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Andrew Kaplowitz:

Again, welcome back. We're very excited to have ITW with us. We have Michael Larsen, who is the senior vice president and chief financial officer of ITW. Michael joined in 2013 having previously served as president, CEO and director of Gardner Denver and you've also had a long industrial career. Very much appreciate you being here, Michael. While I'm walking over, I'll just sort of ask you maybe a follow up to the question I kind of asked you on the earnings call because I think it's sort of an interesting development. You mentioned enterprise initiatives going to be 100 basis points this year. But you answered my question about enterprise strategy, kind of suggesting that the savings can be ongoing, I don't want to say indefinite, but I would say ongoing and that you could sort of achieve 100 basis points pretty much every year. So can you maybe describe how you've honed enterprise strategy over the last 10 years? Because it seems like it's gotten better for you. And if it continues to be good or better, why couldn't you deliver more than your usual target of 35 to 40% incremental margins?

Michael Larsen:

Sure. Well thank you Andy, and thank you for having us back. I think this is our sixth year and every year I wonder whether I'm going to get invited back next year and so far so-

Andrew Kaplowitz:

We'll always [inaudible] you back. [inaudible] ongoing, so, keep going-

Michael Larsen:

Thrilled to be here. And let me just take a step back and answer your question maybe a little differently. I think we're 10 years into our quest here to position the company as a solid organic grower with best in class margins and returns. And we've certainly, I think, come a long way in terms of achieving our goal of being one of the most competitive, highest quality industrial companies in this space. I'll just point to a couple of proof points around our margin profile. For the people that are not aware, our EBIT margins gap not adjusted or in the mid 20s return on capital, 30% plus on an after-tax basis.

We, I think, over that timeframe have uniquely earned the right to be a diversified industrial company just given the quality of the portfolio and the fact that there really are no weak links across this portfolio. And I think also in the process we've kind of gone from a kind of peer average multiple evaluation to now solid 20% plus premium relative to the peer group. So certainly a lot of progress. I think the really good news from our perspective is that there's still a lot of runway in front of us. I mean based on everything that we're seeing today, including the more recent progress, maybe we'll talk about kind of 2022 and the fourth quarter, all points to the fact that we've got another five plus years ahead of us in terms of really continued strong execution on this enterprise strategy.

A significant component of that has been the enterprise initiatives that you were talking about. So, if you look back over the last 10 years, we've generated 100 basis points of margin improvement every year. It adds up to $1.5 billion of cost out over the last 10 years. Really from two big initiatives. One being the re-implementation of our 80/20 front back, think of it as our operating system, across our 84 divisions. Only, a much more powerful 80/20 today than it was 3, 5, 10 years ago as we continue to learn and further improve kind of the tools and the techniques that are associated with 80/20. I think our people, our teams are much better in terms of being real experts at the implementation of the business model. And then the third piece is we're applying these tools and techniques to businesses that are much more differentiated given all the work we've done around the portfolio, exiting the lower growth, lower margin businesses, most of that early on in the beginning of the enterprise strategy.

So that process continues to deliver significant savings for us, as does the strategic sourcing efforts that also have been ongoing inside the company for 10 years. And so think of it as for the first time we're leveraging the combined spend of the enterprise to generate meaningful savings across the company. All of that is done by real strategic sourcing experts, which was really a weapon we didn't have in our arsenal when we started this 10 years ago. So those two capabilities put together is what we collectively called the enterprise initiatives. And I think we were quite pleased when we rolled up the annual plan numbers late last year and then checked in again in January to see that all the projects and activities that support these two initiatives still added up to 100 basis points of margin improvement in 2023.

And as, I think, we talked about on the earnings call, I think we expect that there will continue to be a meaningful contribution from these initiatives on a go forward basis just given that we continue to evolve and get better at applying these tools and the tools themselves evolve. And so I think we feel very confident that the enterprise initiatives will continue to contribute in a meaningful way to the overall performance of the company, which I might add in a world that's ever more challenging and uncertain is a great thing to have in your back pocket.

Andrew Kaplowitz:

For sure. And just ask you one thought that, 'cause you mentioned sort of five more years you think, good runway. Is it across sort of the three different things you do sourcing or simplification?

