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Stephen Volkmann, Analyst, Jefferies Group LLC

Great. Good morning, everybody. It's Steve Volkmann here with Jefferies. Thank you for joining us for this session with Illinois Tool Works. Very pleased to welcome Michael Larsen, the Chief Financial Officer, to join me for about a 25-minute chat. If you'd like to participate here, we'd love to have your input. Those of you there on the webpage, there's a box you can type a question into, which will appear here for me and I will leave it into the conversation. You could send me an e-mail if that's easier for you as well, and we'll make that happen.

So Michael, thank you so much for joining us, and welcome.

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Yeah. Thanks for having us. Glad to be here.

Stephen Volkmann, Analyst, Jefferies Group LLC

Good. So let's move forward. Obviously, you guys just reported the quarter. I think this is probably an opportune time to maybe go through a little bit of what you guys saw there because it was interesting on a number of levels, I think. But obviously, sort of automotive is the area that we've all been focused on in terms of various types of constraints. And that business was a little bit, I think, weaker than most of us had forecasted. So just give us your read of automotive. Did it sort of do what you thought it would do? And kind of the outlook there?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Yeah. I think if I can, Steve, let me just take a step back here and just talk about this at the enterprise level. I think what we saw was really continued improvement in demand across the portfolio. So like the breadth by segment, by geography, in terms of the organic growth rate is really strong. I think it's – with organic growth up year-over-year of 37%, auto OEM almost double on a year-over-year basis. So I think that's kind of the good news that the order intake is really strong across the board. And then kind of the challenges, I'm sure we'll talk about kind of the raw material cost environment. But I also think some of the constraints in the supply chain that are impacting our customers at this point and predominantly in the automotive business.

So, our estimate is that the chip shortage that we've all talked about and the slowdown in production as a result of that and our customers reduced the automotive OEM revenues by about $60 million in the quarter. And that's actually, if you go back to the call in April, that's kind of how we had it penciled in. So we were certainly not overly surprised to see that in Q2. I think the challenges that this is probably going to go on for a little while longer than most people expected back in April. So we're doing everything that we can to support our customers. We're executing

– our teams are executing really well in a very challenging supply chain environment. I think the fact that last year, we took the strategy to stay focused on winning the recovery. And therefore, we held on to our people. We stayed invested in our new products. And our strategy is serving us really well. So, I think we're probably in a better position than most to serve our customers in this really strong demand environment.

So auto OEM, just – it's certainly challenging. I think it will remain challenging for at least a couple of quarters. And we've been through these things before. And I think we'll continue to execute really well and do everything we can to help our customers through this challenging time.

Stephen Volkmann, Analyst, Jefferies Group LLC

So the $60 million of missed business, just to be clear, that's because they didn't ask you to send stuff, not because you, ITW, have preference, right?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Yes. Absolutely. Yes, we're completely ready. And I think they had plant shutdowns here in Q2. There's going to be some of that again in Q3. I think it was $25 million in Q1, $16 million in Q2. And we'll probably see something similar here in the back half of the year. I think the important thing to keep in mind is these are not lost sales, right? So really, what's happening to some extent, the positive is that this recovery is being extended on the back end. I think for cars remains really strong. The consumer is doing well. Dealer inventories are at historic lows. It's going to take, just to get dealer inventories back to kind of normal levels, I mean we're talking, depending on who you believe, 18 months. So, I think that the cycle being extended here is actually a really helpful thing. So…

Stephen Volkmann, Analyst, Jefferies Group LLC

And what about on the margin side? And maybe this is specific to automotive but anywhere else as well. I mean I would imagine that there's a lot of kind of inconsistency around sort of the timing of orders and just sort of things that would weigh on productivity might impact margin. Any way to call that out?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Well, I think it's certainly challenging. I think if you talk to Scott, our CEO; Chris, our Vice-Chair, who have been around almost 40 years inside of ITW, they will tell you that this is one of the most challenging environments that they have seen from a supply chain standpoint, but I said, we're executing really well. And I think on the margin side, price cost is really putting more pressure on margins than the supply chain constraints, right? So – and even so, I think we had three segments with record – all-time record margin performance here in the quarter. So, I think our teams are doing a great job. I think we still have a lot of runway in terms of margin improvement.

Once we get through these near-term price cost challenges for the year, it will be somewhere around 100 basis points of margin impact – margin percentage impact, okay? I think the other thing to keep in mind is from a profitability standpoint, it's neutral. We're working really hard to offset any cost increases with price. But we're still going to improve margins more than 200 basis points this year to all-time record highs for the company in that 25% range. So the enterprise initiatives are still delivering a significant contribution. We did 150 basis points in Q2. We can talk a little bit about that. I know you had a question on the call about the sustainability of that.

