Q1 2011 Earnings Call Transcript
George W. Buckley & David W. Meline
April 26, 2011

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

Hello everyone and welcome to our first quarter 2011 business review. With me today are George Buckley, 3M chairman, president and chief executive officer, and David Meline, our recently appointed senior vice president of finance and chief financial officer.

Today we will review our first quarter results along with an updated outlook for the rest of this year. A PowerPoint presentation accompanies today's conference call, which you can access on 3M's investor relations website at 3m.com. Today's slide presentation and the audio replay will be archived on our website for an extended period of time.

Take a moment if you would 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.

Let us begin today's review, and I will turn the program over to George Buckley. Please turn to slide number three.

Slide 3, Quarter Highlights
George W. Buckley, President, Chairman, and CEO

Thanks Matt and good morning everyone. Thanks for joining us today.

From the numbers, you'll clearly see the first quarter was again a very good one for 3M. We posted over 15% top line growth and, if we correct for the Japan and H1N1 effects, organic growth was running at 10.5%. So, we continue to post growth rates which are among the highest in the company's long history.

We delivered $1.49 EPS in Q1, which is an all time high for the company in the first quarter, and all this was done at a time when Japan's troubles cost us about 3 cents per share and about 70 bps net of sales growth, all of which was organic, plus of course the additional challenges we saw in the Middle East. The unrest there also cost us a little under $10 Million in sales, but nothing significant.

The growth rates were high across the board, with E&C (Electro & Communications) leading the way at 21% growth and Industrial and Transportation almost equaling it at 20%. I&TB will be about a $10 Bn segment for us in 2011 and to see a unit grow this fast in an industrial space is quite remarkable. Five of our six reporting segments reported double digit sales increases in the quarter, with Display and Graphics also very close to double digits at 9% total growth. Currency clearly helped us to be sure, but even without that, four of the six reporting segments reported double digit local currency growth. Emerging markets were again stellar, with sales up 24%, led by developing Asia. We saw double digit sales growth in all geographic regions, including 10.2% in the U.S. We had 47 countries in our portfolio, including the United States that reported double digit sales growth. And can you believe that Germany's sales growth came in at 24.3% in March, just slightly behind China.

This is, I think, a real testament to the progress we're making towards being a higher growth company. We've now had growth in excess of 9 percent for 6 consecutive quarters; which is a further indication that we're cracking the growth code. Unlike most other experiments in growth, I think we've proven we can grow multiple businesses at once, not just those that happen to be in naturally high growth spaces. This is being done by the innovation of our people. I think we are also proving we can grow all the way through the economic cycle. Companies can acquire growth, yes, but I am still very much a believer that organic growth is the true test of a company's long term innate value and capability. Unless there are yet more unforeseen geopolitical problems, it seems we will exceed $30 Bn in sales in 2011 for the first time in our history.

Our acquisition strategy continues to advance too. In Q1 we closed two sizable deals -- Alpha Beta, a Taiwanese tape manufacturer, and Winterthur Technologies AG, a supplier of precision bonded grinding technologies. Both will give us new competitive capabilities that will help customers and make us even more competitive. Other recent acquisitions, such as Cogent, Attenti and Arizant, are progressing nicely and are all ahead of plan. In the quarter, acquisitions added 3 percent to our sales growth.

It wasn't all plain sailing in the quarter as pensions, OPEB, purchase accounting, damage in Japan and raw material price increases chipped away a bit at our gross margins, but most of those items we knew about ahead of time and they will ease or pass away as the year goes on. I'll just remind you again quickly here that Optical Systems has an industry-normal annual price down environment that is baked into these numbers. Selling prices turned positive inside the quarter for the company in total.

Turning to the Q1 highlights, organic volumes were up 9 percent, even without the adjustments I mentioned earlier. We maintained operating margins at 21.6%, with all businesses coming in at over 21%, a phenomenal result in consistency. Operating income was up 9 percent year on year to $1.6 billion, another Q1 record, or up 17% on an underlying basis when we eliminate non-operational items such as Japan, H1N1 and pensions.