Michael Larsen:

Well really what I'm talking about is in terms of the total shareholder return model. We've been really been laser focused really since 2016 on organic growth. And as you know we had some heavy lifting to do early on in the enterprise strategy in terms of simplifying these businesses and getting them ready to grow operationally and getting the margin profile to a point where we would tell the businesses, "Okay, now it's time to really lean in on organic growth." Changed the incentives in 2016 and we've made a lot of progress.

What we're trying to do is position the company so that we can grow 4% plus organically through the cycle. And why 4%? Because 4% at our historical, 35 to 40% incrementals yields operating income growth of 7%. Given all the surplus cash that we generate, some combination of acquisitions and/ or share repurchases contribute another two to three percentage points of EPS growth. So now you're growing 9 to 10. And then you add on top of that an attractive dividend that grows in line with earnings over time, so about 7% if you look at the last 4 years, 59 years in a row of dividend increases, that dividend gives us another 2 to 3. And so now you're looking at TSR of 11 to 13 in what I would describe as fairly low risk, high probability. And of the 11 to 13, the first 7% I talked about is tied to organic growth. The balance is all within our own control, that's capital allocation.

So that's really what we're trying to do. And we've done better than that over the last 10 years. I think we've averaged somewhere around 18 19% TSR. Part of that was the re-rating of the multiple, as I talked about earlier from parody with the piers to 20% plus now, solidly 20% plus. We don't expect that lift again in the multiple, but really solid kind of 4% organic growth, 11 to 13% TSR. That's what we're trying to do. We believe that over any five year period that will put us in the top quartile of the industrial companies, kind of the peer group.

So that's why there's been so much focus on organic growth and solidifying that as the primary growth engine of the company. And the rallying clients at the company is we want to be as good at organic growth as we are operationally at 80/20. Now that's a high bar if you think about it, but that's where we're at. We're certainly encouraged by the progress. 2021 we grew 12% organic. In 2022, we grew 12% organic. This year we're guiding 3 to 5. So certainly very comfortable with the progress that we're making. And again, we're only trying to get to 4. In a normal GDP world, where maybe the global economy grows 2 to 3 through our CBI customer back innovation efforts and others initiatives inside the company. All we're trying to do is get to 4 to 5.

Andrew Kaplowitz:

So related to that, Michael, you talked in Q4 about hiring, you want to bring in some new hires to support organic growth and investing capacity, but you kind of made it sound like this is just normal for ITW. And you also talked about that you highlight 150 to 200 basis points of inflation related costs associated with higher labor expense. So my question really is the, first of all, is that 150 to 200 basis points the cost of doing business now or should that go down over time because it's kind of an unusual headwind this year? And then, is it sort of normal hiring or are you putting it in sort of areas like food equipment or welding where you've had really pretty extraordinary growth over the last couple years?

Michael Larsen:

Well, I think across the company we've continued to invest. I think this year it maybe stands out a little bit more because of the pretty unusual inflationary pressures, not just on the material cost side but also on the wages, salaries, growth investments. I mean, if you look at the last two years you're not going to grow 25% without investing in growth and investing in capacity

Michael Larsen:

... And in new products. But I think you're right. I mean, that's essentially part of the ongoing process of doing business. We fund every good project inside the company. We are and have, really since 2016 with this big growth focus, we have ramped up significantly on the front end of the business. We've hired some commercial expertise, sales and marketing, that we maybe didn't have inside the company. And I think the other thing that's really helped us was the fact that during the pandemic we made the decision based on our margin profile, and based on this fortress balance sheet that we built up, to take the long-term view and stay invested in our growth efforts, stay invested in our people, not lay anybody off, and stay invested in our strategies to a further accelerate organic growth. And I think the pandemic was just another proof point for what we've built, another example of what we've built. And as this highly resilient, very profitable company that when faced with adversity, we can take the long-term view and we can stay invested in our strategic priorities, organic growth in particular.

Andrew Kaplowitz:

So Michael, I want to follow up on your comment around when the recovery. That's what you did, basically, is that you decided to stay fully invested in your people that partly led to the organic growth that you had. As we sort of transition transitioned here, macro slowing a little bit, how do you look at ITW's ability to grow above market? I think when you had your last investor day, you talked about a hundred basis points above market. Now you're talking about 4% growth, but obviously, the market's not static, right?

