



Q2 2010 Earnings Call
George W. Buckley & Patrick D. Campbell
July 22, 2010

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

Good morning everyone, and welcome to our second quarter business review.

For those of you that attended our investor meeting in Kentucky last month, we hope you found it helpful in understanding our company further. Also, as I have mentioned on the past two earnings calls, please mark your calendars for the morning of Tuesday, December 7th, when we will host our annual outlook meeting in New York City. Complete details regarding timing and location will be available later very soon

Before we begin, 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's begin the review, and I will turn the program over to George. Please turn to slide number 3.

Slide 3 – Quarter Highlights
George W. Buckley, President, Chairman, and CEO

Thanks, Matt.

Good morning everyone and thanks for joining us for our second quarter call.

As you've seen, it was another outstanding quarter for us in both revenue and earnings as we essentially repeated and built upon the success patterns of recent quarters.

In fact, sales of \$6.7 billion matched our previous all-time quarterly record set in 2008. Coming off the depths of the recent recession, I think this is a remarkable achievement by 3M's people only one year after such a terrible economic contraction.

We once again delivered tremendous organic volume growth – 18 percent this time – nearly twice the rate of global IPI. While it's difficult to determine accurately the exact sources of the growth, a

strong economy was certainly a factor and, as we explained last quarter we continued to take market share and create new markets with the high level of new product vitality. It's opening many old and many new customer doors for us.

As we've done throughout the downturn, we continued to invest in, and build for the future. In Q2 we took a major step forward, increasing advertising and promotions by nearly 30 percent (mostly in consumer) and increased R&D spending by 13 percent. I think this speaks directly to the strength of the 3M model, in that we are able to generate very high-quality results even as we invest and build for future success.

Second-quarter record operating income was \$1.6 billion, up 34 percent on last year. But I'm especially pleased with our margin performance at 23.7 %, with all businesses achieving 22 percent or better margins. The corresponding EPS of \$1.54 per share is a 38 percent increase year over year.

Slide 4 – Business Segments

George W. Buckley

Let me now take you quickly through the business highlights. Please turn to slide number four.

In our largest business, Industrial and Transportation, sales were up 23 percent and leverage was outstanding, with profits up 66 percent. Within that segment, our newest division, Renewable Energy was up 73 percent in sales, coming off a 72 percent increase in Q1. FYI, we built a brand new coating line for this business in Singapore last September, which very quickly sold out, so we'll be expanding capacity in the months to come. Also of note is that our Automotive OEM sales were also up nearly 50 percent. This compares to global auto builds in the mid 20 percent...and Abrasives – our oldest business – was up an impressive 28 percent.

Health Care sales rose 5 percent in dollars or about 6 percent in local currency terms. The H1N1 was about a point on health care growth. The stars in Health Care were Drug Delivery Systems, which is creating double-digit growth, largely from new products; Dental Care sales were up 7 percent in local currency; and our core Skin and Wound Care business grew at a similar rate. Health Care profits increased in line with sales, reflecting increased investment levels. Even with those investments, margins were a very spiffy 31 percent.

Display & Graphics continued on its impressive growth and profit trajectory, with a 30 percent sales jump and profits up 69 percent. Optical Systems again led the way with a 64 percent sales increase... driven almost entirely by new products. Our technology is in the sweet spot of need as LCD TVs migrate to LED backlights. Another star was our Commercial Graphics business. In 2009 it was impacted greatly by the downturn and is now on an upswing with Q2 sales up 22 percent year on year and 12 percent sequentially. This is especially encouraging more generally since, in our experience, Commercial Graphics is a huge proxy for future business renewal and advertising spend.

Consumer & Office sales rose 10 percent, with organic growth accounting for over half the increase. Acquisitions were also a significant driver with the additions of Ace bandages in the retail health care space and A-One in the Asian retail label market. Consumer & Office is another investment story as we're adding sales and marketing resources, especially internationally, in

addition to the ad/merch investments I mentioned earlier. Profits rose 7 percent with margins at a healthy 22 percent... very good for consumer business in these unusual times.

