



Q3 2011 Earnings Call Transcript
George W. Buckley, Inge Thulin & David W. Meline
October 25, 2011

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

Good morning, everyone. Welcome to our third quarter earnings conference call.

Before we begin, I've got two items just to mention. First, please plan to attend our annual outlook meeting, scheduled for the morning of Tuesday, December 6th at the Grand Hyatt Hotel in New York. An invitation will go out today. Second, we will announce fourth quarter earnings on January 26th, so please mark your calendars.

Today we will address our third quarter results, along with an updated outlook for the remainder of this year. The slide presentation and audio replay will be archived on our website for an extended period.

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

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 the program over to George.

Slide 2, Introduction
George W. Buckley, President, Chairman, and CEO

Good morning, everybody, and welcome. Well, today David and Inge will lead the majority of the formal pieces of the call, but by way of a set-up, I would like to offer a few words at the beginning of the call. The quarter turned out to be a very different one than what we expected.

The challenges that we faced were primarily two causes and two effects. Cause number one was worries about European sovereign debt, and the European economy, and cause number two was the rapid contraction of electronics end markets. It began with TV, extended to other consumer devices and has now crept a bit into factory automation. Effect number one was the slipping exchange rates, as confidence in Europe's ability or willingness to deal with the crisis fell and its economy responded negatively. Foreign-

exchange alone will reduce our earnings by up to \$0.07 over the balance of Q4. This is the reverse side of having almost 70% of your sales outside of the United States. On the second effect, this was simply volume and the under absorption that comes along with it.

In the last few months, worldwide IPI forecast for 2011 has fallen by fully 200 basis points. This is a reset down in expectations for the global economy. Those who know our company well, know two things always happen in these circumstances. First, the changes are always amplified in supply chain, temporarily suppressing net growth. And second, we always see the effect early, typically one to two quarters before our industrial peers. Without these factors of transience, our underlying organic growth would have been almost 6%, so underlying fundamentals are okay. The better news is this, electronics markets always recover quickly and early from these types of flash contractions as do we.

With that introduction, I would like to turn the call over now to David to begin with the details. David.

Slide 3, Third Quarter Developments
David W. Meline, Senior Vice President and CFO

Thanks George and good morning everyone. Let's turn to page number 3. I am going to start with a few brief comments on the quarter, along with a discussion of our current macro view, which has changed since our second quarter call.

At the time of our July earnings call, the late-quarter data was hinting that global economic growth was beginning to moderate. We felt it in our results and described it as such, but at that early point it was difficult to ascertain the extent to which that softness might extend into Q3. Signs indicated this was temporary and that better growth rates would resume in the second half of the year. Japan, of course, further clouded the picture.

In this quarter's results you will see that several of our businesses grew nicely. We posted worldwide sales of \$7.5 billion, a 10 percent increase over last year's third quarter and, notably, a record for any third quarter in our history. Three of our six businesses posted double-digit increases – namely industrial and transportation, safety, security and protection, and health care – and our consumer business expanded their sales as well. Growth in these four segments was achieved through a combination of good organic volume, selling price increases and acquisitions, along with a dose of positive currency benefit. So while there is definitely growth to be had in this economy, certain segments clearly hit an inflection point in the quarter, and some retreated.

Western Europe is experiencing challenges given the uncertainty around fiscal and monetary policy direction. This is impacting consumer confidence and spreading to the manufacturing sector. Our organic volumes in Western Europe declined 4 percent in the third quarter after a flat result in the second quarter and a 4 percent increase in the first.

The consumer electronics market, excluding handhelds, slowed considerably as the third quarter progressed, which impacted our sales in electro and communications, and we also saw it creeping into factory automation too. We sell a broad array of component solutions to all types of electronic OEMs, and roughly ½ of this business's sales go to the electronics industry. We know from history that electronics cycles are fast, so volume declines are deep and short, but the good news is they also normalize quickly.

In display and graphics, LCD TV remains the story, as OEMs are fighting a battle to lower prices, reduce inventories and yet still create value for retail customers.

By and large, with the exception of consumer and office and health care, we are a component supplier to our customers. Our products are generally consumed in our customers' manufacturing processes or imbedded in the customers' end-products, so our business is fairly short-cycle. This means that when economic trends turn down, our customers alter production schedules and we feel the impact sooner than most. And those changes are nearly always accompanied by temporary inventory transients, which amplify the impact on our sales.

