Julian Mitchell:

Perfect. So, thank you everyone for joining. My name is Julian Mitchell and it's my pleasure to have now, Illinois Tool Works, Michael Larsen CFO, for a Fireside chat this morning. Just as a reminder, if you have any questions, please email them to me and I'll make sure to try and ask them. And also, if you get a second, please do try and fill out those survey questions at the side of the screen. And so, with that, I'll hand over to Michael quickly before we go into the Q and A.

Michael Larsen:

Thank you, Julian, thank you for having us and good morning everybody. We thought we'd just kind of try to set the stage a little bit upfront and then of course, we can go into the Q and A. But if we just take a brief look back on 2020, I think as we were managing through the pandemic, I think what became very clear that the progress that we've made, which was executing our long-term enterprise strategy over the last eight years, really put ITW in a position of a significant strength in dealing with the pandemic. And that strength was really built on this really powerful ITW business model. We've talked many times about ITW as a business model centric company. I'm sure we'll come back to that. But particularly our 80/20 front to back operating process in our decentralized entrepreneurial culture served us extremely well during this period of uncertainty and rapid change. Obviously, our best in class margin profile, going into the year with margins around mid twenties, EBIT margin was a big advantage for us.

Michael Larsen:

The fact that we have a highly diversified business portfolio if you look at our segments, seven segments, all segments have margins in the mid to high twenties at this point. There was never any balance sheet risks going into the pandemic, ITW has a strong balance sheet, tier one credit ratings and we generate a lot of free cash flow conversion rates significantly above 100% on a regular basis. So, leverage this position of strength and I think as a team and particularly our operating teams executed really well on the things within our own control to deliver some pretty strong financial performance given the environment. Our operating income ended close to $3 billion operating margins for the year of 22.9%. The low point by the way in the second quarter was 17.5% and we did 25% in the fourth quarter. So, really resilient margin performance as from free cash flow of 2.6 billion, as you would expect from ITW. And I think in terms of return to shareholders, we raised the dividend by 7% in August. So, at this point we continue to aggressively execute our long-term strategy.

Michael Larsen:

We're focused on winning the recovery. We can talk about what that means and really continue to deliver differentiated performance over the long-term. And maybe just to reiterate for the people that may not be that familiar with ITW, again, the [inaudible 00:03:58] your business model is our competitive advantage. And our strategy is centered around leveraging this business model to its full potential and deliver solid growth with best-in-class margins and return. We're really trying to position this company to deliver a top tier performance across a wide range of economic scenarios over a five-year period. So, that's really what this company is geared towards. And our goal ultimately is to firmly

establish the ITW as one of the highest quality best performing industrial companies out there. So, hopefully that kind of helps set the stage a little bit, Julian, and then I'll let you take it from here.

Julian Mitchell:

Yeah, sure. Thank you, Michael. So, I suppose, definitely the business model had a severe sort of battle test in 2020. Came through it with flying colors. When you think now about the recovery, particularly you mentioned that sort of winning the recovery aspects. Maybe help us flush out sort of, what does that mean for ITW? What are perhaps some of the segments where we might see that market share gain is one manifestation of it? Where could we see the fruits of that market share push be perhaps more evident than some of the others?

Michael Larsen:

Yeah. Well, I think in terms of winning the recovery, we have to go back to kind of the priorities during the pandemic. So, at the height of the pandemic, we really focused the entire company, essentially on two things. One was, protect the health and well being of our colleagues around the world, which meant that we provided full compensation and benefits in the second quarter, during the worst of it. We did not initiate any COVID specific restructuring. We were able to stay invested in our people, in our projects, our long-term strategies, our new products, we did not cut back on those. We didn't cut back on pay and benefits. The second priority was really continuing to serve our customers with excellence. And so, our customers were going through some challenging times. If you look at our customer base back in the second quarter, we had segments where our customers were safely shut down for most of the second quarter followed by a very rapid recovery, by the way, starting in Q3 and continued into Q4.

