

Q3 2013 Earnings Call Transcript Inge Thulin & David W. Meline October 24, 2013

Slide 1, Opening Matt Ginter, Vice President, Investor Relations

Thank you and good morning. Here with me today are Inge Thulin, 3M chairman of the board, president and chief executive officer, and David Meline, our chief financial officer. Welcome to our third quarter business review.

Note that today's earnings release and slide presentation accompanying this call are posted on our investor relations website at 3M.com under the heading 'quarterly earnings.'

Slide 2, Upcoming Events Matt Ginter

Before we begin, I would like to address a few upcoming events, highlighted on slide number two. First, we have set the dates for our 2014 earnings calls. They are January 30, April 24, July 24 and October 23.

Second, we will host an investor meeting on the afternoon of Tuesday, December 17th at the Grand Hyatt hotel in midtown Manhattan. We plan to have several presenters on hand for this event, including many members of our senior leadership team.

Inge will provide the keynote presentation highlighting 3M's progress on key strategic initiatives and objectives, and the heads of our five business segments and international operations will highlight their respective businesses. Finally, David will provide a status update to the 5-year plan that we introduced in November of 2012, including capital structure and capital allocation. And, of course, we will articulate our 2014 earnings outlook.

Invitations for this event will be sent this afternoon, so please RSVP as soon as possible and we hope to see you there.

Slide 3, Forward Looking Statements Matt Ginter

Please turn to slide number three. During today's conference call, we will make certain predictive statements that reflect our current views about 3M's future performance and financial results. These statements are based 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, let's begin today's review, and I will turn the program over to Inge. Please turn to slide number four.

Slide 4, Q3 2013 Highlights Inge Thulin, President and CEO

Thank you, Matt, and good morning everyone. As always, I appreciate you joining us today.

I am pleased to report that Q3 was a strong quarter for 3M. We posted an all-time record for quarterly sales and every business grew sales organically. All five business groups posted margins above 20 percent, while we continued to advance our strategic priorities and investments.

Let's take a look at a few third-quarter highlights.

Sales rose 5.6 percent to a record of \$7.9 billion. Organic local currency growth was 5.8 percent in the quarter, led by Safety and Graphics at 8 percent, Health Care at 7 percent and Industrial at 6 percent. Our Consumer business grew 4 percent organically, as did Electronics and Energy.

This quarter's organic growth of 5.8 percent was a significant improvement versus the two percent growth in the first half of 2013. Industrial, Safety and Graphics, as well as Electronics and Energy, showed the most improvement. On a geographic basis, developed economies such as the United States, West Europe and Japan also showed substantial improvement.

On a year-to-year basis, we posted positive organic growth in all geographic regions. Latin America/Canada led the way with double-digit organic growth of 11 percent. Asia Pacific rose 7 percent, the United States was up 5 percent and Europe/Middle East/Africa increased 4 percent.

As expected, currency was a headwind to sales, reducing worldwide sales by 1.7 percent. And acquisitions added 1.5 points to third quarter growth.

So, all in all, a very strong quarter with organic local-currency growth of 4 percent across all developed markets and 10 percent in developing markets.

Operating margins were again strong at 22 percent or 22.4 percent excluding the first-year impact of acquisitions.

All five business groups delivered margins above 20 percent, while also growing their top lines, proof of continued broad-based effectiveness and efficiency. Earnings were \$1.78 per share, up nearly 8 percent versus third quarter of 2012.

Finally, we returned \$2 billion to shareholders in the quarter through dividends and share repurchases, or \$4.8 billion through nine months of the year.

In summary, it was an excellent quarter for 3M on many fronts and our businesses continue to grow very profitably. I thank the 3M team for their outstanding effort to deliver these very good results.

Let me now review the outlook. Please turn to slide number 5.

Slide 5 Updating 2013 Planning Estimates Inge Thulin

With one quarter remaining in the year and the business performing to our expectations, we are narrowing our full-year guidance to \$6.65 to \$6.75 versus a previous range of \$6.60 to \$6.85 per share.