Bear in mind this phenomenon works in both directions. When the economy turns back up, volumes recover sooner and our growth is amplified as the channel fills again. We have been through these corrections many times in our past and we know how to respond. Inge will speak more to this in a few moments.

With that brief intro, I would now like to turn the call over to Inge, who will review the quarterly performance of our six business segments. Please turn to slide number 4.

Slide 4, Most Businesses Grew Sales and Profits in the Quarter
Inge Thulin, Executive Vice President and COO

Thank you, David and good morning everyone.

While there is no doubt the environment is changing somewhat, there is a lot for us to feel good about in the third quarter. Five of our six businesses achieved positive sales growth with three delivering double-digit growth and we posted an all-time record for third quarter sales.

Now, let's take a closer look at each business starting with Industrial and Transportation, our biggest business. Third-quarter sales were up a solid 19 percent to \$2.6 billion, or 15 percent in local currency terms. Sales grew across all businesses, with double-digit increases in abrasives, renewable energy, aerospace, and industrial adhesives and tapes. Geographically, growth was broad-based with sales up 28 percent in Asia Pacific, 22 percent in Europe, 15 percent in Latin America/Canada and 10 percent in the United States.

Acquisitions contributed 6.8 percent to growth. Winterthur, one of our larger acquisitions in this space, is a tremendous addition to our core abrasives business. It is a technology-rich company in the area of bonded abrasives for hard-to-grind precision applications in industrial, automotive, aircraft, and the cutting tool markets. We have long admired Winterthur's technical capability, and we are very excited about the combination of our two companies. Integration is well underway and on track.

Some of our businesses in Industrial and Transportation were affected by the slowing economic activity. For example, the industrial adhesives and tapes business, which sells across most industries, including electronics, was particularly impacted.

In our Industrial and Transportation business, profits grew by 21 percent to \$525 million, with a highly respectable operating margin of 20.4 percent. All in all, it was another solid performance for this business, which represents one-third of our global business mix.

Let's move on to Health Care, sales grew 14 percent to \$1.2 billion, or nearly 11 percent in local-currency. The strongest growth came from our infection prevention business, which drove outstanding high-single digit organic growth in the quarter, in addition to a nice boost from the Arizant acquisition. We acquired this company one year ago and so far it has been a home run. Early indications are that patient warming solutions for the operating room are catching on quickly in overseas markets, where 3M has a strong presence in the hospital channel. Sales also grew nicely in our core skin and wound care business and in health information systems.

Health Care sales increased at a double-digit rate in every geographic region, with Asia Pacific up 20 percent, Latin America/Canada up 16, Europe up 13 percent and the United States up 12 percent. We have been investing more aggressively in emerging markets over the past couple of years to accelerate penetration in our health care platforms, and we're beginning to see the benefits in our results. Operating income in health care increased 13 percent to \$367 million and margins were 29.5 percent.

We are very excited about our new products in the health care space. For example, our Health Information Systems business recently developed and commercialized a breakthrough software that helps hospitals transition to a new standard coding system called ICD-10. We've already been selected by the Centers for Medicare and Medicaid Services to support ICD-10 transition planning at its headquarters in Baltimore. Also, in our food safety business, we have launched a new test procedure in collaboration with a major food manufacturer to monitor shelf life and food quality.

We achieved excellent sales growth in our oral care business, especially in developing economies. Recent acquisitions of orthodontic companies in Brazil and in China have expanded our presence in mid- and lower-tier categories, which will be critical to our long-term success in these early-stage but fast-growing markets.

Let's now turn to Consumer and Office, sales increased 7 percent year on year to \$1.1 billion, or 5 percent in local currencies. Operating income increased 4 percent to \$244 million and margins were strong at 22.3 percent. Growth was broad-based in the quarter, with nearly all businesses growing in local-currency. Notable performances were in our consumer health care, do-it-yourself and home care businesses.

On a geographic basis, sales grew in all regions, with particular strength in Asia Pacific at 18 percent, where we continue to invest in China and India to establish brand presence in this growing part of the world. Latin America/Canada grew sales 11 percent and Europe was up 5 percent, largely due to positive currency impacts. Sales in the United States were up 4 percent, a nice improvement year on year.

