Q3 2012 Earnings Call Transcript
Inge Thulin & David W. Meline
October 23, 2012

Slide 2, Introduction
Matt Ginter, Vice President, Investor Relations

Thank you, good morning everyone, and welcome to our third quarter business review. With me today are Inge Thulin, 3M chairman, president and chief executive officer, and David Meline, our chief financial officer.

First, let me mention three upcoming investor events. First, as a reminder, we are hosting an investor meeting here in the Twin Cities on Thursday, November 8th. If you plan to attend and have not yet responded, please RSVP right away. Second, on December 12th from 8:30 to 10:00 a.m. central time, we will host a conference call and webcast specifically addressing our 2013 financial outlook. Look for an invitation shortly. And third, our next earnings conference call will take place on Thursday, January 24th, 2013.

One more item of note, we recently announced a realignment of our major business groups to better serve global markets and customers. As we described in our October 3rd press release, segment reporting for the new organization will begin in the first quarter of 2013.

Lastly, please take a moment to read the forward-looking statement on slide two. During today's conference call, we will make certain predictive statements that reflect our current views about our future performance and financial results. We base these statements 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. So with that, I will turn things over to Inge. Please turn to slide number three.

Slide 3, Strong Operational Focus Drives Q3 2012 Results
Inge Thulin, President and CEO

Thank you, Matt and good morning everyone. Thank you for joining us today.

For us, the third quarter repeated the pattern we have seen throughout the year: solid earnings, strong margins and steady organic sales growth, delivered against challenging macro economic conditions. Once again 3M's operational excellence was an important factor in our quarter. Our Q3, GAAP earnings per share were $1.65, up 8.6 percent year-on-year.

Operating margins were again strong, at 22.4 percent. All six business segments delivered margins above 21 percent, a sign of continued broad-based effectiveness and efficiency.

Sales in the quarter were $7.5 billion, basically flat when compared with last year. Currency was again a factor, a drag of 3.1 percent. Organic local currency growth was up 2.2 percent with increases in all of our segments, including Display and Graphics and Electro-Communications.

Geographically, the Americas were again strong, including double-digit organic local-currency growth in Latin America, the 11th consecutive quarter that we have achieved that level. The United States rose two percent, Europe Middle East Africa was up one percent and APAC remained flat.

We returned about three quarters of a billion to shareholders in the quarter through dividends and share repurchases. So, all in all, Q3 was another good quarter marked by steady organic growth, operating discipline, efficiency and investment to improve our business.

One example of investment is the acquisition of Ceradyne, which we announced October first. This is an excellent match on many levels, the advanced ceramics technology platform, the global possibilities and, in combination with 3M's technology arsenal, the ability to bring new solutions to numerous industries such as automotive, oil and gas, solar, industrial and electronics, just to name a few. Now, David will take you through the detail of the quarter. David.

Slide 4, Q3 2012 P&L Highlights
David W. Meline, Senior Vice President and CFO

Thank you, Inge. Let's turn to slide number four for a discussion of the third quarter income statement. We continued to operate well in the quarter, with excellent factory efficiency and discretionary cost control, both of which were necessary given the continued soft economy.

Sales for the quarter were $7.5 billion, down 0.4 percentage points year-on-year, including over 3 percentage points of currency headwinds. I will elaborate on the change in sales in just a moment.

Gross profit dollars increased by 1.7 percentage points year-on-year. SG&A spending declined by 3 percent while R&D investment spending rose nearly 2 percent. Total operating income increased 6.1 percent and operating margins were again strong at 22.4 percent, an increase of 1.4 percentage points versus last year's third quarter.

The combination of raw material cost reductions and selling price increases contributed 1.6 percentage points to operating margins in the third quarter, while year-on-year increases in pension and OPEB expense reduced margins by 0.3 percent.

Third-quarter earnings were $1.65 per share, an increase of 8.6 percent. Average diluted shares outstanding declined 1.7 percent year-on-year, which boosted earnings by 3 cents per share. The third-quarter tax rate was 28.2 percent, down 40 basis points year-on-year, which increased earnings by a penny a share. During the quarter, we incurred various restructuring charges totaling 1 cent per share, and insurance recoveries added 2 cents to earnings. As I mentioned before, operating margins improved by 1.4 percentage points to 22.4 percent reflecting continued strong operational excellence across all of our businesses. Please turn to slide five for a more detailed look at our third-quarter sales change.

Slide 5, Q3 2012 Sales Recap
David W. Meline

Third-quarter organic local-currency growth was 2.2 percent, with equal contributions from both volumes and selling price increases. Acquisitions added 50 basis points to sales growth in the quarter. Foreign exchange impacts reduced sales by 3.1 percentage points, as the U.S. dollar remained strong versus the Euro and a number of other currencies. Again, on a total-dollar basis, sales declined 40 basis points versus last year's third quarter.