David will address this topic in more detail in a few minutes.

The quarter also included the announcement of 3M's 53rd consecutive annual dividend increase. In addition, the Board authorized a $7 billion share repurchase in February. For the quarter, our gross share repurchases were $680 million dollars, a great start.

Again, it was a tremendous start to the year. Let me quickly take you through the performance of our businesses.

Slide 4, Big Business Highlights
George W. Buckley

Our largest business, Industrial and Transportation, turned in an absolutely superb quarter with sales growth of 20 percent and operating income up 17 percent. Renewable Energy continued on a roll, with sales up 68 percent, Aerospace was up 38 percent, and our core abrasives and industrial adhesives and tapes were up 31 percent and 23 percent, respectively. Industrial achieved record quarterly operating income of $516 million with operating margins of 21.1 percent. And the acquisitions I mentioned earlier, Alpha Beta and Winterthur, were both in this business. I want here to acknowledge the creative work of one our dear friends, Tony Stokes, the Head of our Automotive Division, who you all met at our last investor meeting, who sadly passed away 10 days ago of a heart attack, and he delivered 16% in what was his final quarter. Tony took a division with relatively low growth and with the force of imagination, inspiration and innovation made it a regular double digit performer, even with these Japanese effects. Thank you Tony, we will miss you.

Health Care sales rebounded nicely, up 13 percent in the quarter, with double-digit increases in every geographic region. Operating income jumped 7 percent to $369 million with operating margins of 29.4 percent. Here, too, acquisitions were important, contributing over 5 percent to sales. The Arizant acquisition is going particularly well outperforming both sales and profit expectations, and the integration is tracking well ahead of plan.

Consumer and Office achieved sales growth of 10 percent, including a little over 2 percent from acquisitions. When you see what is happening in consumer companies and the office environment more broadly, this is really quite remarkable. Operating income was 215 million. Importantly, Consumer did well in Asia Pacific and Latin America – two areas of high growth investment focus for us – with a 31 percent sales increase in Asia and an 18 percent increase in Latin America. So, our investments are clearly making a positive impact. These investments are reflected in COB margins, down 2 ½ points from last year's high levels. So while we're seeing some short-term margin erosion, the key for us is to remain committed to invest and drive this business for the longer term. In addition, COB, like other businesses, absorbed raw material increases in the quarter, also affecting margins. On the product front, the new Filtrete Water Station received the Silver Edison Award for innovation in the Consumer Packaged Goods-Household category.

Sales rose 9 percent in Display and Graphics with our commercial graphics business and newly formed architectural markets business leading the way. In Optical Systems, LCD TV demand was softer, but smart phones and tablet PC demand remained very robust. Knowing the fascination with Optical, I'll expand on this in a few minutes. Overall, the segment posted operating income of $230 million, up 9 percent with operating margins a strong 24.4 percent. One acquisition note, we just announced the acquisition of Original Wraps, Inc. a small company in the commercial graphics space. This company specializes in the design of personalized graphics for vehicles which is turning into another big growth opportunity for us.

Safety, Security and Protection Services posted a sales increase sales of 14 percent, which would have been over 20 percent were it not for H1N1 comps. Operating income was up 9 percent to $199 million with operating margins of 21.4 percent. We expect this unit to be a sizeable beneficiary of increased protective equipment sales when rebuilding in Japan begins in earnest. Also in the quarter, the head of SS&PS, our good friend Jean Lobey, announced his plans to retire on June 1. I am very sad about this since Jean has done an absolutely superb job building this business and we wish him the best. Thank you, Jean. And I know his successor Julie Bushman will continue Jean's good work. FYI, Julie was the former head of our Occupational Health business reporting to Jean.