Seasonal sales and new products helped drive growth in Consumer and Office. Back to school met our expectations and provided a nice lift in sales of our Command brand hooks and mounting solutions. We also expanded our family of market-leading Filtrete products, with a new carbon-based home furnace filter that eliminates odors and allergens. On a global basis, we continued to gain penetration in the home care market, leveraging our leading Scotch-Brite brand. Overall, it was a good quarter for our Consumer and Office business.

Now let's go on to Safety, Security and Protection Services business. Sales rose by 18 percent to \$954 million, or 14 percent in local currency. Organic sales were up high single digits and we added almost 6 points from acquisitions. All geographic regions posted positive sales growth, led by the United States at 28 percent, Asia Pacific at 25 and Latin America/Canada at 21 percent. Operating profit increased 23 percent to \$202 million and operating margins were at 21.1 percent for the quarter.

This quarter's strong growth was driven foremost by personal safety products, with good gains in both respiratory and hearing protection, two sizable platforms within this business. We also saw a surge in sales of roofing granules, driven by last summer's heavy tornado season. That demand has worked its way through the channel and we anticipate some slowing in the fourth quarter.

We drove double-digit growth in security systems, accelerated by the December 2010 acquisition of Cogent Technologies. Cogent gives us important technology in finger, palm, face and iris biometric systems to complement our existing border security and identification solutions. Cogent also expands our reach into law enforcement, public safety and commercial access control applications. During the third quarter, we earned a nice win with U.S. Customs and Border Protection Agency, which is using 3M electronic passport readers in all U.S. air, land and sea ports of entry.

Let's now look at our Display and Graphics segment, sales were \$935 million, down 12 percent year on year and down 14 percent in local currency. As David mentioned, optical films for LCD TVs drove much of the decline. Retail TV demand continues to soften, therefore OEMs are lowering brightness specifications in order to reduce prices. In addition, they are slowing production to lower inventories. On the positive side, we continue to see strong attachment rates on battery-powered devices such as tablet PCs, smart phones and notebooks, where the value proposition for our films is very strong.

Excluding optical, total Display and Graphics sales declined just under 1 percent in local currencies. Sales in traffic safety systems declined a bit in local currency terms, due to low levels of highway construction funding by governments in the United States and Western Europe.

One of our newer businesses in this segment is architectural markets, formed a short time ago to accelerate our penetration in the design solutions market. Products here range from 3M Di-Noc finishes to advanced lighting solutions. This business posted double-digit local currency growth in the quarter, and continues to show excellent potential.

Finally, let's take a look at our Electro and Communications business. Sales were \$838 million, up 4 percent, and profits were down just slightly to \$181 million. Margins for the quarter were 21.6 percent. All geographic regions posted higher year on year growth, led by Europe and the United States at 7 percent each.

Sales rose 9 percent in our electrical markets business, a powerhouse franchise that serves the utility and infrastructure markets. Electrical is a true enduring franchise for 3M that just keeps on growing quarter in, quarter out. We also saw good growth in telecommunication markets in the quarter.

Sales to the electronics industry rose just slightly, a considerable change versus the high growth rates we saw over the past several quarters. As David mentioned, this market has slowed, which significantly affected our customers' production schedules in Q3. This slowdown is expected to persist for the next few quarters.

Electro and communications announced a number of growth initiatives recently, including an agreement with IBM to jointly develop new adhesives to enable the creation of microprocessors that are up to one hundred layers thick. These chips are potentially 1000 times faster than those used today. We also announced a manufacturing capacity expansion for 3M ACCR High Capacity Overhead Conductors, which are gaining traction in the market place on a global base. In addition, we are building new capacity for our 3M branded Novec products used in electronics, data centers, semiconductors and medical markets.

Please turn to slide number 5.

Slide 5, Managing Our Business in the Current Environment

Inge Thulin

As both David and George mentioned, it's clear that the macro trends have slowed and growth rates have drifted lower, which naturally begs the question "How are we responding?"

First and foremost, we will stick to our long-term growth plan and continue to invest significantly in research and development. In fact we have invested \$1.2 billion year to date, up 14 percent. New product introductions will continue to fuel growth as we expand our businesses and drive market share gains. Experience tells us that it is especially important in these times to differentiate ourselves from the competition through great products. This is precisely how we improved our competitive position during the last downturn.

Secondly, we remain bullish on long-term growth in developing markets and plan to continue investing in those countries. Emerging markets now represent 34 percent of the company, up from 17 percent in 2000.

