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Solventum third quarter 2024 earnings

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Corporate speakers:

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

Bryan Hanson – *Solventum; Chief Executive Officer*

Wayde McMillan – *Solventum; Chief Financial Officer*

Presentation

Operator

Good afternoon. My name is Amy, and I will be your conference operator for today. At this time, I would like to welcome everyone to the Solventum Third 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 third quarter fiscal 2024 results, along with an update to our 2024 outlook. Just after market close 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 our presentation.

Please note that during our discussion, our comments will all 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 today's 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 for the call today. Hard to believe, but we've already completed our second quarter as an independent company. And I'd tell you that I'm increasingly encouraged by the progress our team is making against our phased approach to transform this business. And just as a reminder, for those that might be new to the story, we look at transformation in Solventum in two ways. The first one is the turnaround of our business performance; and the second is just obviously standing Solventum up as an independent company. Both of these vectors provide a real opportunity to drive shareholder value.

And then looking at the quarter, Q3 is yet another data point that speaks to the team's overall progress in this transformation and the success of our business continuity efforts, which we clearly see as being reflected in both the performance in the quarter and our ability to raise our full year guidance for the second consecutive quarter.

We saw positive top line growth in Q3 despite a challenging year-over-year comparison. And as a result, as I just referenced, we're raising our full year organic growth rate to the upper half of our prior guidance of flat to 1%, and we're increasing our adjusted EPS and free cash flow guidance ranges as well. We saw operating margins improve sequentially, benefiting from some onetime items that helped offset the known incremental headwind from the 3M supply agreement markups and following our disciplined capital allocation strategy, we paid down \$200 million of debt during the quarter. This should clearly show that we are committed to maintaining our investment-grade rating and prioritizing debt paydown.

When thinking about our progress to date, I'm just incredibly proud of our teams for their continued and steady performance, especially as they continue to work through separation-related activities and challenges. And I want to make sure that I take a minute to say thank you really to all the solvers that I know are listening out there today. It is your continued focus on working through the separation, maintaining business continuity and most importantly, as we always talk about, delivering for our customers. It is greatly appreciated, it is a clear testament to your resolve to move our mission forward.

Okay. Moving from Q3. I'd also like to give an update on our phased approach to stabilizing and separating the business, repositioning us for profitable growth and optimizing the portfolio.

I'll start with Phase 1. And Phase 1 really is just firmly taken hold as we've made significant progress on our mission, talent, culture and structure as well as separation activities, all of which are critical and I would actually say foundational for driving business growth. It's hard to believe, again, but it's been seven months since the spin and our culture is rapidly taking shape, our new leaders continue to gel as a team, learn and assess the business and finalize our go-forward strategy. And the energy across the organization remains high with tangible excitement as I travel around the world for our new mission at Solventum.

We also continue to advance our planning for the Solventum way restructuring project. This project is focused on creating a more flexible, more decentralized structure that ultimately will complement our culture shift, and it will focus on allowing us to create headroom to invest for growth while also concentrating on margins. As we finalize the plan, we're going to provide more context to the project and also obviously includes some expected financial impacts. Given our progress to date, our current project cadence, we are on track to complete the largest majority of Phase 1 activities within our original 12-to 24-month timeline. Just overall, I'd say in this area, I'm really encouraged by our progress, and I'm impressed with the team's ability to manage through the challenges and keep us on track.

Okay. Let's move to Phase 2. As we've referenced in the past, Phase 2 is focused on a long-range plan that will unlock the profitable growth potential of our business, just really ensuring we take full advantage of the attractive markets that we play in. And as a reminder, because we were able to accelerate talent acquisition in Phase 1, we've been able to compress the timeline in Phase 2, now enabling us to share both our long-range plan and our 2025 guidance during the fourth quarter earnings call that we have coming up in February.

And as a reminder, some of the elements of the plan will be, first and foremost, our primary market and submarket selection, again, those markets in submarkets where we will concentrate our efforts on a go-forward basis. And as you would expect, the market selection in this process has biased towards those markets that are faster growth, markets where we have an ability to win and markets that have relative profitability benefits versus our other markets. Inside of these markets, we're also going to be selecting our growth driver initiatives and those will be intended to drive scale and share in these attractive areas.

And I would just say that we continue to make solid progress, and we remain on track to finalize these decisions before the end of the year. And this is critical because final decisions here will facilitate the shifting of our commercial, R&D

and eventually M&A resources to these growth driver areas and this disciplined focus will help us improve the vitality index and the overall innovation of our businesses, which is a key variable in accelerating our growth. Now that said, even before this shift occurs, we do have some recent product launches that are absolutely worth mentioning.

Let's just start with MedSurg. In the quarter, we officially launched in the V.A.C. Peel and Place dressing that we've been talking about. This product gives us three advantages: The first is simplifying the procedure; the second is reducing procedure time; and the third is reducing the number of dressing changes per week. All of these combined give us the opportunity to reach a broader set of patients across multiple sites of care. And I would say out of the gate, the very positive early response we're getting from customers has us focus now on increasing capacity of this product and orienting our commercial structure to drive adoption.