And then really strong volume leverage. I think if you look at our incremental margins of 40% in the quarter, I think – I don't know if there are any other companies who follow that were able to put up 40% incrementals in the quarter. But I think, as long as we continue to grow, our margins will continue to improve just mathematically with the – just given how strong our incrementals are, plus the enterprise initiatives. And then eventually, we'll get ahead of price cost like we always do. And so I think there's plenty of runway towards our long-term operating margin targets that we've laid out of 28% in that neighborhood. And so I think that's kind of the important thing to keep in mind when you look at the current environment and some of the pressures on margins from price cost.

Stephen Volkmann, Analyst, Jefferies Group LLC

So let's just draw that out for a second. So obviously, the plan here, and I think you're successfully doing it, is to cover dollar inflation, sort of dollar for dollar, so you don't have any EBIT dollar impact. But of course, that does impact margin. And how do we look at that as we go forward? Do you then put through sort of a little bit more price in year two so that you're capturing the margin? Or do you have to go back and sort of do enterprise initiatives to offset that? Just what strategically are you…

Michael M. Larsen, Senior Vice President and Chief Financial Officer

I mean I think typically what happens, Steve, is we go into the year with an assumption that price is going to be ahead of cost. And then any incremental cost increases that are coming through, as we're seeing right now, second quarter was a pretty dramatic acceleration in inflation, we offset those on a dollar-per-dollar basis. There's always a little bit of a timing lag from when you see the cost increases to when you can actually realize price. I think for ITW, because our margins are best-in-class in that mid-20s range, just mathematically, we may have a little bit more impact from price cost than other companies. I also think you got to keep in mind, we tend to be more short cycle relative to many of our peers. And we don't do any hedging. So the costs that are flowing through right now are actual costs, right?

So, I think others that are hedging are extending that a little bit further. But eventually, we're all going to have to deal with the same raw material cost environment. So I think those are all things to keep in mind here when you think about price costs. I think ultimately, these raw material cost increases are going to stabilize. They may come back down again. And then what good companies will do that are competing in with really differentiated solutions, products and offerings will hold – price will remain – selling price will remain. And then these cost increases,

raw material costs will come back down again. And that's how you kind of get it back over time. That's historically how it worked.

If you go back and look at the last cycle in 2018, that's how this plays out. It's a little bit more challenging in automotive because of the nature of the industry. These contracts, you're locked in for a longer period of time. And so it's – when raw material costs go up, it certainly works against you. When they go down, it's to your benefit. And so over time, it all evens out. And I think automotive – I think margins were somewhere around 18%, 19% in the quarter. We'll be back where we were, which is in the low to mid-20s at some point when these price cost pressures settle down a little bit.

Stephen Volkmann, Analyst, Jefferies Group LLC

So, I guess the final thing I'm thinking about here, obviously, it's August. We're starting to think a little bit about the next year. Is there any reason not to think that your incrementals might be even a little bit better as you capture the margin, not just the dollars on this price cost?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Well, so just for the record, so we're not really thinking about next year at this point. We're trying to – it is a pretty challenging environment. It's all hands on deck in terms of let's make sure that we can serve our customers better than anybody else. And we have some real advantages in terms of how our supply chain is set up and our manufacturing system is set up. And that's really – our goal is how do we position ourselves to serve customers with this surge in demand, do it better than anybody else and gain share. That's really what the win the recovery strategy go about. I think when we get to the annual planning, our budgeting process in the fall, that's when we'll go through kind of in detail. And you asked about enterprise initiatives. Specifically, what are the projects and activities that are planned for 2022 that will continue to contribute in a meaningful way specifically around our 80/20 front-to-back process but also our strategic sourcing efforts. So, I think all of that will kind of get consolidated and reviewed at the end of – in the fall. And then when we provide guidance at some point next year, we'll give you a sense for what the benefit is going to be. I think what I can tell you is nine years in, these enterprise initiatives continue to contribute in a meaningful way and will continue to improve our margins on a go-forward basis.

What exactly that number is next year? This year, it's going to be a little bit more than 100 basis points. Whether we'll get that same contribution next year, that's what I don't know until we've gone through all the pipeline of projects and activities. But I'm pretty confident that there will be a meaningful contribution in 2022.

