Solventum Q2 FY25 Earnings Call Transcript

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Corporate Speakers:

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Bryan Hanson – *Solventum Corporation; Chief Executive Officer*

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Participants:

Jason Bednar – *Piper Sandler; Equity Research Analyst*

Travis Steed – *Bank of America; Equity Research Analyst*

Patrick Wood – *Morgan Stanley; Managing Director and Equity Research Analyst*

Rick Wise – *Stifel; Managing Director and Equity Research Analyst*

Steven Valiquette – *Mizuho; Managing Director and Senior Equity Research Analyst*

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Operator

Good afternoon. My name is Kate, and I will be your conference call operator today. I would like to welcome everyone to Solventum's Second Quarter 2025 Earnings Call. As a reminder, this conference is being recorded. [Operator Instructions] I would now like to turn the program over to your host for today's conference, Amy Wakeham, Senior Vice President of Investor Relations and Finance Communications. Please proceed.

Amy Wakeham – *Solventum Corporation; Senior Vice President, Investor Relations & External Finance Communications*

Thank you. Good afternoon, and welcome to Solventum's Second Quarter Fiscal Year 2025 Earnings Call. Joining me on today's call are Chief Executive Officer, Bryan Hanson; and Chief Financial Officer, Wayde McMillan. A replay of today's earnings call will be available later today on the Investor Relations section of our corporate website. The earnings release and presentation are both available on the site now.

During today's call, our discussion and any comments we make will be made on a non-GAAP basis unless they've been specifically called out as GAAP. The non-GAAP information discussed is not intended to be considered in isolation or as a substitute for the reported GAAP financial information. You are encouraged to review the supporting schedules in today's earnings press release to reconcile the non-GAAP measures with the GAAP reported numbers.

Additionally, our discussion on today's call will include forward-looking statements, including, but not limited to, expectations about our future financial and operating performance. We make these statements based on reasonable assumptions. However, our actual results could differ.

Please review our SEC filings for a complete discussion of the risk factors that could cause our actual results to differ materially from any forward-looking statements made today. Following our prepared remarks, we'll hold a Q&A session. For the Q&A portion of today's call, [Operator Instructions]. And with that, I'd like to now hand the call over to Bryan.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

All right. Great. Thanks, Amy, and to all of our shareholders and everyone else interested in our story, I just want to say thanks for joining us today for our second quarter results. And I'll just start by saying that we are continuing where we left off in Q1, delivering another solid quarter. And as a result of this positive momentum and strong execution, we are raising our sales growth and EPS guidance for the year.

Now this continued strong momentum gives us even more confidence in delivering the growth and margin targets that we outlined at Investor Day back in March. Certainly, there is still work to be done. There's no question about that. But I am very happy with the progress the teams are making across all of our businesses. And we are quickly and importantly, decisively building on the strong foundation established by 3M.

Our differentiated brands in attractive and diverse markets now combined with the cultural and structural enhancements we've already made are delivering results and accelerating our growth and importantly, again, putting us on a clear path to achieve our long-range plan commitments. And in addition to this, our work to revamp our innovation process is on track, and our forecasted new product pipeline is steadily increasing in value as a result.

And then once we close the P&F transaction, as we've stated before, we will focus on disciplined tuck-in M&A to further enhance our progress. Overall, it's clear to me that our value creation framework and our mission to improve lives have aligned our organization to focus on and deliver results. and begin to establish Solventum as a mission-driven performance leader in our industry.

And I want to thank our dedicated global teams for advancing our mission and driving our success. This type of transformation just doesn't happen without your dedication and your desire to win. So again, thank you for making it happen. Okay a few quick updates before moving to our business segments. Let's start with separation. Wayde is going to give more color on separation in a minute, but I'll just quickly highlight that things are proceeding well, and they are on track.

And I can say that a big part of our success here is thanks to the very experienced team that we have assembled. They have been there and done this before, and they are leveraging past insights to mitigate risk in our process. And our multiyear ERP implementation reached an important milestone as we executed the system cutover in Europe this quarter.

And as most of you probably know, the implementations --- these types of implementations are not without challenges. And well, we experienced some of those challenges in the quarter. But the Solvers in IT, our global supply chain and our businesses came together and worked as a team to leverage our comprehensive risk mitigation plans. And as a result, they delivered the quarter, but most importantly, they delivered for our customers and patients.

And I can tell you that this success is a strong example of one of Solventum's 5 core values, call it advancing together. And it increases our confidence, certainly my confidence, that even when things don't go exactly as planned, we have the right team with the right experience and the commitment to overcome and deliver. This is also a great example of this team's ability to effectively manage our go-forward ERP implementations as well.