Okay. Moving to our Dental Solutions business, we launched the Clinpro Clear Fluoride Treatment, which we believe, and I would tell you, early customer response would indicate, it is a meaningful advancement in fluoride treatment technology. Clinpro is focused on making the fluoride application process simpler for the caregiver, first and foremost, and then improving the experience for the patients. And again, early customer response is positive and would indicate that the product is delivering on its intended outcome.

In our Health Information Systems business in collaboration with Sift Healthcare, we recently introduced a new AI-driven payment integrity solution that we're calling the Solventum Revenue Integrity system. This focuses on improving our customers' reimbursement leakage by predicting reimbursement pretty much at every step of the patient journey, and it's intended to not only reduce denials but potentially prevent them all together, really helping our customers ensure that they get the timely and accurate payer reimbursement that they deserve.

All right. And finally, in our Purification and Filtration business, we recently launched a new product in our Harvest RC family. And this latest addition is focused on improving our customers' manufacturing process. By streamlining time, by streamlining cost of producing, reducing risk during scaling and boosting overall productivity with a clear goal of helping companies bring therapies to market more quickly and with less risk.

Now these recent launches are encouraging. There's no question. Now they may take a little time to deliver measurable results, but they are just the tip of the spear when it comes to a refocused R&D effort that will begin in earnest and during 2025, again, aligning with the selection of our growth driver areas.

Okay. So let's move on to Phase 3, our portfolio optimization phase. As I've shared previously, we have been actively assessing the value contribution and the strategic alignment of our markets and businesses. This work has been well underway since announcing our three-phased plan back at our Investor Day in March. We continue to make progress against this effort. And at the right time, we will discuss Phase 3 in more detail. I think it's important to reiterate on these phases that all phases are not sequential. They are running concurrently. So parts may be in execution mode, parts may be in planning mode, but all are moving forward at one time.

Okay. To close my section out, I'd just like to say that while we are clearly off to a solid start, it is not lost on us that revenue growth remains below market. As we've said, this performance turnaround will take time, but rest assured, we are moving with urgency while also being thoughtful and strategic about building and investing for the long-term. We have an incredible opportunity ahead of us and by focusing on the right areas with the appropriate investments, we are setting the foundation for growth acceleration and ultimately, significant value creation.

Okay. With that, I'm going to turn it over to Wayde. Wayde?

Wayde McMillan – *Solventum; Chief Financial Officer*

Thanks, Bryan, and thanks to everyone at Solventum for the extra effort to separate from 3M and position us to report a

strong second quarter as a public company. As you heard from Bryan, we are tracking to our separation and execution plans across all three phases. I'll focus on updates related to Phase 1 before getting into Q3 financial performance and then wrapping up with guidance. We're continuing to advance our separation efforts. This includes our manufacturing strategy and site selection for our new manufacturing facilities as well as transitioning to our stand-alone distribution centers. We have also made good progress to advance our product licenses and rebranding transitions. We have changed our commercial distribution models in over 60 countries, created structure and hired staff all ahead of schedule.

Shifting to IT. We have implemented new ERP systems in four countries and will continue to roll out globally over the next couple of years. Overall, it's great to see these early successes and our team's resilience as we manage through this complex separation from 3M.

Turning now to our Q3 results starting with sales. For the third quarter of 2024, sales of \$2.1 billion increased 30 basis points compared to the prior year on an organic basis, with reported growth increasing 40 basis points slightly ahead of expectations due to some order timing in the U.S. During the quarter, foreign exchange was approximately neutral. Price was flat for the quarter as we have now normalized from 2023 actions and volume was slightly favorable. From a year-over-year growth perspective, recall that Q3 had a tough comparison.

Moving to the segments. Our largest segment, MedSurg, delivered \$1.2 billion of sales, an increase of 1% on an organic basis. Within infection prevention and surgical solutions, we saw continued adoption of our antimicrobial IV site management solutions with the growth of Tegaderm IV dressing. Sales growth also benefited from continued positive trends in OEM products. Performance in these areas was partially offset by negative pressure wound therapy.

Our Dental segment delivered \$313 million of revenue, a decrease of 3.9%. This decline reflects challenging market conditions and the fact that this segment faced the toughest year-over-year comparison among all four segments. Our Health Information Systems segment contributed \$326 million of revenue, an increase of 1.5%, which benefited from growth of our revenue cycle management platform, 360 Encompass. Strength in revenue cycle management was partially offset by declines in Performance Management Solutions and continued headwinds in clinician productivity solutions.

Finally, the Purification and Filtration segment delivered \$238 million of sales, a decline of 0.3%, which was impacted by declines in drinking water filtration and dialysis membranes, partially offset by better-than-expected strength in bioprocessing filtration and newly expanded capacity in industrial filtration.

Looking down the P&L, gross margins were 57.3% in the quarter, ahead of our expectations and down 100 basis points versus prior year. On a sequential basis, gross margins increased 150* basis points. This included approximately 100 basis points of onetime benefits, which offset the impact of the 3M supply agreement markup. We anticipate some of this onetime benefit will partially reverse in Q4. As expected, operating expenses increased versus the prior year. When excluding the impact of approximately \$30 million of discrete items in Q2 2024, operating expenses in Q3 also increased sequentially. As we have shared before, the added spend reflects public company stand-up costs and growth investments to support our business transformation.