Finally, Electro and Communications momentum continued strong in the quarter – with sales up 21 percent and record operating income of $178 million, also up 21 percent. Within this segment, our electronics markets business posted its sixth consecutive quarter of double-digit local currency growth. Needless to say, we're very happy with the performance of this business and we continue to invest in it. For example, in the quarter we announced expanded global capacity for optically clear adhesives to support the growth of consumer electronics devices, and 3M and Quanta formed a new company to manufacture projected capacitive touch sensors for the personal computing market. We showed you some of the exciting new inventions coming your way at our recent investor meeting in St Paul. In addition EMD, our electrical markets business – which serves the power utility and infrastructure markets – also posted double digit gains. There's lots of excitement in Electro and Communications these days.

That's a quick run through of our business segments. Before I turn the call over to our new CFO, David Meline, let me once again salute the many business contributions of Pat Campbell over the last 10 years or so. He is an important figure in 3M's history and has been absolutely essential to the transformation of 3M into a faster-growing enterprise. Thank you very much Pat and we wish you a long and happy retirement.

And now it's my pleasure to turn the call over to David Meline. David.

Slide 5, Earnings per Share Summary
David W. Meline, Senior Vice President and CFO

Thanks, George, and good morning everyone. I am glad I had a chance to meet many of you at our March meeting in St. Paul, and I look forward to meeting more of you in the near future. Meanwhile, thank you for joining us today, and please turn to chart number 5.

On a GAAP reported basis, first-quarter earnings were $1.49 per share. This is an all-time record for any first quarter, adjusting for the one-time pharma gain in 2007, and a healthy 16 percent increase over last year's $1.29 per share. As a reminder, last year's results included a one-time, non-cash income tax charge of $84 million, or 11 cents a share, resulting from Medicare Part D changes imbedded in the U.S. Patient Protection Act.

We exceeded our own earnings expectations in the quarter, a good result considering that Japan was an unanticipated headwind. We estimate that earthquake-related disruption hurt our earnings by approximately $0.03 per share, which represents lost business in Japan plus our best estimate of impact in other countries. The earnings impact included in lost profit on reduced sales, plus some one-time write-offs of inventory and fixed assets.

We expect additional Japan-related headwinds in Q2, which are factored into our outlook, of course. We assume that these headwinds will wane during the second half of 2011 and that we could see additional sales opportunities in businesses such as protective respirators, traffic safety solutions and commercial graphics, to name a few. George will have more to say about Japan and our forward outlook in just a bit.

Overall, this was a very good quarter for 3M and we are off to a strong start in 2011. Let me walk you through the details. Please turn to slide number 6.

Slide 6, P&L Year on Year
David W. Meline

If you have followed 3M for a while, you know that our financial objectives call for accelerated sales growth, coupled with stable, but premium margins and returns on capital. I think this quarter's results fit that description quite well.

Sales in the quarter rose 15 percent, with 9 points coming from higher organic volumes, 3 points from acquisitions and another 3 points from favorable currency movements. Selling prices rose slightly in Q1, but importantly they improved each month during the quarter as our businesses have stepped up aggressively to help offset raw material headwinds. As a reminder to you, price-down is a normal part of business in a few select 3M businesses, optical being a prime example. Excluding Optical, selling prices increased nearly one percentage point in the quarter.

With respect to organic volumes, we achieved nearly 9 percent growth in the first quarter, even with some headwinds. First Japan, which hurt sales growth by just under a point year on year. The other material headwind was H1N1. In last year's first quarter, we estimate H1N1 added approximately $45 million to sales, which did not repeat in 2011. Adjusting for these factors, organic volumes rose over 10.4 percent in the quarter, or a multiple of 1.8 times global IPI.

We continue to be encouraged by the broad-based nature of our growth. Over the past few years, we have seen steady improvement in the number of businesses that are growing their sales. This gives us confidence in the robustness of our portfolio versus past periods when growth was limited to one or two of our businesses. In fact, nearly all 3M's 40 divisions and nearly 70 countries operated with positive first-quarter sales growth.