Michael Larsen:

Yeah.

Andrew Kaplowitz:

So how do you think about your ability versus that a hundred basis points?

Michael Larsen:

Well, I think to your point, it's difficult to put a number around what's your market growing at when you're in 84 global divisions touching pretty much every aspect of the global economy. So I think the last time we rolled up the numbers in 2019, we said, to your point, we thought we were outgrowing the underlying markets by a percentage point. If we roll those numbers up now, it would probably be more than that. But I just don't have the degree of confidence to tell you, "Here's what the market's growing at. Here's what ITW is growing at." All I can do is, we can point to some encouraging data points. And we talked about this on our earnings call three weeks ago. If you look at our growth rate over the last two years, 12% in '21, 12% in '22, organically, relative to our peers, our proxy peers growing at nine and nine, that is very different from the ITW of just a few years ago. I mean, I think we've never claimed to be in the top quartile from an organic growth standpoint, but now we are.

Andrew Kaplowitz:

Yeah.

Michael Larsen:

And so, while nobody is declaring victory, and we know how much work we have left to do inside the company and every one of our divisions will tell you that they're not there in terms of achieving their full potential organic growth rate, I think it's certainly confirmation that we're headed down the right path here. But to put a specific number around our growth rate relative to the underlying market is, at this point, given all the volatility, is probably not the best thing to try to do.

Andrew Kaplowitz:

So let me follow up in this way then. If I look at a business, like food equipment or welding, the growth has been really, really strong over the last couple of years. And obviously, we know about pandemic reopening, so some of that is helping you. But what's gotten into those businesses? Is it share gains? Is it something you did sort of pre-pandemic or in the pandemic to really energize those businesses' growth?

Michael Larsen:

Well, I think welding and food equipment are actually good examples because there are publicly traded competitors and you can certainly compare our growth rates in those segments and our margin profile to theirs and then you can draw your own conclusions. We would say that we definitely have gained

share as a result of the focus that we've had on organic growth and because of the positioning, the fact that we stayed invested. And then I think, more recently, this has been pretty challenging from a supply chain standpoint. And the fact that we were very intentional about mitigating supply chain risk in order to sustain kind of our superior customer service levels, we had to build inventory. And we've probably, you can look at this yourself, added about a billion dollars of inventory to mitigate supply chain risk, and take care of customers, and ultimately put ourselves in a position to deliver when our competitors can't and therefore gain share.

And there's plenty of anecdotal in evidence inside the company that that's exactly what happened. And we know what our lead times are relative to our competitors and like I said, there's a lot of evidence that we are gaining share as a result of that. Not opportunistic, one-off kind of buys, but really strategic, long-term share gains. I think from that perspective, the pandemic was a great opportunity for ITW to demonstrate how differentiated our supply chain capabilities really are. And I think the results that we're putting up right now would not have happened without those decisions that were made, in terms of staying invested and taking care of customers.

Andrew Kaplowitz:

And then I wanted to ask you kind of alternatively, around specialty products, it's the only business, the only segment, where you have revenues projected to be down in '23 versus 2019. Is that because the overall segment tends to have more of a consumer focus, or is there something else going on there that needs to-

Michael Larsen:

Yeah, I think if you look at kind of the portfolio, maybe to answer it a little more broadly, I think overall demand is really strong in 75% of the company. I think the kind of balance, the 25%, tends to be either more consumer oriented, like specialty as you point out, more interest rate sensitive, that would be our residential construction business, or there's a little bit of a cycle going on in semi right now. Those things add up to about 25% of the company. And so there's no doubt that we've seen some slowing in those end markets. We have projected in our guidance that will continue to slow in 2023. So we're reasonably confident that we've kind of de-risked that.

I'll just say that one of the big advantages of being as diversified as we are is, you're always going to have challenges, or headwinds, in some parts of the company and tailwinds in other parts of the company. And when you add it all up, I told you about the growth rates over the last two years, 12%, two years in a row, and this year, three to five. At a time when certain things are slowing, I think that's another proof point of the value of this high quality, diversified business portfolio and the resilience it gives us to continue to stay invested for the long term.

