3M

Q1 2013 Earnings Call Transcript
Inge Thulin & David W. Meline
April 25, 2013

Slide 1, Opening
Matt Ginter, Vice President, Investor Relations

Thank you and good morning everybody for 3M. I'm here with Inge Thulin today, 3M's president and chief executive officer, and David Meline, 3M's chief financial officer. Thanks for joining our first quarter business review.

Note that today's earnings release and slide presentation accompanying this call are posted on our investor relations website at 3M.com under the heading 'quarterly earnings.'

Also note that our next two earnings conference calls are set for July 25th and October 24th. In addition, we will host an investor meeting on the afternoon of Tuesday, December 17th at the Grand Hyatt hotel in midtown Manhattan. For now, block off 1 to 5 p.m. on that day if you would.

Slide 2, Forward Looking Statements
Matt Ginter

Please turn to slide number two. During today's conference call, we will make certain predictive statements that reflect our current views about 3M's future performance and financial results. These statements are based on certain assumptions and expectations of future events that are subject to risks and uncertainties. Item 1A of our most recent form 10K lists some of the most important risk factors that could cause actual results to differ from our predictions.

Now I'll turn the call over to Inge. Please turn to slide number three.

Slides 3 & 4, 3M Logo and Updating 2013 Planning Estimates
Inge Thulin, President and CEO

Thank you, Matt, and good morning everyone. I appreciate you joining us this morning.

Overall, this was a good quarter for 3M. We delivered solid results in the face of a stronger U.S. dollar and lower factory utilization in a few businesses. Double-digit organic growth in China, Latin America and Middle East/Africa helped us overcome weakness in Western Europe and Japan.

I am pleased that we posted sales growth of around 2 percent against a backdrop of 0.8 percent worldwide IPI. Four of our five business groups drove positive organic sales growth in the quarter.

Health Care posted a four percent gain in organic local-currency, as did Consumer, coming off a very strong Q4.

This is the first quarter of reporting based on our new structure, and as a result, we have clearer visibility on all of our business groups. Let me make a comment on the importance of this change to the Electronics & Energy business group. Here, the new structure not only gives us better visibility but also sets the stage for better asset utilization in the future. We are seeing early progress today and I know that we will see even more as this team takes shape. On the customer front, Electronics and Energy creates for us a launching pad from which we can quickly introduce a broader range of technologies into the market, and fully capitalize on the outstanding customer relationships 3M has earned in this space. In other words, it creates opportunity.

So, Q1 gives us many things to be happy about. That said I want to be clear that we view this quarter in a much longer context and a much larger context. We will continue to manage 3M for the long term and for the sustained success of the company. That approach is clear when you look at our ongoing investments to improve the business. For example, as we told you last November, we are increasing our investments in R&D and intend to be closer to 6 percent of sales at the end of the 5-year planning period.

We continue with capital investments to improve productivity and grow the business. We remain on track for CapEx investment of $1.6-1.8 billion this year. We are building new strength in emerging markets, and in a number of “Push Forward” businesses like Health Care, we are adding resources and on-the-ground expertise. In summary, we are moving forward on all fronts.

We will be pushing hard to take advantage any recovery in the second half. Note that we have not adjusted our expectation on the organic local-currency growth, which remains at 2 to 5 percent. We remain focused on driving growth everywhere.

Slide 5, Q1 2013 Highlights
Inge Thulin

Now, let me take you through a quick look at Q1 results. EPS was $1.61, up slightly year over year. Operating margins were 21.6% on GAAP basis, basically flat year-on-year, and up sequentially consistent with historical patterns. 4 of our 5 business groups came in above 21%. Excluding the effect of acquisitions, margins were 22 percent, very strong.

Sales were $7.6 billion, up 2% in dollar terms, and a record first quarter for us. Organic local-currency growth was up 2.1 percent with Health Care and Consumer up 4 percent, Industrial up 3 percent and Safety & Graphics up 2 percent.

Geographically, Latin America/Canada was up 7 percent, the United States and Asia Pacific were up two and Europe/Middle East/Africa down one percent with Western Europe the main area of challenge. Currency had a negative effect on sales of almost 2 percent in the quarter, and acquisitions added about the same amount.

Finally, in the quarter we returned $1.25 billion of cash to shareholders via dividends and share repurchases.

The first quarter validated our previous view about the beginning of this year. As you recall, we anticipated continued uncertainty and slow growth in the first half of the year, especially in the electronics space and that is exactly what we saw.