We expanded sales in every region of the world in the quarter, with Asia Pacific up 21 percent, Latin America up 23 percent, Europe up 13 percent and the United States and Canada both up 10 percentage points. And as George mentioned, all six of our business segments expanded sales during the quarter.

Gross margins declined by a point year on year, which was largely due to higher raw material inflation. The good news is our businesses have been raising prices, with more to go. For the full year 2011, selling price increases are expected to offset raw material inflation. The positive momentum that we saw in Q1 gives me confidence that we are on the right track; March selling prices were up versus February, February was up versus January, and January was up versus December. So we are trending in the right direction.

SG&A and R&D rose 16 and 17 percent respectively, with the increases primarily attributable to continued growth-oriented investment, currency translation and acquisitions, along with higher pension and OPEB expense. On a percent-to-sales basis, SG&A and R&D were similar to first quarter 2010 levels.

Operating income rose 9 percent to $1.6 billion for the quarter and margins were down about a point to 21.6 percent. Underlying first-quarter income growth was much stronger, however, after considering a few transient headwinds. If we adjust for Japan, H1N1 and pension and OPEB expense headwinds, operating income rose a strong 17 percent year-on-year.

The first quarter tax rate was 28.6 percent, up about 2½ points year on year, excluding the Medicare Part D-related tax charge in first quarter of 2010. Last year's rate benefited from a corporate reorganization that allowed us to increase ownership in one of our international subsidiaries. These benefits did not repeat in the first quarter of 2011. We continue to expect a full year 2011 tax rate of approximately 29.5 percent.

GAAP net income rose 16 percent in Q1, or 7 percent excluding for the Medicare Part D tax expense increase in the first quarter of 2010. Again adjusting for Japan, H1N1 and pension and OPEB expense, GAAP net income would have grown by 24 percent year on year.

Please turn to slide number 7.

Slide 7, Operating Income Margin Recon
David W. Meline

As I mentioned on the prior slide, operating margins were 21.6 percent for the quarter – a level that many industrial-based companies can only aspire to. But margins were 120 basis points below prior-year levels, and I would like to articulate the primary reasons why.

First, organic volume growth of nearly 9 percent boosted first-quarter margins by about 80 basis points. Raw material inflation, net of selling price increases, hurt operating margins by 90 basis points. So net net, organic volume growth leverage and inflation essentially offset one another in the first quarter.

Business disruptions related to the Japan earthquake hurt operating margins by 40 basis points. This effect is expected to increase in Q2, but in the second half we expect it will pass. We believe that our automotive OEM and consumer electronics-related businesses will absorb the lion's share of this impact. Higher pension and OPEB expense penalized margins by 70 basis points year on year. This will hurt margins in all quarters of 2011, but using assumed asset returns and current interest rate levels, pension expense is expected to decline in 2012.

Please turn to slide number 8, where I will review first quarter cash flow highlights.

Slide 8, Cash Flow
David W. Meline

Free cash flow was $502 million in the first quarter with cash conversion of 46 percent. This was lower than our typical first quarter, which averages around 70% cash conversion. Conversion was lower for three primary reasons.

One, we invested an additional $168 million in working capital in the quarter in support of growth. In the receivables area, for example, it is not unusual to see receivables rise late in the first quarter, only to subsequently fall in April as payments are remitted. That is precisely what happened this quarter, given that March was such a strong sales month.

Taxes also had a negative impact on conversion year on year. We received an $82 million tax refund in last year's first quarter that did not repeat this year. Also, recall that in the first quarter of 2010 we booked an $84 million tax charge related to changes to Medicare Part D. This was a non-cash charge, which therefore benefited last year's free cash flow conversion.

Finally, capital expenditures totaled $231 million, up 47 percent or $74 million year on year. Our full-year cap ex estimate remains $1.3 to $1.4 billion. Importantly, we are directing more of our capital investments toward international operations, and developing markets in particular. And a larger portion of spending is directly aimed at new growth programs.

