of the economy, if not perhaps slightly better. But more comments as we get towards the back end of the year and into 2025, give you some longer term outlook for where the company might go.

Julian Mitchell

That's helpful. Thank you. And then just may be toggling back to the short-term as a lot has been asked about the medium term, if we're just thinking about the sort of framework for the second half guidance, I think it's implying an operating margin in the second half of maybe 21% or so. A little bit better perhaps, and that's fairly flattish year-on-year and half-on-half. I just wondered if I had that right, because it looks like restructuring charges are shrinking year-on-year and half-and-half and the top-line is pretty steady. So I just wondered if that was the correct assumption and any drivers behind that? And if there was any preliminary thoughts on sort of third versus fourth quarter dynamics here?

Bill Brown

So yes, let me offer a couple of comments here and I'll ask Monish to maybe fill in a little bit of the blanks on the quarterly progression. But you're right in terms of the cadence here. We do expect revenue to be very similar in the second half to the first half, and that does reflect historical trends. We continue to see strong operational execution and spending discipline just like we saw in the first half. We'll see some tailwinds from the benefit of lower restructuring cost, which is now 60/40 first half, second half. Last time we thought it was 70/30. So some has shifted to the back half, but you do see a bit of a step down. And we do see reimbursement of transition services agreement with Solventum, which began in April.

But at the same time we have higher wages in the back half of the year. We have two full quarters with a wage increase. Our wages went out on April 1, so not in first quarter but in the second, so that's a bit of headwind. That's offset by some lower stock comp. As you know, we made our grants here in the second quarter. We do see some headwinds in our factories. We built inventory through the second quarter that caused some positive absorption. We'll see inventory coming down in the back half of the year. That's going to cause some negative absorption or some headwinds there and then some higher non-operating expenses driven by pension and higher interest costs.

We had a lot of cash balance here in the second quarter. Cash went out the door in July for some legal payments, legal settlements. So our interest costs, interest expense is going to go up. Our interest income will come down in the back half of the year. And then of course, as I mentioned before, we do see some step up in some investments we have in the back half of the year. So those are the biggest drivers. A little bit of tax geography, but those are the biggest drivers. Maybe I'll ask Monish to comment on Q3, Q4 cadence.

Monish Patolawala

Sure. And just Julian, to add on to Bill's points on first half, second half, just data points. We spent $165 million in the first half on restructuring, and at the midpoint that would be another $110 million in the second half. Tax rate will be around 19% in the second half versus 20% in the first half.

If you now go to just the guidance between 2Q, 3Q or 3Q, 4Q, 3Q revenue trends will be very similar to what we saw in 2Q. I think Bill already talked about what it looks like in the market, so that's where the team is seeing right now. I would say continued strong operational execution and spending in 3Q also. You will get a tailwind from the timing of stock comp, which we announced in 2Q, approximately 100 of it that comes back as a tailwind in Q3. But at the same time, as Solventum matures in its ability to execute independently, we also believe that they will keep exiting their TSAs. As I've told you, the TSAs, some are short-term, some are as long as two years. That could go up to three years. We will see lower fees as Solventum begins to exit. And that's an impact of approximately $0.09 from a headwind on an EPS perspective, which is overall still in the range 2Q was heavier than 3Q and 4Q.

Bill talked about the seasonal impact in our factories as we bleed down inventory in Q3. Restructuring costs based on what the team sees right now is flat Q2 to Q3. So the balance will go into Q4 as we talked about. And then you will see -- we talked about $0.11 EPS impact for the second half on Combat Arms and PWS. As you know, we have made payments. By the end of July we would have made $3.7 billion of payments under our agreements under the settlements under Combat Arms and PWS, which means you have a lower cash balance in Q3, and that impacts us $0.06 of EPS. So between pension and interest costs, that's a headwind Q2 to Q3.

The team continues to believe that they can step up to drive long-term growth, to step up investments. And then tax rate for the third quarter will be in the range of 20% to 21%. And the fourth quarter is, the whole year is, I mean, the second half is 19%. So you can back into the fourth quarter, which would be lower. Hopefully, this is helpful to get your models right.

Steve Tusa - JPMorgan Chase & Co. - Analyst

Bill, my first question is, will you get any summer vacation at some point? Because it sounds like, I'm not sure I've ever seen a new CEO in the first three months be shot out of a cannon like this and have this kind of detail. You're usually supposed to wait for about a year so you can reset and get the options before you give the long-term target. So we really appreciate the detail here. It sounds like you've been busy.