Safety Security & Protection Services grew sales 10 percent, a great result even as H1N1-related respirator sales naturally tapered off as that crisis passed. We estimate that H1N1 added about \$18 Million to sales in Q2 results. In comparison, a year ago H1N1 sales totaled \$50 million, so the drag on Q2 growth for the total company was about 0.6%. Security Systems posted growth of over 30 percent, and both Industrial Mineral Products and Building and Commercial Services drove double-digit sales increases. Profits in SS&PS rose 9 percent and margins were maintained north of 23 percent.

Last but certainly not least, Electro & Communications sales rose 32 percent, while profits rose a whopping 150 percent and margins approached 23 percent. Consumer electronics is the story here as our businesses serving the electronics market grew over 60 percent. Using logic chipset sales as a proxy, the industry was up 34%. You might logically ask why we're growing so much faster than the market. The answer again is new products – like our optically clear adhesives – and new market share as, increasingly, 3M components are being specified into a number of leading electronic hand-held devices. Growth wasn't limited to electronics though, as Electrical Markets Division, which is a utility, MRO, and construction oriented division sales grew by 17 percent a YOY and nearly 10 percent sequentially.

So in summary, another terrific quarter with some real “eye-popping” results.

Some observers have said that, as a practical matter, investors are not interested today in anybody's second quarter news or their results, only in what they see as an uncertain future. We certainly understand and sympathize with the basis of that view.

In that vein, let me try to answer two principal questions for you today. The first is, what are we seeing in economies around the world that might indicate where these markets are headed in the coming quarters? And the second question is, what progress is 3M making towards our goal of more or less doubling our natural organic growth rate? Notionally, I mean a target north of 7% growth if IPI is within its normal historical bounds of 3 to 3.5%.

Let's remind ourselves that, with the second quarter now behind us, we have seen the end of arithmetically easier year-on-year growth comparisons. It is now going to get a lot harder for everyone, not just 3M, from here on in. We made that simple observation at the beginning of the year on our Q409 conference call, but it seems to have been misunderstood here and there. We were never speaking about the innate organic growth capability of the company, only a simple exercise in year-over-year arithmetic.

So, turning to the world economies, the pattern of end market demand we are seeing has remained very positive overall, with some of the things you'd expect to see happening and some interesting positive twists and turns.

Asia and Latin America will be no surprise to you in that they remain very strong. Before anybody infers that this was just the law of averages working across several months and many countries, China, as a proxy for Asia, rose 51 percent in the quarter and 45 percent in the month of June and

Korea grew 68 % in the quarter. Brazil rose a comparable 50 percent in the quarter and 42 percent in June. Europe was quite strong for us also, with local currency growth coming in at 11 percent for the quarter and 11 percent in June as well. For context, please remember that the recovery had already begun for us in June of 2009. There was some mild softness in Spain and Greece with sales flat for the quarter as you'd expect, but we have seen no signs of contagion in our numbers. A few small eastern European countries fitted that same pattern, but sales in June showed good recovering trends. FYI, Greece, Spain and Portugal combined make up only 1 ½ percent of our total sales and are therefore not a large factor for us.

Emerging markets as a whole showed gains of 38 %. You can see why we have such focus on our international strategy when you consider that emerging markets now account for fully one-third of all 3M sales. It was a mere five years ago that emerging markets comprised only a quarter of our sales off a significantly smaller base.

For the quarter, the big European economies ran in two different speed lanes. Germany was in the autobahn-style super fast league at more than 20% local currency growth in the quarter and 27% in June, which more than made up for any slowness elsewhere in Europe. Germany's IPI in the second quarter was estimated to be 9%, so we grew at about 3X the market in Germany. Italy, France and the UK were all in the cruise lane at five to six percent.

You can imagine that what happens with these countries from here on will be highly variable from market to marketaffected by a combination of the presenceor lack of..... local stimulus funds, foreign exchange rates (China especially is impacted here) and whether the end markets are local consumer-led or more export oriented and what rates they are recovering at. We clearly don't have the time to go over each of them one by one. Export led manufacturing economies like Germany, Japan, China, Korea and Taiwan all appear to be remaining robust at this time. So overall, we remain cautiously optimistic and think the risk of a secondary economic collapse is small.