Okay. Switching to tariffs. Again, Wayde is going to provide more detail here. But just as a quick summary, last quarter, we discussed some of the mitigations we've already put into place and have been executing against to offset the tariff impact. And based on what we know today about current trade policy and our mitigation efforts, we're reducing the estimated tariff impact for 2025. Obviously, given the fluidity of the environment, we will continue to actively monitor the situation and implement new strategies as needed.

Okay. Now I'm going to move to our business segments, where we continue to demonstrate positive momentum. And I can tell you, a big part of this progress stems from the strategic clarity that we've created through our market and growth driver selection process. That was a very important process to create clarity of focus. And as a reminder, we have 5 growth drivers that will account for 80-plus percent of our growth over the long-range plan. And as we've stated, the 5 growth drivers are Negative Pressure Wound Therapy, IV Site Management, Sterilization Assurance, Core Restoratives, and Revenue Cycle Management.

Now starting with our MedSurg business. We had another solid quarter of progress fueled by our existing and differentiated brands, our recent new product launches and our commercial restructuring to specialize the sales channel in our growth driver areas. For some additional color on the 2 subsegments of MedSurg, our IP&SS business showed solid underlying business performance in the quarter and also benefited from some follow-on advanced order timing. Now this order timing benefit was offset by short-term pressure in our Advanced Wound Care business due to a voluntary recall that had no patient safety concerns.

Now as we look forward into the back half of 2025, we expect Advanced Wound Care to accelerate and our IP&SS sales to moderate. Relative to Advanced Wound Care, we expanded our V.A.C. Peel and Place launch into Europe and established a dedicated acute care sales team to ensure focus on this game-changing technology. Importantly, we've also recently won several large Negative Pressure Wound Therapy customers, reaffirming our confidence in our technology differentiation and boosting momentum as we come into the back half of the year.

When it comes to IV Site Management, we continue to see strong demand for our Tegaderm Antimicrobial solutions with new product launches in major markets across Europe and Asia, again, supported by specialized sales teams across our regions. And within our Sterilization Assurance business, we have seen early success with our 3 new product launches. And even though these are in early stages of the launch, we are already gaining renewals from our larger customers, and our specialized sales team is generating the momentum to drive to full adoption.

In our Dental Solutions business, we continue to gain momentum in Core Restoratives with results driven by a focused portfolio, accelerating new product innovation and specialization of the sales channel. New product launches were a key contributor in the quarter, driven by strong demand for Clinpro Clear and Filtek Easy-Match. And our customer response to our first-to-market 3D-printed Clarity Precision Grip attachments has remained positive, enhancing our ability to deliver a seamless combination of dental and orthodontic solutions. This innovation underscores momentum within the Dental team's internal bet area of Custom Smile Solutions. And collectively, these categories help offset pressure in areas like impressioning materials and core orthodontics, helping us to stabilize the segment even in a challenging market environment. And the team expects new product demand to accelerate into the back half of the year and ultimately drive sales growth improvements as well.

Okay. In our Health Information Systems business, we are clearly focused on Revenue Cycle Management and a key component of this is autonomous coding. And here, we recently announced a new partnership with Ensemble, who is a leading end-to-end provider of revenue cycle management services. This is yet another step in solidifying HIS as the largest autonomous coding vendor and underscores its leadership in AI-driven solutions that transform customer operations.

The ongoing success of 360 Encompass showcases HIS' ability to streamline workflows and deliver meaningful customer benefits. And in our international markets, we are seeing 360 Encompass installations in Australia and expansion efforts in the Middle East, demonstrating HIS' commitment to equipping health care providers with the tools they need to operate smarter around the globe.

Last month, I was on site with over 300 of our HIS customers at our Annual Customer Experience Summit. And I'd tell you it was a fantastic opportunity to engage with customers, hear direct feedback about our solutions and importantly for me, to learn more about our customers' views on the future of the space. Overall, I would say it was an exciting week, very well spent with very good feedback.

And last but not least, turning to our Purification and Filtration business. We saw continued strong demand for our Bioprocessing solutions, again, reaffirming the importance of our advanced technologies in this space. And our investment in expanded capacity for our Industrial business also contributed, driving accelerated growth throughout the quarter. Overall, the P&F business is well positioned for sustained growth, and our transaction process with Thermo is moving along nicely.

And relative to the P&F transaction, in June, we filed an amendment to our agreement for Solventum to retain the Drinking Water business. This has helped simplify the transaction and importantly, increases the opportunity to accelerate the close. Keeping Drinking Water also provides Solventum with the opportunity to unlock additional value tied to this business. And I would just say, overall, Thermo has been a great partner, and we appreciate their collaboration, not just in streamlining the process, but also very importantly, their commitment to ensuring the success of our P&F business. Now before I close, I'd like to highlight a couple of external recognition honors we received during the quarter. Now first, Solventum earned its place on the Fortune 500 in our first year as a stand-alone company.

