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PRESENTATION

Operator

Thank you for standing by, and welcome to the H.B. Fuller Q4 2023 Earnings Conference Call.

I would now like to welcome Steven Brazones, Vice President of Investor Relations to begin the call. Steven, over to you.

Steven E. Brazones - H.B. Fuller Company - VP of IR

Thank you, operator. Welcome to H.B. Fuller's Fourth Quarter 2023 Investor Conference Call. Presenting today are Celeste Mastin, President and Chief Executive Officer; and John Corkrean, Executive Vice President, and Chief Financial Officer. After our prepared remarks, we will have a question-and-answer session.

Before we begin, let me remind everyone that our comments today will include references to certain non-GAAP financial measures. These measures are supplemental to the results determined in accordance with GAAP.

We believe that these measures are useful to investors in understanding our operating performance and comparing our performance with other companies. Reconciliation of non-GAAP measures to the nearest GAAP measure are included in our earnings release. Unless otherwise noted, comments about revenue refer to organic revenue and comments about EPS, EBITDA and profit margins refer to adjusted non-GAAP measures.

We will also be making forward-looking statements during this call. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially from these expectations due to factors covered in our earnings release, comments made during this call and the risk factors detailed in our filings with the Securities and Exchange Commission, all of which are available on our website at investors.hbfuller.com.

I will now turn the call over to Celeste.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Thank you, Steven, and welcome, everyone. In the fourth quarter and throughout fiscal 2023, our team members executed exceptionally well to achieve strong profit growth despite a low-volume environment, record margins, and outstanding cash flow.

I'm very proud of the team's response to the significant volume weakness precipitated by unprecedented customer de-stocking activity over the course of the year. We proactively managed rapidly changing price and raw material dynamics and supplemented those with meaningful restructuring initiatives to deliver these strong results.

Overall, organic revenue improved substantially in the fourth quarter, with consolidated organic revenue declining only slightly year-on-year versus the high single-digit declines we experienced in preceding quarters due to volume weakness.

Pricing was marginally lower year-on-year as expected, following lower raw material costs and also reflecting the impact of product reformulations, and was primarily driven by raw material index-based supply agreements.

As a highly specialized value-added adhesive sealants and functional coatings expert with inherent price-to-value power, evidenced by the fact that over half of our SKUs are specifically formulated for individual customers. We are strategically well-positioned to maintain pricing discipline.

Overall, volume development improved significantly and was flat year-over-year in the fourth quarter. This is a marked improvement over the previous 4 quarters, when volume declined approximately 10% on average.

From a profitability perspective, we continued to execute well and achieved both record fourth quarter and fiscal year adjusted EBITDA margins. This is a testament to the strong leadership in each of our market segments and the power of collaboration exemplified by all our team members. Through systematic execution across all functions, our team appropriately balanced pricing and raw material movements, proactively took restructuring actions to lower our cost profile, and acquired highly synergistic businesses to deliver these record margins.

In the fourth quarter, we achieved a 22% increase in adjusted EBITDA year-on-year, up 32% on a comparable 13-week basis, increasing adjusted EBITDA margin 440 basis points year-on-year to 19.1%. And for the fiscal year, we achieved a double-digit increase in adjusted EBITDA, increasing adjusted EBITDA margin 240 basis points year-on-year to 16.5%.

This demonstrates how successfully executing our strategy to transform our portfolio and purposefully targeting capital allocation to the highest growth, highest margin opportunities can increase the value we provide our customers and generate higher returns for shareholders. And the great news is, we are not done. The growth and margin expansion opportunities that we have in front of us are readily actionable, and we are well underway in our plans to realize these improvements.

Now, let me move on to review the performance in each of our segments in the fourth quarter. In HHC, organic revenue was down 7.5% year-on-year, driven primarily by margin-preserving index-based pricing adjustments with large-volume customers and some lingering yet lessening fourth quarter customer de-stocking activity.

HHC has the highest concentration of index-based supply agreements, given the nature of its customer base. These agreements are designed to maintain margins throughout the cycle and follow raw material cost movements over time. Adjusted EBITDA for HHC increased 42% year-on-year to \$82 million, and adjusted EBITDA margin increased 690 basis points to 19.9%, reflecting exceptional execution.

The team overcame continued customer de-stocking headwinds, leveraging favorable price and material cost management, synergistic acquisitions, and restructuring benefits to achieve record margin performance.

In Engineering Adhesives, organic revenue declined 1.4% in the fourth quarter, which represents continued improvement on a sequential basis. Organic revenue declined primarily due to lower volume in solar and construction-related end markets, which offset strong organic growth in the electronics and aerospace market segments.

Adjusted EBITDA in EA increased 5% year-on-year, up 13% on a comparable 13-week basis, and adjusted EBITDA margin increased 240 basis points year-on-year to 20.2%. The improvement in profitability for EA was driven by favorable price and raw material cost actions and continued strong cost management.