We expect the magnitude of the increase in Q4 to be similar sequentially to what was seen in Q3 off the normalized Q2. In total, we delivered adjusted operating income of \$475 million, which translates to operating margin of 22.8% ahead of expectations given both sales and the onetime benefits in gross margin.

Moving down the P&L to nonoperating items. Our net interest expense benefited sequentially from a higher cash balance. Lastly, our effective tax rate of 22.3**% puts us on track for our full year expected tax rate of 18% to 19%. All in, we delivered earnings per share of \$1.64 ahead of our expectations.

Turning to the balance sheet. We ended the quarter with \$772 million in cash and equivalents with no outstanding borrowings on our credit facility. We generated \$76*** million of free cash flow in Q3, which includes making the first semiannual interest payment, bringing our year-to-date free cash flow total to \$713**** million. Importantly, we're committed to maintaining our investment-grade rating and given strong year-to-date cash flows, paid down \$200 million

of our \$1.5 billion prepayable term loans earlier than anticipated. We continue to expect debt paydown will remain the priority into fiscal 2026. We maintained strong liquidity and financial position with continued free cash flow generation in addition to our unused \$2 billion revolving credit facility.

Corrections to prepared comments on the earnings call for accuracy to be consistent with our SEC Filings:

*Stated as 180 basis points and revised to 150 basis points.** Stated as 22.4% and revised to 22.3%. *** Stated as \$75 million and revised to \$76 million. **** Stated as \$712 million and revised to \$713 million

Now turning to our 2024 outlook. We expect improved organic sales growth to be in the upper half of our full year guidance range of flat to up 1%. This reflects our performance year-to-date and continued execution of our separation plans. While we are not changing our full year foreign currency impact expectation of approximately 50 basis points unfavorable, given recent rates, we do expect foreign currency to be a headwind in Q4. For earnings per share, we are raising our guidance to \$6.50 to \$6.65 on our improved sales outlook and stronger Q3 gross margins. We're also raising our free cash flow guidance to a range of \$750 million to \$850 million to reflect both continued strong cash flow generation and the expectation that capital expenditures will come in toward the lower end of the \$400 million to \$500 million range we provided earlier this year.

In conclusion, we are off to a solid start as a new public company, delivering two consecutive quarters, a better-than-expected performance, which is encouraging given the complex and highly entangled separation. We're delivering on our near-term financial commitments, executing on our separation activities and 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 we'll use our collective expertise in health, material and data science to deliver our mission. While we know this turnaround will take time and focused investment, we're encouraged by the meaningful progress and remain well positioned to execute our value creation plan.

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

Question and answer

Operator

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

Travis Lee Steed – *BofA Securities, Research Division*

I wanted to ask first on the Q4 EPS guidance of \$1.22 to \$1.37. First, a little bit below the Street, anything to call out there? But really the question is more about what that implies about 2025. If you annualize that at the midpoint, it's around \$5.20. Looking at the Street numbers next year, the wide range, \$5.30 to \$5.80 and just trying to figure out, should we be closer to the lower end of that range, higher end of that range? Just any color so we get models in the right place for 2025 would be helpful.

Wayde McMillan – *Solventum; Chief Financial Officer*

Travis, it's Wayde. We'll start with the Q4 EPS that you mentioned. So really, what you're talking about is what's driving

the decline here from Q3 to Q4. So a few things that we have to keep in mind is we had some timing benefits that we called out in gross margin, which will benefit Q3, and those were onetime in nature, and they'll partially reverse here in Q4. So that's the biggest change and really the biggest impact to Q4. We had favorability — additional favorability in Q3 that will be a headwind for Q4. And then continued investment — as we continue to invest in operations and ramp our operating expenses, the — as we said in our prepared remarks, it will be a similar ramp from Q3 to Q4 as we saw from Q2 normalized to Q3. So both the standup cost of standing up the company as well as our growth investments.

And then we called out as well at this point in time, expecting FX to be a headwind. So those are things that are new to Q4 that have to be contemplated in the Q4 earnings per share. But having said all that, we are also raising our EPS guidance for the full year, given the strength of Q3, even though some of it was onetime in nature. And we're going to give some of that back in Q4 for the year, very happy to be raising our EPS guidance.

And then you mentioned 2025 as well. We're not guiding to 2025 yet. Certainly, lots of moving pieces as we are in our first year here post separation. We've got a lot going on to grow revenue, expand margins and then the resulting EPS growth over time. I think it's really pretty well understood that 2025 will be pressured by the annualization of some costs post spin. As a reminder, we spun in Q2 of 2024. So we just have this natural annualization in Q1 of 2025. And that's going to show up in operating margin in a few areas. We've got the 3M supply markup that impacts COGS. So we'll annualize that in the first half of next year. And then we've got our standup functional expenses, which are ramping this year. We'll annualize those next year. We're making growth investments. Some we've made this year, some will be continue to be made next year.

And then we also have the SKU rationalization program that we're contemplating, Wave 2 and how much of a headwind that could be in the extent of those Wave 2 plants for next year.