Looking across geographic regions, Latin America/Canada led the way with strong organic local currency growth of 10.5 percent in the quarter. All six of our businesses contributed to this growth, with particular strength in Safety, Security and Protection Services, Electro and Communications and Display and Graphics. Health Care also posted double-digit organic local-currency growth within the region.

On a country basis, Mexico in particular had another strong quarter, with 19 percent organic local currency growth. Our teams there have done a fantastic job building the business, with focused investments in a number of key areas. Those investments are paying off nicely.

In the United States, organic sales rose 2.3 percent, marking the 12th consecutive quarter of positive growth in the U.S.

In EMEA, or the combined Europe, Middle East and Africa, third quarter sales increased 0.8 percent on an organic local-currency basis. We saw nice double-digit increases in the Middle East and Africa, along with positive growth in Central/East Europe. West Europe was down 1 percent in the quarter, an improvement versus the first half of the year and reflecting the economic growth challenges in that region.

Our West European teams remain focused on taking market share and driving productivity I was encouraged to see that operating margins in the total EMEA region increased year-on-year by nearly 2 percentage points, so our teams there are executing extremely well in the face of challenging macro conditions.

Across Asia Pacific, organic local-currency sales were flat in the third quarter. Growth was strongest in our Health Care and Consumer and Office businesses. Our businesses serving the consumer electronics industry continue to improve, but by no means have we seen a full recovery.

Focusing on the China/Hong Kong region, organic local-currency sales were flat in the third quarter. We saw positive growth in Health Care and Consumer and Office, both domestic-oriented businesses, and in Industrial and Transportation. This growth was offset by year-over-year declines in Renewable Energy and Personal Safety.

Longer term, China remains a key growth engine for the future and we will continue to invest. We regard any challenges there as temporary. Let's now review our third quarter performance on a business-by-business basis. Please go to slide number six.

Slide 6, Q3 2012 Segment Performance
David W. Meline

In the Industrial and Transportation business, sales rose 3 percent on an organic local-currency basis, to $2.6 billion. Automotive OEM led the way this quarter with 11 percent organic local-currency growth. We also achieved good growth in aerospace, automotive aftermarket, 3M purification and industrial adhesives and tapes. On a geographic basis, organic local currency sales increased 8 percent in the United States, 5 percent in Latin America/Canada and 1 percent in EMEA. Asia Pacific sales were flat in organic local currency terms. This is our largest business by a wide margin, so we are encouraged to see such broad-based growth with excellent profitability. Operating income was $575 million, up 9 percent over last year's third quarter, and margins improved by 2 percentage points to 22.4 percent.

Now let's move to Health Care. Third-quarter sales increased 4 percent on an organic local currency basis to $1.3 billion. Operating income grew 9 percent to $400 million, with strong operating margins of nearly 32 percent. We saw strength across the Health Care business, with the strongest organic local currency growth in food safety, health information systems and skin and wound care. Drug delivery was down low single digits in Q3. Geographically, sales expanded in all regions, and especially in Latin America and Asia Pacific where we have increased our investment levels over time.

Now let's look at the Consumer and Office business. Sales were $1.1 billion this quarter, up 1 percent on an organic local-currency basis, and operating income was flat year-on-year at $244 million. Operating margins were 21.9 percent in the third quarter. Our strongest growers in Consumer and Office were DIY, consumer health care and home care, while stationery and office supplies saw modest declines on an organic local-currency basis. Acquisitions added 2.5 percent to sales due entirely to GPI Group, a leading French producer of home-improvement products. We purchased GPI on October 1st of last year, so next quarter it will become part of our organic sales base. On a geographic basis, organic local-currency growth was 7 percent in Latin America/Canada, 6 percent in Asia Pacific and flat in the U.S., while EMEA declined 3 percent. One item of note during the quarter, in light of objections from the Department of Justice, 3M and Avery Dennison terminated the agreement under which 3M would have purchased Avery's Office and Consumer Products business.

Let's take a look at our Display and Graphics segment. Organic local currency growth rose 1 percent in the third quarter to $936 million. We were encouraged that sales increased $54 million, or 6 percent, on a sequential basis. Third-quarter organic local currency sales rose in architectural markets, commercial graphics and traffic safety systems. Sales of optical films declined just slightly year-on-year but rose 15 percent sequentially. On an organic local-currency basis, sales grew by 16 percent in Latin America/Canada and 3 percent in the United States but declined 1 percent in both EMEA and Asia Pacific. Operating profits in Display and Graphics were $199 million, up a strong 11 percent year-on-year, and margins were 21.2 percent for the quarter.