In Construction Adhesives, the organic revenue trend reversed, increasing 5% year-on-year in the fourth quarter. Customer de-stocking actions began in the fourth quarter of last year and continued through the third quarter of this year. As a result, the organic growth achieved in the fourth quarter now more appropriately reflects current underlying demand for CA and our strong share position, but it is still lower than historical levels.

Adjusted EBITDA for CA increased 9% year-on-year, up nearly 18% on a comparable 13-week basis, and adjusted EBITDA margin increased 12.6%. The margin improvement in CA during the fourth quarter was a positive development and followed a consistent seasonal pattern sequentially versus the third quarter. While restructuring actions in the roofing and infrastructure business units are already positively impacting the P&L, restructuring actions underway in the flooring business will contribute to profitability improvement in that market segment in 2024.

Geographically, America's organic revenue improved significantly on a sequential basis, reducing the year-on-year decline from 13% in the third quarter to a decline of 6% in the fourth quarter. Volumes were flat year-on-year in North America and improved substantially versus the third quarter. However, volumes remained weak in Latin America.

In EIMEA, organic revenue was flat year-on-year, as modest organic growth in EA, driven by strength in automotive and electronics, was offset by modest declines in both HHC and CA.

In Asia-Pacific, organic revenue decreased 2% year-on-year, influenced by the relatively volatile recovery in China. While organic sales for HHC and Asia were flat year-on-year in the fourth quarter, organic sales declined slightly for EA, given its greater exposure to China. The fits and starts we are seeing in the Chinese market are not unexpected, and we continue to believe that the overall trend there is positive and improving.

From an overall global economic standpoint, conditions remain subdued. While real GDP measures have been slightly positive, sentiment, particularly within the manufacturing sector, remains weak and cautious. As a result, we continue to plan for a mild manufacturing recession in fiscal 2024, and our expectations for the year ahead reflect this scenario.

We expect interest rates to remain high for the first half of the year and decline modestly in the second half, restricting industrial production and construction activity to lower than normal levels for most of the year.

From a year-over-year comparison standpoint, constrained manufacturing activity will be more than offset by the absence of the de-stocking impact that weighed so heavily on 2023 volume.

We will also benefit from the restructuring and cost-saving actions that we initiated and the acquisitions that we closed in 2023, all of which will be additive to profit growth in 2024.

Now, let me turn the call over to John Corkrean to review our fourth quarter results in more detail and our outlook for 2024.

John J. Corkrean - H.B. Fuller Company - Executive VP & CFO

Thank you, Celeste. I'll begin with some additional financial details on the fourth quarter. For the quarter, revenue was down 5.8% versus the same period last year. On a comparable 13-week basis, revenue was up 1.2%.

Currency and acquisitions collectively had a positive impact of 4.7%. Adjusting for those items, organic revenue was down 3.5%, primarily driven by pricing. Volume was flat, reflecting slower but improving in-market demand in HHC, offset by solid growth in Construction Adhesives.

Adjusted gross profit margin was 31.3%, up 510 basis points versus last year, as pricing and raw material cost actions, restructuring benefits, and general cost reductions drove the margin increase year-on-year.

Adjusted selling, general, and administrative expense was effectively flat year-on-year, reflecting continued cost management and restructuring savings, as well as the impact of last year's extra week, offset by wage inflation, and the impact of acquisitions.

Adjusted EBITDA for the quarter of \$173 million was up 22% versus last year, up over 30% year-on-year, adjusting for the extra week, reflecting pricing and raw material cost actions, the favorable impact of acquisitions, and restructuring savings and other cost reduction actions.

Adjusted earnings per share of \$1.32 was up 27% versus the fourth quarter of 2022, driven by operating income growth, which more than offset higher year-on-year interest expense, depreciation and amortization expense, and a higher tax rate.

Cash flow was very strong for both the quarter and the full year. Full-year cash flow from operations of \$378 million was up \$122 million year-on-year, reflecting higher operating profit and improved working capital, driving our end-of-the-year net debt-to-EBITDA ratio down to 2.9x.

With that, let me now turn to our guidance for the 2024 fiscal year. Based on the market assumptions outlined by Celeste earlier, we anticipate full-year net revenue to be up 2% to 6% versus 2023, and organic revenue is expected to be flat to up 3%, with volume up low to mid-single digits and pricing to be down low single digits.

We expect foreign currency translation to negatively impact revenue by about 1% versus fiscal 2023. We expect adjusted EBITDA to be between \$610 million and \$640 million, representing a 5% to 10% year-on-year increase, as volume growth, restructuring savings, and the impact of acquisitions more than offset wage and other inflation and bonus and variable compensation rebuild. We expect our 2024 core tax rate to be between 27% and 28%, compared to our 2023 core tax rate of about 27%.

We expect full-year interest expense to be \$115 million to \$125 million, reflecting continued strong cash flow and moderating interest rates. We expect depreciation and amortization to be roughly \$170 million, and the average diluted share count to be about 57 million shares. These assumptions result in full-year adjusted earnings per share in the range of \$4.15 to \$4.45, representing year-on-year growth of 7% to 15% versus fiscal 2023.