Andrew Kaplowitz:

So we already talked about this a little bit, so I'm going to rephrase the question I have here in the sense that you never spent that much on R and D as a percent of sales versus a lot of the industrial competitors, but you've gotten obviously very high return for what you've spent it on. So have you done anything different in terms of innovation? I know your folks done customer backed R and D that's also helped you to improve your growth. Was there all the other things we talked about with enterprise strategy?

Michael Larsen:

Well, I think we're not really doing anything differently. I mean, to take a step back, so we are not trying to invent a new molecule or kind of new to the world application. We are much more comfortable with customer back innovation, singles and doubles supported by a patent portfolio of over 19,000 patents of really things that are unique to ITW that only we can provide. And it just happens that this customer backed innovation process has a much higher... The velocity is greater. The outcomes are typically better because when we don't start working on something, if we don't have a purchase order and we are confident that when we develop this product, we don't have to find a way to commercialize it. We know who's going to buy it and what they're going to pay for it. So I would say it's a much more efficient way of doing, of innovating.

It is a little bit difficult for looking in from the outside to get excited about because we don't have these a hundred million dollar innovations, but we have a hundred of a million or two here and there in every division, four or five really meaningful projects for their division that contributes to the overall growth rate of the company.

And I might just add, while we're not doing anything different, we're being much better in terms of how we are innovating for our customers. So what historically has been a contribution to organic growth of maybe a percentage point, maybe a little bit less, to be very honest with you, is now a 2% overall contribution to the organic growth here to the company. And it's not that we had to spend more. I mean we'll spend whatever we need to, but it just happens that our R and D efforts, the way we capture those costs and disclose them, it's about 2% of sales. And so, as sales grow those R and D efforts, certainly the cost will grow. But it's not a matter of cost, it's much more a matter of being focused and being really efficient and smart in terms of how you innovate for your customers. That's how we would describe it.

Andrew Kaplowitz:

Got it. So you know I was going to focus on the near term just for a few minutes.

Michael Larsen:

Sure.

Andrew Kaplowitz:

So, you talked about the 25% of the business up from 20 that's slowing. Have you seen any broader slowing of either that 25% is [inaudible] anymore? Or anything in the 75% that's still slowing? And I thought part of the reason why you got at three to 5% organic growth was to account for incremental slowing. How are these markets trending versus your expectations? Because they kind of have to slow for you to make your guidance come down.

Michael Larsen:

Yeah.

Andrew Kaplowitz:

If that makes sense.

Michael Larsen:

So, you may be a little disappointed in how I answer this, but I think yeah,

Andrew Kaplowitz:

Long time-

Michael Larsen:

It's just our earnings call was three weeks ago, and if I-

Andrew Kaplowitz:

Long time, Michael.

Michael Larsen:

Things can change quickly, I'll give you that. But if I was-

Andrew Kaplowitz:

[inaudible] cycle business.

Michael Larsen:

If I was sitting here and giving you a different update, we probably didn't do a good job three weeks ago. What I will tell you broadly is that everything is on track and playing out largely as expected. In our guidance of three to five, historically, we guide to what we describe as run rates. We look at demand rates exiting Q4. We extrapolate into the year, we adjust for seasonality, and that becomes our guidance. This time around, we thought, just given everything we talk about it, we wanted to be a little bit more cautious, and so we risk-adjusted those run rates down and our guidance is three to 5% organic. We expect that the 25% that slowed in the back half of the year is probably going to continue to slow in 2023.

The flip side is the 75% of the company, demand is still really strong, and the other tailwinds we have is supply chain conditions are starting to normalize and input costs, material cost inflation, the pace of those increases has definitely moderated. And while costs are not coming down, they're certainly not going up any longer either, so I think there's puts and takes as there always is. I'll just say in terms of how we are, the momentum we have going into '23 and how we're positioned to perform in just about any environment and to outperform, I think, just about anybody in whatever environment we end up in for '23 and '24, I feel really good about our positioning at this point.