That said, as stimulus funds run out, we must expect the collective end-market demand in those economies to taper off, accentuated by the more challenging arithmetic of year-over-year comparisons. Underlying market growth is slowly increasing in most markets, but perhaps not at the same rate that stimulus funds could dry up depending on local policy execution. The US is trying to feather in that change to avoid a sharp decline in demand. The outcome is that there will possibly be a period of slower growth beginning in end-markets later this year, perhaps late Q3 or early Q4. This isn't a double-dip per se, it's just a soft spot and very normal as economic growth takes a breather for a while and adjusts to new circumstances such as higher interest rates, lowering stimulus or commodity inflation. All are very normal in my view. We get one in every recovery. But I think the fact here to note is that companies who innovate well can beat this trap.

The unknown factor, and one that is very hard to assess with any precision, is the longer term impact of debt levels in Europe. If all the nations in Europe address this problem systematically and simultaneously, then growth will inevitably ease. Reports suggest this factor could reduce Euro zone GDP by 1 to 1 ½ percent. But in my experience, cuts in social programs are always less successful than their well-intentioned plans. To my mind, as long as the brakes are not put on overly hard, slower economic growth is certainly better than sovereign debt defaults and bodes well

for a better future as default risk falls. And as long as we as a company keep innovating and differentiating, this mild slowing is not necessarily negative for 3M.

After all, we've shown we can comfortably overcome a small 1% GDP reduction in a few countries. It's relative competitive advantage that counts. I maintain my view that, even if you shake the bottle, the cream always comes back to the top of the milk.

In the U.S., the key to improved long term growth remains unemployment and investment. Candidly speaking, if the US Government wanted to help that situation, it would be finding ways to encourage investment in manufacturing and not adding ever more entitlement programs. In my view, prosperity is the best way to ensure security for any nation or any company. US employment is moving forward a bit, if even if at a stalagmite pace. Productivity for us and many other companies is outpacing both inflation and GDP growth ...and that means two things, 1) margin trends will be good and 2) apart from new technology areas, overall hiring will likely be low.

For those companies who have the capability to differentiate, innovate and thoughtfully invest in new as well as core markets, I think the environment can be pretty good. And in a perverse twist of irony, it offers real relative competitive advantage to innovators like 3M. This is simply a process of Darwinian economics at work.

Turning to 3M's growth capability, we've seen trends for three or four quarters which suggest we might be close to cracking the growth code, and that perhaps we're close to reaching the tipping point that we've long been in search of. So when will we know this for certain?

I feel a bit like an economist now by saying that, to be definitive, we need more data. Q3 and Q4 are going to be very important in the quest as the world economy cools a bit and any inventory transients, to the extent that they existed, die down. It's at this point that the share and market creation data will become much clearer. But, "tipping point" or not, all in all, we seem to be making meaningful progress toward our long-term growth objective.

I think that it is completely logical to believe that as our NPVI number goes up, we should expect it to translate into more growth, either through market creation or share gain. If it doesn't, then why bother? What is unknown and probably unknowable, is whether the share gains are sustainable or just a one-time function of economic recovery. The other important factor is the improving implicit quality of the products under the umbrella of that NPVI number, with more platform products being released than ever and a greater percentage of longer lived products. The overall trend is very positive, and we plan to show you more of the data behind it at our annual update in December.

To summarize, our macroeconomic views have played out more or less as we expected, confirming that our plan was – and still is – the right plan.

To speak plainly, we believe we can deliver superior performance whatever economic scenario unfolds, good or bad, and we are not afraid of it. We have clearly demonstrated our ability to generate growth and leverage earnings while always keeping our eyes and investments on the longer term prize of much higher growth.

What's clear is that we have tremendous momentum in our favor...with 18 percent organic volume growth in Q2...which was well in excess of market growth. For three quarters in a row now we have generated net growth about 8 to 9 percent above the market. We all know how fickle these things can be, but this is clearly much more than a one quarter "flash in the pan" adjustment; in fact we have outpaced economic growth by a large margin for nearly a year. If we can do this again in the next couple of quarters, I think we should all conclude the growth point has been proven. I can't, however, promise you a monotonically increasing pattern; the road to growth often has a few bumps on it. We also have to closely watch demand and have the confidence to invest in capacity just a little bit ahead of it. Otherwise we will stifle growth as capacity, not demand, becomes the new choke point.