Just the elephant in the room, though. You talked a lot about capital allocation and I think the narrative obviously around PFAS is that there's negative optionality from the balance sheet, if you will, but that it's a drag. You're talking about being a little bit more on your front foot from that perspective. And the only place PFAS is mentioned is in the slide 2, which is in the legal disclaimers. You didn't talk about it really at all in the slides. What's your take there? And do you have any perhaps pivot and strategy around PFAS and that liability?

Bill Brown

Well, thanks for the question. Look, first of all, we've got a great team of advisors, legal inside and outside that are managing PFAS and other liabilities. When I step back and look at just where we've been, the Public Water Supply settlement was a great step, important first step, really in managing some of the risks. But there's more to be done.

We're continuing to manage litigation from some of the opt outs, other cases within the MDL, there's Europe that's sort of hanging out there. We continue to control what we can control in that area. We've got very exhaustive disclosures in the Q and the K. And again, we have a great team that are really focused on managing that.

Where I think I'm best putting my time are the things that drive value creation for our owners and that's driving the top-line and driving operational excellence in the business. We do generate great cash flow. We see it in the quarter. We saw the first half, 90% to 110% free cash flow conversion for the year. I've got ideas on how we can drive that further over time. We're at 0.3 leverage ratio.

So when I step back, I think we actually have a very strong balance sheet. We can manage appropriately the risks that we see in front of us. And even through that, we have options here to do things with our balance sheet. So, I'm focusing on the things we can control and really getting the team pivoted back to what do we do to drive growth and operational excellence.

Steve Tusa

What do you think the market is missing in its pretty harsh and negative narrative around this PFAS overhang from what you've heard?

Bill Brown

I can't really comment on what the market may or may not be missing on that, Steve. What I'm focusing on the things that we control. I read the Q very, very thoroughly, like all of our investors do. It takes a long time to get through it. I think we've done…we do a great job at the disclosure there. But again, we've got a great team that's managing this. It's a dynamic situation and I trust what they're doing. I'm involved in that. Mike has been very helpful. He has a lot of expertise in this area because of the time he had to spend on it. I'm relying on him here as well. And again, I think where my time is best placed is what do we do to drive the other 64,000 of the 65,000 employees? What are they going to do to drive value creation? We've got a lot of people focused on PFAS. We have to get people focused back on the core things and what makes 3M great.

Andrew Obin

Just a question on, just follow up on capital allocation. It seems that with a lot more visibility on PFAS sort of operational focus, the market is clearly reacting to the message very positively. What are the thoughts about maybe front loading share buyback, particularly as you release working capital? Like, improving on time delivery. What is -- and I know you sort of highlighted buyback as one of the key opportunities, but in transformational stories like this, buying stock at the bottom tends to pay off longer-term. What's your view and the view of the Board on buybacks? Thank you.

Bill Brown

Well, thank you. You're right. I was very purposeful in the four top priorities for capital deployment and number four was around excess cash for repos, or M&A. There's just not M&A on the horizon. So you saw a step into the market in the second quarter. That was under Mike and Monish's leadership, $400 million worth of buyback. We do have capacity. Our balance sheet looks very strong. We have an open authorization with our Board that's close to $4 billion. We keep evaluating this as we sort of manage the risks that happen to be out there, our ability to generate cash, drive down working capital in the back half. And through all those levers, we'll look hard as to what we do with excess cash in the back half as well as into next year. Nothing more to say about that today.

Andrew Obin

Sure. And, historically 3M has been one of the companies that investors would buy, towards the bottom, towards the economic bottom as things reaccelerate. I guess, two-part question. First, do you think 3M still has this cyclical leverage? Because you talked about your product introduction being down quite a bit, but generally do you think this fundamental quality of the business to really reaccelerate into improving industrial and maybe one day consumer fundamentals is still there?

And B, second question is, how far away do you think we are from sort of industrial bottom? Because it just seems like there is no end. We just can, PMIs can find a bottom if, you know, if you could just sort of provide us with your view even when there is any visibility on things bottoming out. I know a long question, but I appreciate your answer.

Bill Brown

No. Good question. I mean, I do think, I do hope that we're bouncing along the bottom. It all depends on what happens here in the back half in the US certainly and what the Fed does with interest rates and what's going on with inflation. There are a lot of geopolitical questions around the world. So I'm optimistic that the market is going to start to recover. But again, I don't have a crystal ball, like nobody on the call really does. So at the end of the day, I step back and I look at what do we do with the assets that we have. And I think about the long history that 3M has in core innovation, new to the world ideas. And I think as we reground ourselves back on that long-term mission, that culture, that spirit of innovation and we reignite that across the thousands of employees in this company that drive it every single day. To me, that's what I'm focused on. That's what I can control.

