



Solventum second quarter 2024 earnings

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Corporate speakers:

Kevin Moran – *Solventum; Senior Vice President of Investor Relations*

Bryan C. Hanson – *Solventum; Chief Executive Officer*

Wayde D. McMillan – *Solventum; Chief Financial Officer*

Presentation:

Operator

Good day. At this time I would like to welcome everyone to the Solventum Second Quarter 2024 Earnings Call.

As a reminder, this conference is being recorded.

I would now like to turn the program over to your host for today's conference, Kevin Moran, Senior Vice President of Investor Relations.

Please proceed.

Kevin Moran – *Solventum; Senior Vice President of Investor Relations*

Good afternoon. And welcome.

Today we will discuss Solventum's second quarter fiscal 2024 results, along with an update to our 2024 outlook. Just after market closed today, a press release was issued with our earnings results and updated outlook. The press release and earnings presentation are available on the Investors section of the Solventum website.

Joining me today are Bryan Hanson, our Chief Executive Officer; and Wayde McMillan, our Chief Financial Officer.

During the call we will be making forward-looking statements that are subject to risks and uncertainties.

For a full description of these risks and uncertainties, please refer to our SEC filings and the forward-looking statement slide at the beginning of the presentation.

Please note that during our discussion today, all our comments will be on a non-GAAP basis unless they are specifically called out as GAAP. GAAP to non-GAAP reconciliations for all relevant periods can be found in the schedules attached to our press release.

For the Q&A portion of the call we kindly ask that you limit yourself to one question and one follow-up.

And with that, I'll hand the call over to Bryan.

Bryan Hanson – *Solventum; Chief Executive Officer*

All right. Great. Thanks, Kevin, and thanks to everyone for joining us today.

I tell you it's exciting to be here for our first earnings call as a publicly traded company, and I want to start that call by saying that I'm encouraged by the progress that we have made and with the results of the quarter, which reflect our ability to come together as a new team and maintain business continuity in the midst of the separation. And we're raising our full-year outlook as we continue to progress our plans to get this business to where we expect it to be.

Simply said, we are moving with urgency, and we remain confident in our ability to create value. And for all the Solvers that I know are listening out there, I want to say thank you. It's your hard work that has gotten us to this point. Make no mistake, this would not be happening, we would not be here without you.

And for the call today, I'm going to provide a brief reminder of our Investor Day presentation, specifically around our situation analysis and reasons to believe in the value creation story, as well as a reminder of and update on our phased approach for the transformation and turnaround.

And then I'll pass it over to Wayde for a deeper dive on the quarter and our improved outlook for 2024, and of course, we'll save time for Q&A and certainly look forward to that conversation.

As some of you may be new to the story since our Investor Day in March, let me start by giving some background on Solventum, our team and again, why we're confident in the value creation story. And I think the right place to start is the spin itself.

We've talked about this before, but we have extensive IP that we share with 3M. And as a result of that, we are executing a highly entangled and, therefore, complex separation.

But to ensure, in a situation like that, we proactively mitigate the risk associated with this type of separation, we have intentionally assembled a team with significant spin and transformation experience. And given the regulatory requirements of the sector, which can significantly impact the planning and implementation of the separation, we have also ensured this team has deep regulated business experience.

Simply put, we have done this before, and we are going to do it again.

Now relative to the business setup, our business segments are in attractive and growing markets. We have strong sub brand recognition in those markets, significant IP protection, solid levels of investment in R&D, and we have global reach.

That said, we also have businesses that have consistently underperformed their markets with flat volume growth over the last two years, coupled with a declining volume trend mainly due to misaligned and unfocused end metrics, which resulted in commercial misalignment and poor R&D productivity.

Now with this as context, and of course, what are we going to do about it, I'd like to remind you of our phased approach to stabilize and then separate the business, reposition it for profitable growth and optimize the portfolio.

As discussed at our investor meeting, we have outlined this in three phases, which are all currently underway and running in parallel.

As you may remember, Phase 1 is focused on mission, talent, culture and structure as well as the spin-related activities to separate from 3M, which are critical, all of them, critical catalysts to driving business growth. Phase 2 is developing and implementing our long-range plan that will reposition us for profitable growth and Phase 3 is portfolio optimization.

Okay. Starting with Phase 1, specifically related to mission, talent and also culture and structure.