Michael Larsen:

And so, our ability to continue to serve those customers, in terms of quality delivery, service, we believe is a real differentiator, not just in a few specific divisions, but really across the company, our ability to do that. And so, those two things we believe have really helped position the company to fully participate in the recovery phase. And we're looking for sustainable strategic share gains at ITW caliber margins. So, these are not opportunistic... Let's take this order just to boost sales. This is all consistent with our long-term enterprise strategy of delivering solid above market, organic growth with best in class margins and returns. I don't have a hard and fast number I can give you versus to what are those share gains worth.

Michael Larsen:

In 2021, I think, given the recovery, it's really hard to establish numbers around market growth versus ITW growth. And so, we'll have to wait a little bit with that. But lots of evidence inside the company where every division can cite specific examples of where they were able to support their customers as a result of that, have gained additional market share to really support their win the recovery strategy as we go forward.

Julian Mitchell:

And I think a couple of years ago, ITW had talked about adding a point or two to enterprise sort of organic sales growth as part of the finishing the job concept. How do you feel the progress has been on that? Obviously, there's the complications of a big downturn, but as you look at the recovery ahead now, does that one to two percent outgrowth number or extra organic growth numbers seem optimistic, conservative... I think sort of lining up to support it?

Michael Larsen:

Yeah. I think Julian is very achievable. Given the differentiated nature of our businesses. Given the focus we've had on organic growth as the primary growth engine, really since the launch of the enterprise strategy back in 2012 and then the specific focus on organic growth and strategic excellence, including incentive plans designed around that starting in 2016, we were actually making good progress in '17 in '18. In '19, we quantified that as we believe we were growing one percentage point above the kind of the markets inside of ITW. And our goal is to get to two to three percentage points of outgrowth relative to the underlying market. We are doing that already in a number of divisions and segments. So, we know how to do it. It's just a matter of maintaining our focus. And I think, again, back to what we were just talking about, the fact that we were able to stay invested in our commercial strategies, in our people, in sales and marketing and new products during the pandemic, I think is really going to serve us well, as we move forward.

Michael Larsen:

Like I said, in 2020, 2021, it's hard to tell what the underlying market growth is. Maybe with the exception of... You'll know what auto production is, auto builds, at the end of the year. And so, we can look at ITWs relative growth rate. I think we put out a 16% growth number, for example, in auto OEM and builds are expected to be somewhere around 14. So, you are seeing that outgrowth relative to the underlying markets. And so, to answer your question, I think all of us here are laser focused on organic growth and we have a high degree of confidence that we will get there in terms of being able to, on a consistent basis, outgrow the underlying markets by two to three percentage points.

Julian Mitchell:

Perfect. And perhaps you've given the guidance for 2021 enterprise wide and by segment. I suppose on that point you have a big surge in the first half of easy comps, then perhaps some slow down in the second half just on a comp basis. But what are the businesses that you think in that second half can keep driving good organic growth when you're looking at the different segments? And perhaps when you look beyond this year. You've seen some cycles at ITW you've seen cycles at your previous roles. How would you assess the slope or shape of what this industrial upturn could look like beyond just the next nine months?

Michael Larsen:

Well, so Julian, as you know, we're not economists here. We are owner operators of these high quality businesses and our guidance based on what we're seeing in these businesses today. So, maybe everybody's not that familiar, but we're assuming that current levels of demand stay the way they are inside of our business. And we're projecting those, call them run rates into 2021, adjusted for seasonality. And you do that, you get to an organic growth rate in that seven to 10% range, obviously significantly higher in the second quarter. The bulk of the decline in 2020, somewhere around two thirds of it was in the second quarter. And so, obviously the comps are a lot easier in Q1 and Q2, but we expect to continue to grow throughout the year.