We are also excited to be named as a "Best Company to Work For" by U.S. News & World Report. And I would tell you, this recognition, in particular, reflects the hard work of our teams and the early success in driving our values and strategy to put people first and become a best and preferred place to work.

And in closing, I'd just say that thanks to our company-wide teamwork and progress against our transformation plan, Solventum continues to chart a solid path forward. We have an incredible opportunity to create meaningful value, and we are making consistent and repeatable progress in that value creation story. The foundation we inherited, combined with the aggressive actions we've already taken, positions us well for continued growth and margin acceleration and ultimately, sustainable value creation.

And with that, I'll turn it over to Wayde for a closer look at our financial results and other key updates. Okay. Wayde, pass it over to you.

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Thanks, Bryan. We're pleased to be able to report another solid quarter as we navigate the separation from 3M and prepare for the divestiture of Purification and Filtration, all while gaining momentum in the business amidst an uncertain macro environment backdrop. Consistent with prior quarters, I'll provide you with a separation update and then transition to our Q2 financial performance.

I'll conclude my prepared remarks with an update on our 2025 guidance as well as a financial update for the pending sale of Purification and Filtration, less the Drinking Water business we are retaining. We continue to execute against separation milestones while making foundational changes to deliver on our long-range plan. In Q2, we made further progress on our supply chain separation initiatives.

We moved our European distribution centers from 3M to multiple third-party distribution centers and exited a distribution center in South America, along with executing our largest ERP cutover to date. We've made further progress exiting 35% of transition service agreements to date, including support services for commercial operations and logistics, human resources, marketing, technology, quality and regulatory.

Finally, we're making good progress coordinating our product packaging and rebranding strategies and have materially completed our corporate rebranding, which includes our facilities, media, and trade shows.

Now turning to our Q2 results. Starting with sales. Second quarter 2025 sales of $2.2 billion increased 2.8% on an organic basis compared to prior year and increased 3.9% on a reported basis. During the quarter, foreign exchange was a 110-basis point benefit to reported growth. Overall, we had stronger-than-expected sales growth that benefited from positive contributions across all segments.

Importantly, volume continues to be the main driver of our continued execution as we align our organization towards delivering sustainable sales growth and new product innovation. We managed ERP and distribution center challenges in Europe as we began executing our ERP and distribution center cutovers. We still expect the favorable timing benefits from Q1 and to a lesser extent in Q2 will be offset by year-end, mostly in Q3. Pricing remains within our expected plus or minus 1% range and the impact of SKU exits in the quarter was 60 basis points.

Moving to the segments. Our largest segment, MedSurg, delivered $1.2 billion in sales, an increase of 3.9% on an organic basis. Growth was again led this quarter by the Infection Prevention and Surgical Solutions business, which grew 5.9%

and benefited from follow-on advanced order timing, which contributed to the higher-than-expected performance. Advanced Wound Care growth of 0.8% was driven by Negative Pressure Wound Therapy with growth muted by the previously mentioned product recall.

Looking ahead to the second half, we expect a trade-off as Infection Prevention and Surgical Solutions absorbs the pullback associated with the order timing benefits in Q1 and Q2, while Advanced Wound Care delivers improved growth driven by acceleration in Negative Pressure Wound Therapy led by single-use Prevena and the continued rollout of Peel and Place. Our Dental Solutions segment delivered $338 million of sales, an increase of 70 basis points on an organic basis.

We continue to demonstrate resilient performance despite a challenging market, aided by innovation across our restorative and prevention products as well as our Clarity aligners. Our Health Information Systems segment contributed $339 million in sales, an increase of 3.2% on an organic basis, which benefited from strong customer retention of our revenue cycle management software solutions, more than offsetting expected declines in clinician productivity solutions.

We remain focused on system implementations to support our hospital customers as they navigate a challenging and dynamic environment for health care spending. Finally, the Purification and Filtration segment delivered $252 million of sales, an increase of 3.1% on an organic basis. Similar to prior quarters, growth was led by our Bioprocessing Filtration and Industrial Filtration categories, partially offset by declines in Membrane OEM.

Looking down the P&L, gross margins were 56% of sales in the quarter, an improvement of 20 basis points over prior year. As a reminder, gross margins include a headwind associated with the 3M supply agreement, which was more than offset by improved sales mix and programmatic savings. Notably, Q2 results also included $4 million related to the accounting treatment of the P&F business, which is treated as a held-for-sale asset and provided a $0.02 EPS benefit in the quarter related to a reduction of depreciation expense.

Excluding the held-for-sale benefit, underlying gross margins improved 20 basis points sequentially compared to Q1, consistent with our expectations for seasonal improvement. Operating expenses of $736 million increased modestly compared to the prior year, which reflects inflationary headwinds, public company stand-up costs and growth investments, mostly offset by savings from our restructuring program, which remains on track to deliver $120 million of annualized savings.