Finally, we expect full-year operating cash flow to be between \$300 million and \$350 million, before approximately \$140 million of capital expenditures. Based on the seasonality of our business and the timing of working capital needs, we expect operating cash flow to be weighted to the second half of the year.

Taking into account last year's de-stocking activity, as well as the typical seasonality of the business, we expect first quarter revenue to be up low single digits and for adjusted EBITDA to be between \$115 million and \$125 million.

Now, let me turn the call back over to Celeste.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Thank you, John. As we enter fiscal year 2024, we are confident in our outlook for positive organic growth, achieving further EBITDA margin expansion, and delivering strong cash flow. As the largest pure-play adhesive company in the world and the market leader in innovation focused on providing highly tailored solutions for our customers, we have successfully transformed our portfolio over the past 15 years into 1 that is concentrated within the highly specified portions of our market segments.

We are executing well in that portfolio, as evidenced by our strong EBITDA margin expansion, and we are ready to institutionalize the discipline choices we are making. As such, we have begun to take portfolio management to the next level by being more proactive and explicit about how we're allocating capital and investing in the highest margin growth segments of the portfolio.

As I've spoken about repeatedly since becoming CEO a little more than a year ago, all of our investment decisions, both organic capital expenditures and M&A, are rooted in transforming H.B. Fuller into a higher growth, higher margin, and higher ROIC business.

Over the course of my tenure with H.B. Fuller, I've conducted annual market segment reviews with each of our 31 market segment leaders to identify the top 25 growth and profit improvement opportunities for the company. This process has become the basis for generating and evaluating all of our growth and investment opportunities, and it has evolved to the point where we have created a growth pipeline full of compelling opportunities that can unlock additional market expansion opportunity and augment our margin profile.

As a result of the success we've demonstrated in transforming our portfolio, a more robust pipeline of step change opportunities, and our track record of executing with speed, we are increasing our long-term adjusted EBITDA margin target for the enterprise from the high-teens to greater than 20% within the next 3 to 5-years.

To better enable our investors to follow our progress, we've divided our market segments into 2 categories, growth and leverage. This replaces our previous categories of high, medium, and low specification because we've successfully migrated to a strongly specified portfolio in each of the markets we serve. About half of our market segments are in the growth category, spanning all 3 GBUs, including but not limited to medical in HHC, electronics, new energy, and the newly created ePower in EA, and infrastructure and roofing in CA.

Growth segments share a few key common characteristics. First, they are large and fast-growing markets, which benefit from global megatrends and technological disruption, such as clean energy, sustainable packaging, and labor shortage, as well as rapidly evolving product designs and the need to innovate. As a result, there is ample room for H.B. Fuller to capture, share, and unlock additional growth by bringing differentiated technologies to market, capitalizing on underlying market trends, and supplementing with M&A.

Second, in these growth markets, we have broad and relevant technology, innovation speed, and the ability to create solutions for demanding applications reliably, rapidly, and accurately. From a financial perspective, growth segments are expected to realize out-sized revenue growth, deliver double-digit adjusted EBITDA growth, and generate greater than 25% adjusted EBITDA margins.

The leverage category consists of 16 market segments, where we are focused on maximizing operating efficiency and cash flow. Leverage segments share a few key common characteristics. First, they require a highly selective go-to-market approach, 1 in which we are rigorous and disciplined about where we choose to play in terms of regions, product applications, and customer selection, focusing on applications where we bring meaningful price-to-value performance for our customer.

Second, in leverage segments, H.B. Fuller is a disproportionate buyer of raw materials at scale, which helps create a margin uplift in these markets. Financially, leverage segments are expected to generate greater than 15% EBITDA margin through benefits of production efficiency, raw material scale, and selective pursuit of applications where we improve our customers' productivity.

It's important to mention that this new structure captures the intuitive decisions we've been making over the past year. With this next-level approach to portfolio management, we are sharpening our focus on ensuring investment activities are directed to our highest-value opportunities to profitably grow the business over the near and long-term.

As mentioned previously, we maintain an up-to-date list of the top 25 opportunities to grow our business and leverage our operating structure, either organically or through value-added M&A. While our primary focus for M&A has been and will continue to be in growth segments, this new structure does not preclude opportunistic investments in leverage segments.

In fact, we recently executed several deals in leverage segments where we're benefiting from superior buying power and efficiencies in our existing plant network as a result of market consolidation.

Acquisitions in leverage segments generally have high synergies and strong return on investment given our speed to integrate, resulting in a very meaningful difference between pre- and post-synergy acquisition multiples.

I have complete confidence in our team, our strategy, and our ability to execute to make this happen. As we continue to focus our high-touch, highly customized portfolio on accelerating innovation and executing efficiently, we're confident in our ability to achieve our new EBITDA margin target. We look forward to keeping you updated on our progress using this new portfolio segmentation.