And then below the line, we've got things to consider there as well. We've got the annualization of interest expense and then our normalizing tax. And so we certainly got a lot going on to annualize the business into next year. And then as we talked about in prepared remarks, we also have our Solventum Way restructuring program, which could give us some tailwind into next year. That program is really designed to do both fund our investments as well as give us some additional margin enhancement. And we'll be putting all of that together into our calculus for 2025. And that will be when we report our Q4 earnings results. We'll give our 2025 guidance.

So having said all that, once we move beyond those items in 2025, we've got a great platform here for which to grow earnings per share and expand margins over time.

Travis Lee Steed – *BofA Securities, Research Division*

And the follow-up question I have is on how you're thinking about portfolio management and managing the dilution around that. I don't know if you're thinking through. Any updated thoughts on portfolio management would be helpful.

Wayde McMillan – *Solventum; Chief Financial Officer*

Sure. I could probably start that one just from a dilution standpoint, we haven't communicated anything in portfolio management yet, so we really can't comment on any dilution at all or how the net impact of any portfolio moves will be. So really no comment there. But I don't know, Bryan, if you just want to talk about our strategy in Phase 3 around portfolio management?

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. I mean I think we've been pretty front-footed on that all the way going back to March, we've talked about Phase 3 as being portfolio optimization. Obviously, Travis, we wouldn't make those decisions if we didn't think it was good for shareholders. And so we'll look at any dilution and offset that dilution. But just know that we're looking at our businesses from a strategic standpoint, we're looking at the value contribution of those businesses and eventually at some point when we have the right data in front of us, we'll begin to share if there's any changes that we're going to make. But we would be thinking about the financial implications of any change. And certainly, we want to make sure it's good for shareholders.

Operator

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

Patrick Andrew Robert Wood – *Morgan Stanley, Research Division*

I guess the first one, I'm just curious, do you have any updated timeline on the TSAs? And how we're thinking about those rolling off? And how are you thinking about reinvestment as those begin to roll off?

Wayde McMillan – *Solventum; Chief Financial Officer*

Patrick, it's Wayde. Yes. So I think the update on the TSAs is really that we're seven months, almost eight months in post spin here, we're making good progress, as we mentioned, in our prepared remarks. But we're also right at the front end of this.

If you look at the Investor Day presentation that we did back in March, we laid out the four main work streams, four main TSAs. And you'll see there that they're in the range of either two to three years, three to four years where we've got the long supply continuity timeline of up to 10 to 12 years. So here we sit in the first year. We don't have any updates on those timelines. I think once we start getting nearer to the two-year mark, three-year mark, four-year marks, that's when we'll be starting to roll off of these different TSAs.

So a lot of work going on within the business. A lot of folks doing just really yeoman's work of trying to separate the business while they do their day-to-day jobs. And as Bryan said in our prepared remarks, we really appreciate all the Solventum employees around the world, taking care of the separation work while they're working through their day-to-day jobs. So a lot to update in the future. But at this point, nothing beyond what we had in the prepared remarks.

Patrick Andrew Robert Wood – *Morgan Stanley, Research Division*

No, of course. I completely get that. And the follow-up is a little specific, but the traditional negative pressure was a little softer, but disposable was strong. Is that--to your mind in the market is that a switch out, right? So are we seeing a transition from that more capital equipment reusable sites/disposable? Or are they completely separate and disposables gaining traction but it's like something else, I don't know, foam or hydrocolloids that are taking the traditional side. What's going on in that market?

Bryan Hanson – Solventum; Chief Executive Officer

Yes. Patrick, thanks for the question. So I would say that there were a couple of things going on with negative pressure wound therapy in the quarter. One that I think is important to note is we had a tough comp – a tough comp generally speaking in the quarter, but that, in particular, was one that was hit – one of the hardest in MedSurg so that was part of it. And to answer your question specifically, they are separate. So the Prevena product line, which is our single-use is – it's a very exciting market, a submarket of negative pressure wound therapy, and that is growing pretty steadily. We're doing well with that product, and we continue to see that kind of traction in Q3, and we expect it to happen beyond as well.

The traditional negative pressure wound therapy is historically slower growth. We do feel like there's real opportunity to unlock growth in that market as well. The Peel and Place product that I referenced in the prepared remarks is one of the mechanisms to do that and the team is pretty excited about that launch.

Operator

Your next question comes from the line of Vik Chopra with Wells Fargo.

Vikramjeet Singh Chopra – Wells Fargo Securities, LLC, Research Division

First one for me, I didn't hear an update on the SKU rationalization project. Any update there would be great. And if you can also let us know when we expect to start seeing benefits from this program? And then I had a follow-up, please.

Wayde McMillan – Solventum; Chief Financial Officer

Sure. Vik, it's Wayde. So you may recall in last quarter, we mentioned that we had Wave 1 that was launched this year, and we're in the process of executing upon that. And they've got a significant number of SKUs out, over 3,000 SKUs that the team is working on and that will have very little impact on top and bottom line. We're also working on Wave 2, but we don't have any update yet. Teams are just working through that, working through the modeling of it. And Bryan and I will be reviewing that here as we get towards the end of the year and make a decision on what SKU rationalization will look like in 2025.

Vikramjeet Singh Chopra – Wells Fargo Securities, LLC, Research Division

And my follow-up question was on the Dental segment. I know you called out tough comps, but you also called out market softness. Just wondering what your expectations are for recovery for the dental market and how you're thinking about growth in 2025?

