Q2 2012 Earnings Call Transcript
Inge Thulin & David W. Meline
July 26, 2012

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

Thank you, good morning everyone, and welcome to our second quarter business review. With me today are Inge Thulin, 3M chairman, 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 third-quarter earnings on Tuesday, October 23rd, and our fourth-quarter earnings on Thursday, January 24th. And as I mentioned back in April, we are planning to host our next investor day here in the Twin Cities on Thursday, November 8th, so 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, Q2 2012 Results Marked by Strong Operational Execution
Inge Thulin, President and CEO

Thanks, Matt. Good morning and thank you for joining us on the call today. As you have seen, Q2 was very similar to our first quarter. We again saw superb operational execution by our team, we continued to grow our earnings, and I am pleased with our broad-based margin performance.

Second-quarter EPS was a record $1.66, up nearly 4 percent year-on-year. We grew operating income nearly 4.5 percent to $1.7 billion, with operating margins of 22.9 percent, up 1.3 percent year-on-year.

All six of our businesses posted margins above twenty percent, reflecting strong execution across the board. The revenue side was also similar to the first quarter. Sales were $7.5 billion, down 1.9 percent, including a negative currency impact of more than 4 percent.

Against a continued uncertain macro-economic backdrop, organic local currency growth was up about two percent with increases in all of our businesses except those affected by weakness in consumer electronics.

Geographically, the Americas once again led the way while Asia Pacific was down slightly. Our teams in Western Europe operated with very good discipline in that very challenging environment. In fact, operating margins improved almost two points there. Overall, Q2 demonstrated 3M's ability to deliver against weak segments and regions, but to me the real story goes well beyond our second-quarter performance.

We approached 2012 with caution and a conservative plan, a plan we continue to execute with discipline and diligence. Clearly, it was the right plan and we got a quick start on it. Our plan called for tight control over discretionary spending and we certainly did so in the first half of the year. Needless to say, that level of cost control will continue for the foreseeable future. Last but certainly not least, we returned over one billion dollars of cash to shareholders through dividends and share repurchases in the quarter.

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

Slide 4, Q2 2012 P&L Highlights
David W. Meline, Senior Vice President and CFO

Thank you, Inge. Let's begin by reviewing the income statement. Please turn to slide number four.

As Inge said, our business operated well in the second quarter, as we delivered outstanding profitability in a continued soft economy. We drove excellent factory performance and costs remained under very good control.

Sales declined 1.9 percent year-on-year, impacted by weak overall economic conditions, and also by the stronger U.S. dollar. I will elaborate on sales in just a bit. Conversely, gross profit dollars increased 0.7 percent versus last year's second quarter. SG&A costs declined 3.3 percent year-on-year, reflecting prudent caution on discretionary spending, and R&D investments increased 1.1 percent. We continue to invest to support future innovation and technology development.

In total, operating income grew by 4.4 percent and operating margins were a solid 22.9 percent, an increase of 1.3 percentage points year-on-year. Major components of the change in operating margin are detailed on the right-hand side of this chart. Selling price increases, net of raw material price changes, added 1.6 percentage points to operating margin, and foreign exchange impacts, net of hedges, added 0.3 percent. Higher year-on-year pension and OPEB expense hurt operating margins by 0.3 percent.

Earnings for the quarter were $1.66 per share, an increase of 3.8 percent. Average diluted shares outstanding declined 3.3 percent year-on-year to 702.6 million, resulting in a 5-cent positive impact to earnings per share.

The second-quarter 2012 tax rate was 30.1 percent, up 3 percentage points year-on-year, which hurt earnings by 7 cents per share. As a reminder, in the second quarter of 2011 we realized a one-time tax benefit from reorganizing one of our international subsidiaries, a benefit which did not repeat this quarter.

During the quarter we recognized insurance recoveries related to last year's earthquake and tsunami in Japan, which added 2 cents to earnings per share. And finally, we absorbed 3 cents of costs in the second quarter related to relocating a portion of our manufacturing operations from Western to Eastern Europe, along with consolidating certain manufacturing and supply chain support activities within Western Europe.