Today, as we look back at Q1 and forward to the rest of the year, we see reason to adjust our guidance in the interest of credibility and clarity.

Two primary factors are driving this decision. First, macroeconomics. The economy remains uncertain and external forecasts have declined a bit since the year's end; the developed economies of Western Europe and Japan in particular. On a market level consumer electronics continues to present challenges. While there are some indications of an upturn later in the year, our optimism is tempered by current reality. We expected a challenging start to the year, but in fact market conditions were tougher than we had expected. Second, the stronger U.S. dollar. We previously anticipated that 2013 currency effects would be neutral to sales and earnings. We now expect a 1.5 percent sales headwind and a 5 cent per share earnings impact for the year. The recognition of these realities leads us to an EPS outlook for the year of $6.60 to $6.85 per share.

In the quarter, we announced 3M's 55th annual dividend increase, an increase of 8 percent. In addition, we announced a new, share repurchase authorization of $7.5 billion.

I will now turn the call over to David for more color on the quarter. David.

Slide 6, Q1 2013 Sales Recap
David W. Meline, Senior Vice President and CFO

Thank you, Inge. Let's begin with slide six, where I will break down the first-quarter change in sales.

Organic local-currency growth was 2.1 percent against a challenging economic backdrop as Inge mentioned. In fact, the most recent forecast from Global Insight calls for 0.8 percent worldwide IPI growth in Q1. Volumes contributed 1.7 percent to our growth and selling prices increased 0.4 percent.

Acquisitions added 1.7 points to sales growth in the quarter. Three deals contributed to this growth – Ceradyne in our Industrial business, FS Tech in Safety and Graphics, and Coderyte in Health Care.

Foreign exchange impacts reduced sales by 1.8 percentage points in the quarter, due in large part to a 14 percent devaluation of the Japanese yen versus the U.S. dollar.

In dollar terms, worldwide sales grew 2 percent versus the first quarter of 2012.

On a geographic basis, Latin America/Canada led the way again this quarter with organic local-currency growth of 7.3 percent, and all five of our businesses posted positive growth in that region. In particular, Health Care and Safety and Graphics grew double-digits.

In the United States, organic local-currency growth was 2.3 percent, led by a 5 percent increase in the Consumer business. We also generated positive growth in Industrial, Safety and Graphics and Health Care.

Asia Pacific grew nearly 2 percent organically in the first quarter. China/Hong Kong grew by 10 percent in Q1, and Japan declined 8 percent.

In EMEA, or the combined Europe, Middle East and Africa, first quarter sales declined 0.8 percent on an organic local-currency basis. Health Care generated low single-digit organic growth in EMEA, Industrial was flat and the other three businesses declined year-on-year. On a regional basis, we achieved solid organic growth in both Central/East Europe and Middle East/Africa, and Western Europe declined 3 percent.

Slide 7, Q1 2013 P&L Highlights
David W. Meline

Let's move to the income statement. Please turn to slide number seven.

First-quarter sales were $7.6 billion, up 2 percent in dollar terms. Our gross profit percentage was a strong 48 percent, equal to last year's comparable quarter. SG&A spending rose in line with sales and we increased R&D investments by 5 percent year-on-year to $430 million. Operating income increased nearly 1 percent to $1.6 billion.

GAAP operating margins were 21.6 percent, down 20 basis points year-on-year. Included in these results was a 40 basis point headwind from acquisitions, therefore underlying margins increased 20 basis points in Q1 to a solid 22 percent.

Profit leverage on organic volume growth added 20 basis points to first-quarter operating margin, and lower year-on-year pension and OPEB expense added another 60 basis points.

The combination of lower raw material costs and higher selling prices added 90 basis points to first-quarter margins.

Lower factory utilization reduced margins by one percentage point, largely related to excess inventories in pockets of our Electronics and Energy and Industrial businesses.

First-quarter earnings were $1.61 per share, up 1.3 percent versus the first quarter of 2012.

One more item which is not on this chart, relates to our corporate and unallocated segment. You will see a first quarter expense in corporate and unallocated of $74 million, which is a $64 million improvement year-on-year. Pension and OPEB expense declined, which accounts for one-half of the improvement.

Part of the remainder relates to our ERP project. Now that we are moving from the development stage and into deployment, more costs are being borne by the businesses rather than corporate. On average, this reduced operating margins in each of our businesses by approximately 30 basis points in Q1, with the benefit coming in corporate. We expect this 30 basis point margin impact to each of the businesses to continue throughout 2013.