Stephen Volkmann, Analyst, Jefferies Group LLC

Okay, and just since we're touching on enterprise initiatives, I think you mentioned you did 150 basis points in the second quarter, I think you might have done, what 120 in the first?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

120 in Q1 and 150 in Q2. Yeah.

Stephen Volkmann, Analyst, Jefferies Group LLC

And the full year target is at least 100. I guess that gives us a wide range, perhaps. But is there any reason to think that would decelerate in the second half?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

I think 150 was better than what we've done in a long time, right? So I think, we'll do more. I mean, I'm pretty confident we'll do a 100 basis points here in the – or better in the second half. We're definitely not slowing anything down. And so I think it could turn out to be a little conservative. We'll see how it all plays out in the second half. So there's – you got to understand, Steve, there's a lot going on in our divisions right now. As you might imagine, demand is surging, some of our businesses are up double year-over-year.

Raw material cost inflation. Customers want product, supply chain constraints. I mean, it's a pretty challenging environment. And I think given that, I think if you look at our organic growth rate year-over-year, I think we in the multi industry space, maybe you can comment on that. I don't think anybody had a higher growth rate than ITW on a year-over-year, based on what I've seen so far. I mean, I could be off and I think even if you look at the two year stack, I think this compares very favorably to the space. I think margins; we're back kind of in the mid 20s, incrementals 40.

Free cash flow, I think we're building some inventory to take care of customers. Receivables are growing and sales are growing. So that's all to be expected and will deliver, record earnings for the year. So I think all in all, I think we're quite pleased with the first half of the year, I think the second half is going to be challenging, but I think we're better positioned than anybody else I can think of to continue to execute at a really high level. So…

Stephen Volkmann, Analyst, Jefferies Group LLC

Okay. Good. So maybe that touches on another question that I've always had, which is kind of how do you know if you're winning the recovery. Maybe the answer is this market share stuff that you just mentioned. But how do you guys look at that internally?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Well, I think it's a little early days to tell whether we are winning the recovery or not. I mean, what we're trying to do is position the company, so that we can outgrow our underlying markets, by a meaningful margin, call it 200 to 300 basis points, not one year, not one quarter, but on a consistent basis. Right. And so I think that's certainly the goal is to get to an organic growth rate in that, 4% plus range on a consistent basis.

I think, anecdotally, I think we went through a couple of examples on the call. There are certainly lots of anecdotal evidence, whether it be in food equipment, where we're able to take care of customers, where maybe our competitors may be having a little bit more of a difficult time. I think in construction, in our roofing business, there are some examples. Automotive aftermarket, if you get the growth rate, they're up more than 30%, that is significantly above kind of what the point-of-sale data would indicate.

So, I think we're – inside the company, we are highly confident that we are well positioned to continue to gain share here, based on how we positioned the company last year. And so, ultimately, the one metric that you should use to determine whether or not we're doing it is organic growth. We'll continue to report organic growth, of course. And I think our goal is, with a reasonable amount of organic growth, in that 3% to 5% range, given our incremental margins, how profitable this company is, we don't really need to be the fastest grower to deliver our best-in-class earnings growth.

And then we'll have an attractive dividend yield, we'll support that with our capital allocation, whether it be acquisitions and/or share repurchase. And you pretty quickly get to a double-digit TSR model here that we've talked about before at Investor Days, that is fairly low risk, high probability that the company can deliver that on a sustained basis over time. And so that's really what we're trying to do here.

Stephen Volkmann, Analyst, Jefferies Group LLC

Right, good. Yes. And obviously, successfully. Let's just go back, you mentioned earlier that you are going to build a little bit of working capital, I think, just in this kind of end market And I'm curious, just bigger picture, it feels like there's a chance that, that people change a little bit the way they think about running companies. And what I mean by that is we've all been focused on sort of zero inventory, one piece flow. That worked fine, when that supply chain was, working perfectly, but it seems less helpful now with all these kinds of issues. So I wonder, do you think there's a difference in how you run ITW going forward post-COVID?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

No. I think the way our 80/20 operating system works; we basically, produce today what we sold yesterday. And so the more we sold yesterday, the more we're going to produce today. And as a result of that we're going to add some inventory, when sales are growing on a dollar basis. I think the important metrics to look at is our months on hand is going to remain in that, 2, 2.5 range, our DSOs are going to remain in that 60 day range. I mean, I think we're, not going to change, how we run the company and frankly, the fact that we're adding inventory, it's not like the bright minds and blend you said to our divisions, Oh, go ahead and add some inventory. It's just the way 80/20 works. And so I think that's, we'll still be somewhere around 100% of conversion rate this year. Usually, we do, 105, 110 will be closer to 100 but still very strong cash flow generation, really strong free cash flow as, see, we generate significantly more operating cash flow than we need to run the company.