On organic local currency growth, we are also narrowing the full-year 2013 range to 3 to 4 percent versus a previous expectation of 2 to 5 percent. We continue to expect that currency impacts will reduce sales for the year by approximately 2 percent. And we look for acquisitions to add about 1.5 percent to sales for the year.

As for the 2013 tax rate, we now anticipate a range of 28 to 28.5 percent. And free cash flow conversion is expected to be approximately 90 percent.

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

Slide 6, Q3 2013 Sales Recap David W. Meline, Senior Vice President and CFO

Thank you, Inge. Let's begin with a review of sales growth. Please turn to slide six.

Organic local currency growth was 5.8 percent in the third quarter, which was a significant acceleration versus the 2 percent we saw in the first half of the year. Volumes contributed 4.8 percent to third-quarter growth and we continued to see good pricing power with selling prices up a full percentage point year-on-year.

Acquisitions added 1.5 points to sales growth in the quarter, related to Ceradyne in our Industrial business and FSTech in Safety and Graphics.

Foreign exchange impacts reduced sales by 1.7 percent points in the third quarter. Currency impacts were negative 6 percent in Latin America/Canada and negative 5 percent in Asia Pacific, while EMEA had a positive 3 percent currency impact year-on-year.

Third quarter sales rose 5.6 percent in dollar terms.

Looking across geographic regions, Latin America/Canada led the way with strong organic local currency growth of 10.5 percent in the quarter. All five business groups contributed to growth in the quarter, including double-digit organic growth in Industrial, Health Care and Safety and Graphics.

Asia Pacific grew nearly 7 percent organically in the quarter. China/Hong Kong grew by 11 percent in Q3, with notable strength in Safety and Graphics and in Health Care, followed by Electronics and Energy. Organic local currency growth was 5 percent in Japan, led by Industrial, Health Care and Consumer.

Organic local-currency growth was 4.5 percent in the United States. Health Care, Industrial and Safety and Graphics led U.S. growth in the third quarter.

In EMEA, organic local-currency sales growth was 4.3 percent. West Europe was up 3 percent year-on-year, continuing a positive trend. This was our strongest growth in West Europe since the first quarter 2011.

Middle East Africa increased double digits and Central and Eastern Europe also posted good growth in the quarter.

Organic local-currency growth was 4 percent across all developed markets, a positive step-up versus recent quarters, and 10 percent in developing markets.

Let's turn to slide number 7 for a discussion of the third quarter income statement.

Slide 7, Q3 2013 P&L Highlights David W. Meline

Sales rose 5.6 percent to \$7.9 billion, which is the highest quarterly sales result in 3M's history. We generated \$3.8 billion in gross profit and gross margins increased 10 basis points year-on-year to 47.6 percent. SG&A and R&D investments rose 8 percent and 6 percent, respectively. Operating income increased 3.6 percent in Q3 to \$1.7 billion.

GAAP operating margins were 22 percent, down 40 basis points year-on-year. Included in these results was a 40 basis point impact from acquisitions. Therefore, underlying margins were equal to last year's third quarter result.

Leverage on organic volume growth added 40 basis points to operating margins in the third quarter and the combination of lower raw material costs and higher selling prices added 1.2 percentage points.

Strategic investments and one-time actions reduced margins by 80 basis points year-on-year. This represents incremental investments in disruptive R&D, our ERP system and restructuring actions.

Foreign exchange impacts reduced margins by 30 basis points and the combination of the U.S. medical device tax and other factors negatively affected margins by 50 basis points year-on-year.

Third-quarter earnings increased 8 percent to \$1.78 per share. Foreign exchange impacts hurt EPS by 4 cents versus the third quarter of 2012, and a lower tax rate added 2 cents. Average diluted shares outstanding declined 2 percent year on year, which added 3 cents to EPS.

Now let's turn to cash flow. Turn to slide number eight.

Slide 8, Q3 2013 Cash Flow David W. Meline

We generated \$1.2 billion of operating cash flow in the third quarter. Working capital investments were higher year-on-year, largely timing-related, and we expect that they will reverse in the fourth quarter.

Capital expenditures were \$404 million, an increase of \$46 million versus last year's third quarter, and we expect full-year cap ex will be in the range of \$1.6 to \$1.7 billion.