In addition, we are targeting \$1.3 to \$1.5 billion of capex in 2011 versus \$1.1 billion in 2010, a healthy increase. We have good line of sight to future growth needs in all of our businesses, so this new capacity will be critical to our future success.

We maintain a strong balance sheet, which enables us to return significant cash to shareholders through the ups and downs of economic cycles. Through nine months of 2011, we returned \$3.4 billion to shareholders via cash dividends and gross share buybacks.

At the same time, we are establishing a 2012 plan with maximum flexibility. We expect the global economy will grow, but at a slower rate, and anticipate there will be growth to capitalize on, but there will be bumps along the way. There just always are and we all know it. We currently expect that the second half of 2012 will be better than the first, as electronics will take a few quarters to wash through the system. Just as we did in 2009, we will take full advantage of this time to engage with our customers to develop unique 3M solutions to their challenges.

In terms of driving productivity, we have already been quite active during this year in a number of businesses. The Display and Graphics team, for example, has been reducing full time and temporary positions, primarily in Asia, to address declining factory utilization levels and put in place contingency plans early around spending. Electro and Communications responded to weakening demand with targeted actions to improve productivity and reduce costs, while staying fully prepared to capitalize on an eventual upswing. In Europe, our new regionalized subsidiary structure is driving speed and simplicity in our

operations, and will save us \$10 million dollars this year. Importantly, all of businesses have aggressively prioritized and are prepared for whatever comes our way in 2012.

Going forward, we have implemented hiring freezes in most developed countries. Replacements will be limited to those key positions that are closest to the customers. Our businesses have also triggered contingency plans with respect to indirect costs, which represent over \$4 billion dollars annually, so there is still room for more improvement. And finally, we are considering the need for more aggressive actions as we monitor economic growth in 2012. We will have more to say about 2012 at our meeting in New York City during the first week in December.

Again, flexibility in our 2012 plan will be key. This quarter's slowdown could prove to be short and temporary or it could linger into next year. We are prepared for either. So in short, our long-term strategy is intact, our financial condition is strong and we are well positioned to win in any economic scenario.

That is a quick overview of business results and operations. Now I will turn the call over to David, who will provide some additional color on the quarter.

Slide 6, Q3 2011 Sales Recap
David W. Meline

Thank you, Inge. Let's start with sales, so turn to slide number 6.

We posted record third-quarter sales of \$7.5 billion, up nearly 10 percent year on year. In dollar terms, the growth was broad-based with all geographic regions increasing year on year. Of note this quarter was Latin America/Canada region with 14 percent growth year on year. This was the 8th consecutive quarter of double-digit sales growth for the region.

Currency was a net positive in Q3, adding 3.1 percent to sales. FX added 5 percent to sales in both Asia Pacific and Europe and 3 percent in Latin America/Canada. However, sales were impacted negatively by the late-quarter surge in the dollar, which cost us over one point of sales growth.

As I mentioned earlier, organic volume growth slowed in the quarter to 1.9 percent. Volumes increased in all geographic regions, with the exception of Europe. More specifically, Western Europe experienced a 4 percent decline in organic volumes for the quarter.

The two factors I mentioned earlier – namely the decline in Western Europe along with slowing in electronics – together hurt 3M's overall organic volume for the quarter by nearly 4 percentage points. Normalized organic volume growth for the company was therefore closer to 6 percent.

We continued to raise our selling prices in the quarter, a necessity in light of higher raw material costs. Prices rose nearly 1 percentage year on year. Adjusting for optical, where price-down is necessary in order to compete, prices for the company rose nearly 2 percent in the quarter. Through nine months to date, all of our other businesses are now in a positive price position and are expected to more than cover raw material costs inflation for the calendar year cumulatively.

Acquisitions added nearly 4 percent to sales in the quarter.

Please turn to slide 7 for a look at our income statement for the quarter.

Slide 7, Year-on-Year P&L Highlights
David W. Meline

Sales, as I mentioned rose 10 percent in the quarter, and gross profit dollars grew 6 percent year on year to \$3.5 billion. Gross margins were 46.6 percent versus 47.9 percent in last year's comparable quarter.

We were able to neutralize raw material inflation with selling price increases in the quarter, and we are on track to fully offset raw material inflation for the entire year, with the exception of optical.

