Q1 2012 Earnings Call Transcript
Inge Thulin & David W. Meline
April 24, 2012

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

Thank you, good morning everyone, and welcome to our first quarter business review.

With me today are Inge Thulin, 3M president and chief executive officer, and David Meline, chief financial officer.

Before we begin, I would like to mention a few calendar items. We will announce our second-quarter earnings on Thursday, July 26th, and our third-quarter earnings on Tuesday, October 23rd. In addition, we are planning to host our next investor day in St. Paul on Thursday, November 8th. We will provide more details in the future, but for now please hold this date on your calendars.

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.

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

Slide 3, Off to a Good Start In 2012
Inge Thulin, President and CEO

Thank you Matt and good morning everyone, thanks for joining us on the call today.

I am very pleased to report that we are off to a good start this year with positive sales, operating income and EPS growth. In fact, we achieved an all-time Q1 sales record of seven point five billion. Industrial and Transportation, SS & PS, Health Care and Consumer and Office all performed well, while weakness in electronics hurt Display and Graphics and Electro and Communications. As we've said, we look for the electronics market to pick up as the year goes on.

Geographically for 3M, the Americas were strong, Asia Pacific was somewhat slower, and Western Europe held its own, with very good operational discipline. For the company, operating margins improved to nearly 22 percent, with five out of six businesses above twenty percent. We executed well and the result was a

seven percent increase in EPS to $1.59, including a 4-cent charge for a voluntary early retirement program and some miscellaneous restructuring.
In February, we announced a seven percent dividend increase, 3M's fifty fourth consecutive annual increase. The first quarter dividend payment, combined with Q1 share repurchases of over half a billion dollars, resulted in a first-quarter return to shareholders of nearly one billion dollars.

So, we're off to a good start, one that sets the right tone for the rest of the year, and one that gives us confidence in our ability to deliver, even against weak segments and regions and against an uncertain global economy.

I thank the 3M team for their outstanding work to achieve these very good results. The quarter highlights their ability to manage 3M's imbedded systems and tools to drive operational excellence and I am extremely pleased with the outcome.

Now, David will take you through the detail of the quarter. David.

Slide 4, Q1 2012 Sales Recap
David W. Meline, Senior **Vice President and CFO**

Thank you, Inge. Let's begin with sales. Please turn to slide number four.

First quarter sales were $7.5 billion, up 2.4 percent year on year. Organic local-currency growth was 1.8 percent in the first quarter, with volumes up just slightly and selling prices up 1.7 percent. Acquisitions added 1.5 percent to sales in the quarter, and foreign exchange impacts reduced sales by nearly one percentage point.

On a geographic basis, total growth was the strongest in the combined Latin America/Canada region at more than 8 percent. Organic local-currency growth was nearly 12 percent in the quarter, so our teams here continue to do an excellent job of building the business. Currency impacts reduced sales in the region by nearly 4 percent, largely due to weakness in the Mexican peso and Brazilian real.

In the United States, sales grew 6.3 percent, with double-digit increases in both industrial and transportation and in safety, security and protection services. The U.S. manufacturing sector remains quite robust and we are seeing some good growth as a result.

Sales in Asia Pacific declined by 2 percent in the quarter, reflecting slower year-on-year demand in global consumer electronics, along with slower growth in China. Both were fully anticipated in our prior outlook, so no real surprises here. On the electronics side, we continue to expect the market to turn positive around midyear. As for China, we are expecting below-trend growth in the second quarter, with better growth rates returning in the second half of this year.

Sales in Europe were basically flat in Q1, with strength in Middle East/Africa and Central/East Europe offset by year-on-year declines in the west. In aggregate, the economies in Western Europe have stabilized, at least for the moment, so things are not getting worse sequentially but they are also not getting better. We built our 2012 plan on this basis, so thus far things are progressing as expected.

Please turn to slide five for a more detailed look at our income statement for the quarter.

Slide 5, Q1 2012 P&L Highlights
David W. Meline

From an operating standpoint, we were quite pleased with our performance in the first quarter. As expected, the economy is not giving us much in terms of underlying growth, but we have a firm handle on discretionary spending and are off to good start to 2012.

Sales and gross profit both increased around two and a half percent in the first quarter. Operating income grew 3.5 percent and earnings per share rose 6.7 percent. Operating margins increased 20 basis points year on year to 21.8 percent.

Breaking down the margin change, first-quarter selling price increases, net of raw material inflation added 0.8 percentage points to operating margin, and other productivity added 0.3 percent. Foreign exchange impacts were a headwind of 0.3 percent, and the combination of higher year-on-year pension and OPEB expense hurt operating margins by 0.6 percent. Again, operating margins improved by 20 basis points in total.

Total SG&A increased $19 million in the quarter, largely related to the voluntary early retirement and restructuring actions mentioned by Inge, and R&D investments increased $13 million, about half of which related to these same events.

Earnings for the quarter rose 6.7 percent to $1.59 per share. The tax rate was 28.8 percent in the quarter, up just slightly versus last year. Average diluted shares outstanding were 706 million, down nearly 3 percent year on year, which added 4 cents of benefit in the quarter.