To wrap-up, I am extremely pleased with our strong performance in 2023 and very excited about the opportunities we have in 2024 to continue to drive value creation. We are successfully executing our strategy to deploy capital to the highest returning opportunities, innovating with speed to deliver solutions for our customers, driving efficiencies throughout our manufacturing footprint, and achieving meaningful synergies from our collections of acquisitions. We are performing very well and we're entering 2024 with confidence, optimism, and strong momentum.

That concludes our prepared remarks for today. Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ghansham Panjabi with Baird.

Ghansham Panjabi - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Celeste, Happy New Year to you. I guess, first of all, on the base assumptions for the first quarter that get you to EBITDA guidance, I think \$115 million to \$125 million, what are you anticipating in terms of volumes and price? Are you still being impacted by de-stocking across any of the operating segments? And then also for fiscal year '24, is the EBITDA guidance sort of weighted more so towards the second half versus historical seasonality?

Celeste Beeks Mastin - H.B. Fuller Company - President, CEO & Director

Yes. So let's start with volume. So for 2024, we're anticipating volume growth of, call it kind of mid-single digits. On the pricing side, we're experiencing the opposite. So as we go into 2024, there's a few things happening. When you look at it from a pricing perspective, we've got a number of index-based pricing arrangements with large customers that are rolling into 2024. We'll see the impact of that on the top line. Also, we are reformulating our products for many of our customers so that we can offer them a product at a lower cost to them and also a lower cost to us. So you'll see that on the pricing side.

On the volume side, we're projecting volume growth that's really more consistent with what consumer buying is expected to be. In fact, we've taken a look and analyzed our shipped volume over the past several years. And when you look at 2023, our shipped volume, our shipped tonnage was down 5% or 6% versus 2019. So we're anticipating a year that we would consider more normal in 2024.

John J. Corkrean - H.B. Fuller Company - Executive VP & CFO

Yes, Ghansham, I'll give you a little color on kind of Q1 versus the rest of the year guidance. So, if you look at the assumptions for revenue that kind of underlie this, Celeste laid them out for the full year. For the first quarter, we'd expect organic revenue to be flat to down low single digits, offset by positive impact of 4% to 5% from acquisitions.

As it relates to EBITDA guidance, if you look at the midpoint of our EBITDA guidance for Q1, that would represent about 9% growth year-on-year. And then that would -- based on the midpoint of our full year guidance that would represent about 6% growth year-on-year for Q2 through Q4. Of course, there is seasonality in the business, as you know. So the numbers in the second half of the year for EBITDA will be higher than the first half of the year. But I'd say as it relates to year-on-year performance, I don't think it's more weighted to the second half of the year.

Ghansham Panjabi - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Got you. Helpful. And then on the reformulation dynamic, can you just sort of expand on that? Is that sort of typical at this point in the raw material cycle? Which segments are you seeing that at current? And then also going back to your 20% EBITDA margin threshold over the next 3 to 5-years, why outline that now? I mean, the world is complex. There's a lot going on and so on and so forth, with inflation and growth, et cetera. What should we take away in terms of your confidence and outlining that as part of yesterday's release?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes, so let's start with your question about the reformulation dynamic. So, yes, that is typical at this point in the cycle. And maybe if I just kind of speak to our product portfolio and our pricing -- the realities of our pricing strategy, it'll help explain this.

So when you look at, and I mentioned it in the script, over half of our customers or over half of our SKU base is unique to a customer. So if you look at our SKU count, over half of those SKUs are sold to a single customer. So we're working closely with these customers day-in and day-out. And we understand their needs, as you point out, in this part of the cycle, cost matters to our customers. And our ability to reformulate our products not only impacts their cost, but more importantly, our ability to reformulate our products enables them to often use lower cost substrates. So that reformulation work is ever occurring.

And as a consequence, there's not only innovation that we're bringing to this customer base, but as you look at it, it's an amazing dynamic because the amount of adhesive that is used in our end products is just so small relative to the total that whatever we can do to reduce the overall system cost for the customer matters a lot more than the cost of our adhesive.

So in fact, if you look at our customer base, 97% of our customers spend less than \$500,000 on adhesive. So, on any given adhesive, they're spending about \$25,000 per SKU or less. One of the things that is woven into this business model is that we have a lot of pricing resilience as a consequence. Second question, sorry.

Ghansham Panjabi - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Yes, yes.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

I'll stop there just to make sure if you had any follow-on questions to the pricing piece before I talk about the margin.

Ghansham Panjabi - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

No, that's perfect.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes, great, you really see that in our growth margins recently. Moving on to your second question about EBITDA margin, why now? I mean, why not now, Ghansham? I'm very confident about where we can take this portfolio. We've really dissected this and thought about it long and hard and when you look at these 2 segments, what we've done is really create a structure that directs our investment. We've identified these high EBITDA margin, high growth spaces. You saw the bubble chart representing our top 20, 25. That chart was boiled down from 220 opportunities that were brought to us by our team. There's a lot of ways and a lot of places to grow in this \$70 billion Adhesive industry, and we feel confident that with our organization structure, really highlighting these 31 different market segments that we're able to pinpoint those opportunities where we can really grow the business.