We've already created a new mission statement and articulated our company values. And I got to tell you, what an amazing opportunity was to help write the mission and values for a new company.

I feel incredibly lucky to be a part of something so meaningful.

I see the mission and the values of a company as absolutely critical to its success.

Because when done right, it becomes a common purpose and connection across the team, capturing the hearts and minds of all of our team members, which again, I see as an essential enabler of sustainable business performance.

And we've held mission ceremonies around the globe, meeting with thousands of our employees to discuss how they bring the mission to life.

It doesn't matter where region or country or business I'm in, it is clear. The team is excited and ready for the future as Solventum.

Now relative to talent, which is really one of the key areas where spinning a company creates value, we continue to move fast.

We've completed the selection of our level one leadership team, finalized the structure for level two and identify key positions at levels three and four, that are critical to the turnaround.

And we're actively internally sourcing or acquiring experienced talent in these roles as well.

At the end of the day, we're trending ahead of my expectations in talent acquisition, benefiting from a lot of high-level industry talent that understand the value creation story and are interested in joining this team.

We're also making great progress on our culture and structure project. This is a restructuring project we are calling the Solventum Way. The goal here is to create a more nimble and less hierarchical structure that drives increased autonomy, speed and very importantly, accountability and will also help us ensure that we have the ability to invest for growth while enhancing margins. Moving to the separation activities inside of Phase 1.

It's obviously early days with most of the work still ahead of us, but these are critical months in the separation, and I'm happy with our progress. This quarter's financial performance alone speaks to a successful start with our business continuity efforts while standing up a newly independent company. Again, I want to compliment the teams for delivering on their commitments in the face of separation distraction.

For areas like our supply continuity project, manufacturing and IT separation, I feel good about our disentanglement plans. This is hard work, but the teams are progressing these initiatives with speed.

From a timeline perspective, our supply continuity project will extend beyond twenty-four months, but we expect the majority of Phase 1 activities to be completed in twelve to twenty-four months post spin.

I should also note that given the timeframe of Phase 1, it will naturally overlap with Phase two and Phase 3. Phase 2 is focused on a Solventum Way of long-range plan to position us for profitable growth.

Because we were able to accelerate talent acquisition in Phase 1, we've actually shortened the path to finalize our strategic plan in Phase 2.

Now we expect to share this plan during our fourth quarter earnings call which will coincide as one would expect with our 2025 guidance.

So key elements of that plan — not comprehensive, but key elements of that plan will be our primary market and submarket selection. Again, those markets that we're going to double down in.

Inside of those markets will be the growth driver initiatives to be able to build scale. And probably most importantly, showing that we're going to shift our commercial R&D and eventually, resources to those growth driver areas. And as you would expect, we're currently assessing primary markets and growth drivers, and our intent is to finalize these decisions before the end of the year.

Once we've identified the primary markets and the growth drivers, we'll begin shifting, as I said before, our resources, starting with commercial infrastructure changes, things like specializing the sales organization, things like changing the incentive plans that we have for the sales organization to bias our focus in the growth driver areas.

We'll also shift where we spend R&D dollars so that we align our new product pipeline toward innovation that matters and is material in the growth driver markets. And finally, as we expect that our focus on debt reduction, over the next 24 months, will allow more flexibility to expand our capital allocation priorities including potential tuck-in M&A tied to our, again, growth driver areas.

Okay. Moving on to Phase 3.

We're looking at pathways for our portfolio optimization through inorganic means in order to bring additional strategic clarity, organizational focus and value creation. And as a result, we are actively assessing our various markets and businesses and their value contribution to deliver on our strategic and financial priorities.

Now that said, given how early we are in the spin process, there are contractual considerations that will influence Phase 3.

Okay. To summarize what I just said, because I think I threw a lot at you, number one, our foundational work on mission, talent, culture and structure is ahead of schedule and progressing well and positively impacting our Phase 2 timing.

From a separation perspective, it's early days, but also pivotal days in the process. And things are progressing well and I have confidence in our team. Number three, given our early progress on our strategic plan and SKU project, we now intend to share our long-range plan during our fourth quarter call which again will coincide with our 2025 guidance.

And number four, Wayde will speak more to the quarter in a minute, but our first quarter as an independent company was a good early sign when it comes to business continuity and progress on our phased approach.

Before I turn it over to Wayde, I just want to reiterate that we have an incredible opportunity to create significant value and that I believe the actions we are taking today, relative to executing the separation and identifying opportunities to reposition this company for profitable growth, will set us up for significant value creation in the future.