On the whole, our businesses are executing very well in this period of softer economic growth. Let's now review our first quarter performance on a business-by-business basis.

Please go to slide number six.

Slide 6, Q1 2012 Segment Performance
David W. Meline

Industrial and Transportation had an excellent quarter, with sales growing at 9 percent. Sales increased in every region of the world, with the United States leading the way at 13 percent growth. As I mentioned, the manufacturing sector of the U.S. economy is growing nicely. Europe and Latin America/Canada grew 6 percent, and Asia Pacific grew 8 percent. We posted double-digit sales increases in a number of areas, including industrial abrasives and automotive OEM. We also grew double-digits in our fastest-growing aerospace business. Aerospace has grown tremendously over the past few years and recently was elevated to become 3M's newest division. It's a great business poised for even faster growth.

Organic local currency growth was 7 percent in the quarter. Acquisitions added over 3 points of growth, largely related to Winterthur in the abrasives market and Alpha Beta in industrial tapes, both of which are tracking well versus our expectations. Operating income was $600 million, up 16 percent, and we improved margins by 1.4 percentage points to 22.5 percent. The Industrial and Transportation team has done an outstanding job transforming what was once a low-growth to no-growth business into a true industrial powerhouse.

Now let's move to Health Care. Sales grew 2 percent to $1.3 billion, with broad-based organic growth across the majority of our portfolio. We drove strong double-digit sales growth in health information systems this quarter. This is an excellent growth business and the industry leader in solutions for coding and classification of patient data. We work with more than 5,000 healthcare organizations worldwide, offering software solutions that improve productivity and enhance the accuracy of patient records. Earlier this month, we further strengthened this business by acquiring CodeRyte, a leader in clinical natural language processing technology and computer-assisted coding solutions for outpatient providers. We also posted mid-single-digit growth in food safety, skin and wound care and infection prevention, and oral care sales rose at a low single-digit rate. Sales declined in drug delivery systems against a challenging first-quarter comp. On a geographic basis, sales increased 11 percent in Asia Pacific, 9 percent in Latin America/Canada and 3 percent in the United States. European sales declined 6 percent in the quarter due to economic softness and ongoing austerity measures in many countries.

Developing markets remain a bright spot for Health Care, with double-digit sales growth in the first quarter. The health care industry is just beginning to take off in many developing nations, and we plan to expand our investments here as 2012 progresses. Operating income in health care increased 9 percent to $402 million, a strong result in an industry with its share of challenges at the moment and margins were 31.4 percent.

Now let's look at the Consumer and Office business. Sales again topped $1 billion this quarter, a 4 percent increase year on year. Our do-it-yourself business grew at a double-digit rate via a combination of acquired and organic growth. Recall that in October of 2011 we acquired the GPI Group, a French producer of tapes, hooks, insulation and floor protection products. GPI buys us speed and critical mass in the large European home-improvement channels.

On a geographic basis, Europe grew 16 percent in the first quarter, with positive gains from the GPI acquisition offset in part by lower organic volumes. We drove 9 percent sales growth in the combined Latin America/Canada region and 7 percent in Asia Pacific, while sales declined 1 percent in the United States. Consumer and Office generated $234 million of operating income in the quarter, up 9 percent year on year, and margins improved by 90 basis points to 22.4 percent.

Let's move on to the Safety, Security and Protection Services business. Sales were just shy of $1 billion in the first quarter, up 6 percent year on year. We drove high single-digit sales growth in our personal safety business, influenced by strong manufacturing activity in many areas of the world. The outlook here remains very positive.

Our roofing granules business also grew nicely in Q1, driven by warm weather conditions as well as some inventory rebuild at the OEM level. First-quarter sales declined in the security systems business against a tough comp year-on-year. Looking geographically, sales rose 16 percent in Latin America/Canada, 10 percent in the United States and 4 percent in Asia Pacific. Sales declined 3 percent in Europe. Good unit growth and excellent factory efficiency drove a 16 percent increase in operating income for Safety, Security and Protection Services. Margins improved 2.2 percentage points to 23.6 percent.

Let's now look at our Display and Graphics segment. Last year's first quarter was particularly strong for D&G, so we faced a tough comparison in Q1 of 2012. Sales were $832 million in Q1, down 12 percent year on year. Optical systems' sales fell 28 percent in the quarter, which was all LCD TV-related. Quarterly comparisons in optical get easier as 2012 progresses. Sales grew nicely in both architectural markets and commercial graphics. Worldwide sales declined just slightly in traffic safety systems, although U.S. sales in this business were quite strong. On a regional basis, sales rose 9 percent in the United States and 7 percent in Latin America/Canada. Sales declined 11 percent in Europe and 19 percent in Asia Pacific. Operating profits in Display and Graphics were $163 million and margins were nearly 20 percent for the quarter.