Andrew Kaplowitz:

So let me ask you about that 75% that's not slowing. In fact, in 4Q, you mentioned that you actually saw larger than usual seasonal uptick. To the extent you can, can you talk about that acceleration? And I do often ask you about your CapEx businesses. They were strong in Q4. What does that tell you about the global economy?

Michael Larsen:

Well, let me preface this with I'm not an economist. Okay?

Andrew Kaplowitz:

Neither am I.

Michael Larsen:

But I think we were certainly really encouraged by the sequential increase in demand that we saw from Q3 to Q4. And so I think what you're referring to is typically, we see revenue per day go up 2% from Q3 to Q4. We actually saw it go up 4% from Q3 to Q4. And like I said, really strong demand across the vast majority of our portfolio. And so including automotive, which granted, had an easy comp year-over-year, about up 20%, I think food equipment was up 17. Somebody correct me if I'm wrong, but double-digit growth in test and measurement even with some slowing.

So I think all of the demand for capital equipment, welding equipment going into the industrial side to our big customers there, demand there remains really strong. And so I think we were really very optimistic going into this year for those businesses. And at the same time, we know that things can change quickly, and so I think that's where, again, I point to the resilience of the company. I'll point to our ability of our teams and the divisions to read and react to whatever the conditions on the ground may be. I think you look at our track record of execution and our say/do ratio, it's hard to not feel really good about where we're at.

Andrew Kaplowitz:

So maybe I can ask you a similar question by region. Europe hanging in there, US doing reasonably well, and China, you're doing seems like very well on China in particular, even with the noise; Chinese New Year, COVID, all that kind of stuff. Any updates as we come out of Chinese New Year? You still feel good about China actually being above your three to 5% growth for the year?

Michael Larsen:

Yeah. When we look at this by geography, and I should say we don't run the company by geography, I think one thing that's really unique about ITW is that our margin profile is very similar in all three major geographies. We are as profitable in China as we are in North America and Europe, which is a little unusual, I think. In our guidance of three to five, maybe that has North America maybe towards five, Europe towards three, and China kind of in the mid-single digits. For the first time last year, we surpassed a billion dollars in China. We grew 6% organically in China last year.

And I would say this, our Chinese colleagues have done an incredible job over the last two years under very difficult circumstances. Frankly, much more difficult than anything that we had to go through here in the US, and they have passed whatever obstacle was thrown at them. The results speak for themselves and so, I think, big thank you to our Chinese colleagues. About half of our business in China is, I think as you pointed out, the automotive business, and we are seeing really significant growth on the EV side of things in China.

We're very optimistic. We are investing in capacity to meet the demand that we're seeing right now as well as projected for the next few years, so we feel very good about China. Of course, there's going to be bumps in the road just like there were last year, but long-term, we feel really good about how we're positioned. Not just in automotive, but also in test and measurement, food equipment, and polymers and fluids, and our other businesses in China.

Andrew Kaplowitz:

Great. I want to open up to the audience in a few minutes, but first let me ask you about price versus the cost. You mentioned a little bit a 70 basis points tailwind in Q4, which was nice to see. I think you've known an expectation tailwind of about 100 basis points for '23. Can you clarify whether that's based on pricing that you've already done? Is this going to be a normal year for pricing? We've seen commodities

bounce off the bottom here. Does that actually help with the price versus cost equation, because it allows you to convince customers you got to keep raising price? How do you think about that?

Michael Larsen:

Well, let me just go back a couple years here. I think when we started to see really significant ramp-up in inflation in early 2021, the overall guidance was we want to offset those raw material cost inflation with price on a dollar for dollar basis. The objective was not to recover the full margin impact, and you can make those decisions when your EBITDA margins are 25. Our teams did an amazing job, I think, again, really responding, reacting to these material cost increases, this barrage of cost increases appropriately and decisively.