In total, we delivered adjusted operating income of $474 million, which translates to an operating margin of 21.9%, ahead of expectations. Moving down the P&L to nonoperating items. Our net interest expense and other nonoperating spend improved modestly versus Q1. Lastly, our effective tax rate of 18.3% was better than our expectations, driven by favorable geographic mix.

Overall, we delivered earnings per share of $1.69, ahead of our expectations, driven mainly by sales outperformance and favorable margins. We also ended the quarter with $492 million in cash and equivalents with no outstanding borrowings on our revolving credit facility.

To date, we have made cumulative repayments of $500 million on our $1.5 billion prepayable term loans, which includes another $100 million paid off in June. For Q2, we generated free cash flow of $59 million, which was consistent with our expectations of improvement over Q1 and reflects normal seasonality and the timing of interest payments.

Now turning to our 2025 guidance update, which reflects our Q2 performance and momentum to start the year. As a reminder, our guidance is for the whole company, including the Purification and Filtration business, which is treated as held-for-sale until the transaction closes. Starting with full year organic sales growth, we have increased our outlook to a range of 2% to 3%, a 50-basis point increase above our prior guidance.

We continue to estimate a 50-basis point impact of SKU exits, which we anticipate will ramp throughout the year. Excluding this planned impact, our annual growth outlook is 2.5% to 3.5%, reflecting the continued volume-driven performance across our business segments as we execute against the phased approach to reposition for growth.

Regarding foreign exchange, we now estimate currency will have a favorable impact of approximately 50 basis points on sales growth for the full year. This compares to our prior expected impact of neutral and will have a positive benefit on our reported sales and earnings per share. And based on a better-than-expected effective tax rate through the first half of 2025, we are now comfortable at the low end of our initial guidance range of 20% to 21%.

Before commenting on earnings per share, I want to bring you up to date on our latest thinking on tariff headwinds, which we now estimate to be $60 million to $80 million, down from our initial range of $80 million to $100 million and impacting Q3 slightly less than Q4. The reduction represents improved estimates for U.S. and China tariff rates, partially offset by higher rates for Europe and other smaller regions.

The favorable update will ease pressure on gross margin and operating margin in the second half of the year, and we continue to anticipate achieving full year operating margins now closer to the midpoint of our initial plan range of 20% to 21%. Altogether, for earnings per share, we have increased our guidance to a range of $5.80 to $5.95 from the previous guidance of $5.45 to $5.65, which reflects the strong performance in the quarter, combined with further improvements into the second half of the year.

We are maintaining our free cash flow guidance in the range of $450 million to $550 million. As a reminder, free cash flows are impacted in 2025 from separation-related costs, and we expect our free cash flows to improve in the future as those costs step down in 2026 and again in 2027 as we complete the separation from 3M. Before closing out, I also want to provide you with an update on our Purification and Filtration divestiture.

Following the amended terms Bryan touched upon earlier, we are updating our estimated pro forma annual adjusted EPS deal accretion to a range of $0.25 to $0.30, an increase of $0.10 compared to the estimated EPS accretion shared at our Investor Day. We are also revising the gross margin accretion to approximately 100 basis points compared to our earlier estimate of 200 basis points and revising our operating margin accretion to 50 basis points compared to the earlier estimate of 100 basis points.

This deal represents a major milestone for our portfolio transformation strategy and accelerates our timeline to pay down debt to deleverage our balance sheet, which we expect to achieve through further paydown of our term loan and bond buybacks while positioning us to pursue programmatic tuck-in M&A. On an annualized basis, the transaction improves our gross margins, operating margins, and earnings per share. Based on expected close by year-end, we continue to anticipate the impact on earnings per share will be neutral in 2025.

Finally, I want to reiterate our commitment to continued investment, consistent with our attractive growth driver opportunities and realization of the long-term value creation ahead. We will balance these investments by identifying opportunities to expand margins and generate strong cash flows.

In conclusion, we had a solid quarter and are making great progress towards achieving our long-range plan goals of accelerating sales growth to 4% to 5% and growing earnings per share at a 10% CAGR. We are also executing well on our plan to separate as an independent company. We can feel the momentum building and are excited about the continued value creation story at Solventum. With that, I'll now hand it back to the operator for the Q&A portion of the call.

Operator

[Operator Instructions] Your first question comes from the line of Jason Bednar with Piper Sandler.

Jason Bednar – *Piper Sandler; Analyst*

Real nice quarter here. Why don't we start with the organic growth guide. You're doing really well with MedSurg, especially considering the pull forward of the business you had last quarter. Maybe talk about the trajectory that you're seeing in that part of the business? What's driving some of that upside? Is it the commercial organization, just the focus? Anything you can add there? And then maybe talk a little bit about the back half, knowing that your comps here are still really favorable for that part of the business?