Okay. Wayde?

Wayde McMillan – *Solventum; Chief Financial Officer*

I'll start by echoing Bryan's sentiment and thank everyone at Solventum for their hard work, getting us to where we are today.

Our 3-phased approach is designed to create significant value over time.

I'll keep my remarks mostly focused on updates related to Phase 1 and separation activities before getting into Q2 performance and then wrapping up with guidance.

To separate, we have significant efforts underway. We're moving our manufacturing lines from 67 plants to 29 Solventum plants, two of which we're building new at this time.

We're also separating our distribution and supply chain by changing from 122 to 73 distribution centers.

Our rebranding efforts are significant across 90 countries.

We have changed our commercial distribution models in over 60 countries. The IT work streams may be the most complex as we're working to transition over 1,000 systems and stand up over 70 new platforms including our new SAP ERP system globally.

In parallel to the separation work, we are already making progress on the turnaround, which is centered on improving revenue growth and expanding margins.

It's important to understand the historical baseline and I'll provide some background for each metric as well.

For revenue, we have historically underperformed our mid-single-digit markets with flat and declining volumes over the past two years. This was clearly reflected in 2023 where price was more than all the revenue growth for the year.

As we move out of a hyperinflationary period and price normalizes, we are intently focused on turning around the negative volume growth.

Bryan covered the Solventum Way restructuring project, which touches every segment, function and region in the company. This effort is ongoing and will be an important part of our investment to reposition for growth and margin enhancement plan.

Additionally, we remain focused on a comprehensive global SKU rationalization initiative.

Our goal is to streamline and simplify the company by eliminating less strategic, low growth and/or low-margin SKUs or product families.

We have already identified approximately 3,500 SKUs to be eliminated as part of wave one of this initiative.

They represent about 5% of total SKUs and will help simplify the supply chain. And they will not have a material impact to revenue and margin in 2024. This is a promising start and real progress achieved to date. Wave two is expected to be more impactful to revenue and margin in 2025.

The turnaround is also focused on improving margin. The before-mentioned Solventum Way and SKU projects are designed to identify efficiencies to reinvest and improve margins. We have seen our historical operating margins step down from approximately 25% in our 2022 and 2023 carve-out financial statements in the Form 10 to our planned 21% to 23% in 2024.

We're not including 2021 in our baseline, given it was significantly inflated by the post-COVID rebound. This 200 to 400 basis point decline is due to the additional cost of products supplied by 3M as well as increased operating expenses to stand up a public company, and the investments to reposition for growth.

Turning now to the financial update. I want to remind everyone this is the first time we'll be presenting financial results as a stand-alone company.

We previously reported Q1 2024 results under a carve-out basis as the first quarter was still under 3M. With that, I'll provide an overview of our Q2 results and then shift to full-year guidance.

Starting with sales.

For the second quarter of 2024, sales of \$2.1 billion increased 20 basis points compared to prior year on a reported basis while improving 1.3% on an organic basis.

During the quarter, foreign exchange was a headwind of 110 basis points.

Sales growth reflected the expected normalizing of price.

While we reported a slight volume increase in the quarter, this included a discrete benefit from backorder improvement, without which volumes continued to decline.

Moving to the segments.

Our largest segment, MedSurg, delivered \$1.2 billion of sales, an increase of 1.8% on an organic basis, led by the negative pressure wound therapy product category and continued adoption of our antimicrobial IV site management solutions. This segment was the primary beneficiary of reduced back orders.

Our Dental segment delivered \$331 million of revenue, a decrease of 2%, which reflects volume pressures associated with challenging market conditions, partially offset by pricing.

HIS segment contributed \$328 million of revenue, an increase of 3.6%, which was fueled by continued adoption of 360 Encompass inside of revenue cycle management, and steady results in performance management solutions.

Similar to the prior quarter, strength in these areas was partially offset by declines in clinician productivity solutions due to changing market conditions and inconsistent investment.

Finally, the Purification and Filtration segment delivered \$238 million of sales a decline of 0.9%, which was impacted by performance in drinking water filtration, partially offset by better-than-expected strength in bioprocessing filtration.

Overall, volume declines were partially offset by pricing. Gross margins were 55.8% in the quarter. This represents a reduction of 200 basis points over prior year, primarily driven by increased costs in international and unfavorable mix within MedSurg that was driven by backorder recovery in the lower-margin OEM business.