Bryan Hanson – Solventum; Chief Executive Officer

Yes. So maybe I'll take a crack at that one. So I can't predict when we're going to see that softness turn. But it is impacting our business, but probably the bigger impact for us again was comps in the dental business. We see softness in the market impacting our business. But given the portfolio that we have and just the procedures that we typically play

in that are less elective in nature, we don't usually get as impacted as other players in the dental space. So it's a negative pressure on our business for sure, but not maybe as much as other players in dental. I don't know that I want to speak to when we're going to see that turnaround for us. We're going to focus on what we keep control. And the team is pretty excited about the Clinpro product launch. It doesn't sound that amazing when you talk about fluoride treatment, but it's a pretty amazing innovation in that space, and our customers are seeing it that way. The good news is we got a lot of demand as a result of it. The bad news is we don't have the capacity for it right now. So we're working hard to get capacity in place and support that demand.

Operator

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

David Harrison Roman – *Goldman Sachs Group, Inc., Research Division*

Wayde, I was hoping you could maybe unpack a little bit of the drivers in the gross margin line. And specifically, this is a line, obviously, where there are a lot of moving parts. And last quarter, you had some discrete headwinds around international and OEM mix. This quarter, you had some tailwind dynamics. And I believe the full recognition of the 3M supply agreement reflected in there. So as we think about a baseline normalized gross margin, is that 56% and change number a good starting point? And how should we just think about the different moving parts around this line item, whether that's potential SKU rationalization, business mix investments you're making to expand your own supply chain independents, et cetera?

Wayde McMillan – *Solventum; Chief Financial Officer*

David, thanks. I'm glad you asked that question because there is a lot of moving pieces on this one. And we took a little extra care to put some additional information in the prepared remarks, but it's always good to talk about it here in Q&A. So I'm glad you brought it up. So just to summarize, we had approximately 100 basis points of onetime benefits here in Q3, and that offset the impact of the 3M supply agreement markup in the quarter. We do expect part of that 3M benefit to reverse in Q4, which results in a lower margin in Q4, as you mentioned, and then, as you also mentioned, recall that in Q2, we had some unfavorable higher international cost impacts in gross margin, and that is some of what we saw reverse here in Q3. So if you package all that together, we had some headwinds in Q2 that somewhat reversed in Q3 and then we get a benefit in Q3 that will also be a headwind in Q4.

So I think one way to think about this, David, would be to take Q2 and Q3 and put them together and then use an assumption for the 3M step-up as well as some of the benefit here. I think what you'll do is come out below — just below that 56% that you're talking about.

David Harrison Roman – *Goldman Sachs Group, Inc., Research Division*

That's super helpful. And I appreciate on the portfolio management side but that's a continuously evolving process. But maybe, Bryan, you could help us think through like when you talk about kind of value to the organization. They're sort of like the one way to look at was it's just pure dilution from an EPS perspective. The other way to think about it is how it fits in strategically, whether that's opportunities for cross-divisional product development or commercialization where you have the right to win? Like HIS is a great market, but it may not fit necessarily with the MedSurg business. So help us kind

of think about the parameters that you're using to assess the portfolio management decisions?

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. I mean, you hit them pretty well. If you think about where we're going to invest, I think that's the most important because you've got to know where you're going to invest, didn't know where you're not going to invest and then you make decisions from there, what you're going to do in those not invest areas. But the areas we're going to contrate on, first and foremost, are the fastest growth markets that we have. We need to make sure that anything we're going to invest in gives us positive mix from a revenue growth standpoint. So that's #1.

Number two, as I talked about in prepared remarks and you just referenced, it is to make sure that we concentrate in areas where we do believe we have a pathway to win, right? We have to be in a market position that is favorable and where we believe we have the right to win in that space.

And the third is really important as well, going back to mix. But from a margin perspective, we want to make sure that we have a good margin profile in the markets or businesses where we're going to be investing as well. If we're going to grow fast in those businesses, and we don't have attractive margins, then we're going to get negative mix and we don't want that in margin.

So those are the primary areas. And to your point, where do our businesses connect and work in a one plus one potentially be a three? Is there value in that? It doesn't have to be there, but that's a nice add as well.

Operator

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

Frederick Allen Wise – *Stifel, Nicolaus & Company, Incorporated, Research Division*

Bryan, just reflecting on your opening comments about your increasing encouragement of the progress that's been made. Maybe focusing that thought towards the MedSurg business again. Help us better understand how the — the new sales and leadership team you brought in place are affecting the business, how the new Peel and Place wound product that you're talking about. How is it going to — how are some of these changes concretely going to affect the business as you reorient sales as you rethink compensation and just talk through that, if you would, and help us think about where you expect over the next year or two. What's that translate in terms of growth in these early days of Solventum for the MedSurg piece?

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. Thanks, Rick. And I think it's a good proxy actually for the entire business, to be honest, because it's a similar game plan almost across all businesses and functions. But it makes a big difference. If you think about just MedSurg in particular, we've made some pretty significant changes. And if you think them — think about the deficiency in revenue growth versus market. First thing you need to do is do a root cause analysis. Why am I underperforming markets that are attractive today. And when you do that root cause analysis, you find where those deficiencies lie. And they can be in three different areas. We're already in attractive markets, so we know that's not one.

