Q4 2011 Earnings Call Transcript
Inge Thulin & David W. Meline
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Slide 2, Introduction
Matt Ginter, Vice President, Investor Relations

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

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 and 10Q 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 David.

Slide 3, Third Quarter Was a Good Finish to the Year
David W. Meline, Senior Vice President and CFO

Thanks, Matt, and good morning everyone. Please turn to slide number 3.

First, a brief summary of the fourth quarter, which I felt was a good finish to the year. We drove record sales and good returns, and things finished largely as expected.

We once again saw some real strength in our many of industrial-oriented businesses, along with steady growth in consumer and health care. On a geographic basis, Latin America and the United States were the fourth-quarter stalwarts.

The consumer electronics industry continued to adjust production levels during the quarter to better match demand and supply, much as we had described on our third quarter call in October and again at our December investor meeting in New York. This had an impact on our Display and Graphics and Electro and Communications businesses, particularly within Asia Pacific.

The flooding in Thailand hurt fourth quarter sales by an estimated $35 million and operating profit impact of $20 million, which was in line with our estimates. On the positive side, we recorded $23 million in insurance

recoveries related to last year's earthquake and tsunami in Japan. Therefore, from a profit standpoint, these two items largely offset one another.

We once again drove strong double-digit growth in Central/Eastern Europe and the Middle East, which more than offset weakness in the west. We have yet to see significant signs of recovery in Western Europe. Inge will talk more about our businesses in just a minute.

Income rose 5 percent year-on-year, and operating margins finished at 19.2 percent. Free cash flow was $1.2B and we converted 128 percent of net income to cash, a good result and typical for a fourth quarter at 3M. So the business continues to generate significant profit and cash flow.

Finally, in early January we announced the acquisition of Avery Dennison's office and consumer products business. Inge will describe this in more detail in a moment.

Let's take a closer look at sales for the quarter, so please go to slide 4.

Slide 4, Q4 2011 Sales Recap
David W. Meline

Quarterly sales were $7.1 billion, up nearly 6 percent year-on-year. The combined Latin America/Canada region was up a strong 10 percent, with organic growth more than offsetting nearly 4 points of negative currency. The United States also had an excellent quarter, with 7 percent organic growth. U.S. organic volumes have now grown for several quarters consecutively.

Sales in Asia Pacific rose 3 percent in the quarter, slower than we have seen in recent quarters. Part of this, of course, was due to consumer electronics, where the market continued to seek bottom. We expect the market to turn positive sometime in the second quarter.

Clearly, China was also a factor in the fourth quarter, as the Chinese government successfully slowed activity to stem inflation. Our China team anticipates continued below-trend growth in the first half of 2012, with stronger growth returning in the second half.

Europe rose 4 percent, with strength in Middle East/Africa and Central/East Europe more than offsetting weakness in Western Europe.

Selling prices rose 2 percent in the quarter, which exceeded raw material inflation, and for the full year, the net impact was neutral. Acquisitions added 2.3 percent to sales in the quarter, and foreign exchange impacts were basically flat.

Please turn to slide 5 for a more detailed look at our income statement for the quarter.

Slide 5, Q4 2011 P&L Highlights
David W. Meline

During this period of slower economic growth, we are paying increased attention to protect the bottom line. For example, we have implemented hiring freezes in developed countries, and replacements are being limited to key positions that are often closest to customers. Our businesses have also triggered contingency plans with respect to indirect costs, these costs total over $4 billion dollars in annual spending for the company. The early results were encouraging, as fourth-quarter indirect spending was down, both year-on-year and sequentially. So, we are getting traction here.

In the fourth quarter, sales rose 6 percent, gross profit increased 4 percent and both operating income and earnings per share rose 5 percent. Operating margins were 19.2 percent.