So the growth segment is full. It's a compelling list of opportunities within that pipeline. Then you look at the leverage segment and I feel like our teams are really winning in these leverage markets and they're really focused on driving those things that matter to our customers and that create margin uplift in our business. And again, you saw that in our results over the last year as well as in the last quarter and HHC was a really good example of that last quarter. There are more leveraged segments in HHC than growth segments. The most leveraged segments in the company are in HHC, and you see how they managed successfully to drive, really drive those businesses forward.

Operator

Our next question comes from the line of Patrick Cunningham with Citi.

Patrick David Cunningham - *Citigroup Inc., Research Division - Research Analyst*

Maybe just on the portfolio construct and how you've laid it out here, how should we think about the balance of, inorganic investment in the growth category versus the leverage category? You know, I would think that there, based on some of the recent deals you've done, there's maybe more of an outsized opportunity to go after these low-risk consolidation plays with significant synergies versus the growth markets, which maybe have more execution risk and less tangible commercial synergies. So, how are you thinking about the pipeline from an inorganic perspective relative to the construct you've laid out?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes. So, I'll start with the leverage category. You nailed it there. There's a lot of opportunities for industry consolidation in that leverage space. Our M&A strategy in the leverage segment tends to be more opportunistic, and we do underwrite those deals very heavily on cost saving synergies. And you can see the success we've had in those Beardow Adams is a good example of a consolidation acquisition in a leverage segment that's performing well for us, in fact, performing well ahead of the deal model by about 40%.

So, then you migrate to the growth category, and I wouldn't say so much that, there's execution risk in these inorganic opportunities in the growth category. In fact, a lot of the opportunities that we're focused on are very selective. This tends to be a place where we have the opportunity to buy smaller companies that have been very focused on a certain technology or a certain region, and typically, as we look at those technologies, they tend to fit well within our broader portfolio of technologies and fit really well with our market experience.

So, the growth opportunities--M&A is a really good tool in the growth category, because so many of those products are qualified or require really a long time to build from an organic perspective. By buying into those markets, you get an automatic qualified product to run with. And I'll use Adhezion as a good example for an acquisition that we did in a growth category.

We were basic in cyanoacrylates. We really have great cyanoacrylate technology, but we needed an octal-based cyanoacrylate technology. So, we acquired Adhezion, and the integration there has been very well run. And in fact, we have already, in that market, we've already leveraged our SecurePortIV product that came through Adhezion into 514 countries -- oh, sorry, hospitals in the United States. And on top of that, we've already also signed a GPO contract for our tissue bonding adhesive that came through Adhezion that is a contract that represents 40% of the hospitals in the U.S.

So, I don't see so much execution risk there. I just really see the opportunity for us to get into these niche-y, selective, high-margin spaces that we can then grow better than the companies that owned them previously.

Patrick David Cunningham - Citigroup Inc., Research Division - Research Analyst

I appreciate that. That's very helpful. And then I just wanted to dig in a little bit on price. Maybe can you help quantify the portion of the portfolio that's on index mechanism to quantify how much is subject to some of these reformulation pressures that you're seeing? And then how should we think about more normalized structural pricing when we get back to flatter raw material and healthier demand environment?

Celeste Beeks Mastin - H.B. Fuller Company - President, CEO & Director

Yes. So, let me start by saying that, if you look at our pricing performance in 2023, that less than 25% of our customers received a price decrease. And included in that number would be customers on indexes as well as those that are not. So, I'd say when you look at price decrease impact, about half of that comes from index customers. And what we do see is that for our non-index-based customers that get price decreases, that decrease is less than what you see with the index-based customers.

So, that's kind of, a snapshot of 2023 to use to think about pricing in what was an incredibly challenging market. Our volume was down 8%. And that's sort of how I describe pricing resilience. When you think about more normalized conditions, the impact of indexes, it's just a margin preservation tool, right? So, you'll see those indexes move with our raw material market. There'll be a lag.

And then, as far as a normalized pricing environment, I mean, typically what is occurring throughout the year, low volume year or not, is we're constantly innovating with our customers. Sometimes we're innovating to bring them fancy new technology that enables them to introduce a new design. And, that product is priced to that value. Sometimes we're reformulating to help them address, cost needs or maybe just reformulating or tweaking to accommodate a change that happened because they shifted their line speeds or they wanted to use a new substrate. So, there's a lot of new pricing that happens in any given year because of that innovation, as well as just, ongoing status quo pricing resilience.

Operator

Our next question comes from the line of Mike Harrison with Seaport Research Partners.

Michael Joseph Harrison - Seaport Research Partners - MD & Senior Chemicals Analyst

Happy New Year to you. I was hoping that maybe we could dig in a little bit on the HHC segment. I'm really trying to get a sense of what the margin cadence there could look like versus this 20%, very strong 20%-ish level you achieved in Q4. Can you maybe give us a sense of whether there were some one-time positives in there in terms of reduced incentive comp, lower discretionary spend, or maybe some of this price cost that was positive in Q4 but is starting to roll over into next year? And then I guess as we see maybe some better volume performance in that segment going forward, what kind of incremental margin contribution could we expect from that HHC segment?