But it could be that you don't have the rigor in place from a commercial standpoint that's pretty easy to fix. So if we get the right talent in place, we start to then as a result of that talent, get better mechanisms to drive commercial rigor, change our compensation structure, which we're doing in 2025 to be more performance based. Those are all things you can do right out of the gate by bringing the right people and getting that rigor in place. And we are doing that, not just in MedSurg but across the board.

The second is changing commercial structure. And again, as you start to pick your growth driver areas and you begin to isolate the areas where we want to specialize our sales organization and/or expand it, we're going to be doing that as well as we come into 2025. That takes a little bit longer because you got to isolate the areas, you've got to hire the people and you've got to train the people, you've got to get them to be productive. But that is definitely something that we'll be moving forward on.

The one that takes a little bit longer that we'll have in MedSurg and the other businesses as well, is just getting the innovation gaps filled. That will take us a little longer. You've got to ideate once you know the gaps, you've got to then develop, you have to get regulatory approval, and then you eventually launch. But those are things that the new team will be focused on, obviously.

But I would just say that I fully expect, given the changes that we've made that we're going to see underlying business improvement in 2025. In MedSurg, and that will be across all of our businesses. And I think we're going to benefit from exactly what you said. The talent upgrades that we've made, the focus they're going to have on commercial rigor and the change in compensation plans that we have and also some of the new launches, just like Peel and Place. We've got to get the capacity up in those areas but we should benefit from those.

I want to caution everybody, though, if we're getting out over their skis because that's one variable. Obviously, when we look at 2025, we do have some offsets to that. We just talked about SKU rationalization, which put a little pressure on 2025. We've got some comps that we're going to have to deal with in pricing and back order recovery. But make no mistake, I look at 2025 for MedSurg and our other businesses as the tip of the spear to begin to change the underlying business performance of this company. And that will then, as a result, start to take us off that historical underperformance that we've had.

Frederick Allen Wise – *Stifel, Nicolaus & Company, Incorporated, Research Division*

And just a follow-up, and maybe I shouldn't be focusing on this, but I'd be curious to hear your thoughts. The ERP transition, it's encouraging that you've already implemented in four countries. Where are we in that process? And maybe talk to us about what it means, what you're expecting from those initial efforts and what — how we think about that as a positive underpinning driver for '25 and beyond?

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes, Rick, it's Wayde. I can take that one. And you're highlighting one of the biggest areas of the separation. One of the areas that's getting the most attention. We've got some of the biggest project teams, operating mechanisms, Bryan and I are involved and down all through the organization. The ERPs are the backbone of our systems. And so we're spending a lot of time here, no question.

We are encouraged to get four countries done. But as you can imagine, we picked smaller countries to start with. And that's by design because we want to make sure that we've got all of our teams focused on ERP and the implementation of them and all of the different phases of the program as we execute from planning to execution and then hypercare on the other end.

And I would say, out of the first four, a couple of them went really well. A couple of them, we had some bumps and challenges, but the teams really pulled together, worked through them, worked hard with our customers to try to close any gaps that we had, and we're in a much better place after these first four and now we're moving on. And we're going to continue to move, of course, with the biggest one, our U.S. implementation in North America. And so we've got a lot of planning in place, a lot of work being done. But as you're highlighting, this is an important one for us and be very focused on it.

Bryan Hanson – *Solventum; Chief Executive Officer*

I'll just maybe draft off of those comments, too. And we were very focused when we brought people in, in certain functions, particularly IT, manufacturing and others that have been through this type of ERP consolidation in the past, ERP cutovers and even directly involved in spins. And I think that's really important because if you've lived it and you've been burned by it, you know where to look. So the team, I think, is very capable of managing. It doesn't mean it's not without risk. We're definitely going to see risk. We already have had some challenges to manage through them. But we have a great team that should be able to get this done to get it done effectively.

Operator

Your next question comes from the line of Ryan Zimmerman with BTIG.

Ryan Benjamin Zimmerman – *BTIG, LLC, Research Division*

So I'll ask both questions upfront. Just if you could, Wayde, remind us, I think you have about 11% of revenue in China. First, is that the right way to think about your exposure there? And look, we're two days into a new administration. There's a lot of discussion about tariffs and potentially the impact there. Just remind us kind of what you're manufacturing potentially over there and how to think about those considerations, if you don't mind.

And then the second question, in the purification business, given the IV shortages that are going on right now, is there any consideration about the impact to dialysis filtration or things of that nature that may use a lot of saline solution in the near-term?

Bryan Hanson – *Solventum; Chief Executive Officer*

Do you want to take the P&F and I'll take the first one?

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes, sure.

Bryan Hanson – *Solventum; Chief Executive Officer*

So let me just maybe correct on the China view. We have just a little over 5% of our business in China. So it's not as significant as 11% that you referenced. If I just think about the tariffs, I think, first and foremost, we just need to see what actually happens here. I think everybody is going to kind of wait and see what happens. The good news is, though, when I think about what we actually bring in from China, it's a relatively small number. And as a result of that, just given what we know, I really don't see tariffs as being a major impact to our business. Now anything can change. But based on what I see today, I don't see it as a major impact to our business, which is a good thing, obviously. On the P&F, I'm not — you want to answer that one?