Volume growth added 0.2 percent to fourth quarter operating margins. Selling price changes, net of raw material inflation, added 0.8 percentage points, and other productivity contributed 0.3 percent. Higher year-on-year pension and OPEB expense hurt margins by 1.0 percent and foreign exchange was a 0.5 percent headwind in the quarter.

SG&A increased 5 percent in the quarter, and R&D costs were down slightly. Recall that in the fourth quarter of 2010, we accelerated investments to bring forward a number of 2011 growth programs. Given current economic realities, we chose not to repeat this in the fourth quarter of 2011.

Earnings for the quarter were $1.35 per share, up 5 percent versus last year's fourth quarter. The tax rate was 26.7 percent in the quarter versus 25.3 percent last year, which reduced earnings by $0.03 per share. Conversely, a lower share count added 4 cents of benefit in the quarter.

Please turn to slide number 6.

Slide 6, Q4 2011 Cash Flow
David W. Meline

Free cash flow for the quarter was $1.2 billion, up $116 million versus last year's fourth quarter. Income was of course up year-on-year, and working capital was a net year-on-year benefit in the fourth quarter. Cap ex investment was $517 million, consistent with prior year levels. Full-year cap ex was $1.4 billion, which was within our original expected range.

During the fourth quarter, we converted 128 percent of net income to free cash flow. We contributed $209 million to our pension and OPEB plans in the quarter, which lowered the conversion rate by 22 percentage points.

Note at the bottom of this slide we intend to contribute $800 million to $1 billion to our pension and OPEB plans in 2012 versus the $600 million that we contributed in 2011. Of the 2012 contribution, $600 million will occur over the first two quarters, compared to $125 million in the first half of 2011. As a result, free cash flow conversion rates will be lower than historical trends in the first half.

We paid $384 million in cash dividends in the quarter, and gross share repurchases were $494 million.

Our strong balance sheet enables us to return significant cash to shareholders and, importantly, to continue growing the business through economic ups and downs.

Now, Inge will address the fourth quarter performance of our business segments. Please go to slide number 7.

Slide 7, Q4 2011 Segment Performance
Inge Thulin, Executive Vice President and COO

Thank you, David, and good morning everyone. I am pleased to report that our businesses have responded well to the current economic environment, and that was evident in our fourth-quarter results. Let's take a closer look at each business, starting with Industrial and Transportation.

This business posted outstanding growth in the fourth quarter, as sales rose 14 percent to $2.4 billion. All businesses within Industrial expanded their sales, with double-digit increases in most businesses. All geographic regions drove double-digit sales growth, with Asia Pacific up 17 percent, the United States up 15, Europe up 12 and Latin America/Canada up 10 percent.

Organic local currency growth was 8 percent in the quarter, an impressive result. Acquisitions added another 6 percent to growth, the two largest being Winterthur and Alpha Beta. Winterthur is a Swiss-based, technology-rich addition to our abrasives business, specifically in hard-to-grind precision applications. Alpha Beta is a Taiwanese tape manufacturer that strengthens our offerings in B and C product tiers. Both acquisitions are tracking very well versus our expectations.

Profits grew by 14 percent to $472 million. Operating margins were 19.6 percent, basically flat year-on-year, as the team drove strong productivity to offset a 50-basis point headwind from acquisitions. Also, included in Industrial's profit for the quarter, was $20 million dollars of insurance recoveries related to the Japan earthquake and tsunami. All in all, this was another solid performance for our Industrial and Transportation business.

Let's now look at Health Care. Sales grew 5 percent to $1.3 billion. All businesses within Health Care grew their sales with infection prevention and skin and wound care leading the way.

Health Care sales increased across all regions, with Asia Pacific up 11 percent, Latin America/Canada up 10, the United States up 5 and Europe up 2 percent. Operating income in health care increased 12 percent to $389 million and margins were 30.8 percent.

Health care continues to gain recognition for innovation. For example, 3M ESPE was recently named the most innovative dental company for the seventh consecutive year.

