Q4 2012 Earnings Call Transcript
Inge Thulin & David W. Meline
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Slide 1, Opening
Matt Ginter, Vice President, Investor Relations

Thank you and good morning everyone. On today's call we will discuss our fourth quarter and full-year 2012 performance, along with the 2013 outlook. Inge and David will each make some opening comments and we will leave plenty of time for your questions.

Recall that during the fourth quarter we announced a realignment of our major business groups. Segment reporting for the new organization will begin in the first quarter of 2013. Today's results are presented on the basis of our existing segment structure. We will furnish supplemental historical business segment sales and operating income information reflecting the segment realignments in an 8K. Expect to see this filing sometime around mid-March.

Let me mention a few upcoming dates and events. First, our 2013 earnings conference calls are set for April 25th, July 25th and October 24th. Also, we will host an investor meeting on the afternoon of Tuesday, December 17th. I know that December calendars fill quickly, so please hold this date. More details will be available later this year.

Slide 2, Forward Looking Statements
Matt Ginter

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 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, please turn to slide number three and I will turn the call over to Inge.

Slide 3, Introduction
Inge Thulin, President and CEO

Thank you, Matt and good morning everyone. I appreciate you joining us today. For 3M, 2012 was a year of preparation, progress, and performance. We developed and introduced our vision and strategies and we aligned our organization more closely with our customers and markets. We combined several businesses for increased scale and relevance and formed new businesses in promising markets.

We brought new strength to marketing, sales and e- business. We gave new emphasis and leadership to Lean Six Sigma, and we put in place a dedicated team to more efficiently integrate our acquisitions. Today that team is hard at work on both the FS Tech and Ceradyne acquisitions. You will recall from our November meeting that Ceradyne is both a good business and a strong technology play to build out 3M's ceramics platform.

I'm very pleased that in 2012, we brought portfolio prioritization into the forefront of how we manage the company. This is important for long-term success and we are using the process to improve short-term results as well. In a few minutes I will discuss several actions we have recently taken.

Perhaps the most significant progress made last year was the strengthening of 3M's commitment to innovation. We expect R&D to approach six percent of sales by 2017 and you see some evidence of our increased investment in the fourth quarter of 2012.

Finally, as you all know, we reset our financial goals for the next five years. We now have targets that are both realistic and aggressive with real possibility of upside. All these actions are evidence of preparation and progress. Let me summarize our 2012 performance. Please turn to slide 4.

Slide 4, 2012 Full-Year Results
Inge Thulin

For the year, earnings per share were up six percent to $6.32. Operating income rose to $6.5 billion, or a 5% increase. We maintained outstanding margins of 21.7%, with five of our six business segments delivering above 21%.

Sales for the year were nearly $30 billion. In organic local currency terms, sales increased 2.6% with particular strength in Latin America/Canada, up 11% and the United States, up 4% for the year.

Asia Pacific was flat for the year in organic local currency impacted heavily by a soft global consumer electronics industry, and Europe/Middle East/Africa was down 1%.

Currency impacts reduced worldwide sales by 2.4% and acquisitions added nearly one point. We returned $3.8 billion in cash to shareholders through dividends and share repurchases, which was 86% of net income for the year. And finally, ROIC for the year was 20%.

In summary, a solid year of results during uncertain economic times. The 3M team is well-aligned and the company well-positioned to compete to win in 2013 and beyond.

I'll now turn the call over to David for more detail on our fourth-quarter 2012 results. David.

Slide 5, Q4 2012 Sales Recap
David W. Meline, Senior Vice President and CFO

Thank you, Inge. Let begin with slide 5, where I will break down the fourth-quarter change in sales. Fourth-quarter sales rose 4.2%, our strongest increase of any quarter in 2012. Organic growth was 4.3% as volumes rose 3.6% and selling price increases were a positive 0.7%. Acquisitions added nearly one point to sales growth in the quarter, and foreign exchange impacts reduced sales by one percentage point.

On a geographic basis, Latin America/Canada was once again our fastest-growing region, with organic local currency growth of 9.7%. This performance was broad-based, with all six of our businesses generating positive organic growth in the region, including double-digit increases in Health Care, Safety, Security and Protection Services, Consumer and Office and Electro and Communications.

Brazil and Mexico both posted impressive results. Brazil grew 11% organically in the face of a still-recovering economy and Mexico grew 10%. Organic local currency growth was 5.8 % in Asia Pacific. Japan declined year-on-year reflecting continued tough economic conditions, and the rest of APAC rose nearly 10% on an organic basis. For non-Japan Asia, this was the best quarterly growth performance in nearly two years. China was a significant contributor, with organic local currency sales growth of over 16 percent.

We also had another very good quarter in the United States, with organic sales up 5.2%. Consumer and Office led the way with a strong double-digit performance.

In EMEA, or the combined Europe, Middle East and Africa, fourth quarter sales declined 1% on an organic local-currency basis. Western Europe was down 0.6% year-on-year. The economies there have stabilized but are not yet growing. Our teams in the region continue to focus on market share gains and productivity.

