

Q206 Earnings Conference Call Transcript

Matt Ginter- Vice-President of Investor Relations and Financial Planning and Analysis

Good morning, I'm Matt Ginter, head of Investor Relations for 3M, and welcome to our second quarter 2006 business review. Before we begin, I have a few brief announcements.

As in prior quarters, today's discussion will follow a series of PowerPoint slides, which are currently available on our investor relation's website. During today's conference call, we will make certain predictive statements that reflect our current views and estimates about our 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 10-Q lists some of the most important risk factors that could cause actual results to differ from our predictions.

Both George Buckley, our Chairman, President and CEO, and Pat Campbell, our CFO, will make some formal comments on our results and forward outlook, and then we will open it up for Q&A. So now I'd like to turn the program over to George Buckley...
George.

George Buckley- Chairman, President and CEO

Thank you, Matt and good morning everybody.

Clearly this quarter was a tougher one than the last one and I want to get right down to explaining what went on. Let me begin by stating how disappointed we were in our performance, and that no one on this call is more disappointed in it than me.

The rapid impact of the Optical films inventory correction clearly accounts for the lion's share of the shortfall this quarter. You also saw this pattern repeated in the earnings of the many LCD OEM manufacturers that we supply our products to.

We had three things which happened in this optical films business this quarter. First, sales of monitors, where 3M has traditionally had high attachment rates and good margins, sharply declined. Desktop monitors have matured and are becoming commoditized. Second, we had a simultaneous inventory correction in the channel for LCD TV's. Lastly, we had a troublesome start up of a new optical film plant that makes DBEF film product.

The new plant first went live with commercial product at low volumes in November of last year, and helped us service the market as LCD TV production accelerated. We have had difficulty manufacturing consistently excellent film and the new line was shut down for much of April due to a mechanical failure. The film line was quickly repaired and has

been running since the first of May. Overall, the start up has been challenging and yields are, by our standards, very low. It is important to note that the plant has been delivering significant quantities of high-quality film to customers and we are able to screen out film that does not meet specifications prior to shipping. It is hard to separate all the contributory costs here, but we estimate these issues are costing us a couple points of margin in this business.

These plants are very complex and the manufacturing processes to get high yield and consistently high quality product is very challenging. This is why it is so hard for others to enter these high performance optical film markets. It is not at all unusual for these things to happen during plant startups. I would state here that, even with this yield challenge, we have more than enough capacity to meet anticipated customer demand later this year. This plant was added to increase capacity in anticipation of growth, as well as to significantly reduce the manufacturing costs for large-format films for LCD TVs. Longer term, as larger formats get more popular, this is an important strategic advantage for 3M.

The dynamics of the rapid changes in the consumer electronics field are well known. We had been heretofore blessed by strong growth in LCD TVs and monitors, driven by early adopter purchases of these products. But in my view, we are beginning to see the LCD TV market changing gradually from a pure early adopter mode to the more traditional seasonal cycles seen in other consumer electronic purchases. The inventory correction that took place in the channel may therefore have been exaggerated by these seasonal pattern changes.

To people unfamiliar with these markets, the sharp fall off seemed unusual and surprising. But let me explain how these markets work.

This is a market where the end product has a life cycle of only nine to twelve months, and the price of that product is declining by 20 - 25% annually. So if the retailer and manufacturer do not correct the inventory ASAP, if they see excess, perhaps only in one quarter, the end product is potentially obsolete and worth considerably less at retail than it was previously. Consumer electronics are not like wine, they do not get better with age. In environments of relatively low margin for the OEM manufacturers of these products, it is absolutely vital that they do not become the victims of excess inventory.

This all explains why, in these kinds of markets, inventory corrections can be sharp and disturbing, even if you have the best sales and operating planning process possible. Precise projections of volume are hard. But they are just that, corrections, and the demand changes can be just as high in the opposite direction, especially as seasonality creeps more vividly into the picture. It does not signify that somebody in the management of these companies was asleep at the switch – things simply changed tremendously quickly.

From our perspective, it also tells you why it is critical that we continue to invest in order to diversify our offerings, in the optical systems division and throughout the broad 3M

portfolio, in order to prevent a largely cyclical business from becoming too large a portion of our revenues and profits. This is absolutely essential.