Once again, operating margins improved by 1.3 percentage points to 22.9 percent, as our teams are executing very well.

Please turn to slide five for a more detailed look at our sales change for the quarter.

Slide 5, Q2 2012 Sales Recap
David W. Meline

Sales for the second quarter were $7.5 billion. Organic local-currency growth was 1.9 percent, driven by higher year-on-year selling prices, and volumes were flat versus last year's second quarter. Acquisitions added 0.5 percent to sales in the quarter. Foreign exchange impacts reduced sales by 4.3 percentage points, as the U.S. dollar strengthened considerably against the Euro and other currencies.

On a total-dollar basis, sales declined by 1.9 percent year-on-year. Organic local-currency growth in Latin America/Canada was 11.4 percent, another strong showing by our teams in that part of the world. All six of our businesses contributed to the increase, with three businesses growing double-digits, namely Electro and Communications, Health Care and Safety, Security and Protection Services.

Organic sales growth in the United States was 3.6 percent. Organic local-currency sales declined slightly in Asia Pacific, as strong sales performances in both Health Care and Industrial and Transportation were offset by slower year-on-year demand in the consumer electronics industry. Japan declined 2 percent and China was up slightly year-on-year. We expect to see improving growth rates in China in the second half of the year.

On an ex-electronics basis, organic local-currency sales growth was 6 percent in Asia Pacific. We anticipate that our growth rates in consumer electronics will begin to improve in the third quarter and continue into the fourth. This improvement is due in part to easier comparisons, as our sales to this market slowed in the second half of 2011. But of course there are other factors in play, such as the timing of customer new-product launches.

In EMEA, or the combined Europe, Middle East and Africa, second quarter sales declined 1.9 percent on an organic local-currency basis. Regardless, challenges remain in Western Europe as these countries work through their economic and fiscal issues. We remain focused on what we can control, such as driving for additional market share and maintaining firm cost discipline.

So now let's dig into our business segment results. Please turn to slide number six.

Slide 6, Q2 2012 Segment Performance
David W. Meline

Industrial and Transportation generated sales of $2.6 billion in the second quarter, an increase of 4 percent on an organic local-currency basis. The growth was very broad-based, led by double-digit increases in both automotive OEM and aerospace. We also posted good growth in industrial abrasives and in our energy and advanced materials businesses. On a geographic basis, organic sales in local currencies increased 8 percent in Latin America/Canada, 7 percent in Asia Pacific and 5 percent in the United States, while EMEA declined just slightly in the quarter.

Operating income was $614 million, a year over year increase of 13 percent, and margins in the business improved by 2.8 percentage points to a solid 23.4 percent. Industrial and Transportation is the largest of our six segments, and continues to generate significant productivity and profitability.

Now let's move to Health Care. Once again, our Health Care team delivered superb results. Sales were $1.3 billion and operating income grew 13 percent to $414 million. Operating margins exceeded 32 percent.

Sales in the second quarter increased more than 5 percent on an organic local-currency basis. All businesses and geographic areas contributed to this growth, with particular strength in food safety and health information systems, or HIS. Both HIS and food safety are priority investment areas for us, and we are pleased to see another quarter of high growth in these spaces.

HIS also closed the acquisition of CodeRyte in the second quarter. CodeRyte is a leader in clinical natural language processing technology and computer-assisted coding solutions for outpatient providers. It is a great business in an important technology area…and a natural adjacency to our core coding and classification technology base. There are early signs of strong synergy between our businesses, which will enable further growth for HIS.

Looking geographically, we are pleased with our progress in emerging markets. These countries naturally seek higher-quality health care, and our investments in these areas are beginning to pay off. In the first half of 2012, organic local-currency growth in emerging markets was more than 14 percent for Health Care, led by our skin & wound care and infection prevention businesses. Of particular note this quarter were China and Mexico, each of which exceeded 20 percent organic growth in local currencies.

In developed markets, we also posted positive organic local-currency growth, despite weakness in Western Europe. This is a testament to the strength of our health care portfolio and the quality of our teams. Profit margins in Health Care were a strong 32.3 percent in the second quarter. Our factories continued to run very efficiently, discretionary spending is under firm control and the portfolio mix was excellent.