For the full year 2013, we anticipate a total expense in corporate and unallocated of approximately $350 million $400 million.

Now let's turn to cash flow. Turn to slide number eight.

Slide 8, Q1 2013 Cash Flow
David W. Meline

First-quarter operating cash flow rose by $166 million, or 20 percent, to nearly $1 billion. Cash flow benefited from $269 million of lower pension and OPEB contributions, offset in part by higher tax payments.

We invested $324 million in capital expenditures during the first quarter, up $63 million versus first quarter of last year, and are projecting $1.6 to $1.8 billion for the full year 2013.

Free cash flow rose by $103 million, or 18 percent, to $670 million. Free cash flow conversion was 59 percent, a 9 point improvement versus the first quarter of 2012. First quarter is typically our seasonal low point for free cash flow conversion and improves as the year progresses.

We returned $1.25 billion to shareholders in the first quarter, comprised of $440 million in cash dividends and $805 million of gross stock repurchases. For the full year, we are now tracking toward $3 billion in gross share repurchases, which is at the high end of our previously expected range of $2 - $3 billion.

Let's review in more depth our first-quarter performance on a business-by-business basis, starting with Industrial. Please go to slide number nine.

Slide 9, Industrial
David W. Meline

First-quarter sales were $2.7 billion in Industrial, up 3 percent on an organic local-currency basis against a tough 7 percent comp in Q1 of 2012.

Most of Industrial's businesses grew organically in the first quarter. Aerospace again grew double-digits, due to a combination of market share gains and strong end-market growth. Industrial adhesives and tapes, which is 3M's largest operating division, had solid organic growth in the quarter, as did the personal care business. Organic sales declined in our advanced materials business.

Automotive OEM grew 2 percent organically in the first quarter versus a 1.5 percent estimated decline in Q1 global auto production. We continue to gain relevance and higher penetration levels in this massive market.

On a geographic basis, organic local-currency sales in the Industrial business rose 6 percent in Latin America/Canada and 4 percent in both APAC and in the United States. Organic sales were flat in EMEA, with broad-based declines in Western Europe offset by double-digit increases in Central/East Europe and in Middle East Africa.

The Ceradyne acquisition added 3.6 percent to this quarter's growth in Industrial. Integration is progressing very well, with newly combined technical teams working to identify a number of future growth opportunities. We are injecting LEAN throughout the operation to drive maximum efficiency and capture value quickly. Profits are ahead of plan, while sales were short of plan in the first quarter, largely defense-related, whereas sales in the industrial parts of the business are on track. We were encouraged in March when Ceradyne was awarded a $40 million dollar-plus order from the U.S. government for Small Arms Protective Insert armor plates for the government of Afghanistan.

First-quarter operating income was $576 million and reported margins were 21.5 percent. Ex-acquisitions, Industrial operating margins were 22.5 percent.

Now let's move to Safety and Graphics. Turn to slide ten.

Slide 10, Safety and Graphics
David W. Meline

First-quarter sales were $1.4 billion, up 2.3 percent on an organic local-currency basis.

This growth was led by our commercial graphics and architectural markets businesses. We also posted positive organic growth in building and commercial services, personal safety products and roofing granules.

The traffic safety and security systems business posted an organic sales decline in the first quarter, largely due to weak government funding levels and a slow start to the U.S. construction season. We also restructured part of the business in Q1 to improve its competitiveness going forward with associated costs of $4.5 million in the quarter.

On a geographic basis, organic local-currency sales rose 10 percent in Latin America/Canada, 4 percent in Asia Pacific and 3 percent in the United States. Organic sales declined 4 percent in EMEA.

The FSTech acquisition added 2.2 percent to growth in the quarter, and integration efforts are tracking well versus our expectations. This business also secured a major contract during the quarter for highway tolling with the Bay Area Transportation Authority in San Francisco.

Operating income in Safety and Graphics increased slightly to $335 million and operating margins were a strong 23.7 percent. Excluding acquisitions, first quarter operating margins increased 20 basis points to 24.3 percent.

Next up is Health Care, found on slide eleven.

Slide 11, Health Care
David W. Meline

Health Care sales totaled $1.3 billion, up 4 percent on an organic local-currency basis. We grew organically across the Health Care portfolio, with particular strength in food safety, critical and chronic care and health information systems.

On a geographic basis, Latin America/Canada grew 12 percent, Asia Pacific grew 7 percent, EMEA grew 3 percent and the U.S. grew by 2 percent.