John J. Corkrean - H.B. Fuller Company - Executive VP & CFO

So, Mike, I'll try to provide a little color on that. I would say there were no real unusual one-time favorable items in the fourth quarter. Variable comp was lower across the company, so that benefited HHC.

Looking forward, they delivered these margins in a year where volume was a real challenge. So I think we're really confident that they can maintain margins in this zip code, maybe not 19% every quarter, but I think we've shifted our focus from maybe 3 or 4 years ago when we viewed HHC as sort of a mid-teens type of EBITDA margin to upper teens. And I think that we should be able to maintain that, particularly when volume starts to return.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes, and I mean -- the HHC team is just doing an excellent job executing. They have continued to win business throughout -- over 2023, and the wins just keep piling up coming into 2024. They've done really a nice job in their growth segments, bringing innovation like in the beverage labeling space. They've introduced a beverage labeling adhesive that allows labels to come off bottles more quickly in the washing process, more quickly and at lower temperature.

So they've got some growth segments that are really bringing solid innovation to customers. And then they also have just really managed how they run their leverage segments. A good example is tape and label. I mean, we never used to sit here and talk about tape. So tape and label, we have a new market segment leader there, and he's just very successfully choosing what parts of tape and label we really want to play in. And that's part of us succeeding in these leverage segments, picking where we truly add value and we can generate better margins and better profitability for our products, as well as continuing to leverage effectively our plant network and our raw material network. So, they did a nice job demonstrating the power of leverage, and you're going to continue to see that with that HHC team.

Michael Joseph Harrison - *Seaport Research Partners - MD & Senior Chemicals Analyst*

All right. And then maybe a broader question just on what you guys are seeing in terms of de-stocking activity. I'm well aware that you guys have a December month that is going to be contributing probably to some weakness at least starting your fiscal first quarter. But just curious what you're seeing across some of your key markets, areas like packaging and maybe some other consumer-related areas where you had been seeing de-stocking, as well as what you're seeing in construction. Are you encouraged that as we start the calendar year that we're getting order patterns more back to normal, or is that going to take a few more months still?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes. So let me talk a little bit about kind of how we're seeing all 3 of these businesses pulling out of this -- I'm going to call it past de-stocking phenomena. So in Q4, what was really interesting to me as I looked at the development in Q4 month-over-month and providing a lot of transparency here, the CA businesses each and every month of Q4 were positive volume.

Our EA business was positive in 2 of those 3 months in progression. And our HHC business was positive in the last month of our fourth quarter. And so we kind of just watched that de-stocking roll back. I'm confident it's complete in CA. We never really saw a big impact of it in our EA business. It's really not the nature of most of that business. But we certainly did -- saw dramatically in HHC and I feel comfortable coming to a conclusion there. Does that answer your question, Mike?

Michael Joseph Harrison - *Seaport Research Partners - MD & Senior Chemicals Analyst*

Yes. I appreciate the additional color there.

Operator

Our next question comes from the line of Jeff Zekauskas with JPMorgan.

Jeffrey John Zekauskas - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Just I guess first a question about the guide. The adjusted EPS is \$4.15 to \$4.45. What's the guide for GAAP EPS?

And secondly the interest expense for next year is \$115 million to \$125 million. In the fourth quarter you were at \$33 million, which would push you higher than that. Why should -- now I get maybe you're doing net interest, but even net interest for this year is in the \$130s million. So why should interest expense come down to \$115 million to \$125 million?

And then you talked about this indexed pricing. So, is the meaning of that that your raw materials continue to decline and then what you do is you give some of that back or in a sense did you over earn a little bit in 2023 and now you have to give a little bit of that back? So, maybe we can try those to begin with.

John J. Corkrean - *H.B. Fuller Company - Executive VP & CFO*

Sure, Jeff. I'll try to handle the first one and I'll let Celeste comment on the pricing question. So adjusted EPS, yes. So we don't really guide on GAAP EPS, but I would say if you're looking at what kind of non-GAAP items or items that are adjusted, I think we've expected to be in the \$35 million to \$45 million range next year pre-tax. So I didn't do the calculation on what that means from an EPS standpoint.

So lower than this year, but we do still have some of the integration related costs and some of the restructuring that will happen in 2024. So on interest expense, we are projecting it to be lower. 2 dynamics there, 1 is the strong cash flow that we had in the year, particularly in the second half has reduced our debt balances going into --2024. We are projecting interest rates to decline in 2024, not in the first half, but we've baked in a 25 basis point decline in borrowing rates in Q3 and 25 basis points in Q4. So that's what drives the difference, right? This doesn't reflect any potential acquisitions in 2024. We don't reflect those in our guidance, but assuming that we continue to show strong cash flow and continue to pay down debt, it kind of results in this type of interest expense profile. Celeste, do you want to talk about index pricing?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Absolutely. So yes, as I mentioned, when you look at our outlook for 2024, we anticipated a mid-single digit price in 2024, and that was directly related to what we anticipate will happen with our index pricing as well as some product reformulations for sure. So you saw that, you see that in our guidance. Those are largely a margin preservation tool, but they do, Jeff, have a little bit of a lag effect. And so they're not really lumpy, but what you're seeing is the impact of those raws coming down in prior years starting to get reflected in price in the upcoming year.