Our health care team continues to exemplify innovation for 3M. The health care industry has its challenges to be sure – austerity in Western Europe, for example – but our business continues to deliver excellent results.

Now on to the Safety, Security and Protection Services business. Sales rose by 9 percent to $927 million, all of which was organic. We drove double-digit growth in security systems and in personal safety products during the quarter, along with single-digit growth in building and commercial services. Sales declined in the roofing granules business, due to channel inventory corrections in the United States.

Looking geographically, sales rose 18 percent in the United States, 17 in Latin America/Canada and 13 percent in Asia Pacific. In Europe, sales declined 4 percent.

On the innovation front, this business for the first time ever exceeded $1 billion dollars in new product sales in two thousand eleven.

Operating profit increased 4 percent to $171 million and operating margins were 18.5 percent in the quarter.

Let's now look at our Display and Graphics segment. Sales were $823 million, a 9 percent decline year-on-year.Optical film sales in total fell 17 percent in the quarter, which was all LCD TV-related. Films for battery-powered devices continue to grow nicely. These include tablets, smart phones and notebooks.

Elsewhere in Display and Graphics, sales grew in both commercial graphics and architectural markets. Sales declined in traffic safety systems, as government highway funding remains weak, particularly in the U.S. and Western Europe.

On a regional basis, sales declined 1 percent in the United States and Latin America/Canada, 10 in Europe and 12 percent in Asia Pacific.

Profits in Display and Graphics rose 10 percent in the quarter, as the team drove outstanding productivity. Operating margins increased over 3 points to 19.2 percent.

Moving to Electro and Communications, sales were $768 million, down 3 percent, and profits declined 7 percent to $153 million. Margins for the quarter were very close to 20 percent. Growth was again led by our electrical markets business and sales were flat year-on-year in telecommunications.

Sales in our electronics-related businesses declined high single digits, reflecting ongoing production adjustments across much of the industry. We expect these adjustments will continue until inventories are back in line with demand.

On a geographic basis, sales increased 6 percent in Latin America/Canada, 5 in the United States and 2 percent in Europe. Sales declined 9 percent in Asia Pacific, of course heavily impacted by electronics.

Finally, let's look at the Consumer and Office business. Sales topped $1 billion this quarter, a 6 percent increase year-on-year. Half of this growth was organic, with particular strength in our do-it-yourself, stationery products, office supplies and home care businesses.

We also added 3 points of growth to Consumer and Office this quarter via the recent acquisition of GPI Group. France-based GPI produces tapes, hooks, insulation and floor protection products and is an excellent complement to our existing do-it-yourself business. It will help us quickly expand our presence in European home-improvement channels.

On a geographic basis, sales growth was strongest in Europe at 15 percent, again boosted by GPI. Sales grew 11 percent in Asia Pacific, 9 in Latin America and 1 percent in the United States.

Operating income in Consumer and Office increased 2 percent to $179 million and margins were 17.6 percent, diluted somewhat by the acquisition. If we back out GPI's results, underlying margins were 18.4 percent, up 20 basis points versus last year's fourth quarter.

Please turn to slide number 8.

Slide 8, Avery's OCP Business is an Attractive Asset for 3M
Inge Thulin

We were very pleased to announce the acquisition of Avery's consumer and office products business earlier this month. As you know, Avery is a leader in this space with labels, binders and other office products. We anticipate closing sometime during the second half of this year.

The acquisition brings several strategic benefits. We gain immediate scale in the United States, as well as several valuable brands including Avery, Highlighter and Marksalot. As you might expect, we plan to bring much-needed innovation to the business and, in the end, customers will benefit through better products, service and value. The purchase price is $550 million dollars cash. As you can see on the slide, the multiples are quite attractive at 0.7 times trailing sales and 5.7 times trailing EBITDA. We see potential to expand operating margins to around 20 percent in the out years.

We are very excited about this acquisition and look forward to bringing new value to our customers.