Free cash flow was \$747 million and we converted 61 percent of net income for the quarter. For the full year, we anticipate free cash flow conversion will be around 90 percent.

We paid \$431 million in cash dividends during the quarter, or \$1.3 billion year-to-date.

If you looked at our balance sheet in today's press release, you would see that the worldwide cash and marketable securities are \$1.6 billion lower today than one year ago. We are managing the business with lower cash levels, the U.S. in particular, for several reasons.

First, the business continues to grow and generate significant cash flow. Second, rising interest rates are positively impacting our already well-funded pension status. And finally, our capital structure remains very strong, which is an important component of our business model, but we do not intend to strengthen it further.

Gross share repurchases during the quarter were \$1.5 billion and, for the reasons cited above, we are increasing our expected range to \$4.5 to \$5 billion versus a previous range of \$3.5 to \$4.5 billion.

And as Matt mentioned, we will provide a full planning update at our upcoming investor meeting in December, including capital structure and capital allocation.

Now let's review our third-quarter performance on a business-by-business basis. Please go to slide number nine.

Slide 9, Industrial David W. Meline

Our Industrial business had a good third quarter, with sales of \$2.7 billion and 6.2 percent organic local-currency growth. The growth was broad based as all operating divisions and all geographies posted positive growth.

Our aerospace and automotive OEM businesses generated double-digit organic local-currency growth, and we also saw strong growth in advanced materials, liquid filtration, automotive aftermarket and industrial adhesives and tapes.

On a geographic basis, organic local-currency sales rose 13 percent in Latin America/Canada, 8 percent in EMEA, 6 percent in the US and 3 percent in Asia Pacific.

The Ceradyne acquisition added 4.1 percent to growth in the quarter. Integration is going very well and profits continue to exceed expectations. Nine different 3M divisions have launched development projects that leverage Ceradyne technology.

First-year sales are a bit short of plan due to U.S. troop drawdown efforts, but we are winning new business with customers. In September, for example, we earned an \$80 million contract to supply enhanced combat helmets to the U.S. Marine Corps.

Third-quarter operating income was \$568 million and reported margins were 21.3 percent. Excluding Ceradyne, Industrial operating margins were 22.2 percent. Margins were also impacted by negative FX and strategic investments in growth programs and our ERP system.

Please turn to slide number ten.

Slide 10, Electronics and Energy David W. Meline

As expected, our Electronics and Energy business rebounded nicely in the third quarter compared to the first half of the year. Sales were \$1.4 billion, up 4 percent in organic local currency terms, and operating income rose 3 percent to \$300 million.

Margins were 20.7 percent, up a bit versus last year's third quarter, and up 3 percentage points sequentially.

Electronics-related sales increased 4 percent on an organic local-currency basis. Market demand was stronger year-on-year and we were spec'd in to a number of newly introduced electronic devices.

Most industry sources are projecting flat demand for electronics this holiday season. As a result, we are planning conservatively through year-end.

On the energy side, organic local-currency growth was 3 percent. Electrical Markets led the growth, boosted by record sales of our ACCR overhead power conductor. Communications and renewable energy were both slightly positive year-on-year.

On a geographic basis, organic local-currency sales increased 6 percent in Asia Pacific, 3 percent in Latin America/Canada and just slightly in EMEA. Organic sales declined 1 percent in the US.

Please go to slide eleven.

Slide 11, Safety and Graphics David W. Meline

We saw growth accelerate in Safety and Graphics in the third quarter. Sales were \$1.4 billion, up 8 percent organically, a significant increase from the 2 percent in the first half of the year.

We generated double-digit organic growth in personal safety products and in roofing granules. Our commercial graphics and building and commercial service businesses also posted good organic growth in the quarter and traffic safety and security rose slightly.

Sales in Safety and Graphics grew organically in all major geographic regions, with strong double-digit growth in both Asia Pacific and Latin America/Canada.

The FSTech acquisition added 0.9 percent to growth in the guarter.

Safety and Graphics generated operating income of \$315 million, an increase of 7 percent versus last year's third quarter. Margins were up slightly year-on-year to 21.8 percent. Excluding FSTech, third-quarter 2013 operating margins were 22.1 percent.