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. Good to hear from you, Jason. Why don't I start with what's driving the MedSurg business, and then you can speak to any movement between quarters. So, what I would say is that right now, MedSurg, as we've talked about before, has 3 of our growth drivers. So, if you've got 3 growth drivers in your business, you better start to see some traction because that means we're spending a lot of time and effort in those areas.

And inside of those growth drivers, regardless of which one we're looking at, there are really 3 levers that we're seeing. The first one, as you referenced, is the commercial restructuring that we've done to specialize the team. That is paying significant dividends. It really is -- it's a whole cultural change that we have in place. It's a specialized team, and it's an incentive plan that is getting people focused on growth. So that's a big piece of the movement right now.

But the second one is pretty big, too. It really is taking advantage with this new engine with these brands that we have that are differentiated in the space. And I probably don't talk about this enough, but these are brands that have been around for a long time that have real clinical differentiation that are as valuable as a new product launch in the right hands with the right focus. So that's a significant benefit to us that probably I underappreciated when we started the game here.

And then third is just the new product launches that we've had that we've talked about, either in Sterilization Assurance or Negative Pressure Wound Therapy or other parts of IP&SS. So those are the variables that are working. And here's the thing, we're just getting started. So, the momentum is there. The confidence is growing, and I would expect to see us continue to grow ahead of where we are today. So, I don't know, Wayde, do you want to talk to anything about?

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Yes, sure. Jason, on the second part of your question there around growth rate in the second half. And I think for context, it would be helpful just to frame it for the total year. So keep in mind, we reported 3.5% growth in the first half. And as we've shared, about 1% of that is due to order timing that we got in advance in the first half of the year, and we expect to see that pull back in the second half, mostly in Q3.

And if you look at our guide now at 2% to 3% for the year, the second half implies a midpoint of 1.5%. And so, as we give that 1% to the first half, we take it from the second half. And if you normalize what we said in the first half was we were normalized at 2.5%. And if you shift that 1% back to the second half, it would be at 2.5% at the midpoint. In other words, we think we're growing consistently in this 2.5% range in the first half when you normalize for order timing.

And in the second half, at the midpoint of our guide, if we continue to grow at the rate we are, we'll be in that 2.5%. And as Bryan said, we feel like we've got really good momentum in the business here. Certainly, there's puts and takes, but we've got, I think, a real building success story here with the commercial output that Bryan just outlined.

Jason Bednar – *Piper Sandler; Analyst*

Very helpful. And Wayde, I'll stay with you. Just a question on maybe the EPS bridge, if you could, from last quarter to this quarter, you raised by $0.32 at the midpoint. You beat it almost by a quarter. We're picking up a dime on updated tariff assumptions, but you've got FX as a tailwind, it doesn't seem like there's much being attributed to back half organic growth numbers maybe inching up a little bit. Tax is a good guy. So, I'm just wondering what may be cutting the other way that we're not accounting for? Or is this just conservatism on only raising by the amount that you did here today?

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Yes. I noticed how you asked the question there. It is quite a strong raise, and we are only halfway through the year. So, what we'll say here is we're tightening the range as we progress through the year. And given the year-to-date performance, it raises our confidence. And as you said, we're in that $0.33 increase at the midpoint.

And this accounts for the Q2 beat plus upside in the second half. And as you know, and you just listed several of them, we're certainly managing a lot of variables. Number one, the separation activities, but also tariffs, taxes, foreign exchange. And given we're only halfway through the year and that these variables can turn, we are comfortable with the raise that we put in place this quarter.

We're very happy to be tracking ahead of our commitments for the year, including offsetting pretty substantial tariffs here. And so, we think it's a strong raise. We'll continue to monitor all these multiple variables, continue to progress on our separation activities, and we'll see how we look in the second half of the year.

Operator

Your next question comes from the line of Travis Steed with Bank of America.

Travis Steed – *BofA; Analyst*

I guess, Wayde, there was a lot of moving parts in the quarter, order timing, patient recall, ERP, SKU rationalization. I don't know if there's a way to kind of walk through those again and kind of bridge the 2.8% you reported and just kind of get to more of an underlying growth rate in the quarter that's kind of apples-to-apples. And then that way we kind of think about the underlying growth in Q3 a little bit better versus kind of first half, second half.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. Good to hear from you, Travis, and I appreciate you thinking that I can't answer that question. You go right to Wayde. But I'd tell you that what I would say is we did have a lot of puts and takes particularly on the revenue line in the quarter. And we wanted to call those out in the prepared remarks because people would have questions on why certain businesses were up, certain businesses were down.

But I think on an underlying basis, if I take all those puts and takes into account, the 2.8% that we posted is a good view of what the realistic growth was in the quarter. So, you can kind of take that 2.8% and say that's the bank number. That's what we did. Puts and takes for sure, but they offset for the most part, and that's a good view of what we did in the quarter.