Please turn to slide number 9.

Slide 9, 2011 Was a Good Year Despite a Tougher Economy
Inge Thulin

To summarize, two thousand eleven was a good year for our company in a challenging environment.

We grew sales 11 percent, with double-digit performances in Industrial & Transportation, Safety, Security & Protection Services and Health Care. New products helped fuel the growth, and we finished the year with 32 percent NPVI.

Sales in developing economies rose 14 percent, and now represent 34 percent of the company. We continued to generate premium operating margins, finishing 2011 at nearly 21 percent. Margin strength was broad based, with all businesses above 20 percent for the year.

Earnings were $5.96 per share, an increase of 6 percent. We once again generated significant free cash flow of nearly $4 billion, and return on invested capital was 20 percent. This strong cash flow allowed us to return $4.3 billion to shareholders through a combination of dividends and share repurchases, up 81% versus 2010.

So, all in all, there is much to feel good about in our 2011 results, and the company is well positioned for success again this year.

Please turn to slide 10, where I will summarize our forward outlook.

Slide 10, 2012 Planning Estimates
Inge Thulin

While our plans for 2012 have firmed up since we last spoke with you, we still think it is appropriate to maintain maximum flexibility. We don't know precisely what the global economy will bring this year, so we are managing costs very carefully in the early stages. But maximum flexibility also means capitalizing on opportunities as they arise. The key here is to be ready to act quickly on those opportunities, no matter what they are.

We know that in uncertain times, innovation is more important than ever. It differentiates great companies from the rest of the pack, so we will preserve key investments in R&D, sales and manufacturing to ensure future growth.

We also know that emerging markets continue to present very promising platforms for growth in the future. Whatever challenges they present today pale in comparison to their opportunities. There is no better example than China, where near-term issues will not affect our investments for long-term success and growth. Sales in China grew five percent in the quarter and 13 percent ex-electronics, both clearly below trend. This is the result of several factors:

First, the Chinese government is successfully cooling the economy to manage inflation. As David mentioned earlier, our China team anticipates that stronger growth will return in the second half of the year. Second, China's prominence in consumer electronics contributed to our lower growth rate in Q4, and we also expect that to turn upwards sometime in the middle of the year. Third, the soft economies in Western Europe, for example, continue to affect exports, and it's difficult to gauge exactly when conditions might improve. Overall, we agree with the consensus view that China growth will become more robust as 2012 goes on.

But the main point I want to make is this: any temporary troubles are trumped by the magnitude of the China opportunity, and we will continue to invest to create and realize opportunities there. And the same is true of all developing economies.

At our December meeting in New York City, we described our financial expectations for 2012. Our outlook has not changed since then, so today we re-affirm those expectations.

We expect that full-year 2012 earnings per share will be in the range of $6.25 to $6.50. Included in this range is an estimated nine cents per share year-on-year increase in pension and postretirement benefit expense. We are estimating organic volume growth between 2 and 5 percent for the year. We expect that operating margins will be between 21 and 22.5 percent, with the lower end largely a function of potential one-time costs on acquisitions that might be completed later in the year. This is purely a planning assumption at this point. Finally, we continue to expect a tax rate of 29.5 percent in 2012. Sales and profit growth will be challenging in the first half of two thousand twelve. It's our view that first-quarter economic growth will be low, and will improve as the year progresses.

Underlying these estimates are several factors. Europe,of course, is contracting at the moment. Again, consumer electronics will be tough in early 2012, and we expect to see recovery around mid year. Optical, in particular, will have its toughest comparison in the first quarter. Finally, we expect to incur costs of four

cents per share in the first quarter related to a voluntary retirement incentive program in the United States, along with some selective restructuring in a few mature countries. These actions, in aggregate, will be neutral to full-year 2012 earnings, with the costs incurred in Q1 and the associated benefits realized over the remainder of the year.

That concludes our formal comments today. Now we will be happy to take your questions.