We do not know precisely how long it will take for the excess retail inventory to bleed off. According to Display Search, channel inventory for LCD TVs is dropping rapidly, but the correction at our end of the channel will continue for a little while longer. It began to accelerate rapidly for us in mid-June and I think it will likely persist into the middle of the third quarter.

Another unknown right now is where the mix of Optical film margins will eventually settle out. Pricing pressure in this industry is enormous, and while I expect margins to remain attractive, and to additionally offset some of the downward price pressure with ongoing cost improvements, given the poor state of the monitor market, the reality is that we will be somewhat lower in mix than in the past.

Nevertheless, despite all of what I have said, this optical films business continues to be a jewel in 3M's crown and provides a high growth opportunity for the future. 3M's capability remains unmatched in this category - both our technology and our manufacturing - and despite the onset of seasonality going forward, we believe the second quarter to be the low point of the year, revenues will again increase in the third and fourth quarters in anticipation of the holiday buying season.

I can assure you that the issues within our control – specifically things like the scale-up of the new multi-layer film manufacturing line to increase capacity - are being addressed immediately and forcefully. They will be resolved as quickly as possible.

I mentioned at our May meeting in New York that we are significantly under invested in our core. This fact compounds the transition issues we face both in cost and targeted growth rates, and finding the right balance in this transition requires a lot of finesse and care. Internally we are working on new ways to stretch our capital dollars much further than was once the case so we don't induce a glut of capital spending going forward.

Unfortunately, under-investing in the past has created some challenges in the present. Putting aside the aforementioned optical issues, manufacturing costs in the second quarter increased in a handful of divisions, and in many cases we can point to under-capacity as the root cause. For example, in our roofing granules business, we are short of capacity in facilities that serve the still hurricane-torn areas of the southern United States. We are still supplying our customers, but we must do so from farther-away locations, and we are contractually obligated to pay the huge extra freight bills to get the rock to their shingle manufacturing sites. Nor are we allowed to pass through the costs of raw materials as copper used to color the granules; copper has tripled in cost this past twelve months or so. These two factors alone cost this business several hundred basis points of operating margin in Q2.

Moving now to SG&A, investment spending also increased this quarter. This would not have been a visible problem but for the optical issues I mentioned earlier. Our

enthusiasm to invest in sales growth contributed to this increase, and we overshot our targeted spending mark. But because this increase was self-generated, it can also be self-corrected, and it is being corrected as we speak.

We also saw a continued trend upwards in inventory that began back in late 2004, that has to be bled off over the next few quarters. We did this to attack some poor service issues. These service issues are a function of the very long and convoluted supply chains we built over our long history and, over the next few years, we'll gradually unravel that puzzle and change the supply chain footprint to better reflect our customer's service needs. This inventory challenge was exacerbated in the second quarter by the shortfall in Optical systems sales, but also by the sluggishness we saw in visual systems, automotive and diaper tapes sales, which I'll mention again in a few minutes.

Even as we make necessary corrections, the enthusiasm for growth that we shared with you earlier in the year has not waned one iota. The emerging growth mind-set at 3M continues to gain momentum, and will continue to dominate our plans and our path going forward. When a company makes the kind of change in emphasis we've been making to encourage growth, it's always a challenge to get the early balance right. Investments in new products and supporting channel investment always happen a little before the sales growth and earnings improvement can be measured.

Overall, if you exclude for a moment the shortfall in optical film sales, our growth rate would have been well within our targeted range for the quarter. I can assure you that our growth plan is gaining momentum and the trick here will be to avoid getting distracted by short term events and not losing our focus on growth.

We achieved this growth despite significant quarterly contractions in some sizable non-core businesses. For example, sales in our visual systems business were down 18% year on year and revenues declined by 8% in our diaper tape business. The latter case is a classic example of a business that did not invest in its own future and suffered the consequences. We are now visibly inventing our way out of this problem, but it takes time to do it.

The fact is that progress is evident in each main element of our growth plan: expanding the core, growing through strategic acquisitions, building new businesses, and in international growth. Let me take a moment to provide you with some examples.