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Bryan, I think you covered that really well. Just to highlight a couple of other data points that we put in the release and in our prepared remarks. As Bryan said, 2.8% is pretty representative of what we think the business is growing with several puts and takes. Order timing was less in Q2 and certainly less than we saw in Q1, but had a benefit, as we said, primarily Infection Prevention Surgical Solutions, again, just given the set up of that business.

And we called out the SKU impact of 60 basis points headwind. That was about double the impact that we saw in Q1. So those are a couple of pieces there. I certainly appreciate a lot of moving pieces. Obviously, in a separation like this, we've got more to deal with. But having said that, we're still very happy with the momentum we saw, the momentum we're building here in Q2 and the strength of Q2 to give us the confidence to raise the guide here, puts us in a good position for the second half of the year.

Travis Steed – *BofA; Analyst*

Great. sorry, Bryan. But the other thing I'd like to ask is kind of more like -- so you're kind of at this kind of mid-2% underlying growth rate right now. And as you look forward, and I know you're not going to give next year's guidance, but is there any kind of reason why we shouldn't think about this growth rate getting better? Or does it decel for certain reasons or accelerate for certain reasons? Just kind of trying to think through the puts and takes in the model going forward.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. So, we're going to have a -- as you probably remember, a bigger SKU impact next year. We had talked about 50 basis points this year, Wayde, before I say it, did we already say what it is? It's going to be about 100 basis points next year. So just -- you got to take that into account first and foremost.

But outside of that, if you just get rid of SKU for a second and you look at underlying business strength, we would fully expect to continue to enhance our growth. That's the plan. And it's going to be through those 3 vectors, the commercial restructuring that we've done and the focus that we have will continue to pay dividends, the new product launches that will continue to come in 2026 as well. And of course, the brands that we already have in the market that we're basically relaunching.

And I can't wait, at some point, we need to get folks out to the businesses so they can talk about some of these brands that have been out there for a long time but are significantly underpenetrated. They're very profitable. They're clinically relevant, and we are going to relaunch those products.

Operator

Your next question comes from the line of Patrick Wood with Morgan Stanley.

Patrick Wood – *Morgan Stanley; Analyst*

I'll keep it to one. I guess, at least from our perspective, the organic growth is going better than expected and doing well on that side. And if all things go well towards the end of this year, you're going to have a balance sheet that looks pretty radically different.

So, I guess, compared to when you first took over the business, how are you feeling about that capital allocation? You mentioned bolt-on M&A, but like how much you feel you need to do that to buy into the kind of midterm growth range versus the levers that you've already got, we're early with Peel and Place.

How are you thinking about interplay between buying new businesses to kind of augment the growth versus what you have on hand today versus when you first took over, if that makes sense?

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Okay. Thanks, Patrick, and thanks for the one question. I thought it was going to be a really long one. So, I appreciate the one question, and it's relatively short. I would say that the M&A, to me, is an enhancement to - not a requirement to - get to the mid-single-digit growth rate. We had said 4% to 5%, which gets into mid-single digits in our LRP.

That is an organic go get that we're feeling much better about. And if anybody was doubting whether we could get there or not, I think our performance so far is squelching that out. But I don't look at M&A as a way to get there. I see M&A as a way to potentially accelerate getting there or potentially overachieve.

Operator

Your next question comes from the line of Rick Wise with Stifel.

Rick Wise - *Stifel; Analyst*

Maybe talk about, if you would, a couple of the underpinning processes underway. You highlighted, Bryan, the progress – the positive progress on the ERP front in the EU. Maybe talk us through the next big milestone there, timelines there. And just maybe remind us, if you would, the impact of this process going on and being maybe when it's totally completed and the impact you think it's going to have on the business? How are we going to see it? I mean, does it -- is it going to -- is it more in working capital that we're going to see it, something about cash flow? Just help us think through about the positive longer-term implications of this process.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. Thanks, Rick. And so maybe I'll start with that, and then I'll pass it over to Wayde to talk about some implications. Implications beyond the obvious. If something goes wrong, it has -- could have an immediate impact on revenue, but our goal is to make sure that that doesn't happen. So, you can talk about other potential implications.

And I would just say that, first and foremost, we just need to complete this larger implementation that we're in. That's what we're highly focused on. Things have had some challenges, but we've really overcome them. So, I'm feeling great about where the team is, but that's first and foremost.

We've got some smaller implementations through the rest of the year, but they're immaterial relative to this one. And then we don't have our next large cutover until 2026, where we have 2 that we're expecting in 2026. And we'd be pretty much fully through this as we come into the end of 2027. And then Wayde, anything you'd want to...