Michael Larsen:

And so, the question really is, where do you expect that markets will accelerate or slow down? And again, we're not really an economist. There are people that make a living trying to project those things. Given the short cycle nature of our businesses we are a company that really can read and react to the Auto trends like in our business units as we see them today. So, there's no incentive for us to go out on a

limb and try to project what this recovery might look like. What I can tell you is, obviously, if you look at the fourth quarter, all of our businesses may progress in Q4 around to Q3 and certainly Q2. I think in terms of acceleration, we saw the sequentially revenues were up 5% from Q3 to Q4 where normally they're essentially flat.

Michael Larsen:

So, really good progress, not just in automotive, but also in some of the more CapEx related businesses. So, I think in welding. We saw a nice pickup on the, not just on the commercial side, but also on the industrial kind of the heavy equipment side of things. And as we talked about on the earnings call, a few weeks ago, that momentum really carried into 2021 and January is off to a solid start here. And so, we are based on what we're seeing in our businesses, obviously our guidance reflects that high single digit organic growth, earnings, EPS growth in the high teens at the mid point. So, I think we're confident and optimistic going into 2021.

Julian Mitchell:

Perfect. And you mentioned on the whole, ITW clearly performed extremely well the last 12 months. Those businesses that had been viewed as perhaps growth challenged pre COVID, maybe help us understand how some of those have have performed. And I sort of asked that in the context of the statement that divestments will be left for 2022 to allow some of the weaker stuff right now to sort of have its cyclical lift.

Michael Larsen:

Yeah. Well, So, the growth challenge businesses, it's a very small number. I mean, we're talking about a handful of businesses with combined revenues of somewhere... it's in the 100 million dollars, hundreds of millions of dollars, not billions. These businesses are in their respective industries, best in class businesses. They are certainly from, in terms of margins and returns and just the quality of how these businesses are run. They're better than most of their competitors. They just don't have the level of differentiation that they need to get to ITW caliber, organic growth rates and margins and returns. And so, in terms of kind of the long-term strategic fit, our views have not changed since when we talk about divestitures in 2018, we still believe that these are better fit with other companies.

Michael Larsen:

I'd say two things, this year, Julian, we're focused on winning the recovery and all of our focus... The best thing we can do for the company is to get the organic growth rate going. And so, that's our primary focus, is on the recovery, take care of our people, take care of customers, get the organic growth rate going and divestitures are a little bit of a distraction. And I think given how they're performing this year and as MNA markets kind of normalize, we actually... By the way, think they're going to be worth more money in 2022. So, we're just going to defer it for now and really focus on them on accelerating the enterprise strategy and get to our full potential. And then, ultimately we will get to the divestitures at some point here.

Julian Mitchell:

One point, I suppose, circling back to the share gain and the winning the recovery, several industrial companies they've talked about stepping up investments this year, with that view to, "Well, look, revenue growth is good. It will stay good for a while so let's invest a lot now to ensure we maximize our market share in that revenue rebound." And that's obviously having some negative impact on margins,

at least in 2021. When you look at ITW in the context of sort of that message, doesn't sound like there'll be that need for stepped up investment. Maybe just give us some context around your perspectives on that. CapEx may have to come up but other than that it sounds like other things are at a good run rate already.

Michael Larsen:

Yeah. I think you're exactly right, Julian. We stayed invested in our people, in our long-term strategies, in our projects. Obviously, going into 2020, there were some capacity expansions that did not take place for obvious reasons. And so, our CapEx spend was a little bit lower than usual. Not because corporate told the business units, "You can't invest," but because the business unit said, "I'm just going to wait until the recovery path is clearer." And so, you're going to see kind of CapEx come back, but we're talking maybe a year of a year, maybe we'll add 100 million dollars in CapEx. We're going to add some working capital. Of course, as the business... You're not going to grow in the high single digit without adding some working capital, maybe to the tune of 100 million but our operating cashflow is $3 billion plus.