3M people have proven that we can simultaneously do acquisitions, invest heavily in the long term, drive R&D productivity, and service lower parts of the pyramid without margin collapse. If the growth point gets proven in this next couple of quarters, then if I were in your shoes, I'd soon be asking the next question "how much more money can you put to work and repeat the trick."

Slide 5 – Planning Framework
George W. Buckley

So with that let me address our outlook for the year. Please turn to chart number five.

With a strong second quarter behind us and great forward momentum, we are raising our full year 2010 expectations for the third consecutive quarter. We now believe that organic sales volumes will come in between 13 and 15 percent for the year versus a prior forecast of 10 to 12 percent. We also expect that earnings per share will fall somewhere within the band of \$5.65 and \$5.80 on an adjusted basis versus a prior expectation of \$5.40 to \$5.60.

We anticipate that operating margins will be above 22 ½ percent for the year, half a point higher than our previously expected numbers. Our tax rate and share count estimates are unchanged versus last quarter.

I hope this kind of color helps you. I'll now turn it over to Pat, who will explain our Q2 results in more detail.

Slide 6 – P&L YOY Change
Patrick D. Campbell, Senior Vice President and CFO

Thanks George, and good morning everyone. Please turn to slide number 6.

On a year over year basis, sales rose 18 percent in the second quarter to \$6.7 billion and, importantly, equaled the previous peak sales level from second quarter of 2008. Growth was led by Asia Pacific at 42 percent and Latin America at 23 percent. We saw tremendous growth in some large and important business industries, including 61 percent in electronics and 49 percent in automotive OEM. As George mentioned, we grew much faster than the underlying market in both of these cases.

As in the first quarter, organic volumes drove our results in the second. Organic volumes rose 18 percent worldwide, with increases of 38 percent in Asia Pacific, 22 percent in Latin America, 11 percent in Europe and 9 percent in the United States.

Acquisitions added 70 basis points to growth versus the second quarter of 2009, primarily attributable to the recent purchases of ACE Products, home of one of the great consumer health care brands, and A-One Labels, the second-largest retail and office label producer in the world. Both of these transactions are on track to deliver in 2010 and well beyond.

Selling prices declined 60 basis points in the quarter, about in line with our plan entering the year. The decline was largely due to normal price-down trends within our electronics businesses.

Gross profit grew 20 percent year on year and gross margins rose just over a point to 49 percent. Strong volume growth certainly boosted gross margins, and factory utilization rates were very good in the quarter. We also experienced carryover benefits from restructuring actions undertaken in 2009.

These gains more than offset some modest pricing headwinds, both in terms of selling prices, which declined 60 basis points, and raw materials, which increased just over 3 percent year on year on a gross basis. We fully anticipated this in our plan for the year. Looking ahead, we expect raw materials to be a slight headwind again in the third quarter, but costs are likely to flatten out in the fourth.

Finally, we saw significant improvements in yield, waste, speed and productivity...driven heavily by 3M's many lean six sigma teams around the globe.

SG&A costs increased 9 percent, which included a 15 percent increase in sales and marketing investments. We continue to invest in advertising and promotion...which is up nearly 30 percent year on year...as well as sales reps and new marketing talent, particularly in high-growth developing economies. R&D investments rose \$41 million, or 13 percent, to \$350 million for the quarter. And once again, general and administrative costs remained under very good cost-control.

Operating income rose 34 percent to \$1.6 billion, a record for any second quarter in 3M's history, and margins surged nearly 3 points to 23.7 percent. The second quarter tax rate was 26.6 percent, down about 4 points on a year on year basis due to a lower international tax rate along with the resolution of a number of US federal tax audits. We continue to expect full year tax rate to be about 28 percent or lower, which would imply a 29 percent rate in the back half of the year, with the 3rd quarter slightly higher than the fourth.

On a GAAP reported basis, we generated record second quarter earnings of \$1.54 per share, up 38 percent year on year.

Slide 7 – P&L Sequential Change

Please turn to slide 7 for a look at our sequential P&L results.