As far as what's happening in raw materials, we actually right now, as you know, we monitor 4,000 different raw materials, so I'm talking about a raw material count here. About -- almost half of those materials are still in the declining phase, and I'm declining -- I'm talking about Q4 versus Q3 here. So we'll continue to have raw material benefit carryover into 2024 because it does take a while for these raw materials to make their way through production onto our P&L. Still a deflationary raw material environment.

Jeffrey John Zekauskas - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Sure. Then for my second question, if you look at your 3 major segments, this year HHC had a very strong year, Engineering Adhesives was pretty good, and Construction was pretty tough. In 2024, which segment do you think will do the best, which the worst, what's the one in between? And when you look at your acquisition environment, you spent a couple of hundred million this year on acquisitions. What do you think you're going to spend next year? What's the outlook for opportunities as best as you can tell?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes. So, when I look at these 3 segments, HHC, EA, and CA, I think both EA and CA will do well in 2024. I'd call it kind of mid-single digit organic growth in both of them, CA being a little higher than EA. HHC, we'll probably still see them down low single digits as we kind of work through a lot of this indexed pricing and as they solidly get their feet underneath them coming out of the de-stocking phase. Relative to M&A, I think you'll see a very similar M&A performance and focus from us and spending in 2024 as you did in 2023.

Operator

Our next question comes from the line of David Begleiter with Deutsche Bank.

David L. Begleiter - *Deutsche Bank AG, Research Division - MD and Senior Research Analyst*

Celeste, can you talk to the Q1 guidance sequentially implies a pretty dramatic severe decline in incremental margins. Why is that?

John J. Corkrean - *H.B. Fuller Company - Executive VP & CFO*

So, David, maybe I'll take that and Celeste can add to it. It's really the reflection of the seasonality of the business. So, when you look at Q1, it's the beginning of December through the end of February. So, you've got the Christmas and New Year's holidays. You have Chinese New Year. So it's always our lowest revenue quarter and correspondingly lowest margin quarter. So it's really nothing changing in the dynamics of the P&L. It's really just the lower volume quarter for us.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

This year, Chinese New Year is about 3 weeks closer to the end of our quarter. And so -- China's recovery has been very inconsistent. It's bouncing around a lot and we're anticipating we might see some impact from that.

David L. Begleiter - *Deutsche Bank AG, Research Division - MD and Senior Research Analyst*

Understood. To be clear, just on raw materials, what do you expect them to be down on a percentage basis in 2024 versus 2023?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

So, my reference to raw material cost reduction in 2024 is largely related to carryover. So that's one impact. When I was speaking to our 4,000 different raw materials that we track, I was speaking about Q4 versus Q3. That's where we saw the biggest bulk of our raw materials, not quite half, was still declining. Now, interestingly enough, right, a third of them are increasing as well. So it's really a mixed bag as it relates to raw materials. Hopefully that clarifies my comments.

John J. Corkrean - *H.B. Fuller Company - Executive VP & CFO*

And David, I can give you just a little more color. If you look at what is reflected in our guidance and what we're seeing is that the impact of raw materials through the P&L year-on-year the impact of pricing ought to be relatively neutral, right. So, and as Celeste said, the raw material impact is predominantly carryovers, and it won't be as big of a benefit this year. We talked about this year, the combination of raws and pricing. At the beginning of the year, we expected them to contribute \$130 million to \$150 million of benefit which ended up being more than that. But next year, as I said, the raws and pricing should more or less offset. As we said, pricing will be down low single digits. So you can do the math on what that would look like from a P&L standpoint.

Operator

Our next question comes from the line of Vincent Anderson with Stifel.

Vincent Alwardt Anderson - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

I was hoping maybe you could just highlight a few areas where you have a very high degree of confidence in your organic volume outlook. Just given your otherwise conservative macro view and maybe just separating between products that have been growing consistently over the years and just were overshadowed in 2023 versus products where your customer feedback is what gives you a high degree of confidence?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Got it, Vincent, sure. Let me just talk a little bit about some of the wins that we've had because I think that helps convey where my confidence is coming from and you can really get a feel for how the portfolio is growing. So, our electronic space has really ramped up and our team is winning repeatedly there. For example, those new foldable phones, as it happens, those are really hard to bond to because you're bonding a pretty flexible screen and a really small bond line at a hinge. So we have successfully secured new applications in that foldable phone space. That's a growing category, so -- and that's a really demanding application. So, that's a good example in automotive.

The automotive business has been really interesting this year. So, throughout 2023, we saw, as did many others, double digit growth in automotive on a global level. Actually, when I look at Q4, what I found particularly notable was that growth continued in automotive in Europe at that double digit rate.