On a sequential basis, these two factors, along with the return to more normalized pricing weighed on gross margins.

As expected, operating expenses increased both versus prior year results and sequentially compared to Q1. The added spend includes standing up new functions and to support our growth strategy.

It's also important to note that Q2 SG&A was high due to a stock-based compensation charge for legacy 3M employees. This and other smaller discrete items in Q2 represented an additional spend of approximately \$30 million.

In total, we delivered adjusted operating income of \$430 million, which translates to operating margin of \$20.7 million.

Moving down the P&L.

Interest expense also increased sequentially, reflecting the first full quarter impact of our February 2024 debt issuance, which was partially offset by interest income. Lastly, our effective tax rate of 12.2% came in favorable due in part to the estimated geographic mix of our statutory income post spin, which includes a year-to-date adjustment. All in, we delivered earnings per share of \$1.56, ahead of our internal expectations.

Turning to the balance sheet. We ended the quarter with \$897 million in cash and equivalents with no outstanding borrowings on our credit facility.

We generated \$297 million of free cash flow in Q2, bringing our year-to-date total to \$637 million.

Importantly, we are committed to maintaining our investment-grade rating and expect debt paydown will remain the priority over the next 24 months.

We maintain a strong liquidity and financial position with continued free cash flow generation in addition to our \$2 billion revolving credit facility.

Now turning to guidance for 2024.

We are raising our organic sales growth guidance range up to 0 to up 1%. This reflects first half performance including the benefit from backorder reduction in Q2, an updated assumption that SKU rationalization will not have a material impact on 2024 results, and importantly, building confidence in business continuity.

We are not providing quarterly guidance, but I do want to be sure to highlight the second half dynamics of the year-over-year comparisons which will play a large role in the organic sales growth in Q3 and Q4.

For background, Q3 was the highest growth rate in 2023 and therefore, is a tougher comparison and results in expected flat to down growth rate in Q3 2024, while Q4 was the second lowest growth rate of 2023, with an easing comparison for Q4 2024.

For earnings per share, we are raising our guidance to \$6.30 to \$6.50 on our improved sales outlook and favorable estimated tax rate.

We continue to expect free cash flow in the range of \$700 million to \$800 million.

For reference, a few additional items we've previously shared.

On gross margins, we continue to expect incremental gross margin headwinds from the 3M supply agreement markup will begin to flow through our P&L in Q3 2024.

For operating expenses, we anticipate the continued ramp for investment to build out stand-alone functions and support our growth strategy through the second half of the year. All in, we continue to expect full-year 2024 operating margin in the range of 21% to 23%.

Turning to tax rate.

We are updating our full year effective tax rate to 18% to 19%, an improvement of 200 basis points from our earlier assumption of 20% to 21%.

It's important to recognize that this change to our tax rate is expected to be temporary for 2024, as we're benefiting from a near-term favorable mix based on where we are generating our income which is a function of realizing separation costs in certain jurisdictions.

In conclusion, we are off to a solid start, closing our first public quarter.

We're delivering on our near-term financial commitments, executing on separation activities, focusing on turning around the business, while raising the top and bottom line guidance for the year.

Looking ahead, we will continue to execute on our phased approach to transform our business and make improvements across our key operational metrics, accelerating revenue growth, expanding margins, driving free cash flow and optimizing our capital allocation.

We will use our expertise in health, material and data science to deliver our mission.

We are encouraged by the early progress and look forward to the value creation plan ahead.

I'll now hand it back to the operator for the Q&A portion of the call.

Question & answer:

Operator

Our first question comes from Travis Steed from Bank of America.

Travis Steed – BofA; Analyst

Congrats on your first earnings call.

Wayde, I wanted to start with the guidance raise and really understand all the moving parts there.

A lot of the EPS raise came from the tax, but it sounds like things are maybe been tracking ahead of plans and pushed the SKU rationalization to 2025.

If anything, are you more confident in the outlook here and what drove the guidance raise? And how to think about Q3 and second half modeling for the different line items?

Bryan Hanson – Solventum; Chief Executive Officer

Travis, this is Bryan. Maybe I'll start with some of your questions, particularly around just some of the confidence we have and what's kind of pushing our guide. And then Wayde, I'll pass if you, you get into more specifics there.