Slide 6, Q4 2012 P&L Highlights
David W. Meline

Let's now review the income statement. Please turn to slide number 6.

Sales for the quarter were $7.4 billion, an increase of 4.2% in dollar terms. We generated $3.4 billion in gross profit and maintained strong gross margins of 46% for the quarter. SG&A spending rose 1% and we increased R&D investments by 10% versus the fourth quarter of last year. Operating income increased 5.8% in Q4.Operating margins were 19.5 percent, up 30 basis points year-on-year. Four primary factors contributed to the margin change.

First, as I mentioned earlier, we grew organic volumes by 3.6% in the fourth quarter, which we leveraged into approximately 50 basis points of higher operating margin. Second, the combination of lower raw material costs and higher selling prices added 1.4 percentage points to fourth-quarter margins. Selling prices increased 0.7% year-on-year, largely due to carryover price benefits from actions taken earlier in 2012. Raw material cost deflation was approximately 3.5%.

Third, acquisitions in total reduced operating margins by 50 basis points. As Inge mentioned, we are in the process of integrating two recently closed deals, Ceradyne and Federal Signal Technologies. Both integration efforts are going well with no major surprises, and from a financial perspective we are right where we expected to be at this point in time. Adjusting for these deals, operating margins would have been 20% in the fourth quarter. Finally, we experienced lower factory utilization in Q4 versus the same quarter of 2011, which combined with other factors, hurt fourth-quarter operating margins by 1.1 percentage points. All things considered, we delivered full-year operating margins of 21.7%, right near the midpoint of the 21.5 to 22 percent range that we were expecting.

Fourth-quarter earnings per share increased 4.4% to $1.41. Average diluted shares outstanding declined 1% year-on-year, which added a penny to EPS. The fourth-quarter tax rate was 28.7%, up 2 percentage points year-on-year, which reduced earnings by 4 cents per share. The fourth quarter concludes another successful year for 3M, and with our plan in place and our organization aligned, we anticipate a strong 2013.

Let's now review our fourth-quarter performance on a business-by-business basis. Please go to slide number seven.

Slide 7, Q4 2012 Segment Performance
David W. Meline

Sales in the Industrial and Transportation business were $2.5 billion in the fourth quarter, an increase of 4% on an organic local-currency basis. We achieved good growth in a number of businesses, including industrial adhesives and tapes, abrasives, automotive OEM and personal care products. We posted double-digit increases in two businesses, namely liquid filtration and aerospace and aircraft maintenance where we continue to win business and penetrate further into these important markets. Our renewable energy business declined 12% on an organic local currency basis.

On a geographic basis, organic local currency sales in Industrial and Transportation increased 6% in Latin America/Canada and in the United States and 4% in Asia Pacific. Industrial and Transportation's fourth quarter organic sales were flat in EMEA.

Operating income was $469 million and margins were 18.8 percent. Adjusting for Ceradyne, Industrial's operating margins were similar to fourth-quarter 2011 levels.

Now let's move to Health Care. Fourth-quarter sales increased nearly 6% on an organic local currency basis, to $1.3 billion. Health Care generated $430 million in operating income in the quarter, up 11 percent year-on-year, and operating margins were 32.3%.

Continuing the trend from recent quarters, the growth in Health Care was very broad-based. All businesses posted positive organic local currency sales growth in Q4, led by food safety, health information systems, skin and wound care and oral care.

On an organic local currency basis, sales increased in all major geographic regions, with double-digit increases in Latin America/Canada and Asia Pacific.

In developing markets, Health Care drove nearly 15% organic local-currency sales growth continuing our recent success in these areas and we expect the momentum to continue.

In developed markets, our Health Care team continues to generate solid, profitable growth despite ongoing government austerity efforts in many major countries. In summary, a superb quarter for Health Care.

Now let's look at the Consumer and Office business. Sales were $1.1 billion this quarter, up 9% on an organic local-currency basis, and operating income rose 29% to $230 million. In the United States sales increased at a double-digit rate in the fourth quarter. Holiday sell-through was good and we saw some holiday-related sales shift from the third quarter into the fourth. This shift boosted our Q4 growth rate by an estimated 1.5 percentage points year-on-year.

We continue to benefit in the U.S. from a strong flow of new products in Consumer and Office, such as our recently introduced line of Command Clear wall hooks. We are also gaining excellent traction in safety products for the retail channel, most notably in protective eyewear under the 3M TEKK brand. Finally, Filtrete-brand filters grew well in Q4, boosted by colder weather patterns in many parts of the country. Elsewhere in Consumer and Office, we also drove double-digit organic local-currency growth in Latin America/Canada, and low single-digit growth in both Asia Pacific and EMEA.

On a worldwide business basis, our strongest growers were consumer health care and DIY with positive growth also in home care products and stationery and office supplies. All in all, this was a strong quarter for our Consumer and Office team.