And part of that is because we've brought some new products to market there. By the way, during Q4 in the U.S. we finally saw a cooling, but I really think that that is just related to the strike and an anomaly. But -- back to the wins in automotive, when you think about how the technology is developing in a car -- we call the development conversion because we're seeing a lot of these big glass dashboards in automotive that have been recently introduced. We're winning. We just won a big application actually with an OEM on that big glass dash, and we won that because of conversion.

We understood what it took to bond a touch screen, touch panel, because of our work in phones and electronics. And we're able to get there faster for our customer than anyone else. So, really good growth in that EA space plus this addition of the e-power category which we're pretty bullish about. When we talk about e-power, we're talking about sealing and bonding and thermal management applications for power storage and batteries. We now have 17 customers signed up and buying our EV Protect product, our unique product there which facilitates thermal management.

So, those are some examples in EA. When you look at the CA business, we expect roofing to bounce back in 2024. Also, I'm seeing some great wins in our infrastructure market segment. Let me tell you about this, because I think this really helps makes our acquisition strategy come to life as it relates to infrastructure. We bought a company called GSSI about a year ago that makes butyl-based tape for metal bonding. So, think about metal buildings for example. And we also bought a company called XCHEM in the Middle East that had some experience in infrastructure.

So we've started to localize our very popular Fosters brand product at XCHEM now to support these big Middle East infrastructure projects. At the same time, we've taken this butyl-based tape from GSSI and re-branded it Fosters and introduced it as a system in the Middle East. And we actually just recently won a Phase 1 application in Qatar in one of the big LNG projects.

So, I'm bullish about infrastructure. I'm excited that roofing is bouncing back. That's the CA business. And then there's HHC, these guys and gals are delivering like crazy. In our hygiene segment, we've introduced a pad fastening adhesive that bonds to some of these hard-to-bond substrates. So that's gone well. That's a big category for us.

Also in packaging, I'm getting a contract across my desk every week for some big CPG customer packaging contract. So we've done well there. Part of that is our focus on sustainability, which has really evolved in the packaging space. And it's kind of created a renaissance opportunity for us in HHC. And then, of course, I spoke to our now most recent success with Adhezion in the tissue bonding and sealing applications. Really excited that, we're getting that product for topical skin bonding as well as the secure port IV product now into hospitals around the country. So we've got a lot of momentum, Vincent. And, every day I'm seeing wins and feeling bullish about what these GBU's can do.

Vincent Alwardt Anderson - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Well, all right. That's excellent. And my follow-up was on Fosters anyways, so.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Good.

Vincent Alwardt Anderson - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

I'll just leave it there.

Operator

Our final question comes from the line of Rosemarie Morbelli with Gabelli Funds.

Rosemarie Morbelli

And I will add the Happy New Year wish for everyone. A lot of my questions have been answered, but I was wondering if you could give us a feel for the size of your growth categories in each of the AC -- I mean, CA, HHC, and so on. And then if you look at your growth margin -- at your margin target, EBITDA margin target with growth targeting 25% and leverage 15%. Can you give us a feel as to where they are now? Is that something you can share?

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Let me provide a little more information here. So, when you look at our growth and leverage categories, Rosemarie, what you see is that, about 50% of our sales and about 50% of our EBITDA, plus or minus 5%, resides in each category. And I didn't mean it to turn out that way. It just turned out that way. So, it's a pretty balanced portfolio. And when you look at what's in the space today, we say that our growth target is 25% EBITDA margins. We're definitely at the high-teens there already and starting to push forward. And that'll be the category where we really, direct more of our investment.

So I'm confident we can increase that toward that 25% target fairly quickly. In our leverage category, they're pretty close already to that 15% collectively and can easily exceed that. So that's about where we are today.

Rosemarie Morbelli

That is helpful. And I was wondering, as part of that margin progression, are there any product lines that you think that no longer belong in the portfolio and will help boost the margin and help you get to that 20% plus overall over the next 3 to 5 years, as you pointed out? In just the general dollar amount, I understand you cannot give any specifics.

Celeste Beeks Mastin - *H.B. Fuller Company - President, CEO & Director*

Yes. So as we look at those -- at all of the -- we've been digging deep into these various market segments since I arrived. And as I referenced, I've already been through a couple of these extensive market segment reviews. And as we do that, what I'm really focused on is what's the industry structure in each of these spaces and why do we deserve to win? And how are we as a company executing against the needs in that space? And so, we're still very much evaluating every one of these market segments in great depth. Divestment is not a decision that we would make lightly. And this new portfolio management structure is just 1 more lens now that we're using to evaluate it with.

Rosemarie Morbelli

I appreciate it, and congratulations on the great quarter.

Operator

I would now like to turn the call over to Celeste Mastin for closing remarks.

Celeste Beeks Mastin - H.B. Fuller Company - President, CEO & Director

Thanks everyone for joining us this quarter. We look forward to hearing from you again at the end of Q1. Have a great day.

Operator

This concludes today's call. You may now disconnect.

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