So our priorities remain, fully invested in our businesses that generates the highest possible rate of return. That includes, CapEx of somewhere around 300 million this year, which is 2% of sales. And that's really – that is after funding, everything that we want to do inside the company to generate and generate a really high rate of return at the company level with 30% after tax return on invested capital. We want to maintain an attractive dividend that grows in line with earnings over time. We'd love to do acquisitions that meet our strategic and financial criteria. We've got a great one lined up here with MTS that's going to close here in the second half. And then what's left over is really – gets allocated to an active share repurchase program of about a $1 billion this year.

So even I don't want anybody to think that because we're building a little bit of working capital, it's going to change how we think about the company. Absolutely not, we're going to continue to run the company the way we have for a long time. And I think it's got a pretty solid track record in terms of delivering, strong total shareholder return performance.

Stephen Volkmann, Analyst, Jefferies Group LLC

Yeah, absolutely. Just because you touched on sort of capital deployment and M&A, the flip side of that is obviously divestitures. You've done a number of those in the past; you kind of put the brakes on for a little while, any update on your thinking there?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Well, I think we put the brakes on because we really wanted to focus on winning the recovery last year. And by the way, it was probably not the best time to try to sell a business, in a global pandemic. So I think that made a lot of sense. I think our view is these businesses have performed really well, are taking advantage of the recovery, just like any other ITW business would and are probably – or pretty certainly going to be more valuable once we decide to relaunch the process, which will be somewhere, in probably back half of this year, early next year.

We're not talking about a significant number of businesses. I think when we laid this out at Invest Day, three years ago, we said about a $1 billion in revenues. We're about halfway there. And so, I think it's something we'll get to work on later this year, early next year, and we'll keep you posted.

Stephen Volkmann, Analyst, Jefferies Group LLC

Okay, great. And I think we just have a couple of minutes left. So I'm curious, ESG has become a bigger issue. Obviously, in the investor base, I'm not sure you're one of the first people, people think about with ESG. But maybe that's a mistake. Maybe we should be spending more time focused on your ESG efforts. Is that something that takes a lot of your time and thinking? And just any comments there?

Michael M. Larsen, Senior Vice President and Chief Financial Officer

I'll be honest with you, I think it's been a part of this company for a long time and that dates back to way before it became kind of the hot topic, to be honest with you. I think this company has a long history of kind of doing the right things. I think, certainly there's more focus around ESG, if you look at our metrics, how we're being assessed by third parties. I think we're kind of in the top quartile. We've recently upped our greenhouse gas emissions reduction targets, and we're making really good progress there. With regard to diversity metrics, really strong governance has always been the strength of the company.

So I think it's certainly a topic, I think it's, we want to do this the right way. We're not going to, if we're going to put out targets, we got to make – we want to make sure, we can get there in a way that makes sense. And so we're, it's an area we spent quite a bit of time on, but I think we're really confident, that we're on the right path here and frankly have been for a long time. So…

Stephen Volkmann, Analyst, Jefferies Group LLC

Okay. Great. Well, your support for the workforce was remarkable through COVID. So…

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Yes, I mean, I think that's another example. Right? I mean, everybody talks about; their employees are their most valuable asset. And I think, for us, that is certainly the case. And so, we did everything we could last year to protect our people, during the worst of the crisis. And I think we got a little lucky this recovery came, so quickly and if we had gone down a different path, we would really be scrambling to bring people into the company. And by the way our people are, every one of our 45,000 plus people is an 80/20 expert, right?

So, it takes time, once you – you can't just bring somebody in from the street, they need to learn 80/20 and how we do things. And so they are really, and I think if you look at our performance last year all of that credit goes to our 46,000 colleagues around the world and how they took care of each other and took care of customers and continued to support and execute our enterprise strategy, I think was pretty remarkable. And we're seeing the benefit in our financial performance here in Q2 and also for the full year and beyond that, so I think a big thank you goes to our people.

Stephen Volkmann, Analyst, Jefferies Group LLC

Super. All right. We are out of time a big thank you to you from us and look forward to keeping up on everything and nice to see you.

Michael M. Larsen, Senior Vice President and Chief Financial Officer

Sure. Take care, Steve. See you.

Stephen Volkmann, Analyst, Jefferies Group LLC

Cheers.