Let's take a look at our Display and Graphics segment. Sales in the fourth quarter were $910 million, an increase of 8.3%. Optical systems had a good fourth quarter, with sales up double digits and stable profit margins year-on-year. Optical finished the year largely as we had expected. We also posted positive organic local-currency sales growth in architectural markets, traffic safety systems and commercial graphics.

Display and Graphics grew 12% organically in Asia Pacific, 10% in Latin America/Canada and 5% in the U.S. EMEA sales were down 2% year-on-year.

Operating profits in Display and Graphics were $152 million with operating margins of 16.7%. Margins declined 2.5 percentage points year-on-year, largely due to the FSTech acquisition along with start-up costs in a couple of businesses.

Let's examine the Safety, Security and Protection Services business. Fourth-quarter sales were $904 million, down 2% on an organic local-currency basis. We posted good growth in most businesses with notable strength in infrastructure protection and personal safety products.

Sales declined in our security systems division as the market remains soft and the business has been under strategic review. Inge will address the actions we are taking to better-position security systems for success going forward.

On a geographic basis, organic local-currency sales rose 13% in Latin America/Canada and 1% in Asia Pacific, and declined 7% in the U.S. and 5 percent in EMEA.

Operating income in Safety, Security and Protection services decreased 5% year-on-year to $162 million, and margins were 18%. Margins declined 50 basis points, impacted by the aforementioned challenges in security systems.

Finally, let's review Electro and Communications. Sales in this business totaled $776 million in the fourth quarter, up 1.8% in organic local currency terms. Operating income totaled $142 million, down 6.5% year-on-year, and margins were 18.4%.

On an organic local-currency basis, sales increased in touch systems, electrical markets and telecom. Sales declined a bit in consumer electronics and we are anticipating first quarter will be similar. In geographic terms, Latin America/Canada rose 10%, the U.S. increased 4% and Asia Pacific rose 1% while EMEA declined 3% in the quarter.

That concludes my discussion of the business segment results. Let's move on to cash flow, so please turn to slide number seven.

Slide 8, Q4 2012 Cash Flow
David W. Meline

From a cash flow perspective, fourth quarter was quite similar to the same quarter of 2011. Free cash flow was $1.231 billion, up $10 million year-on-year.

We invested $507 million in capital expenditures during the fourth quarter, down $10 million versus fourth quarter of last year. Full-year cap ex was $1.5 billion… which was in line with our expectations entering the year.

Free cash flow conversion was 124 percent in the quarter…versus 128 percent in last year's comparable quarter. For the full year 2012, free cash flow conversion was 86 percent.

We returned over $1.1 billion to shareholders in the fourth quarter, including $714 million in gross share repurchases and $407 million in cash dividends. For the full year 2012, we returned $3.8 billion to shareholders, or 86 percent of net income. So that concludes our review of the fourth quarter. Now I'll turn the call back over to Inge.

Slide 9, 3M logo
Inge Thulin

Thank you, David. Before we get to your questions, I'd like to spend a few minutes on 2013 and how we are working to strengthen 3M. I said earlier that 2012 was a year of preparation, progress and performance. With the planning behind us, 2013 is a year of putting our plan into action and truly competing to win. To win, we are strengthening our portfolio and, at the same time, working to resolve some challenging business issues. For example, in November we announced the combination of our Security Systems Division with our Traffic Safety Systems Division. In recent times these businesses have not performed to the standards we expect and we are addressing

these issues head on. Government spending for security has decreased over the last few years and those same factors have also affected our traffic safety systems business.

In the big picture, bringing these two businesses together creates an opportunity to optimize the overall business and increase efficiency. We announced last week a restructuring in these businesses that will result in the reduction of around 300 positions worldwide and we will take a related Q1 charge of $8 million.

In a company of our size and breadth, there will always be some businesses under strategic review and while the specific solutions may differ, the underlying principle is the same, they will not stay under strategic review for long. We will take action. And, in context, these situations are few when compared to 3M's overall portfolio of outstanding businesses.

For 2013, we will continue to drive our strategies, invest in innovation, commercialize new products as quickly as possible, and work to take market share everywhere. We have confidence in our plan and our people, and in the planning estimates we gave you in December, which you can see on slide 10.

Slide 10, 2013 Outlook
Inge Thulin

We expect 2013 earnings per share in the range of $6.70 to $6.95. We look for organic local-currency growth of plus 2 to plus 5 percent. The tax rate is expected to be 29.5 to 30 percent. And finally, we anticipate free cash flow conversion of 90 to100 percent.

As for the near term, we are naturally a bit more cautious. There remains a degree of uncertainty as we see some economies growing and others are slower to recover. The same dynamics can be found in specific markets. Health care is doing well, for example, while consumer electronics has yet to fully recover.

Specific to the first quarter, we anticipate approximately $30 million of restructuring and one-time acquisition costs. This includes the $8 million in restructuring cost I mentioned earlier. The point is we will execute our plan to keep improving and growing the business.

Thanks for your attention, we'll now take your questions.