Sales rose 6 percent sequentially, despite approximately 2 percent points of currency pressure, so in fact underlying volumes rose nicely versus the first quarter. Sequential growth was broad based, as 5 of our 6 businesses posted improvements and the other, namely Health Care, generated sales that were about the same level as Q1. So the company overall continues to improve and expand, quarter by quarter.

At a sub-segment level, there were many sequential sales highlights, but I will hit just a few of them. Optical films posted impressive quarter on quarter growth of nearly 30 percent as customer production levels rose in anticipation of a good year of sales of LCD TVs and other electronic devices. Other notable increases included traffic safety systems, industrial tapes and adhesives and automotive aftermarket solutions. Our retail DIY business also posted very impressive sequential sales gains, boosted by a continuous flow of great new products such as new-generation Scotch Blue painters' tape and Filtrete home furnace filters.

Gross profit increased in line with sales, and gross margins were a solid 49 percent. Factory throughput in the second quarter was similar to Q1 levels, and raw materials nudged slightly higher on a sequential basis, but we managed to match Q1's gross margin percent regardless. Gross profit was boosted by ongoing productivity efforts, which continue to play a critical role in our future strategy. Future growth investments demand continuous improvement throughout the business.

SG&A and R&D investments both rose 2 percent sequentially. Recall that stock option expense is highest in the first quarter, commensurate with when we grant options to employees. Adjusting for this, SG&A and R&D both increased over 5 percent on a sequential basis.

Operating income increased 10 percent versus Q1 and incremental profits rose 40 percent. Operating margins were up nearly a full point versus the first quarter to 23.7 percent. Net income and earnings per share increased 20 percent and 19 percent, respectively.

Now let's turn to the balance sheet and cash flow. Please turn to slide number 8.

Slide 8 – Balance Sheet/Cash Flow

Free cash flow for the first six months of 2010 was \$1.9 billion, a year on year increase of over 10 percent, and we converted 92 percent of net income to free cash flow over the period. Slightly lower capital expenditures accounted for most of the difference. We anticipate that capital investments will begin to accelerate in the second half of 2010, as a number of our key product lines are at or near full capacity. We expect to invest approximately \$1 billion on cap ex in 2010, and early forecasts indicate that 2011 could be up 25 to 30 percent. These additional investments are mostly for growth related investments.

For the full year of 2010, we are forecasting that free cash flow conversion will be right around 100 percent.

Acquisition activity was light in the first half of the year, but we expect to increase our acquisition activity level in the second half with a number of good opportunities in the hopper.

Net working capital turns were 5.4 at quarter end, an improvement versus 5.3 last quarter and 4.8 one year ago. Accounts receivable turns were 7.2 versus 6.6 one year ago, as receivable balances are up only 8 percent year on year versus an 18 percent sales increase. So receivables are in very good shape. Inventories rose 15 percent year on year, again less than the rate of sales growth, and turns were 4.4 in June versus 4.3 one year ago. We certainly are not satisfied at these inventory levels, but considering the rapid ramp up in demand over the past two quarters, along with tight supply in some raw materials, it was good to see continued forward progress in our turns. Overall, our working capital is in good shape and we are well positioned for future growth.

Cash returned to shareholders totaled \$748 million in the second quarter, roughly double the amount paid in both the first quarter of 2010 and in the second quarter of 2009. We resumed share repurchases in Q2 after a few quarters without, and we expect to continue buying additional stock during the remainder of the year.

(pause)

To quickly summarize, the second quarter was another very good one for 3M. We drove strong growth and outstanding bottom-line leverage, even with significant investments to continue driving higher future growth. We raised our earnings guidance from a previous level of \$5.40 to \$5.60 to \$5.65 to \$5.80 per share, and we expect that organic sales volume growth will be in the range of 13 to 15 percent for the full year, 3 points higher than our previous expectation. Operating margins should be north of 22.5 percent for the year, and we are anticipating a tax rate at or below 28 percent, assuming no change of course to current tax laws. Finally, our balance sheet is in great shape and puts us in a strong position given uncertainty about the shape of the recovery. Regardless of how the economy shakes out, we will remain focused on outrunning our competitors and delivering superior financial results.

That concludes the formal portion of today's conference call, so let's begin the Q&A.

Sign off
George W. Buckley

That concludes our second quarter review. Thanks everybody for listening, and for your continued support of our company. Cheers.