A number of our large core divisions showed double-digit local currency sales growth in the quarter. Examples include dental at 17 percent growth, commercial graphics at 14 percent, electronic markets materials division at 13 percent, electrical markets division at 11 percent, construction and home improvement at 10 percent, and occupational health and environmental safety, which is the home to our market leading family of respiratory protection products and services, at 10 percent. And our traffic and safety systems division, another large core business, was just shy of double-digit growth. I think we could have had even greater sales in some of these divisions if we had the necessary capacity.

We made significant progress in the quarter toward building new businesses to capitalize on emerging opportunities in high growth markets. For example, our Track and Trace initiative is nicely taking shape. We put in place a leader with experience in building businesses at EDS, to pull together the existing assets within 3M and to identify potential acquisitions to fill in the gaps in our offerings.

Turning to acquisitions, we have announced eight so far this year. Our most recent and largest is the purchase of Security Printing & Systems Ltd in the UK. This is a very exciting and potentially very valuable asset – Security Printing has supplied passports to the UK Government for more than 40 years, but for us, the addition of RFID components imbedded in electronic passports will bolster both our track and trace and overall border and civil security capabilities. They also have superb security and secure ID card capabilities and we intend to expand and grow this business significantly internationally as part of our Track and Trace initiative. This is the first of several tuck in acquisitions in this area that I expect you will see.

The fourth element of our growth agenda – International – continued to demonstrate both progress and its potential. Optical film sales dragged Asia's results down a bit, and therefore International down in total, but as we discussed, this is a short-term situation. I call your attention to performance in several key countries. In the quarter, China posted local currency growth of 27 percent, India was up 47 percent, and Poland grew 24 percent. Russia posted local currency growth of 22 percent, and Turkey 34 percent.

Overall, there is no doubt whatsoever that our growth agenda is advancing and delivering real results. The near term difficulties with Optical in no way diminish my confidence and optimism in 3M's prospects. Our top line guidance remains five-and-one-half to eight percent, which is in the neighborhood of 2 times IPI. Realizing that economic conditions wax and wane, 2X appears to be a good growth target for 3M.

Now I will turn the call over to Pat, who will walk you through the financial details of our second quarter results. Pat ...

Pat Campbell- Chief Financial Officer

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

Second quarter sales were \$5.7 billion, up 7.5% versus last year. Organic local-currency growth was 4.6%, and acquisitions – mainly CUNO - added 2.6% to the top line growth. Three of our six businesses grew in line with our expectations, primarily Health Care, Safety, Security and Protection and Electro and Communications. On a geographic basis, organic local-currency sales were up 6.5% in Asia Pacific, about 5% in the U.S. and 3% in Europe. As we mentioned on last quarter's conference call, second quarter sales growth was negatively impacted by approximately one percentage point due to the timing of this year's Easter holiday.

Reported second quarter operating income was \$1.2 billion, a decline of 5.5% year-on-year. This percentage does not tell the entire story, as 4.3% of this decline was due to higher stock options expense and 3.9% was due to a combination of special items – which I will explain in detail in a moment. Adjusting for these items, year on year operating income was up 2.7%. Operating income margins were 21.5% including a negative 1.6% margin impact from stock option expensing. Putting these adjustments aside, this was the first time in over four years that we did not expand operating margins year on year, and we missed our earnings guidance, which I am very disappointed in.

Second quarter earnings per share were \$1.15, up almost 20% year on year. Special items this quarter added a net 10 cents to earnings per share, while last year's second quarter results included a 10 cent penalty. Again, I will explain these items in detail in a moment. Also included in this result is 7 cents of stock option expense in the second quarter as compared with 4 cents for the same quarter last year.

Let me be clear. The second quarter increase in option expense is not a function of granting more options to employees. Rather, as we discussed on last quarter's conference call, the increase was largely due to a requirement under FAS123R to immediately expense stock options upon grant date for those employees who are considered retirement eligible. A 3M employee is considered to be retirement eligible upon reaching age 55 with 5 years of service. Twenty-five percent of this year's grant award was to these employees. Since we grant our employee stock options in the second-quarter, the immediate expensing of those options granted to retirement eligible employees results in higher stock option expense in the second-quarter. Accounting rules do not allow restatement for the retirement eligible impact. In the second quarter, the specific cost associated with this pool of employees was \$55 million pre-tax, or 5 cents per share.

I know many of you are interested in a status update on our efforts to seek strategic alternatives for the pharmaceutical business, but there is not much to report yet. An offering memorandum went out during the quarter, we have received initial bids, and due diligence is underway.