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Yes, sure. So, on the cost, I think, is your question, Rick, where we're incurring cost to separate both in OpEx that we carve out for non-GAAP separation costs as well as capital expenditures. And as we said a couple of times, we will expect to see that ramp down in 2026 and then ramp down further in '27, as Bryan said, the big boulders here to move are those ERP implementations. And as Bryan said, we're planning to have those completed in 2027.

As a result of that, we're expecting our free cash flows, that's the metric that we'll see significantly improve in 2026, and then again in 2027, as we don't have to incur those separation-related costs anymore. And I think I would just add to this one as part of your question is not having the distraction and the level of work and focus that people have to put on separation activities while they're doing their day job.

We've got a lot of our best and brightest working really hard on the separation. And I think what we're looking very much forward to is getting to the other side of the separation and then focusing just on building and strengthening the business.

Rick Wise - *Stifel; Analyst*

Got you. Just a brief follow-up. You highlighted that, of course, and remind us that the Drinking Water business, you've kept it for all the reasons you said. And I think Bryan's words were the potential to unlock additional value here. Maybe talk through that. When -- how might that value be realized? How big a priority? Is that something that could happen this year or next year? Any additional color would be welcome.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. Thanks, Rick. And I would say for a number of reasons, I probably don't want to get into too many specifics about the timing of a transaction, particularly a future transaction. But the goal here is to really just take the time that we need because we've got a lot going on right now to ultimately be prepared for a transaction and also ensure that we find the right home for our Drinking Water business and our team members there. So it's not an urgent thing for us. It is one that we want to make sure that we've got the time to do, and we find the right company.

Operator

Your next question comes from the line of Steven Valiquette with Mizuho Securities.

Steven Valiquette – *Mizuho; Analyst*

So really, I just want to follow up on the Health Information Systems segment. Curious to hear more about the partnership with Ensemble for autonomous coding. And they're the leader on kind of full RCM outsourcing. And from that press release in May, really, I mean, it says that Ensemble is going to implement your autonomous coding solution really across all 28 of their health system clients, if I read that right. I mean it seems like to be like a pretty large revenue opportunity.

So, one, are you able to quantify the revenue opportunity tied to that partnership? And also, what's the timing of that sort of implementation? I mean that would be pretty large to make sure that in the way I'm reading it right that, that size and magnitude. But just any quantification around all that would definitely help.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. So maybe just for some that don't know Ensemble, I'll just take one step back and then answer the question. Ensemble really is a -- as you referenced, it is a leader in outsourcing the revenue cycle management services. So, in other words, they would come into an account, they absorb that whole responsibility, including the FTEs from the account and then they provide those services for the hospital or hospital systems.

So, it's different than what we do. It's truly absorbing that entire process. And then inside of that, they would use products like ours. Now obviously, with this relationship, there's going to be a bias to our technology, things like Encompass 360, for instance, or 360 Encompass. So that's the relationship. The benefit that we'll see is the marketing arm of our organization can now talk about the benefits of Ensemble and potentially get customers to move towards them.

The benefit we get, which is what you referenced, is now Ensemble, then we'll begin to integrate our technologies into their accounts or new accounts. And the benefit they have as a result of putting it in, particularly with autonomous coding, is it can take the cost down for them to service those accounts and that increases their margin profile. Now to be fair, autonomous coding is in early stages. We're moving rapidly, obviously, but it's not going to be applicable everywhere.

But I fully expect us where we can do it to move aggressively with Ensemble to be able to, again, make the process more efficient. And ultimately, the goal here is not just efficiency, is to get better reimbursement because as you drive autonomous coding versus a human being and being involved in the process, you get fewer mistakes. And as a result of fewer mistakes, the concept is you get better revenue capture.

So that's the reason why Ensemble is focused here and excited about it. And I'm pushing pretty hard; the same way you are is to make sure that we're driving fast. I don't want to size the opportunity, but we wouldn't have done the partnership if we didn't think there was a real opportunity here.

Steven Valiquette – *Mizuho; Analyst*

Okay. The only real quick follow-up is to win that partnership, was there like an RFP where you had to compete against others to get that partnership? Or was there already like just a through a relationship kind of evolved into this? Just curious of any sort of back color on that as well.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

It's more of a relationship and I'd say a mutual respect. I mean one of the most dangerous things that we can do in autonomous coding is go with folks that don't know the quality aspects of doing coding. And so if you're going to bring autonomous coding, you've got to be careful not to do it too rapidly where you lose the quality control.

And I think Ensemble trust that we're going to do that and do it well, and we trust that they're also going to do the same thing. So that, to me, is what makes the relationship really strong. They're high quality, and we're the same way.

Operator

Your next question comes from the line of David Roman with Goldman Sachs.

Jenny Rabinowitz – *Goldman Sachs; Associate Analyst*

This is Jenny Rabinowitz on for David. Just a quick one from me. I was hoping you guys could walk through the decision to raise organic sales growth and EPS guidance while maintaining free cash flow and more broadly, the puts and takes you consider for free cash flow throughout the year.