Now let's look at the Consumer and Office business. Sales were $1.1 billion this quarter, up 3 percent on an organic local-currency basis, and operating income rose more than 10 percent to $222 million. Operating margins rose 1.5 percentage points year-on-year to 21 percent.

From an end-market perspective, top-line growth was quite good across the mass retail, DIY, grocery and drug channels. This growth more than offset continued weakness in office wholesale and retail, which continues to be impacted by high unemployment levels.

Acquisitions added nearly 3 percent to second-quarter sales, largely related to the October 2011 purchase of GPI Group. GPI is a French producer of tapes, hooks, insulation and floor protection products for the home-improvement channel. Integration is moving along well and the business is on track toward its financial objectives.

On a geographic basis, organic local-currency growth was 9 percent in Latin America/Canada, 5 percent in Asia Pacific and 4 percent in the U.S. while EMEA declined 6 percent during the quarter.

Safety, Security and Protection Services business also had a good quarter. Sales were just shy of $1 billion in the second quarter, and operating income grew over 6 percent year-on-year to $258 million. Operating margins rose 2 full percentage points to 26 percent. A number of factors drove the margin improvement, including net positive impact from price and raw materials, improved factory utilization levels and positive mix.

Total organic local-currency sales growth for the business was 3 percent, with significant contributions from the infrastructure protection, personal safety and building and commercial services businesses. Second-quarter sales declined year-on-year in the security systems business. Looking geographically, sales rose more than 20 percent in Latin America/Canada, and 2 percent in both Asia Pacific and the U.S. Sales declined 4 percent in EMEA.

Let's take a look at our Display and Graphics segment. Sales in the second quarter were $882 million, down 7 percent in organic local-currency terms. Optical systems' sales fell 20 percent versus last year's second quarter, largely driven by LCD TV. On a sequential basis, sales improved by 8 percent. We continue to see good growth in 3M films for battery-powered devices such as smartphones and tablets where 3M's value proposition remains very strong.

Also in D&G, architectural markets and commercial graphics continue to grow nicely. Sales in traffic safety systems declined slightly in the quarter on an organic local-currency basis. On an organic local-currency basis, sales grew by 9 percent in the United States and 8 percent in Latin America/Canada. Sales declined 14 percent in Asia Pacific - largely electronics-related - and 6 percent in EMEA.

Operating profits in Display and Graphics were $179 million and margins were 20.3 percent for the quarter.

Lastly, let's review Electro and Communications. Second quarter sales in this business were $824 million, operating income was $195 million and operating margins increased 60 basis points to an impressive 23.7 percent.

Sales were down year-on-year in our consumer electronics-related businesses. Our 2012 plans in this space called for a challenging first half of the year, which has been the case. We continue to believe that growth will improve in the second half of 2012, due to a combination of improved industry demand and easier year-on-year comps.

Organic local-currency sales increased in our electrical markets business, while the telecom supplies business declined a bit. In geographic terms, Latin America/Canada rose 13 percent and the U.S. increased 6 percent, while Asia Pacific and EMEA declined 5 and 8 percent, respectively.

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

Slide 7, Q2 2012 Cash Flow
David W. Meline

Free cash flow for the quarter was just over $1.0 billion dollars, down $125 million year-on-year. This amount includes a voluntary $250 million contribution to our U.S. defined benefit plan. We made a similar size voluntary contribution in the first quarter of this year, putting total year-to-date discretionary cash contributions at $500 million. This amount is consistent with our plan for the year.

In total, second-quarter pension and OPEB contributions totaled $335 million, which was $271 million higher than Q2 of last year. For the full year, we anticipate total contributions of about $1 billion to our pension and OPEB plans, and we remain very well-funded at the moment.

On the positive side, free cash flow benefited from lower working capital investment and higher levels of net income. Capital expenditures were $358 million, up $63 million versus second quarter of last year…and we remain on track to invest $1.3 to $1.5 billion for 2012 in total.

Free cash flow conversion was 88 percent in the quarter versus 100 percent in last year's second quarter. Adjusted for pension and OPEB contributions, conversion was 117 percent this quarter versus 105 percent in Q2 of 2011.