Please turn to slide number three for a recap of our sales performance.

As I mentioned, worldwide sales increased 7.5% versus last year's second quarter. Volumes increased 7.4%, with organic volumes up 4.8% and acquisitions adding 2.6% to growth. Selling prices and foreign exchange impacts basically offset one another in the quarter.

In the United States, sales improved 8.4% vs. last year's second quarter. Organic growth in the quarter was 4.9% with volumes up 3.1% and selling prices adding 1.8%. All 6 businesses had positive growth in the quarter. Acquisitions added 3.5% to US growth in the second-quarter.

Sales in our international operations were up 6.9% in U.S. dollar terms. Local-currency sales were up 6.3%, with organic volumes increasing 6.0% and selling prices decreasing

1.6%. International selling prices were down about as expected, impacted by our businesses that serve the consumer electronics industry. International sales were impacted by the slowdown in the LCD industry, as our optical film sales are recorded where our customers reside in the Asia Pacific region. Acquisitions added almost 2.0% of additional growth, and foreign currency translation increased second-quarter sales by about a half a point.

Organic local-currency growth was 6.5% in Asia Pacific, with Japan down one percent and the rest of the region up 11%. Acquisitions added 2.2% of additional growth in the quarter. All six of our businesses posted positive local-currency growth in Asia Pacific during this quarter.

Europe delivered 4.9% local-currency growth in the quarter, including acquisition related growth of 1.8%. As we mentioned on last quarter's conference call, second-quarter growth in Europe was tempered due to the timing of the Easter holiday. Since Easter is in the second quarter this year compared with the first quarter last year, local-currency growth in Europe was held back due to fewer billing days in the second quarter. We estimate the impact on Europe's second quarter local-currency growth was about 4 percentage points. Importantly, European organic local-currency growth over the last two quarters has averaged over 5%, an encouraging sign compared to recent years.

And finally, local-currency growth was just shy of 4% in Latin America. Excluding the impact of the decline in our CRT rear projection business in Mexico and the move of a sizable flexible circuit customer from Puerto Rico to Singapore, Latin American organic local-currency sales increased 10.3%. Acquisitions added an additional 2 points of growth in the quarter.

As we discussed in last quarter's call and included in our first-quarter 10-Q, I would like to take a moment to explain the earnings impact of special items. On slide four we have provided a detailed earnings analysis of second quarter special items for both 06 and 05.

Two of this quarter's special items impacted SG&A expense. First, we entered into an agreement in principle during the second quarter to resolve the antitrust class action involving direct purchasers of transparent tape that, as previously disclosed, had been scheduled to start trial at the end of May. The settlement is conditioned on court approval, which will be sought promptly upon execution of final settlement agreements and is expected to be granted later this year. Second, during the quarter we incurred expenses associated with our efforts in seeking strategic alternatives for our pharmaceutical business. These costs included items such as professional fees along with retention bonuses for key employees during this transition period. The combination of these two items negatively impacted earnings-per-share by \$0.04.

Also affecting this year's second quarter was \$105 million of positive adjustments related to the resolution of the US tax audit through 2001, the substantial resolution of audits in certain European countries and adjustments and tax accruals for all other open years. These tax adjustments amounted to a \$0.14 per-share benefit. The company will

complete the preparation and filing of our 2005 federal income tax return in the third quarter. As part of this process the company anticipates it will record a positive adjustment to its provision to US income taxes in 2005. The amounts are uncertain at this point in time and our forward guidance today will exclude any adjustments.

George will address our guidance later in the call.

As you may recall, in last year's second quarter we announced our intent to reinvest \$1.7 billion of foreign earnings back in the United States pursuant to the provisions of the American Jobs Creation Act of 2004. This act provided the company the opportunity to tax effectively repatriate foreign earnings for U.S. qualifying investments specified in its domestic reinvestment plan. As a consequence, in the second quarter of 2005, we recorded a non-recurring charge of \$0.10 per-share.

In total, special items in this year's second quarter resulted in an earnings-per-share benefit of \$0.10 per share versus a charge of \$0.10 per share in last year's second quarter. Including all of the special items in both periods, second quarter 2006 earning-per-share were \$1.15 versus \$0.96 cents in the second quarter of 2005. As mentioned, option expense was \$0.07 cents in the second quarter this year versus \$0.04 cents in last year's comparable quarter.