As the quarter progressed, our sales did not develop as expected, particularly in September. Demand patterns were very good at times, but choppy during others. As Inge mentioned earlier, we took action to adjust our factory loading levels in some businesses, but the effects were not fully realized in the third quarter. The resulting under absorbed overhead largely explains this quarter's gross margin decline.

Helping to mitigate these factors are ongoing savings in our factories including faster line speeds, waste reduction, yield improvements, energy savings and other ongoing productivity improvements, driven by our lean six sigma teams around the world.

SG&A rose 13 percent year on year, with 10 points of the increase coming from FX and acquisitions. Underlying SG&A therefore rose 3 percent. Similarly, R&D investment rose 10 percent versus third quarter of last year, maintaining a healthy 5.2 percent of worldwide sales. Six points of the R&D increase related to acquisitions and FX. Our business teams are working aggressively to achieve a 32 percent NPVI target in 2011, which would be an outstanding result considering a lower sales outlook.

Operating income was \$1.6 billion, up slightly year on year, and margins were 21 percent. Earnings for the quarter were \$1.52 per share, down a penny versus last year's third quarter. The tax rate was 28.6 percent in the quarter versus 26.8 percent last year, which cost us \$0.04 per share. A lower share count added 2 cents of benefit in the quarter.

Slide 8, Cash Flow
David W. Meline

Please turn to slide number 8.

Free cash flow for the quarter was \$1 billion and we converted 94 percent of net income to cash, consistent with our historical third quarter average. Net working capital impacts were slightly positive year on year, as both inventory and accounts receivable turns were right in line with third quarter 2010 levels.

During the quarter, we contributed \$248 million to our pension and OPEB plans, \$55 million less than in last year's third quarter. At present we are planning to contribute another \$200 million to our plans in the fourth quarter, which would put the full year pension and OPEB investments at \$600 million in total. Cash taxes paid were \$43 million higher year on year.

Investment in cap ex for the quarter was \$336 million, up \$108 million year on year. We anticipate full year capital expenditures of \$1.3 to \$1.5 billion, up from \$1.1 billion in 2010. More than half of this investment will be in international locations supporting our ongoing strategy to localize production to better serve our customers around the world.

Gross share repurchases in the third quarter totaled \$849 million, putting us at \$2.2 billion through nine months of the year. For the full year, we now anticipate spending in the range of \$2.5 to \$3 billion, up from a prior range of \$2 to \$2.5 billion gross for the calendar year.

Slide 9, 2011 Planning Estimates

David W. Meline

Turning to slide number 9, with three quarters of the year behind us, let me address our updated outlook for the year. Please turn to slide number nine.

We now expect that earnings per share will fall within the band of \$5.85 to \$5.95 per share, versus a prior expectation of \$6.10 to \$6.25. Organic volume growth will come in between 3 and 4 percent for the year versus a prior forecast of 6 to 7.5 percent, reflecting the more challenging economic environment we face. This is expected to reduce full year earnings by \$0.25 to \$0.30 per share.

Partially offsetting this is the impact of a lower share count. We have been more aggressive in purchasing our stock of late, which has the effect of boosting full-year earnings by \$0.04 to \$0.06 cents per share.

On the tax rate, we now estimate that our full year tax rate will be approximately 28.5 percent versus our previous projection of 29 percent. This equates to an additional \$0.04 of earnings versus our July guidance.

Finally, foreign currency impacts will still be positive for the year, however recent US dollar strength has reduced the estimated benefit by \$0.06 to \$0.10 per share for the full year versus our prior forecast. Approximately two-thirds of this reduction can be attributed to the fourth quarter.

Full year operating margins will be approximately 21 percent for the year. As a reminder, we are absorbing a \$0.22 per share pension and OPEB expense headwind in our 2011 results. Our new guidance, adjusted for this item, implies year over year EPS growth of 8 to 10 percent.

Lastly, I would like to share our early thoughts on next year's pension and post-retirement expense. We are currently estimating a 10 cent per share headwind in 2012 related to pension and OPEB expense. This forecast assumes that the discount rate on our US plans remains 4.5 percent, which is equal to the rate at September month-end. It also assumes U.S. asset returns of positive 6 percent, also equal to our actual performance through the first nine months of the year.

This wraps up our formal comments today. I look forward to seeing many of you at our meeting in December for a complete discussion of our 2012 plans. We hope you can make it.

Now we will be happy to take your questions.