In developing markets, Health Care grew 13 percent on an organic local-currency basis, with notable strength in India, Middle East/Africa, Brazil, Central/East Europe and Southeast Asia. Developing markets represent one-fourth of our Health Care sales today and a significant opportunity for tomorrow. In developed markets, the business grew 2 percent organically, including 6 percent in Japan.

Operating income rose 1 percent to $404 million, and margins were 30.8 percent, down 60 basis points year-on-year. Starting January 1st of this year, we began absorbing additional costs related to the U.S. medical device tax. The first quarter cost was just over $5 million, representing a 40 basis point drag on Q1 worldwide operating margins.

For many years, our Health Care business has grown organically, each and every quarter, with consistently outstanding margins. The business generates tremendous value for our customers and for shareholders.

Please turn to slide number twelve.

Slide 12, Electronics and Energy
David W. Meline

In Electronics and Energy, sales were $1.3 billion for the quarter, down 2 percent in organic local-currency terms. Growth was slightly positive on the energy side of the business, with strength in electrical markets offset in part by weakness in telecom and renewable energy.

Electronics, which is 60 percent of the segment, declined about 4 percent organically. Lower market demand also triggered sizable inventory reductions by some of our OEM customers and their tier suppliers. As a result, our factory utilization ran lower than we had been expecting and we expect this will persist into the second quarter.

From an electronics end-market standpoint, we are expecting a second-half recovery for three primary reasons: one, inventories should be in good shape after Q2; two, wafer starts and capacity utilization are gradually increasing; and three, the semiconductor book-to-bill is indicating an upward trend.

Operating income in Electronics and Energy declined 16 percent year-on-year to $196 million, and margins declined 2.4 percentage points to 15.3 percent. Lower volumes and utilization were the primary drivers here.

Finally, let's review the Consumer business, found on slide number thirteen.

Slide 13, Consumer
David W. Meline

Sales in Consumer were $1.1 billion this quarter, up 4 percent on an organic local-currency basis.

All of our businesses delivered positive local-currency organic growth this quarter, with particular strength in the consumer health care, DIY and home care businesses.

From a geographic perspective, organic sales growth was 8 percent in Asia Pacific and 5 percent in the U.S. and in Latin America/Canada. EMEA declined 6 percent.

In developing markets, the Consumer business grew 9 percent in organic local-currency in Q1. Consumer is one of our most significant opportunities in developing markets, as the middle class is growing rapidly in many of these countries and retail is growing with it. 3M's global capability and local presence around the world gives us a distinct advantage in serving those retail customers.

Quarterly operating income was $237 million in Consumer, equal to the first quarter of 2012, and margins were 21.9 percent for the quarter. Margins declined 40 basis points year-on-year due to higher investments in areas such as e-commerce, design and advertising/merchandising.

So that concludes our review of the first quarter. Now I'll turn the call back over to Inge.

Slide 14, with 3M Logo
Inge Thulin

Thank you, David.

Before we go to your questions, I want to update you on our progress in several areas.

First, portfolio management. On the Q4 call I referred to actions to consolidate our Traffic Safety Systems and Security Systems businesses. These restructuring actions were completed in the quarter with associated costs of $4.5 million in the quarter. The point here, of course, is that we are directly addressing the more challenging segments of our portfolio.

You should also know that we are increasingly directing a larger percentage of resources toward our "Heartland' and 'Push Forward' businesses.

Second, a word on Ceradyne. As David mentioned, the integration of Ceradyne is progressing very well, and profits are ahead of plan. I am excited about the emerging technology synergies from our newly strengthened ceramics platform.

Finally, we announced new leadership in the APAC region. Our new Area Vice President of Asia Pacific, Jim Bauman, has successfully managed a wide range of businesses and functions across the company, and has extensive international experience. He is a proven leader.

In addition, Kenneth Yu, the energetic, longtime head of 3M China, will now be applying his impressive business-building skills in developing markets around the world. The new leader of 3M China is Donald Chang, who most recently led and developed our business in Southeast Asia very successfully. Donald is another great builder of businesses and the ideal new leader to implement our new China plan.

So, our history of very strong leadership in the APAC region continues. To wrap up, we remain confident looking ahead and are keenly focused on elements within our control – advancing our long-term strategic objectives, driving productivity and improving the business. 3M's unique combination of technology strength, manufacturing excellence and global capability will enable us to deliver sustainable increases in sales, earnings and cash flow. As I said earlier, we are moving forward on all fronts.

Thank you, we will now address your questions.