On slide number five, we compare our second-quarter P&L versus last year's comparable quarter. Again, note that we elected to restate prior periods for the expensing of stock options. Therefore all numbers shown will reflect this as well as excluding special items.

As I previously mentioned sales were up 7.5% year over year.

Second quarter gross margins were 50.1%, down 70 basis points year on year. The combination of lower than anticipated sales volumes, higher than expected start-up costs for our new multilayer LCD film facility, along with supply chain inefficiencies in a handful of businesses that are capacity constrained, drove much of the increase. These businesses include roofing granules, medical supplies and respiratory products, to name a few. In addition, 30 basis points of the gross margin decrease was attributable to the difference in stock options expense year on year.

SG&A expense was 22.4% of sales, up 1.1 percentage points vs. the comparable quarter last year. The increase is largely due to the combination of higher advertising and merchandising investments, along with hiring additional sales reps to ensure better global market coverage in many of our businesses. Obviously these investments are aimed directly at higher revenue growth. Finally, 40 basis points of the SG&A increase was attributable to the stock options expense year on year difference.

R&D expense increased 10.3% year on year, or 6.2% to sales.

Operating margins were 21.5%, including a 160 basis point drag from the expensing of stock options.

Second quarter net interest expense was \$11 million versus \$3 million last year, with the increase in interest expense due to higher interest rates and a decrease in interest income due to lower cash balances.

3M's tax rate for the second quarter, excluding special items, was 32.5%, similar to recent quarters. Putting aside the impact of stock options, the tax rate reflects a 30 basis point increase due to the expiration of the R&D and Orphan Drug Tax Credits on December 31, 2005. In the event the Internal Revenue Code is amended to reinstate these credits, an equivalent positive impact would be reflected in our tax rate in future quarters.

Including the special items in the quarter, our tax rate was 23.3%.

Net income was \$808 million dollars, down 2.6%, and earnings per share decreased about 1.0%. Second quarter results include \$56 million after-tax due to stock option expense, or \$0.07 per share, versus \$22 million after-tax and \$0.04 per share in last year's second quarter.

The sequential quarterly P&L comparison is found on slide number six. Remember that the first quarter was an all-time record operating margin for the company.

Sales were up 1.7% versus the first-quarter as four of our six businesses drove positive sequential growth. Health Care, Electro and Communications and Consumer and Office and Safety Security and Protection. Operating income declined 10.5% sequentially, half of which was due to the difference in stock options expense, with the remainder primarily related to the decline in optical film performance.

On a sequential basis, net income and earnings-per-share both declined by approximately 10%. Stock option expense was \$0.07 per share in the second quarter versus \$0.02 per share in the first quarter.

Slide seven shows our year to date performance.

With half of the year behind us, I felt it was important to reflect on our performance to date versus last year.

Please remember that, while the quarter did not meet our expectations, this is a very good business. Margins, ROIC and return on equity are all well in excess of 20%.

First, sales are up almost 8% through the first six months, with organic local-currency growth up 6.4%. Acquisitions added an additional 2.4% of growth.

Operationally, we are performing at levels very similar to last year. Year to date we have been able to leverage the top-line growth into a 9.4% EPS growth, excluding special

items in each year. On a year-to-date comparative basis stock options had a negligible impact.

Please turn to slide eight where I will recap our segment results.

Our Industrial and Transportation business delivered local-currency growth of 11.0% including 7.9% growth from acquisitions, primarily CUNO. We acquired CUNO in August of 2005. It is a world-class liquid filtration company with a long history of double-digit top line growth at attractive operating margins. It is a great addition to our portfolio.

Operating income in the second-quarter was \$321 million, up about 3% including a negative 3.2% impact year over year from the expensing of stock options. We drove positive local-currency sales growth vs. last year's second quarter in all business with the exception of personal care. However, growth was below our expectations in three key businesses- automotive aftermarket, industrial adhesives and tapes as well as the automotive OEM business which George referred to, which continues to be impacted by softness in the US automotive industry.