Finally, let's move to Electro and Communications. Sales were $808 million, down 3 percent. As expected, our electronics-related businesses posted sales declines in the first quarter, reflecting lower year-on-year customer production levels. Our 2012 plan called for an upturn in electronics sometime around mid-year and this remains our best estimate. We did see sequential sales improvement in Q1, so that is certainly a positive sign. In the electrical markets business, sales were up year on year, while telecommunications declined a few percent. On a geographic basis, sales increased 5 percent in the United States, 4 percent in Latin America/Canada, but declined 7 percent in Asia Pacific and 6 percent in Europe. Operating income in Electro and Communications was $168 million in the first quarter, and margins were nearly 21 percent, a good result in a tough growth environment.

That wraps up our business segment discussion. Please turn to slide number seven.

Slide 7, Q1 2012 Cash Flow
David W. Meline

Free cash flow for the quarter was $567 million, up $65 million year on year, so we are off to a very good start in 2012. Bear in mind also that this amount includes a voluntary $250 million contribution to our US defined benefit plan, something that we've not done before in Q1, therefore the underlying increase is much higher. Our pension funded status is in good shape despite today's low interest rate environment and we are continuing to stay ahead of the curve.

Working capital was a net year-on-year benefit in the first quarter, as our businesses are doing a nice job of managing capital in this environment. Lower tax payments and higher income also boosted free cash flow. Capital expenditures were $261 million, up $30 million versus first quarter of last year and we remain on track to invest $1.3 to $1.5 billion for 2012 in total.

First-quarter pension and OPEB contributions totaled $337 million, which was $276 million higher than Q1 of last year. This was factored into our 2012 plan, and you may remember that we discussed it on last quarter's call. As you can see on the bottom of this slide, we expect to contribute a similar amount in the second quarter. For the full year, we anticipate contributions of about $1 billion to our pension and OPEB plans.

Free cash flow conversion was 50 percent, a 4 point improvement versus the first quarter of 2011. Adjusted for pension and OPEB contributions, conversion was 80 percent this quarter versus 52 percent in Q1 of 2011.

We returned nearly $1 billion to shareholders in Q1. Specifically, we paid $410 million in cash dividends in the quarter, and gross share repurchases were $524 million.

That wraps up our discussion of the first quarter. Now I will turn the call back to Inge.

Slide 8, Vision
Inge Thulin

Thank you, David.

So far today we have been focused on the first quarter, but I'd like to change the subject for a few minutes and address a topic that is generating a lot of enthusiasm and support with our employees and with our customers. And that is our new vision for 3M.

I sensed that a vision for the entire company could really inspire our employees and position us positively with our customers, so we set out to capture the essence of 3M with a clear vision that is both timely and timeless.

I shared it with my direct reports on my first day in office and with all employees worldwide a few days later. I introduced it earlier to connect immediately with employees and to send a very clear message about 3M's direction, purpose and future.

Today it's my pleasure to share it with you. Please turn to slide eight.

3M Technology Advancing Every Company

3M Products Enhancing Every Home

3M Innovation Improving Every Life

I believe this captures well the essence of 3M: *technology, products and innovation*. It reflects what we do for our customers every day: *advance, enhance and improve*. It sets a stretch goal for all of us: **EVERY** company, **EVERY** home and **EVERY** life, all around the world.

From a performance standpoint, if we can make good progress toward realizing our vision, we can look forward to many more good quarters and many more years of increasing value for our shareholders.

We have had a super response from our employees, very supportive and excited. It was very encouraging to me also to see how our customers have responded. Whenever we meet with customers we share the vision, and it resonates very, very well with them. Of course, a vision means very little if you don't perform. With that, let's turn to slide nine for our outlook for the rest of the year.

Slide 9, 2012 Planning Estimates
Inge Thulin

We believe our expectations about global end-market trends are still valid and we are continuing to manage with them top of mind. Industrial markets continue to show strength, while consumer and health care markets remain steady. We are seeing some early improvement in the semiconductor market and we expect the electronics industry to pick up mid-year.

Geographically, the Western Hemisphere is doing well with Latin America leading the way – our teams there are doing a terrific job. Western Europe has stabilized, but at lower levels. Growth in the Asia Pacific region is slower because of China, Japan and the electronics market, but we still anticipate re-acceleration in the second half of the year.

As we are executing well and keeping the right balance between cost and investment, the Q1 results give us confidence to accelerate a number of targeted investments in technology, business building and emerging markets. Overall, we're looking at a range of thirty to fifty million. These investments will support faster technology development in promising areas such as biotech and lighting.

We will also invest to grow our Oil, Gas and Mining business, a segment with big potential. Of course, we are familiar with this market, and with added focus and investment, we can build a stronger position for 3M. Aerospace, as David mentioned, is another opportunity where we are looking to build our strength. We will also invest more in Emerging Markets, for example, Health Care in Latin America and China, and in personal safety everywhere, another high-growth, high-potential space.

So, looking ahead, we believe the right outlook for the year is an earnings range of $6.35 to $6.50 -- we're raising the lower end of the range by a dime. We continue to expect organic volume increases within the 2 to 5 percent range, and margins in the range of 21 to 22.5 percent.

It's still early in the year, and as always, we will continue to manage prudently even as we build for the future.

We will now be pleased to take your questions. Thank you.