There are lots of great markets out there. There are lots of different pockets of places where we can invest in to innovate, to penetrate, to grow, to differentiate offerings versus our competitors. So that's what I'm focusing my time on. The economy is going to do what it's going to do. I'm just watching where the trends happen to be and investing in places where we think we can drive some differentiation and grow higher than the market. So long answer to your question, but that's the way I think about it.

Andy Kaplowitz - Citigroup, Inc. - Analyst

So maybe, Bill or Monish, you mentioned that growth across your businesses has generally been in line with your expectations. But just focusing on transportation, electronics, I know comps get a little more difficult in Q4, but would you say there are some upside as your original low single digit growth forecast there? Do you see consumer electronics holding up in the second half and have you seen any improvement yet in semiconductors?

Bill Brown

Well, thanks for the question. We actually had a very good first half. It's partly due to consumer electronics. There was some spec-in wins that we happen to have there. We had a pretty good first half in auto, as Monish mentioned in his prepared remarks company-wide we're up 9%. A lot of it's going to be in that TEBG segment. We were outgrowing the build rate. But as we watched over the last 90 days, the build rate for the year, which was down 50 basis points, now down 200 basis points for the year. A lot of it's going to be in the back half of the year. So we've got a little bit of caution on auto builds in general, which is factored into the guidance that we've provided. Maybe I'll ask Monish to offer a little more commentary on that, if there's anything more.

Monish Patolawala

No, same thing. I think we'll have to, Andy, as you know, this is cyclical, so we'll have to watch what happened in the second half. Bill mentioned that even in the prior question and that's what the team is watching. We are watching all the trends that all of you watch, which is build rates on cars, build rates on consumer electronics, what the holiday season turns out to be, I think, are all factors the team look. They watched in the past and will continue watching. And based on what we know right now, the team feels the guide that we have given you, which is for the company as a whole, is fair.

Andy Kaplowitz

Helpful. And then Bill maybe can you talk about 3M's ability to price across its portfolio? When I hear the conversation regarding limited new product intros and R&D, obviously the thought is that can all impact price. So how structurally, how effective can you be and how fast in sort of impacting pricing? And then it's hard not to notice. Consumer, for instance, remains pretty muted. I think that is just the market, but is it particularly challenging to price in that segment?

Bill Brown

That's a very, very good question. From what I can tell last year, we had pretty significant price increases and we did cover inflation. This year in our sort of 1% center point of our 0 to 2 guidance, we have positive price within that. So we continue to see pricing. It's certainly lower than on a year-over-year basis than it was last year. So on a macro basis, our ability to price has been pretty good with capturing back inflation.

But what I'm looking at is the more details around how we price by customer, by segment, by product, not just gross price, but net price. So discounts, market development funds, all of those things between gross and net price. And is there an opportunity at the real micro level to price better? My instinct is that there is an opportunity here and this is an area that I'm going to focus a lot of time and attention on that. Sometimes it's training, sometimes it is systems, sometimes it is data visibility. But there's an opportunity on a much more granular level. Take a look at how we price, and I'll know more in the next number of months and couple of quarters as we go through the analysis. But I do believe we'll find some opportunities do better job on pricing there.

The other point you had mentioned about new product development, you're exactly right. Which is as we innovate and develop differentiating features, we should be able to get better margin and better pricing on those new products that are coming out. So as we reinvigorate the NPI engine, which I expect to do, hopefully that does drive price improvement, margin improvement, over time as well.

Joe O'Dea - Wells Fargo Securities - Analyst

In the interest of time, I'll just keep it to one. But Bill, just curious if you could expand a little on the dispassionate portfolio review comments. I understand sort of no specifics today, but if you could just talk about your timeline for completing reviews? And then as you do these, what are the key metrics that you ask business leaders to present on in the reviews as you sort of focus on decision making there?

Bill Brown

So good question and look, 90 days in the job, I'm trying to learn the business, learn, meet the team, understand what's going on in the business. So there's a lot that's happening right now and I'm really focused there. I'm not to the point of any particular conclusions, I'm not necessarily near that. But it is something that's on our mind. We're going to look hard at.

The teams are looking at this as well, is how are we growing in each segment versus competitors. What's the earnings growth outlook? Are we able to expand margins or not? What does our NPI pipeline look like? And based on who we compete against, do we have an opportunity through better execution, through better operations, through new products coming down the path, to improve our positioning in certain segments.

At the end of the day, we're an innovation driven company. Technology differentiation is the lifeblood of how we compete. So I'll be looking hard at businesses where we can bring technology differentiation into the business and provide value to customers that's different than our competitors. And I contrast that with commodity like businesses that perhaps don't really fit so well. So, no specific lens other than that, but we'll take a hard look at this and make some conclusions in the coming quarters, or next year as we get our arms around what's the business we should be in and also which businesses that we ought to be looking at outside the company.