Despite a lower Q1 conversion, we expect to achieve 100 percent conversion for the full year 2011.We spent $680 million on share repurchase in the first quarter, so a nice step up here. Finally, we invested nearly ½ billion in acquisitions – primarily the closing of Winterthur and Alpha Beta.

That is a quick summary of our first-quarter business performance. At this point I will turn the program back to George. Please turn to slide number 9.

Slide 9, Japan Situation Update
George W. Buckley

I'll now give you some flavor on the outlook for the coming quarters as best as we can see it at this stage. Let's first speak for a moment about the Japan situation.

Last year Japan was about $2.5 Bn in sales for us, so it was around 9% of our total. It will interest you to know that Japan had been clocking around 9% net sales growth prior to the earthquake. While we finished down 3% in organic local currency sales for the month of March, sales were still up 5% in local currency for the first quarter, clearly you showing both the underlying sales momentum there and the impact of the earthquake.

The human cost to us was blessedly small, with no employees or family members losing their lives and only about 10 families losing their homes. We have done everything possible help to these people, thankfully a few of them, without forgetting the scale of the tragedy to them as individuals or their families.

The earthquake and its tragic aftermath ended up costing us about $27 Million in the quarter, or 3 cents per share, and we estimate that it will cost us about $140 Million for the year or somewhere between 10 and 13 cents per share, depending on the geographic and end-market mix of sales. These are worldwide impact numbers, with only about half of the direct impact being in Japan. Industries affected around the globe are obviously those with Japan as part of their supply chain. On a positive note, the northeastern Japanese ports are now open again and there appears to be some basis for optimism about a gradually bettering situation in TEPCos Fukushima power plant, with cold shut down of the reactors forecast by year's end. We've also purchased back-up standby power generators for the three largest plants to ease any concerns about electricity supply.

Logically, we expect the impact in Q2 to be worse than it was in Q1, so things will probably get a bit worse due to Japan before they get better. This is partly because there is a full quarter's effect in Q2, and partly because component shortages will likely become worse for a while as the quarter unfolds and existing stocks are drawn down. However, Japan is mobilizing well and we expect this to be the worst of it and the negative effects will gradually abate as we move into the second half of 2011.

We think the Japan impact in Q2 is in the range of seven to eight cents per share, with about half of this total coming from our automotive business. Q3 might be a small negative, but Q4 should become gradually positive; so net net a small impact in the second half of the year. We'll see new compensating demand from reconstruction in telecoms, electricity distribution, construction and safety apparatus, plus rapid re-filling of automotive and distribution pipelines, and we all know the power of that to drive results. We are focusing on organizing for that uplift now. Not everyone agrees with me, but worries about Japan's impact on the world economy should also be significantly more muted in H2 as new sources of component supply are found by Japanese companies, or, alternatively, where their competitors take share and fill the sales gap with their own finished goods.

I think the net of all of this is that the Japan situation, while fluid and challenging in parts, seems more than absorbable and manageable within our guidance. So far, we have not included the benefit of any insurance recoveries or receivables in our earnings forecasts, or of any strong rebuilding recovery in Japan, which may begin sometime in Q3/Q4 and wash over into all of next year. But we know historically that restocking will begin a little before demand. So this is another upside for the year. As we all know, success in insurance claims is a duel between the tenacity of the insured and the terms and conditions of the policies and the doggedness of the insurers. So we've taken a conservative stance. History suggests, however, that we'll be successful to a reasonable degree.

Slide 10, 2011 Outlook
George W. Buckley

We note that Optical Systems did very well in Q1, with volumes up nearly 12%, but also that the TV channel, which is about 40% of Optical Systems Division sales, is a still a little full, with about three week's excess inventory in the channel. History tells us that the retailers and set manufacturers will correct this excess inventory quickly with production cuts, plus the impact of model changes that will take place in Q2. But in contrast, the largest set manufacturer, Samsung, who only broke even in this business in Q4, and lost money in Q1, is forecasting higher sales in the second half, so the correction may not be that severe.
But for planning purposes, we have allowed for some volume contraction from loss of LCD TV attachment, which frequently happens in the ebb and flow of competition and pricing in that channel. The institutionalized 10 – 15% annual price down is already included in our numbers. I think it's important here to make a point about the increasing strength of 3M's broad portfolio of businesses – we're no longer the one or two-trick pony we once were. When we feel confident enough to take up our estimates for the year even in the face of the scenario I just described, it's clear that Optical does not hold the same weight relative to our other businesses that it once did.