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes, sure. I mean we have not seen any falloff in demand for support of the dialysis business out of purification filtration that the teams have brought up to us. So at this point, we think that all the different centers, dialysis centers and all the companies in the value chain are working very hard to continue to service that and that we haven't seen any falloff.

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. And as a matter of fact, we are always under capacity constraints here. So if anything, we could add capacity to help out the demand.

Operator

The next question comes from the line of Jason Bednar with Piper Sandler.

Jason M. Bednar – *Piper Sandler & Co., Research Division*

Bryan, Wayde, I wanted to start with a follow-up on Dental Solutions, you had a distributor with some internal cybersecurity issues that probably affected demand in the fourth quarter of last year. So you've got an easy comp here in the fourth quarter. Obviously, a tougher comp that we just saw that we lapped here in the third quarter. But I just love to hear how you're thinking about pricing and volume dynamics in the dental market once we get past some of the noise with comps here in the second half of the year.

Bryan Hanson – *Solventum; Chief Executive Officer*

Yes. You're actually — you're right on. When you think about comps. First of all, Q3 was a tough comp. Q4 is an easier comp in the dental space, in particular, because of what you just referenced.

When I think about price volume, I think that in the dental business, very similar to our other businesses, pricing is normalizing now. And so I don't know that I think dramatically differently than what we've been saying all along that we need to see volumes increase because we've been depending way too much on pricing as a result of the inflationary period, which is ending and pricing is now normalizing, and that's exactly what we saw in the quarter. So I don't see

pricing as being a big lever for us in dental. I see it like all of our other businesses, we have got to get the volume up.

Jason M. Bednar – *Piper Sandler & Co., Research Division*

And maybe one quick follow-up and then a separate question. But are you still comfortable, Bryan, looking at pricing as being positive in dental? Or is it more neutral-ish in dental going forward? And then as a follow-up, a separate question. And drafting off of some of the past portfolio management question. At what point – I think it's something – there's a lever or a metric – 25% of assets are, and correct me if I'm wrong on that measure, but past that level, if you're looking at a divestiture, you have to get clearance from parent 3M and again, correct me if I'm wrong on that. I'm sure there's some legalities in there. But what's the level you'd have to clear in order to get that clearance? Or asked another way, are there smaller assets? Obviously, you're doing SKU rationalization, but other assets you could sell off where you would not have to get such clearance?

Bryan Hanson – *Solventum; Chief Executive Officer*

So on the pricing, I'm just going to hold on that one. We're not going to get specific pricing thoughts on individual businesses, but maybe wait in a second, you can just speak to our overall view of pricing when we think about it from a company standpoint, which you've talked about in the past.

When I think about the considerations for portfolio moves for us, normally, you have the typical considerations on whether you're going to make a portfolio move. We have additional considerations that you're talking about right now as a result of the fact that we're so close to the spin from 3M. And there are multiple considerations that you've got to think about as a result of that. In some of those, we don't have complete control over. So some of them we do, some of them we don't.

What I would just say there is the same way that we're assessing our businesses, we're also clearly understanding what those considerations are we're assessing them and then managing through them. We feel like we need to do that proactively so that is not a barrier for us to do transactions if we want to. I'm not committing that we are going to do transactions. I'm just saying we don't want that to be a barrier for us. Of course, there's two to play there. It's not just us that 3M has got to be involved in that decision as well. So you want to maybe talk about pricing.

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes. I'll pick up on the pricing comment that you had. And Jason, good to hear you on the call. So just in summary, Q3, as we mentioned in the prepared remarks, we did as we've been communicating for some time now, expecting normalization of pricing, and it was neutral to our Q3 performance. And so the good news is we are starting to see volume improve as revenue growth over the past year and first half of 2024 was more than all driven by price. So the business has really been benefiting from price for some time. And now we're starting to see volume turn and start to improve. It's not to say we're satisfied at all. We're not satisfied with the results and the growth yet. But it is good to see the volumes start to improve versus the underperformance over the past few years and that's where the business has been experiencing volume declines.

Operator

The next question comes from the line of Chris Senyek with Wolfe Research.

Christopher Michael Senyek – *Wolfe Research, LLC*

Two questions. First, in terms of Health Information Systems, the organic growth rate was a little light relative to some of the past few quarters. Was there anything anomalous in the third quarter that we wouldn't expect to recur going forward?

Bryan Hanson – *Solventum; Chief Executive Officer*

Thanks for the question. So I would say, if I just kind of break down the quarter, it's pretty steady in our revenue cycle management business. I feel really confident and comfortable in that business. The team has a good handle on it. It's somewhat of an annuity business, but that was steady. What we continue to see is, I think, Wayde, you referenced in your prepared remarks some challenges in clinical productivity solutions. That's where our MModal business was acquired and I'll just be fully transparent. It just never was really fully invested in. And in that fast-paced market, if you're not investing aggressively, you fall behind, and we did. And that's where we're going to continue to see some pressure. The team is working on a solution, but I really don't see that as any kind of significant improvement in that particular part of the business in the short-term.