Brett Linzey

Bill, I appreciate the rundown on the priorities. I thought the example on the command strips was quite striking. As you're thinking strategically about optimizing some of these touch points, do you think you have the personnel resources internally, the incentive structure internally to drive these changes or are you looking to third parties? Just trying to understand the timeline and what needs to be done here.

Bill Brown

Oh, thank you. Yes, this is a -- it's a complicated problem. It's a lot of products, a lot of SKUs across a lot of factories and distribution points. If you look at this on a global basis, you map all the DCs and all the flows, all the factories, it's a spider's nest. I mean, it's a lot going on here. And we do have a great team in operations that are looking hard at this. We have outside advisors that have been involved and this will take some time. It's not a quarter, two quarters away. We'll continue to take a hard look at optimizing the networks and the flows. So, we have the right people at the top level and I do think that we've got the right incentive structures around this as well and motivations for the team.

Nicole DeBlase - Deutsche Bank AG - Analyst

Maybe Bill, you could talk about the level of employee response and engagement. I suspect that you've probably been making a bit of a world tour in your first few months. All of this change sounds really exciting and would just love to hear how employees have been responding to what you'd like to do.

Bill Brown

Look, I think employees here are excited. They're engaged. They want to make a difference. They want to see 3M grow. They want to see share price come up. They want to see recognition for doing great things in the world and then developing new products. That's the message I'm providing to you today. That's the message I'm offering to our employees. My priorities as I have explained to you, is what I've explained in some more detail with employees in town halls. So I think it's resonating well. I think hopefully it's energizing people, but again, we've got a lot of strong people here who have been here for a while, that really want to make a difference and I'm appealing to that. So I think the response has been good so far, again 90 days in.

Deane Dray - RBC Capital Markets - Analyst

Lots of impressive game plan in terms of all the different operational initiatives, Bill, and it just raises the question for me is, you can't do everything at once. So what's the element of triage? And also, this is not a

one man show. Talk about your team. Are you deputizing internal folks? You have an army of consultants, you've got a CFO search you've got to do, and then how much change can the organization handle at once? Is there any element, I mean, lots of stuff needs fixing, but is there a sense of how you can layer these in and can change be too disruptive?

Bill Brown

No, it's a great question. I mean, look, these are all important priorities and I do think we can both try to drive growth through the mechanisms that I mentioned, as well as operational excellence. I think it's fundamental. I've been through this before. It's not my first rodeo on these things. I can see a path to getting this work done. We have a great team of employees here. We have engaged outside advisors to help us across these different pieces and focus in some of these dimensions.

Yes, it's a busy start, but I think we have the right team to deliver it. I think we have the right focus and priorities. We're going to have to manage it and manage the capacity of the team to respond to all these pieces, but yes, I'm optimistic. I think we'll look at these pieces individually as we go forward. I've laid out a pretty full laundry list of things we want to do, but we'll prioritize these things as we get towards the back end of the year.

But at the end of the day, we're not going to be able to invest to grow unless we drive operational excellence. And I would say operational excellence is in fact a growth driver. When you're running, your on time in full out of your factories at mid-80s, 86 and change percent was our second quarter results. We should be above 90%. The fact is, when you're below 90, we're missing sales. So by getting our operations to run better, that is a growth lever. As we drive productivity in our factories and create savings there, that we can reinvest in growth initiatives, that's a growth lever. So I think you've got to do both of these two pieces at the same time and work the pedals and that's what I plan to do.

Kevin Estok – Jefferies - Analyst

Hi, good morning. This is Kevin Estok on for Laurence. So I was just wondering if you could give a little bit more granularity on what you're seeing in terms of Chinese demand and whether you're seeing any green shoots there? And I'll leave it there just because of time.

Bill Brown

So thank you for the question. Look, China for us is about 10% of our revenue. We had a good first half. We're up about 13% in the first half and part of that is electronics. When you look at the piece that's sort of local for local, if you will, it's about 1% so flattish and pretty similar to what other multinational, maybe even a little better than what a lot of other multinationals are seeing in China. Again, it's about 10% of our business, an important market, and we've seen good growth in the front half of the year simply because of the consumer electronics and auto builds.

Bill Brown

Okay. Well thank you, everybody, for joining and participating today and for the thoughtful questions. I want, again, thank all 3Mer's around the world for their hard work and their dedication and I want to wish Monish well in his future endeavors. So thanks again for joining the call and I wish everybody a good day. Thank you.