And I think we actually learned a lot of things about how to do this back in the '18, '19 timeframe, if you remember the steel tariffs. I think that really, we learned some lessons and applied those and did a good job keeping price cost EPS neutral, but it certainly had a cost from a margin standpoint. If you go back and look, overall margins were diluted by about 240 basis points from Q1 '21 to Q3 '22, and Q4 was the first quarter where we saw positive price cost margin impact of 70 basis points, which obviously contributed to the incremental margins being 52% in Q4, 12% organic growth, 52 incrementals, 18% income growth. And certainly the new news, I think, enterprise initiatives, again, of 100 basis points, but I think the new news was the positive contribution from price cost. I think what you're referring to as, I don't know how you said it, my guidance or whatever, I think I said ballpark, we've got some good momentum of price cost. If that carries into 2023 based on everything we know today about price and cost, I think we're going to start to recover some of that margin impact. Included for '23 is there's certainly some carryover from a price standpoint and also an assumption that there's going to be normal price increases like there always are.

I think, like I said, costs are not going down. Labor costs actually are going up, but I think if we were to find ourselves in a deflationary environment, I think there's certainly going to be some pressure on price and we want to maintain our price premium. We are typically the command of premium on price based on the performance of our products and our customer metrics. We want to maintain that premium, but we also want to compete and we want to gain share. And so wherever we end up from a pricing standpoint, I think even if we have to give up a little bit of price, it's not the end of the world.

Andrew Kaplowitz:

Let me ask you a related question on auto OEM. Obviously, it's a little harder there on the price versus cost front, but is there anything you can do in terms of whether it's restructuring, contract renegotiations, to get margins back up there?

Michael Larsen:

Well, I think if I said at the enterprise level, price costs of 240 basis points of margin dilution, it's probably been 2X that in automotive. And so I think it's going to take some time to recover that. There's the contractual nature of that industry as such that I think it just takes longer to get price. If you want to participate in the industry, that's the way it works, and so we have to innovate. We have to win new content per vehicle. We have to provide solutions that our customers are willing to pay for, and it's probably going to take us two to three years to recover the margin impact in automotive if things

Michael Larsen:

... broadly stay the way they are. And again, if your margins are 25% EBIT, that's okay. We understand why that is. Automotive right now, EBIT margins are 18. I think, broadly, if you are a supplier to the

automotive industry, the average EBIT margin in normal times is six. And we're reasonably confident that we're going to regain the price cost margin impact. Not because we're better at pricing, but because we're better at taking care of our customers than our competitors are.

Andrew Kaplowitz:

Questions from the audience? Any questions?

Speaker 1:

Thanks. Just a quick one on the EV opportunity. Can you just give us a sense of what the content per vehicle that you're seeing today versus ICE vehicles, whether it's number of parts, kind of parts, and what the ASP mix looks like in margin impact?

Michael Larsen:

Yeah. We actually believe that the total opportunity in terms of content per vehicle is greater on EV than it is on ICE. The current content per vehicle on an EV is about $32 versus $37 on an internal combustion engine. That $32 is growing faster than the $37. There are a lot of difference differences by a geography, but we're really excited about the opportunity in EV. A lot of the products that we sell are directly transferable. So, a lot of the plastic fasteners, for example, are equivalent on an EV versus an internal combustion engine. And then there are some additional opportunities around thermal management around the battery, the heating, the cooling of the battery, the fastening of the battery, whether it's with fasteners or with glue developed by performance polymers, as well as we do the air registers. These new very slick air registers that you see on EVs, typically there is a lot of focus on how do you reduce the overall levels of noise in the cabin. Because EVs tend to be quieter, you don't want to hear your AC running.

And so, those are the types of opportunities that we're working on with our customers, the charge port mechanism. So, we think there's really a lot of opportunity on the EV side and particularly if you look at the growth in China, that's been the big driver for that business really over the last few years. So, when you look across the company, that's an area where you can't help but be really excited about the organic growth opportunity.

Andrew Kaplowitz:

Any other questions? Michael, let me just ask you about, you actually said for your guidance for this year that you expect all your segments to grow margin, but you have a couple segments, like construction for instance, which you are projecting to be down decently. We already talked about specialty products a little bit. Is it price cost that's really helping, you doing product line simplification, something like construction, what's getting you to improve margins in a business?