So obviously three components that Wayde talked about that are driving our guide and, really, our confidence. The first is just the business continuity is feeling pretty good right now and we're making great progress against our plan.

That's number one.

Number two is Wayde referenced in his prepared remarks, it's just the backorder recovery that we banked in Q2. And then the SKU clarity, and Wayde will talk more about that in a second, but we just have better clarity of the impact we're going to see in 2024 versus 2025. That's broad-based what we're feeling right now and that's the reason for the guide change.

I think importantly, though, just to maybe click down in the business continuity and progress against our plan.

It doesn't feel like a long time.

It's only been four months now but those are pretty pivotal months in the separation. A lot can happen in those months. And for the most part, we delivered in pretty much every primary area during that time. And I think most importantly, business continuity. That's where the biggest risk is.

And every day that passes, Travis, we just feel better about reducing risk, retiring risk and then further executing on our turnaround strategy.

I guess probably the simplest way to say it is a lot could have gone wrong and it didn't, which is great.

It doesn't mean it's going to be simple from here, but the momentum is positive, and that drives our confidence.

But probably equally maybe even more important than that is we're really moving fast in talent acquisition. And I think probably anybody would recognize that you don't really want to put a strategy in if you don't have the people in place that are accountable for the strategy.

So the faster you can move to put people in place, particularly in level 1 and level 2 positions, it's just critical to formulating the strategy, having ownership of the strategy and then eventually, that flawless execution of the strategy.

So those are the things that we feel like are moving in the right direction, increasing our optimism. And hopefully, that's reflected in our tone in the guide.

So maybe with that way, we can give a little more color on the other components.

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes.

Sounds good. Happy to pick up on how we're thinking about guidance here and SKU project.

As Bryan said, we're really pleased to be in a position where we can raise our full-year guidance after just our first stand-alone quarter here as a public company.

So let me talk about the new range.

Really built off the back of what we called out in the quarter here, in Q2, revenue was ahead of our expectations because of the backorder reduction that we got, and that was from an improvement in service levels.

So positive signs, as Bryan said, for business continuity.

So the new range then contemplates normalizing the second half for that — for the price benefit that we've been seeing and it continues to wane into the second half as well as a tougher comp for that back order recovery. When you normalize for those two things from the first half, the high end assumes we see improvement in the business. And then near the low end assumes a more consistent performance.

So we feel real comfortable with the range here that we have for the second half.

It's early days, but we are pleased with the business and its performance to date through the first half of the year, really, with the second half to go. And just keeping a focus on that #1 priority for us is our growth driver strategy.

A little color down the P&L. If we think about gross margins, we mentioned in the prepared remarks, a couple of things that drove costs higher in the quarter, both the international costs and some unfavorable mix in MedSurg, really, around

the margin on those backorder recovery products.

And so lots to consider, puts and takes.

It could be different next quarter.

We are still expecting a step-up in cost from 3M and but that doesn't necessarily mean a step up in gross margins because there are a lot of puts and takes. And so even with all that and the step up in cost, we are still comfortable with our 21% to 23% operating margin expectations for the full year of '24. And I should probably just touch quickly on OpEx, because that is also an important part of how we think about modeling here.

We called out, in our prepared remarks, that we had a good amount of discrete items, not unexpected in a separation. It's always a bit noisy with things that are coming out of the separation-related work. So we called out one in particular, a large expense that we took for stock-based comp and then a few other things that really were about \$30 million in the quarter.

So with that, we still anticipate the continued ramp for the investment to build out our stand-alone functions and to support our growth strategy through the second half of the year, but that will be off a normalized Q2.

So all in, feeling really good about the guide and happy to be raising both the high end and the low end at this time.

Travis Steed – *BofA; Analyst*

The next question I have is, when can you guys start growing earnings again? I know 2025 is kind of a down year.

But if you think about the plans that you have, is '26 a year where you potentially could grow earnings? And I don't know if there's any way, high level, to think about some of the things that you have to deal with in '25 and some of the headwinds you have in '25, like the SKU rationalization and kind of help us size some range of impact on that.

Bryan Hanson – *Solventum; Chief Executive Officer*

Wayde, if you want to provide a little more color on the — some of the pressure points in '25.

Obviously Wayde talked about it in his prepared remarks, '25 has got some unique annualization of expenses that are going to put pressure on us. And you're right, '25 is going to be a tough year for EPS.

But we absolutely would expect that to begin to recover in '26.