Michael Larsen:

So, one of the byproducts of 80/20 is that we are extremely efficient in terms of capital. This is not a capital intensive business. We invest wherever we can create competitive advantage through the business model. Internal investments are priority number one, because they generate the highest rate of return of anything that we do. And so, you're not really going to see what you're talking about, which is a big spike in investments and even in the cost structure, because we didn't... This is a very flexible cost structure. And so, a lot of the costs have already came back in the second half of last year as volumes recovered. So, we believe this year our operating margins should expand by, I think we said 160 basis points at the mid-point.

Michael Larsen:

A lot of that is from things within our own control. And so, the enterprise initiatives, 80/20 sourcing, the specific projects and activities are going to contribute 100 basis points approximately this year, independent of volume. Last year and every year, since the beginning of the enterprise strategy, that's been the case and 2021 will be the same. It's actually remarkable. Eight years in, we're still generating 100 basis points. If you do the math, that's 130, $140 million of structural cost savings, actually 1.4 billion since we started the enterprise strategy. So, those are still with us. We're going to get some pretty good volume leverage and we're going to continue to invest and the margins should end up in the 24, 25% range for 2021.

Julian Mitchell:

And then, picking up on that, Michael, there was preexisting sort of 2023 margin ambition. So, maybe help us understand how the COVID performance and the guide for this year. How does it make that high twenties margin goal look today from your standpoint? And also, I suppose very good tailwinds to margins from volumes and enterprise initiatives, one headwind, perhaps not discretionary costs coming back in ITWs case, but price cost is something that was a headwind three, four years ago for the company on margins. Why the confidence this year that, that won't repeat?

Michael Larsen:

So, let me start with kind of the long-term margin targets. We're highly confident that we're going to achieve those margin targets. I mean, I think we've talked about this before. The more work we do around the business model on 80/20, the more opportunity we find and the more... This business model inside the company has been in a constant state of evolution over the last 30 years. The way we do 80/20 today is very different from a few years ago. And so, it's never been better than it is today. Our people have never been better practitioners of the business model, the raw material, the quality of the businesses has never been better. And so, we have a high degree of confidence we'll get to the 28% margin target. Obviously, COVID, we've lost some time here but I think if you look at our guidance, 2021, we're basically back at 2019 and maybe a little bit better than that even.

Michael Larsen:

So, the long-term trajectory and the potential for organic growth margin improvement, return on capital, cashflow, dividend... All those targets we've laid out align with our enterprise strategy. We're just as committed to those as we were before. I do think you're pointing out... there's definitely, as these economies are recovering globally. There's definitely some pressures on raw material, particularly in our case, steel, resin chemicals, we're seeing inflation. The way we manage that at ITW going into the year we have a plan that factors in all the known raw material cost increases and price increases. That's typically a slight positive as we see these raw material costs come in at a higher level in 2021, our businesses are reacting and raising prices.

Michael Larsen:

The challenges that can be a lag between when you see those raw material cost increases and the price increases are realized. And so, you could see certainly some margin pressure in the short term, but it's really... We're going to try to minimize this lag as much as we can. Ultimately, we will recover that. Just like we did last time around, but it's going to maybe take some time and it's not going to... The headwind, it would have to be really an extraordinary year for it to become significant enough that it puts real pressure on the margin goals we've laid out for 2021. And like I said, if there's pressure in 2021, it will be recovered in '22 and beyond. And so, I think the companies you follow Julian, ultimately should be able to offset these cost increases with price. It's really more a matter of time.

Julian Mitchell:

Perfect. And then, Michael, perhaps shifting to capital deployment. It's an exciting time for ITW, announced the first sort of material acquisition in a number of years with the MTS business a few months ago. So, maybe help us understand sort of how does that deal instantiate a lot of the capital deployment priorities of ITW today. And what are the leavers in that specific business to get the margins up from that sort of mid-single digit to IT caliber level?