We returned over $1 billion to shareholders in the second quarter, including $410 million in cash dividends and $639 million in gross share repurchases. And on a final note, during the second quarter we issued $1.25 billion of long-term debt, spread over 5- and 10-year terms, at record low corporate yields. So that concludes my discussion of our second-quarter financial results. Now Inge will address our forward outlook.

Thanks, David. During uncertain times like these I am especially appreciative of 3M's business model, a model flexible enough to allow investments to improve the business and yet disciplined enough to deliver earnings and superior margins when economic growth is challenging.

We are well known for our culture of innovation but just as real is our culture of continuous improvement. For example, in the first half of this year, we absorbed restructuring costs of seven cents per share. Given that most knowledgeable observers see slow or stalled global growth in the second half of the year, we will continue the approach that served us very well in the first half: strong execution and productivity, good cost discipline, and continued investments and actions to improve and build our businesses around the world.

We are, in fact, increasing our momentum to move 3M forward. For example, in the quarter we announced the acquisition of Federal Signal Technologies group. FSTech is focused on electronic toll collection, parking management hardware and software services; key adjacencies to our traffic safety systems business.

On last quarter's call we talked about investments in Aerospace and in a newly formed business, Mining, Oil and Gas Solutions. They both progressed very well this quarter. Aerospace grew 24 percent, and Mining, Oil and Gas at 20 percent, significantly faster than the market. I look for great things from these businesses, as they both operate at the crossroads of advanced technology and megatrends.

As you know, 3M is a true pioneer of international business. Many of our international companies have existed for decades, for example, 3M Brazil dates back to 1946. Over the years we have developed global capabilities that are second to none. Our newest frontier is Sub-Saharan Africa, where we just launched an initiative to broaden our presence in this emerging market. In Q2 we announced the formation of a new subsidiary in Nigeria and reactivated our operations in Kenya. We believe Sub Saharan Africa holds long-term opportunity for 3M of more than half a billion dollars.

Also in the second quarter, we took steps to establish a stand-alone company in Saudi Arabia. 3M already does sizeable business there, and with a wholly owned subsidiary, we can make a step change in our

growth there. We expect 3M Saudi Arabia to be in full operation on September 1st. Here again, we see long-term opportunities in the 500 million dollar range.

We took actions this quarter to fully realize opportunities like Africa and Saudi Arabia by increasing the effectiveness of the way we go to market and serve customers. In addition, we just appointed a new vice president of Global Sales Operations to increase sales skills, competence and productivity around the world. The new VP of global sales is an experienced sales professional a proven leader who has led 3M businesses in Europe and North America with great success.

Also, with the increasing importance of digital platforms in the marketplace, we have elevated eTransformation with the appointment of a vice president for this function. The new leader has both the understanding and experience to lead our companywide efforts, as he has led similar efforts at a number of companies before joining 3M. The objective is to build and scale our e-platform to realize rewards in increased sales, brand presence and productivity.

These two appointments, along with the previous appointment of a vice president of Global Marketing Excellence, will significantly increase our sales and marketing horsepower at the center of the company and improve our capability to drive growth and penetration everywhere. That is a quick summary of some of the ways we are moving the company forward. I'll now turn to our outlook for the balance of the year. Please turn to slide 8.

Slide 8, 2012 Outlook
Inge Thulin

First, my confidence in the company's ongoing performance leads us to affirm our EPS outlook in the range of $6.35 to $6.50 for the year. We do so with full consideration of additional headwinds from currency in the second half. Looking upon sales, we expect organic local currency growth of 2 to 5 percent for all of 2012. We trimmed the high end of the range by a point, based on the first half and on our views about global economic activity going forward. Strong pricing should offset slightly lower volumes and comps become easier as the year goes on. After the good margin performance in the first half, we are raising the bottom end of the margin range from 21 percent to 21.5 percent. And the tax rate remains unchanged.

To me, the second quarter demonstrates that 3M continues to operate very well, with alignment, discipline and always with an eye toward opportunity. Thank you for your attention. We will now take your questions and comments.