We'd be extremely disappointed if we didn't start to head in the right direction in '26.

So Wayde, I don't know if you want to provide anything more in '25. I thought you provided a lot in your prepared remarks, but.

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes. I certainly can.

I'll have to say, we're not guiding to '25 and '26 yet. There are certainly a lot of moving pieces as we're in our first year post separation.

We do have a lot going on to grow revenue and expand margins. And as Bryan said, resulting EPS growth over time.

However, we do think it's well understood that we'll be pressured by the annualization of some of these costs post spin in 2025.

So just to list them, we've got the 3M supply markup that will annualize.

We'll be annualizing our stand-up functional expenses. And then below the line, we'll be annualizing interest expense. And all of this is because we've got three quarters this year as a public company, and we'll annualize our fourth quarter next year.

And then I did mean to touch on the SKU project as well because this one is just great. Great progress out of the gate, real nice start.

We found that there was a lot of opportunity to take out a significant number of SKUs already in our first wave here. And the good news is they don't impact revenue in a material way. There's a very small impact.

We don't expect them to impact margins or revenue in 2024.

And the real benefit is it will help us simplify the supply chain.

We'll save a few million dollars on rebranding as well because we don't have to rebrand these SKUs that had very low value to us.

So the team is continuing to work on the next wave, which we do anticipate will have more of an impact on 2025, but that work is still underway, and we don't have an update there yet.

Operator

Our next question comes from Vik Chopra from Wells Fargo.

Vik Chopra – *Wells Fargo; Analyst*

Congrats on a nice quarter. A couple for me.

So by math, the revenue guidance raise as about \$80 million to \$150 million of dollar upside to 2024. Maybe just help us understand what business segments are driving this? And then I had a follow-up, please.

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes, Vik, happy to take that.

We don't break it down by segment.

But what we can say is that the message that we put into the prepared remarks was the most important one. There's a good amount of risk as we separate the business and business continuity and we gained a lot of confidence.

It would go from a long ways from having no quarters to having one quarter.

As Bryan mentioned, it was a pivotal quarter for us. That's where the confidence really grew.

And so it's really across the board that we're thinking that we're going to see some strength.

Obviously the backward recovery in MedSurg was a good size. I think Bryan called it banking it in the second quarter here. a good sized bump for us.

So with that, the business continuity and then also the SKU reduction program. We don't think it's going to have as much of an impact on '24. That would be just across the three segments with products, not including HIS.

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes.

I might just add to that, too.

If you think about, really, four vectors, and I won't go through all of these, but there are four vectors that you can accelerate growth with. And it's no there's no rocket science here. They're pretty basic.

But for the things you got to do to drive it, one of the first things you can do, the fastest impact is just upgrading talent to drive better commercial rigor and just changing incentives to your – for your commercial organization to focus on growth. And those are the things we can do right now right.

We're bringing in great people. We've accelerated and promoted people that are very capable in the organization and brought people from the outside. That will have a dividend pretty quickly, because they will increase the rigor and accountability in the organization.

So that we would expect to help us in the back half of '24 and certainly into '25.

Vik Chopra – *Wells Fargo; Analyst*

Got it. Very helpful. And then just my follow-up question.

Can you just share some high-level feedback on your conversation with the activist and just provide an update as to how much of a stake they've actually amassed?

Bryan Hanson – *Solventum; Chief Executive Officer*

As you would imagine, as a public company, we don't talk about any individual investor. That said, as a public company and humble people, we absolutely listen to our shareholders and appreciate the feedback, but probably no more to say about that.

Operator

Our next question comes from David Roman from Goldman Sachs.

David Roman – *Goldman Sachs; Analyst*

I hope to get one in here on the financial side and then one follow-up on the strategic planning side. Maybe just starting on — with respect to the outlook for the balance of the year.

I'm trying to put together some of the moving parts as it relates to first half versus second half. And maybe, Wayde, you could help us bridge, a little bit, the commentary around the reiteration of the 21% to 23% operating margin. That's roughly what you did here in the first half with some of the commentary around the 3M supply agreement, as well as the incremental investments and what that implies for sort of an exit rate for the year.

And then, as I look at free cash flow year-to-date and the updated guidance, it implies a significant step-up in cash utilization here in the second half.

Can you maybe help us understand some of the moving parts there as well?

Wayde McMillan – *Solventum; Chief Financial Officer*

Sure.