Where we did see maybe a bit of an anomaly was our performance management business was soft in the quarter. I don't expect that to continue. There was just some volumes in the quarter that impacted that business. I do not expect that to continue.

On the positive side, as I referenced in revenue cycle management, one of the new product launches that we have around data integrity is pretty interesting. It's early days for sure. We've got to prove some things out. But as you can imagine, our customers are always worried about leakage when it comes to reimbursement. And we're using this data integrity solution to be able to get them the information they need and submit from a reimbursement standpoint to ensure they get better reimbursement leakage. So that's one thing that we're going to concentrate on and try to drive in the market. But generally speaking, outside of the performance management anomaly in the quarter, which should not repeat next quarter. It was pretty standard.

Christopher Michael Senyek – *Wolfe Research, LLC*

And then a question maybe for Wayde, in terms of foreign currency, is the guidance based on the spot rate as of the end of the quarter? And then if you could talk a little bit about the revenue cost mix geographically as we think about translation and an [indiscernible] task of trying to model what that might be?

Wayde McMillan – *Solventum; Chief Financial Officer*

Sure. Yes. So FX for us, we typically set the rates near the date when we were guiding. So over the past week or so, we factor that into our guidance discussions and planning. And so we're not using in the quarter. We're using something closer to our earnings call date, which has seen quite a bit of volatility over the past few weeks. I'm sure that's why you're

asking the question. And then just to summarize again, we had very little impact here in Q3 but based on the recent FX rates, we do expect a headwind, both top and bottom line here in Q4.

As far as our revenue and cost mix geographically, I think it's pretty well understood that the HIS business is almost all in the U.S., but the other businesses have good exposure outside the U.S. And so we're running manufacturing within the U.S. and outside as well. So we don't have details to provide at this point as far as that translation mix goes.

But I think just generally, the way to think about it would be given the diversification of our three product segments that are a good amount of our business outside the U.S. as well as inside, we're going to be subject to most FX moves like any other med device company. And then from a manufacturing footprint standpoint, we also have a good amount of manufacturing all throughout Europe, a little less in China and Asia Pacific.

Operator

And our final question for today comes from the line of David Roman again with Goldman Sachs.

David Harrison Roman – *Goldman Sachs Group, Inc., Research Division*

Thanks for letting me sneak another one in here. I want to just come back, Bryan, to a comment you've made a couple of times around capacity and your ability to meet demand? And how do we square that with kind of the ramp in CapEx here compared to what you originally provided at the analyst meeting? And should we expect some of the CapEx that may not have occurred this year to flow into next year. And I think you're also retrofitting a headquarters. How do we kind of put all that together? And what does that mean for your future CapEx?

Bryan Hanson – *Solventum; Chief Executive Officer*

So obviously, I'll pass that over to Wayde to talk about CapEx. But maybe just to make sure that I'm clear, there's a couple of different vectors of capacity when I'm talking about it. One would be in purification and filtration. We are investing capital there to drive capacity. We saw that in our industrial business and it had a benefit in the quarter. We're doing the same when it comes to our membranes business, and those are pretty significant investments that we've made. On the membranes business, it will take a little bit of time for it to come to fruition over the next couple of quarters.

When I talk outside of purification and filtration knowing when I think about capacity with Peel and Place or I think about capacity with Clinpro, that's not really a heavy capital intensity there, that's just demand planning. We just did not have the right demand plan in place and the commercialization planning for that launch and we underestimated the demand. And as a result, we just don't have the capacity to fill it. So don't think in those two areas, significant cash spend or capital requirements, they're pretty low-intensity capital businesses. We just didn't get the demand right. But maybe, Wayde, you talk about the total CapEx?

Wayde McMillan – *Solventum; Chief Financial Officer*

Yes. So we've guided to \$400 million, \$500 million since the start of our public company here in Q2, and we've just updated that this quarter to thinking to the low end of \$400 million to \$500 million. Having said that, David, we know we're going to have to make investments for both the separation as well as the organic growth of the business. And as

Bryan said, there's a couple of areas in addition to our new products where we're capacity constrained and I think one of the advantages of the growth driver strategy that will bring is a very focused growth investments. And by doing that, we can be very much planful where we're making our CapEx expenditures and doing them in areas that we know we're going to be growing the business versus kind of a blanket approach to growing the business.

And then you're always trying to catch up in the areas that you're growing and maybe over investing in others. So again, one of the byproduct advantages of our growth driver strategy is Bryan mentioned earlier, shifting resources to get behind the growth drivers. But part of that is the capital expenditures. And as Bryan mentioned, one of the criteria for the growth drivers is thinking through the relative profitability, and we include capital intensity in that. But having said that, we know we're going to be investing. In addition to supporting a faster growth of the business over time is also to separate the business, and we're investing pretty heavily right now, as we talked earlier about ERPs. We also have pretty significant manufacturing line moves, moving our distribution centers and logistics. So we've got a lot of work to do and CapEx is one of the things that we're going to have to spend on to separate the businesses.

Bryan Hanson – *Solventum; Chief Executive Officer*

Okay. Seeing no further questions, I'll close the call just by saying thank you so much for joining us, and I hope that everyone has a wonderful day.

Operator

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