Now let's look at Health Care, found on slide twelve.

Slide 12, Health Care David W. Meline

Sales in this business were \$1.3 billion, up 7 percent in organic local-currency terms. As was the case in Industrial, we generated positive organic sales growth in every division and in every geographic region within Health Care.

Organic sales growth was strongest in food safety, health information systems, oral care, drug delivery and critical and chronic care.

On a geographic basis, organic local-currency sales increased 11 percent in Latin America/Canada, 9 percent in Asia Pacific, 6 percent in the US and 5 percent in EMEA. And across all of the developing markets, Health Care generated 14 percent organic sales growth. This is very similar to recent quarters.

Operating income was \$426 million, up 7 percent year-on-year, and margins rose 40 basis points to 32.1 percent. Margins were helped this quarter by a gain on the sale of a small, non-strategic asset offset in part by the U.S. medical device tax, the net of which added 1 percentage point of margin.

Our Health Care business continues to post strong and consistent sales growth and excellent profitability, this helps stabilize the more cyclical elements of our portfolio. The business generates tremendous value for 3M.

Finally, let's review the Consumer business, found on slide number thirteen.

Slide 13, Consumer David W. Meline

Consumer also posted a strong third quarter with sales of \$1.2 billion and organic local-currency growth of 4 percent. Operating income was \$247 million, up slightly year-on-year, and operating margins were 21.5 percent.

Organic sales growth was strongest in our consumer health care, home care, stationery and office supplies and DIY businesses.

On a geographic basis, organic local-currency sales growth was 9 percent in Latin America/Canada, 7 percent in Asia Pacific, while EMEA increased just slightly. Organic growth was 3 percent in the U.S., helped by a good back-to-school season.

Developing markets within Consumer grew 10 percent organically in the third quarter.

Similar to Health Care, the Consumer business is a very steady grower with excellent profitability and is a stabilizing force within the 3M portfolio.

That concludes our discussion of 3M's detailed third quarter results. I'll now turn the call back over to Inge.

Slide 14, with 3M Logo Inge Thulin

Thank you, David.

Before we take your questions, I want to highlight our progress on three important strategic levers. Portfolio management, investment in innovation and business transformation.

First, portfolio management.

We continue to strengthen and prioritize our portfolio. The Electronics and Energy business is a good example of where we are making progress.

In the third quarter, we consolidated the Infrastructure Protection Division into the Electrical Markets Division, giving this business a lower cost structure, improved market relevance and greater international reach. Also, earlier this year we integrated Touch Systems into the Electronic Solutions Division to align these businesses to better serve our customers. There is more portfolio work to be done here, and we continue to look at other structural opportunities.

One of the primary reasons for forming the Electronics and Energy business was to present a single 3M voice to the electronics industry. Now we are easier to work with and more relevant to

large, fast-moving electronics customers. And, I am happy to report that we are receiving very positive reactions from customers on all of these changes.

Second lever, investment in innovation.

Innovation remains the center of our plan. As I hope you remember, last quarter we shared some details about how we are investing in longer-term disruptive technologies with significant growth potential.

We are now funding 20 new product platforms, several of which are expected to be introduced to the market in 2014. We are also investing in a new, state-of-the-art laboratory facility at our headquarters in St. Paul, Minnesota, which I announced last year. We broke ground in August, and construction is well underway. This new laboratory will be an important hub for 3M's global research network.

Finally, the third lever. We continue to make good progress with respect to business transformation and ERP implementation. We successfully went live in Taiwan, Russia, Indonesia and the Philippines and, in October, we went live in Canada. Next up is our European/Middle East/Africa Supply Chain Center of Excellence in Switzerland in November. Twenty more countries are scheduled for 2014. We expect to achieve benefits in many areas including supply chain, working capital management, customer responsiveness, improved business planning and faster decision making.

In closing, we delivered a strong third quarter, with good broad-based performance across all businesses. We remain focused on expanding our business, driving productivity and executing our plan with strong discipline.

Thank you for your attention and we will now take your questions and comments.