So just to cover a little bit more, David, to your question on first half, second half outlook, I think I touched on revenue, a good amount there, just highlighting that we had a couple items in the first half that won't repeat in the second half pricing, waning and then the back of recovery, which is opportunistic and we don't anticipate seeing that in the second half at this point. And so that's what gets us our revenue growth rate, and it's a 0 to 1% for the year. And so you can do the math on that for the second half.

I do just want to highlight from our prepared remarks that there is a comp — significant comp issue between Q3 and Q4, so that's important for revenue.

You mentioned bridging the — and the exit rate around operating margins. The way we're thinking about this is Q2 had some headwinds in gross margins and operating margins for us. Those are offset with the favorability in revenue. And so that's what gives us confidence to hold the 21% to 23% for the year.

We're not going to comment on an exit rate at this point.

We're not giving the quarterly guidance.

Obviously we've just got one quarter under our belt. And we've got a long ways to go.

We're just not going to get to that level of detail.

But what we can tell you is we had gained a lot of confidence in the quarter, and we learned a lot about the business post separation.

So it's building confidence and that's what allowed us to raise both the top and the bottom line here — just after our first quarter.

You mentioned cash as well.

I would say probably the biggest things that we're managing here post separation is just all of the timing of the intercompany work that we're doing as well as standing up our capital expenditure processes. And so we do think we will be using more cash in the second half of the year to settle out some of those as well as ramping up our capital expenditure use in the second half.

David Roman – *Goldman Sachs; Analyst*

Got it. And then Bryan, I appreciate your comments on being ready to share more with us on the fourth quarter call. But I think you've made comments in other forums about kind of the turnaround on the top line being roughly a five-year period of time.

Can you maybe update us on any thoughts with respect to that outlook and how that falls into the context of the phasing of the different parts of the Solventum turnaround that you referenced earlier?

Bryan Hanson – *Solventum; Chief Executive Officer*

Absolutely. And good to hear from you.

So I would say — I'll repeat a little bit of what I said and then maybe add some additional color.

I see this as an opportunity for us in our strategic plan to very clearly articulate what markets and sub markets we're going to care about, right, we're going to double down in. And those will be our faster-growth markets, as you can imagine. We're working through that and I would expect to pick those by the end of 2024.

Once we do that, that begins the shift of resources, commercially, R&D, M&A when we get to that point. And that begins to drive traction and focus in those areas. That just takes time, but maybe I can double-click on the revenue growth accelerators.

I referenced that there were really four of those.

And it just — again, there's no secret sauce here.

If you've ever run a business and you turn one around, you drove revenue acceleration, these are the things you have to do.

It's just a question of doing them and how much time they take. And so I'll just kind of start with the first as I referenced, getting great people in place that know how to drive rigor in a commercial organization is paramount, and it's the fastest way to drive revenue growth.

Second fastest way is commercial structure changes, either specialization or just increasing reach in those important spaces that we're going to concentrate on.

Third, as you would expect, would be increasing the productivity of R&D.

We have to do less of these iterative approaches in R&D and more impactful, more meaningful launches inside of the high-growth areas. And then probably in parallel with that would be portfolio optimization. And I look at that in two ways.

The first would be tuck-in acquisitions to give more scale in those fast-growth markets.

And the other would be potentially exiting categories that are slow growth, right, those are the ways that you would get there.

If I just think about the timing of those things, kind of going to your question, again, on the talent side, it's right now.

In the back half of '24 into '25, we should expect to see that benefit. Commercial structure changes just take a little longer because you got to know where you're going to do them, and then you got to actually hire people and change the structure. That's more probably the latter part of '25.

If I think about R&D productivity, once you start a project, probably best case when you start one is 2026, but likely beyond that, just depending on the product complexity, the regulatory requirements.

And then portfolio optimization, really, at least on the acquisition side, depends on just deleveraging timing. And so when I think about the LRP, why these are important is because we're figuring out now the mix of these elements that we're going to need to accelerate growth where the major gaps are. And as we work through that mix, that will inform, not just our LRP, but the time to accelerate the revenue growth.

So hopefully, that gives a little more color versus what I've said in the past, but those are the elements to get us there.

Operator

Our next question comes from Vik Chopra from Wells Fargo.

Vik Chopra – *Wells Fargo; Analyst*

Just hopping back in queue for a couple of quick follow-ups. That \$22 million of corporate and unallocated revenues, do you expect those to continue going forward? Should we be building those into our revenue projections?