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Yes, sure. So, the logic to raise organic sales growth, I think we've talked about -- Bryan had it in his prepared remarks and a little bit more color in the Q&A here where we feel really strong with the commercial improvements even faster than we expected, and that's what's given us confidence there. And then obviously, down the P&L, we're seeing mix benefits and strong performance in margins, and that's what's also helping us on the EPS side.

Having said that, I think the main crux of your question is why not seeing that increase in free cash flows as well. And what I would say there is that we've had a slow start on free cash flows at the beginning of the year. Here, we've had some timing of payments that we had to make in the first half.

And so, we've got some work to do in the second half to achieve the guide. And so that's why we're holding the guide where it is. We are anticipating improvements in working capital as well as lower deferred cash payments and that's really what improves the second half over the first half. But as I think everybody knows, cash flow can be lumpy. And so, we still anticipate delivering in that range for the year.

Operator

Your next question comes from the line of Brett Fishbin with KeyBanc Capital Markets.

Brett Fishbin – *KeyBanc; Analyst*

Maybe I'll shift to, I think, the one segment that hasn't come up yet. I was just curious if you could maybe touch on how you're viewing the underlying patient trends in the Dental Solutions business. Obviously, it's been a little bit of a challenging space post-COVID. But just wondering if you've started to see like any change in kind of the underlying volume trend around patients.

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. We really haven't seen a dramatic change. I would almost say, unfortunately, at the end of that statement because we'd like to see it improve. The good news, I guess, is that it's not decelerating at least on a broad-based perspective -- from a broad-based perspective, but we're not seeing the acceleration yet either.

I would say that when we talk about acceleration in our business, we're not depending on any acceleration in the market. We're truly depending on the new products and the traction they're getting in the marketplace and our specialized sales organization. Now if we happen to get a positive traction in the market, that would benefit us for sure, but we're not counting on it right now.

Brett Fishbin – *KeyBanc; Analyst*

Yes, makes sense. I'll also ask one kind of open-ended follow-up. It sounded like you had some new product launches expected in Dental into the back half. Maybe just more broadly, if you're willing to touch on any new products or general areas that we should be looking out for in that segment or in the rest of the business in 2H?

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

Yes. In Dental, specifically, I'll give the team credit because they had a period of time where there were no product launches, and they've done a nice job of really accelerating that machine and launching this year, and that is what is going to drive our growth. And it's products that they've already put out. I don't want to talk about any they haven't launched yet, but Clinpro Clear is a big one in fluoride treatment, the Filtek Easy-Match, which is just a simplified process to be able to get a match when you use Filtek composites and then the Clarity Precision Grip Attachments, which can be used with our Clarity trays or anybody else's trays as well. And those are great launches that they have that are building momentum in the field, and that's what will drive that performance.

Operator

[Operator Instructions] Your last question comes from the line of Lei Huang with Wells Fargo.

Lei Huang – *Wells Fargo, Associate Analyst*

This is Lei calling in for Vik Chopra. Congrats on a nice quarter. You talked about some of the segments in terms of outlook, MedSurg kind of underlying growth first half, second half. Can you talk about how do we -- how should we think about quarterly cadence for growth in the second half in general? And any additional comments around growth outlook for the other segments in the back half?

Bryan Hanson - *Solventum Corporation; Chief Executive Officer*

I think maybe I'll take a shot at that just to see if I got the question right. But I would say from a cadence standpoint as we come into the back half, Wayde talked about the first half, second half kind of growth rates before.

And obviously, when you look at on the surface, not underlying growth, but on the surface, you're going to see a bit of a pressure point in Q3 because we believe that's when we're going to get most of that order timing up. And then you'll see improvement from Q3 and Q4. But that's probably the most I can give from a cadence standpoint. So pressure in Q3 because of the order timing unwind, a little bit in Q4, but not as much.

Wayde McMillan - *Solventum Corporation; Chief Financial Officer*

Yes. I think you got it, Bryan. We're not giving specific quarterly organic sales growth rate. But just as you framed it, we're expecting a little lower sales growth rate in Q3 as a result of that pullback in orders that we saw in the first half and a little higher in Q4.

Operator

I'll now turn the call back over to Amy for closing remarks.

Amy Wakeham - *Solventum Corporation; Senior Vice President of Investor Relations & External Finance Communications*

Great. Thank you, Kate, and thank you, everyone, for listening and for your questions. We do appreciate your interest in Solventum. If you have follow-up questions or need anything else, please don't hesitate to contact the Investor Relations team directly. This concludes our second quarter fiscal year 2025 conference call. Kate, you may now close the call.

Operator

This concludes today's conference call. You may now disconnect.