Let's examine the Safety, Security and Protection Services business. Third-quarter sales were $926 million, up 1 percent on an organic local-currency basis. Growth was led by the infrastructure protection and personal safety businesses. This growth was largely offset by declines in roofing granules and security systems. On a geographic basis, sales rose 20 percent in Latin

America/Canada and 2 percent in EMEA, but declined 6 percent in the U.S. and 4 percent in Asia Pacific. Operating income in this business was $196 million, down 3 percent year-on-year and margins were 21.1 percent.

Finally, let's review Electro and Communications. Third quarter sales in this business were $820 million, up 0.1 percent in organic local-currency terms. Operating income increased 3 percent to $186 million and margins were 22.7 percent. Organic local-currency sales increased in electrical markets and declined year-on-year in both the telecom and consumer electronics-related businesses. On the electronics side, a number of industry product lauches were delayed, contributing to lower-than-expected growth in our business. Overall the industry is showing signs of recovery, but at a much slower pace than expected earlier in the year. In geographic terms, Latin America/Canada rose 17 percent, the U.S. increased 4 percent and EMEA rose 1 percent while Asia Pacific declined 4 percent in the quarter.

Both Electro and Communications and Display and Graphics posted positive organic local-currency sales growth in the third quarter, the first after multiple quarters of decline. We expect similar momentum in the fourth quarter, helped by favorable year-on-year comparisons.

That concludes my discussion of the business segment results. Please turn to slide number seven.

Slide 7, Q3 2012 Cash Flow
David W. Meline

Free cash flow for the quarter was $987 million, down $39 million year-on-year. This amount includes $246 million in pension and OPEB contributions which was similar to the last year's third quarter. Year-to-date contributions totaled $918 million, and we expect approximately $1 billion for the full year.

Capital expenditures were $358 million, up $22 million versus third quarter of last year and we expect to invest approximately $1.5 billion for 2012 in total. Free cash flow conversion was 85 percent in the quarter versus 94 percent in last year's third quarter. We returned $735 million to shareholders in the third quarter, including $408 million in cash dividends and $327 million in gross share repurchases.

So that concludes my discussion of our third-quarter financial results. Now Inge will address our forward outlook, beginning on slide number 8.

Slide 8 Realigning Our Businesses
Inge Thulin

Thank you, David.

Earlier this year we shared 3M's Vision, followed quickly by our strategies. Consistent with our strategy to build relevance and presence in the marketplace, we recently announced a realignment of our major business groups to better serve both global markets and customers.

As Matt said, we will begin reporting results under the new structure in the first quarter of 2013. Very simply, we move from six businesses to five business groups: Consumer, Industrial, Health Care and two newly formed business groups: Electronics & Energy and Safety & Graphics. The realignment is a natural outcome of our strategy to increase relevance to our customers and to broaden our presence in the markets we serve. By building scale more broadly across the company, we create critical mass in each business group to take better advantage of innovation and commercialization opportunities.

The Electronics and Energy business group illustrates this concept very well. We will bring together all of our capabilities in these markets to increase our impact and relevance with big, global OEM customers. At the same time, we enhance our ability to leverage key manufacturing and marketing assets.

I am personally very encouraged by early feedback from multiple customers, who look forward to strengthening partner relationships toward mutual success. Please turn to slide 9.

Slide 9 3M Logo – Intro to Outlook
Inge Thulin

In the shorter term, however, we still face the challenge of sluggish economies in large developed regions like Western Europe and Japan. As David said, the teams there are working to take share and drive productivity, and I am pleased with our progress.

In China, the year clearly has not played out the way most anticipated. But as we have said many times, short-term challenges will not divert us from future opportunity, so we will continue to invest and build our business and our capabilities locally for the longer term. Our "China for China" approach is the right approach as the Chinese economy evolves away from its dependence on exports, and toward domestic, consumer-oriented businesses.

Of course, China is not the only location where we are investing to improve our business and strengthen 3M innovation. In Q3 we announced plans to build a new, state-of-the-art laboratory facility at our headquarters in St. Paul, Minnesota. The new lab, scheduled to open in early 2015, will house some 700 scientists who currently work in other facilities here. With the latest in equipment, it will be an environment designed specifically for the development of innovative technologies, and an important hub in 3M's global research network. Let me now turn to our outlook, please turn to slide 10.

Slide 10, 2012 Outlook
Inge Thulin

With one quarter left in the year and no indication that conditions in the fourth quarter will be dramatically different from the third, we are adjusting the full-year earnings outlook to a range of 6.27 to 6.35 per share. This range includes three cents per share of anticipated acquisition-related expenses, largely Ceradyne.

On organic local currency growth, we now expect a range of two to two point five percent. We look for a currency penalty of approximately two point five percent, a little lower than it has been running. And we look for margins in the range of 21.5 to 22 percent.

In summary, Q3 market conditions were challenging and we expect this through the end of the year. We will continue to expand our business, drive productivity and execute our plan with strong discipline.

Thank you for your attention. We will now take your questions and comments.