Wayde McMillan – *Solventum; Chief Financial Officer*

So I'm glad you asked that one, Vik. An approximate number to the \$22 million for the rest of the year, yes.

So in other words, that's a good estimate for the next couple of quarters this year.

Vik Chopra – *Wells Fargo; Analyst*

Okay.

So build out \$22 million roughly for Q3 and Q4. Got it. And then I don't think I heard an updated FX assumption for the year.

Can you help us out with that?

Wayde McMillan – *Solventum; Chief Financial Officer*

Oh, FX.

So we're – we just use the current FX rates at this point for the following – Kevin, do you actually have that?

Kevin Moran – *Solventum; Senior Vice President of Investor Relations*

Yes.

So right now the last assumption we provided from a revenue perspective is 50 basis points of impact.

We did not update that.

So it's safe to assume that, that's still our best guess.

Wayde McMillan – *Solventum; Chief Financial Officer*

And the way we do that, Vik, is we just take the current rates approximately right now and apply that.

So we're expecting 50 basis points for the full year.

Operator

Our next question comes from David Roman from Goldman Sachs.

David Roman – *Goldman Sachs; Analyst*

Appreciate you're taking the additional questions here. Just maybe a few clarification items. Wayde, starting with the tax rate.

I know you talked about some catch-up items that had occurred in the quarter.

But I think as you look at the year-to-date tax rate and the updated guidance, it kind of puts the tax rate in that 20% to 21% range in the back half of the year.

Is that a fair characterization of where that should land? And then secondly, you did make a passing reference to restructuring. Are you already at a point where you are ready to start rationalizing down costs? And how is that impacting your outlook here?

Wayde McMillan – *Solventum; Chief Financial Officer*

Sure.

I'll pick up on tax rate and then, Bryan, if you want to talk about some of our strategies, so that's probably the right way to take it.

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes.

Wayde McMillan – *Solventum; Chief Financial Officer*

So for tax rate, you've got it. Basically, we've had better-than-expected tax rate for the first half of the year.

We had a pretty sizable year-to-date catch-up here in our first quarter post separation. And the second half is similar to what we expected for the full year when we gave our full-year expectations. And this is one of the areas that has to settle out a little bit as we separate and our tax team is hard at work at it.

So that's what we're comfortable with for a guide at this point. And then from a restructuring standpoint, Bryan?

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. Great question, David. Glad you asked it. So what I would tell you is our work is — we do feel like we're in the right position to start this project. And I think it might be — it might surprise you, actually, the primary reason for it.

So there's really two in my mind, but the one that comes to me is the most important is the restructuring is focused.

We're calling it, again, Solventum Way.

It's focused on streamlining our structure so that we can complement the culture shift that we're putting into place.

We are going to change the culture of this company.

We're going to look for speed.

We're going to move faster.

We're going to be autonomous, and we're going to drive accountability in the organization. You have to have the right structure to drive that culture shift. And I promise you, when we do it and we are doing it today, it will turn into growth.

That drives growth in an organization. And as we know growth drives the leverage in an organization in a really sustainable way.

The second part of a program like that is what you would normally do in the business and Wayde and I have done it in the past, it's to allow us the headroom to not only invest for growth, which we have to do, that's a primary area of focus, but also drive margin expansion.

So we absolutely feel like that's the right thing to do now for those reasons.

Wayde McMillan – *Solventum; Chief Financial Officer*

Bryan, I think you covered that really well.

I'll just add, I think part of the question was around timing and just maybe to reflect back on the Investor Day in March, where we laid out our four key actions for value creation and we talked about driving efficiencies to fuel the investment that Bryan just covered, and so no change in strategy, just sharing more about our efforts as we go here. Revenue growth remains the top metric for sure.

But as Bryan said, driving efficiencies will help us first fund additional growth initiatives as well as we look to expand gross margins over time.

Kevin Moran – *Solventum; Senior Vice President of Investor Relations*

Okay.

It looks like there are no further questions.

So I will close it by just saying thank you so much for joining us on our first public call and we look forward to engaging with many of you over the coming months. Thanks, and have a great day.

Bryan Hanson – *Solventum; Chief Executive Officer*

Thanks so much.

Operator

Thank you, everyone, for attending today's conference call.

You may now disconnect.

Have a wonderful day.