As we have mentioned in past quarters and as George referred to earlier, sales in our Personal Care diaper tape business continued to decline year on year, which reduced overall Industrial and Transportation sales and operating income growth by 0.8% and 1.4%, respectively. This business is working relentlessly to invent new solutions for its customers to recover volume lost over the past year or so. We will be more competitive in this space, but it will take us some time.

Health Care's sales were \$1 billion in the second quarter. Organic local-currency growth was 3.3%, with acquisitions adding an additional 80 basis points of growth. Growth was led by our dental and medical supplies businesses, two solid 3M franchises that offer some of the strongest brands in their respective industries. Excluding our pharmaceutical business, which is approximately 20% of Health Care, second quarter local-currency growth was greater than 7.0%.

Geographically, Health Care's revenue growth was strongest in the North America.

Operating income in the quarter was down 5.0%. Adjusting for stock options and pharmaceuticals, operating income would've been flat for the quarter. Health Care was adversely impacted in the quarter by operational issues in medical and orthodontic associated with product start-ups and supply chain.

The underlying fundamentals in Health Care remain very strong. An aging population, along with emerging economies rapidly adopting western health care practices, make this business an important platform for future growth. We are investing in sales and marketing capabilities in this business in our core strength areas, such as infection prevention, wound care, dental and orthodontic product systems, and others.

Moving on, the Display and Graphics business posted local-currency sales growth of 6.5% with an operating income decline of approximately 13% including a 3.3% reduction due to stock options. .

As George mentioned, Commercial Graphics delivered strong double-digit local-currency growth in the second-quarter with strong end market penetration and differentiated products that offer superior value to customers. And Traffic Safety Systems maintained the momentum from the last three quarters with near double-digit local-currency growth.

Optical film sales volumes increased at double-digit rates in the second quarter, however as George mentioned, sales growth was below our expectations. We estimate that the impact from the overall LCD industry slowdown and inventory correction in the second quarter, along with the mix impact from weakness in the monitor segment, accounted for approximately 2/3 of the shortfall in optical film operating income versus our expectations. The remainder of the shortfall was due to manufacturing start-up costs previously mentioned by George.

As in past quarters, sales growth in Display and Graphics was dampened by the continuing decline of our CRT rear projection lens business. Excluding the negative impact of the CRT rear projection lens business, total D and G local-currency sales would have been up 8.1%.

Consumer and Office posted organic local-currency sales growth of 4.4% in the quarter, with an additional 20 basis points of growth coming from acquisitions. Growth was led by our businesses serving the retail do-it-yourself channel – boosted by outstanding brands such as Scotch blue masking tape and Filtrete home filters. We also posted solid growth in the retail office superstores and commercial office channel.

On a geographic basis, revenue growth was strongest in the United States, while growth outside the US remains a bigger challenge, particularly in Western Europe.

Second quarter operating income was \$121 million, down 11% year on year. Options hurt income growth by about 4 percentage points.

During the second quarter we increased our advertising and merchandising investment in Consumer and Office to support the recent launch of a national advertising campaign for Post It Picture Paper, along with other products such as Scotch blue masking tape, Scotch-Brite home cleaning products and Nexcare brand bandages. While these investments impacted the growth rate in operating income this quarter, it is a vital step in supporting both new and existing products for our retail customer base.

Our Visual Systems business, which offers primarily analog overhead and electronic projectors and film, continued to experience declines, which reduced second quarter Consumer and Office sales and operating income by 1.1% and 1.6%, respectively.

We anticipate that operating income in the third quarter will grow at a double-digit rate in the Consumer and Office business.

Local-currency growth in our Safety, Security and Protection Services business was up 8.3% to \$653 million. Growth in the business continues to be driven by strong global demand for personal safety products, especially respiratory protection. We continue to invest in additional respirator capacity, such as our recent announcement of a new respirator manufacturing facility in Korea, which will serve the Asia Pacific region.

Operating income was \$145MM in the second quarter, down 1.6% versus last year's second quarter, including a 3.7% negative impact from stock options.

Gross margins declined both year on year and sequentially in this business, with the majority of the impact due to our roofing granules business, which George described in his opening comments.

Finally, our Electro and Communications business posted sales of \$632 million. Organic local-currency growth was 5.3%, driven by strong global demand for our specialty adhesives, fluids and tapes for the electronics market, along with electrical products for insulating, testing and sensing. Acquisitions contributed another 80 basis points to growth in the quarter. Operating income was \$123 million, up 7% year on year, and including a negative 4.3% impact of stock options.