Michael Larsen:

Well, let me just say this. When I say something like that it's not because that's the way I'd like it to be. It's based on what our divisions told us in their bottoms up planning process, which is how we do it at ITW. It's not a tops down process. And as we rolled up the numbers from 84 divisions, every one of our segments was showing margin improvement on a year by year basis, which is really what we're looking for, is just a little bit of progress every year. A little bit better this year than last year as we continue to progress towards our full potential could, because we're not done at 25% EBIT margins. I mean we've committed to 28%, I think I may have said 28% plus at one point. And then that-

Andrew Kaplowitz:

You might have whispered 31%, before-

Michael Larsen:

I don't think so. I think I would remember that. But I think 31% is the welding margin. And even the welding business making 31% with their largest competitor making half that I think they tell us that they can continue to improve margins and the big driver is growth. If you deliver organic growth at 35% to 40% incrementals, you can't help but continue to improve your margins. I think construction's a little bit of a different story. I think we are expecting, due to the softness on residential construction, that business will be down 3% to 5% organically. Obviously there might be some carry over from a price standpoint that kind of helps buffer the full margin impact. And so we expect some slight, I think it's not a whole lot, but we do expect some margin improvement also in the construction business.

Andrew Kaplowitz:

And then cash flow obviously has been, as we talked about, a little pressured by higher inventory and supply chain, you feel good about a hundred percent this year, factors in your control to get there.

Michael Larsen:

I feel really good. I think our free cash flow conversion rate has been a little uncharacteristic for the last two years because of this intentional decision to add working capital. You know what I mean? The business is growing double-digit, so you are going to have to add some working capital. And then on top of that, we decided to de-risk some of the supply chain issues and add about a billion dollars worth of inventory.

We're running at three and a half months on hand, but normally we're running at two. And there's no doubt in my mind that as supply chain conditions begin to normalize, those levels of working capital will come down. And at the same time, I will tell you this, that the priority is to take care of customers. And so, if we have to keep inventory levels where they are for another year, that's fine. Given this balance sheet, given our margin profile, that's not a problem. I think we said a hundred percent plus this year that assumes basically no improvement in working capital this year. That's probably a pretty conservative assumption. So, if things normalize and if we can take care of customers, I would expect that number to probably be a little bit better than that.

Andrew Kaplowitz:

I only have 30 seconds and I still have two questions for you. So, I'm going to ask them very concisely. One is, are there any MTS type acquisitions out there for you, how do you feel about that?

Michael Larsen:

Yes, there are. I think it's not a matter of demand, we'd love to do another couple of MTS acquisitions. We're really excited about that one. It's really more a supply issue. You got to find them and you got to find a willing seller. And we are only going to buy businesses where that can grow at 4% plus. We can improve margins from mid-teens to mid-twenties and we can earn a reasonable rate of return that makes sense to the company and for our shareholders. And so, MTS, we're going to end up in the high teens by year sevens on an after tax basis, maybe even a little bit better based on the progress the team's making. But to the extent that those acquisitions become available, you should expect us to definitely lean in and be aggressively opportunistic when it comes to opportunities like that.

Andrew Kaplowitz:

And the last question is, I've been asking all the companies, what are the top two or three innovations, megatrends or structural changes that have affected or could affect your company over the next five years? Are there any emerging industry trends that are, perhaps, being overlooked in current discourse?

Michael Larsen:

Again, I think you're going to be very disappointed in my-

Andrew Kaplowitz:

Not going to talk about so many megatrends.

Michael Larsen:

Maybe I don't get invited back next year, but I will tell you this-

Andrew Kaplowitz:

Not talking about megatrends-

Michael Larsen:

Mike, my crystal ball is not better than yours or anybody else's. I think, what I will tell you, and maybe we will end on this, I think I do know for sure that this will continue to be a very challenging and a very uncertain and dynamic environment. And in times like this, I think you want to be positioned with companies that have advantaged business models, that have highly resilient, high quality business portfolios that have margin profiles in the mid-twenties return on capital 30% plus that have the resilience and the ability to take the long-term view and really position the company for long-term performance versus having to react aggressively to a recession or whatever else might come at us. So, I guess what I'm saying is, for what it's worth, in times like this, I think ITW is not a bad place to hang out.

Andrew Kaplowitz:

I think it's a good way to end. Appreciate the time, Michael. Thank you very much.

Michael Larsen:

Thank you.