In 2005, Optical was roughly 8% of the company sales and 18% of company profits. Today, due to growth in so many new areas, it is now about 5.7% of our sales and 7% of profits. Still important, but only about a third of the economic impact on 3M that it once was. It's still volatile, and hard to forecast yes, but it's now time to stop worrying only about Optical.

The balance of the Display and Graphics business is also seeing very robust demand. Commercial Graphics is very strong; with sales well north of 20% in Q1 and this is nearly always a precursor for bettering economic times.

For the year, even with Japan, we expect that operating margins will be between 21.5 percent and 23 percent, with the lower end largely a function of potential one-time costs on deals not yet identified or closed.

There is no question that for now, overall U.S. manufacturing seems to be weathering the economic storm reasonably well and a weak dollar provides opportunities for export. I think that 3M's growth and that of the U.S. economy is still going to be strongly led by emerging markets. Demand for construction equipment is also robust. On housing, just when you think it is at the bottom it seems to get worse. So housing prices probably still have some way to fall this year, but ultimately, at some point, that will attract more buyers. That will be the start of a housing recovery. But in the United States and parts of Western Europe, the bugaboo still remains high unemployment. Automotive demand remains vibrant, with non-JOEM manufacturers probably able to supply a lot of the lost volume from Japanese sources. We're also seeing strong sales growth in renewable energy with growth rates of 68 percent in Q1, abrasives, automotive, air and water filtration, and electronics generally particularly in adhesives and hi-tech fluids and multi-touch technologies all grew strongly. The growth is really broad-based with too many areas of growth to mention specifically and innovation is driving it.

I don't want to seem like Jeremiah, and I mean the prophet not the bullfrog, but I can also see a similar set of economic circumstances emerging to those that we saw in mid 2008 with a weak dollar, rapidly increasing oil prices, high commodity prices and treasury yields, et cetera. Though on the positive side, liquidity is plentiful and banking is far more sound. Uncertainty breeds a wide range of forecasts and outlooks, for example, the latest Global Insight forecast calls for global IPI to fall significantly from 5.5 percent to 4.2 percent. We have to imagine that a combination of Japan, commodity inflation, the Middle East, and persistent high unemployment, must take money out of the world economy and contribute to somewhat slower growth. But ultimately, only history will prove some prognosticator correct.

I keep on hoping for a quarter without this level of uncertainty. But that doesn't seem likely for a while. We are monitoring the situation very closely, and with so many unknowns, we are staying conservative as you might expect from us. Our motto is to prepare and invest physically for the upside, but prepare mentally for any downside. And, we are certainly more upbeat than some! As George Bernard Shaw said, the best way to predict the future is to go out and create it, and that's the business we're in.

Based on the underlying performance of the company, on our momentum, currency impacts and high levels of new products, when we net all of this together, we remain much more optimistic than pessimistic about the year. The net of all our reasoning is that we expect organic sales growth to accelerate from a range of 5.5 to 7.5% to a new range of 6 to 7.5 percent, including the 1 percent drag from Japan. So that moves the underlying top end of our range, ex-Japan, up to 8.5%. So for 2011, in total, with acquisitions, price and a more positive currency outlook, we are expecting double-digit growth in revenues. Demand has been so strong in some new product areas that we may need to add fixed capital there to keep up.

Earnings are now expected to be in the $6.05 – $6.25 range even after the Japan impact, but we make no allowance for the positive upside of insurance recoveries.

Thank you very much everybody for your attention. We'll now be happy to take your questions.