Electro and Communications has performed consistently well over the past several quarters.

Please turn to slide number 9, where I will review a few balance sheet and cash flow metrics.

Net working capital turns were 5.2, down 0.2 turns sequentially and down 0.4 turns vs. the second quarter of 2005. The sequential change is partly due to normal seasonal increases in certain businesses. For example, we build inventory in Consumer and Office in anticipation of the big back-to-school season. Our optical films business is building inventory in preparation for accelerating demand for LCD TVs during this year's holiday season. And finally, In Traffic Safety Systems, where sales are skewed toward the warmer months of summer, we also build inventory to prepare for this peak season.

Capital expenditures were \$261million, an increase of \$44MM year on year and \$71MM sequentially. To date we have spent \$451 million of our expected \$1.1 billion capital expenditure plan for 2006. The second quarter acceleration is demand driven, as these investments are largely supporting growing businesses. We have recently announced additional capital investments for optical films in Poland, respiratory protection products in Korea, and customer centers in China and Russia, among others. We also have approved capacity additions for medical supplies, Filtrete filters, Scotch blue painters tape and roofing granules, just to name a few.

Second quarter free cash flow was \$539 million, which was lower than last year due in large part to second quarter 2006 tax payments of approximately \$500 million versus \$270 million in last year's second. Also, as I just mentioned, we are continuing to invest in cap ex and working capital in anticipation of increasing demand.

We paid \$348 million in dividends to our shareholders in the second quarter. Stock repurchases were \$527 million during the quarter, up from the first quarter's \$251 million. Weighted average diluted shares outstanding were 770.4 million, down 2% from last year. And finally, our debt to capital ratio was 19.0% at the end of the second quarter.

Now I will turn the call back to George, who will address our expectations going forward. Please turn to slide number 10.

George Buckley- Chairman, President and CEO

Thank you Pat. The longer-term outlook for the rest of the year looks OK for now. We have cost savings actions in place to inoculate ourselves against the remaining short-term challenges with the LCD film situation. I do see signs of uncertainty creeping into the US economy, and of course, the global picture. On costs, we've seen disappointing price gouging from some suppliers and increases in other commodity and transportation costs. This has crept into our factory cost. This has cost us 60 basis points in the year over year quarter. For the next 6 months, we will be using our superb lean 6-sigma capabilities to gradually get this out of our cost base.

As for our guidance going forward, for the third quarter, we expect organic local-currency sales growth of 4 to 8 percent. I set the bottom 4% number to allow for any residual bleed off in any LCD oriented inventory, with acquisitions adding about an additional 1.5 points of growth to this picture.

Third quarter earnings per share are expected to be in the range of \$1.10 to \$1.15, including \$0.04 per share impact from stock options expensing. 2005 third quarter earnings-per-share, restated to reflect stock options expensing of \$0.02 per share, were \$1.08.

For the 2006 calendar year, our guidance remains unchanged versus our July 7th press release. We expect full year 2006 earnings per share to be within the range of \$4.55 to \$4.65, including a \$0.17 impact from option expensing in 2006 and \$0.14 option cost in 2005. Also included in this estimate are the previously mentioned net gains from special items of \$0.10 per share in the second quarter of 2006. Organic local-currency growth is expected to be 5.5 to 8 percent for the year with acquisitions adding approximately 2 percentage points of additional growth.

As Pat mentioned earlier, we may have further positive tax adjustments in the third quarter, the amount of which is unknown at this point. We also will incur additional restructuring charges or other expenses associated with evaluating strategic options for

our pharmaceuticals business. Neither of these items are included in our third quarter or full year guidance.

Let me just say in conclusion that 3M is a superb company and we will manage these short-term challenges vigorously. Having led the company for a little over 6 months, I'm coming to know the superb character and capabilities of 3M's people. We don't like getting buffeted by things outside of our control, but we do know how to handle them. Whatever adjustments may be made, the underlying fundamentals of 3M, combined with its culture of innovation, give me tremendous confidence in our ability to grow and deliver superior returns for the long haul.

That concludes our formal comments. Also joining Pat, Matt and myself is Jim Stake, executive vice-president of Display and Graphics, who would be happy to take any of your questions. Thank you everybody.