Michael Larsen:

Yeah. I mean, we're really excited about the acquisition. I just want to make clear before people get too excited. Our primary growth engine is organic growth. Okay? So, well, we are excited because this business has all the raw material that we need to grow above market. Like we did in Instron business, which there's some similarities between those businesses. So, it's a business that can grow organically above market. It is a business that has the raw materials so that through the implementation of the business model and it's going to take some time. We're highly confident that we can improve the EBIT margins from kind of mid high single digit to ITW caliber margins in the twenties. It doesn't happen

overnight. It takes some time, but just like we did within Instron, we're highly confident that we can get there. And I Should just say we've committed to that.

Michael Larsen:

So, we've talked about ITW caliber margins by year five. We've talked about after-tax return on capital in the high teens by year 10. And so, we have committed to targets that really and expressed of everything I talked about in terms of the raw material. And I should say, a really talented team that we would look forward to welcoming to the ITW family, middle of the year-ish when the deal closes. In terms of ITW overall capital allocation strategy, this is very consistent and the strategy has been consistent since we launched in 2012, 2013. And there's not going to be a significant change as a result of this. Number one priorities invest in our businesses. We talk about that. It's new products, CapEx, supporting our organic growth efforts in these businesses is the highest return investment that we can make.

Michael Larsen:

And so, that's priority. Number one. The dividend is a really important part of our long-term total shareholder return model. And so, an attractive dividend that grows in line with earnings over time is a big part of that equation. It's important to a long-term shareholders. Third is acquisitions. Highly selective quality acquisitions if others come along that have the raw material, we're certainly going to look at those. And we obviously have the capacity, the balance sheet, the cash flows to do a lot in terms of acquisitions, but we're also going to be very disciplined in terms of how we think about those. And then, fourth ultimately is the surplus capital of what remains this year. It's about a billion dollars of surplus capital and rather than invest outside of our competencies and capabilities, we make the decision to return that surplus capital to our shareholders through an active share repurchase program. So, we're going to do about a billion dollars in 2021. So, that's kind of the capital allocation framework and like I said, no significant changes relative to prior years.

Julian Mitchell:

You mentioned Michael, the sort of discipline aspect. And I suppose that that can be quite challenging. When you see valuations rising inexorably, it feels like... I do you as a CFO to see a good funnel of MTS fiennes type deals out there where you're having to look at sort of smaller assets now that can generate an acceptable return?

Michael Larsen:

Well, I think we have a unique advantage as ITW. And that is the ability to improve margins more than anybody. Just given the power of the business model. And so, we're not really constrained in terms of multiples. I mean, it's really more a matter of having the right raw material to grow above market at ITW caliber margins and generate a rate of return on that capital. But also frankly, if we're going to invest our own time and resources and effort, it has to be worth it, right? And so, a lot of these smaller assets is it really worth it? And so, we've talked about wanting to do, division size or up acquisitions and they are definitely out there. I think at the same time, I will say, it's really important to be disciplined in terms of your strategic and financial criteria. It's easy to get excited about a strategic acquisition, but ultimately we have to be stewards of our...

Michael Larsen:

This is our shareholders money and this is our team's time and effort and we're going to be disciplined as we always have been when we look at these acquisitions and we're hopeful that there will be others. We're really pleased about this one and we're looking forward to the next ones.

Julian Mitchell:

So, we should expect perhaps possibly some MTS, TNS size deals this year?

Michael Larsen:

Well, I think a lot of is, as you know, Julian is opportunistic, right? I mean, you need to find the right asset and you need to find somebody that's willing to sell that business. And so, there are not hundreds of those opportunities around, but if you look hard enough, you're going to find them but it's really hard to predict timing of these deals.

Julian Mitchell:

Understood. Perfect. Well, thank you very much, Mike. And I think we're out of time, unfortunately. I know you have a busy lineup of meetings. So, thanks very much for the Q and A and also for everyone who dialed in.

Michael Larsen:

Yeah. Thank you, Julian. And good questions and thank you for having us at your virtual conference and thank everybody for listening in and thank you for your interest in ITW.