# Q3 2006 Earnings Conference Call Transcript

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

Good morning, I'm Matt Ginter, vice president of financial planning and analysis and investor relations for 3M, and I would like to welcome all investors to our third quarter 2006 business review. Allow me to make a few brief announcements before we begin.

Today's discussion will follow a series of PowerPoint slides, which are currently available on our investor relations website at 3M.com. These slides will remain on our website, along with an audio replay of today's call, for an extended period of time.

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 Pat Campbell, our CFO, and George Buckley, our Chairman, President and CEO, will make some formal comments on our results and our forward outlook today, and then we will open it up for Q&A.

So now please go to slide number two, and I'd like to turn the program over to Pat Campbell.

## Pat Campbell- Chief Financial Officer

Thanks Matt and good morning everyone, it's a pleasure to be with you.

The third quarter was a good one for 3M, and there are a number of items I would like to highlight about our performance. First, we continue to make good progress towards being a more consistent and faster-growth company, while maintaining our superior margins and return on capital. This was the third consecutive quarter of achieving record revenues and the fifth consecutive quarter in which all six of our businesses posted positive local currency sales growth. Sales increased almost 9% year-over-year, reaching an all time quarterly high of $5.9 billion. Organic local-currency growth in the quarter was 5.6%, and acquisitions added an additional 1.7% to growth. We have accelerated the pace of acquisitions and year-to-date have announced 16 transactions that will add approximately $350 to $400 million of additional sales in their first full year with 3M.

As we anticipated last quarter, we saw a nice sales rebound in our optical films business in Q3, driven largely by accelerating consumer demand for LCD televisions. Optical films posted record sales in the quarter, and volume growth was over 20% year-on-year.

Reported operating income was $1.3 billion in the third quarter, and margins were nearly 23%. Adjusting for differentials in year-over-year stock options expense and for pharmaceutical-related transition costs, operating margins were nearly 24%, matching last year.

Earnings per share, again on a reported basis, increased 9.3% to $1.18, which includes approximately 2 cents per share penalty year-on-year related to stock options expensing. EPS would have increased at a double-digit rate, adjusting for special items and stock options expensing.

Free cash flow was $787 million, an increase of 11.6% over the third quarter of 2005.

During the quarter, we repurchased a record $1.2 billion of our shares, taking advantage of a significant undervaluation of our stock price and our Board of Directors authorized an additional $1 billion in share repurchases, raising the total authorization to $3 billion covering the period from February 2006 to February 2007.

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

As I mentioned, worldwide sales increased 8.8% versus last year's third-quarter. Volumes increased 8.2%, with organic volumes up 6.5% and acquisitions adding 1.7% to growth. Selling prices declined 90 basis points while translation added 1.5% to third quarter sales.

In the United States, sales improved 6.2% vs. last year's third-quarter. Organic local-currency growth in the quarter was 4.4% with volumes up 3.4% and selling prices adding a point. U.S. organic growth was led by our Consumer and Office, Safety, Security and Protection Services and Industrial and Transportation businesses. Acquisitions added 1.8% to US growth in the third-quarter.

Sales in our international operations were up 10.6% in U.S.-dollar terms. Organic volumes increased 8.6%, with particular strength in China and Korea. In addition, Europe had an outstanding quarter, with organic volumes up 5.3%, which is about where they stand on a year-to-date basis. We are very encouraged by the performance of our European business teams.

As expected, international selling prices decreased 2.2%. Acquisitions added 1.7% of additional growth outside the United States, and foreign currency translation increased international sales by 2.5 points.

On slide number four, we compare our third-quarter P&L versus last year's comparable quarter. Note that we elected to restate prior periods for the expensing of stock options. This chart also excludes special items in this year's third quarter.

As I previously mentioned sales were up 8.8% versus the third quarter of 2005. Operating income was $1.4 billion, up about 7% after absorbing a negative 1.5 point impact from year-on-year differences in stock option expense.

Operating margins were a strong 23.1% in the quarter, which is flat versus last year's third quarter after adjusting for stock options.

Third quarter gross margin was 48.9%, down 2.1% year on year. Let me break down this reduction into two primary parts. First, about a quarter of the gross margin change was due to non-operational items, namely changes in FX rates and differences in stock option expense. Second, the remainder of the changes relate to what I will call more operational – that is, some very specific circumstances in a few of our businesses that we are carefully managing.

Of the operations, more than half is related to our LCD film business, which we discussed in last quarter's earnings call. The LCD TV market is growing by leaps and bounds, which is driving much higher sales for this business, albeit at lower overall gross margins. The manufacturing issues we experienced last quarter were largely resolved as the quarter proceeded.

The remaining operational impacts on gross margins relates to a handful of supply chain inefficiencies that we are working through. Part of this relates to strategic actions we have taken to move production closer to customers, and others are capacity-related. These businesses include roofing granules, medical supplies and respiratory products, to name a few.

In dollar terms, SG&A expense was essentially flat year-on-year, but with increased volumes, we ended up at 20.0% of sales. We continue to invest in growth-oriented SG&A. For example, total selling expenses, which include such things as sales reps, advertising and merchandising and marketing costs, increased in line with revenues. In other SG&A cost categories that are less tied to growth and of a more administrative nature, our objective is to drive greater leverage, and in fact these expenses were down versus last year's third quarter.

R&D expense increased 8.1% year on year, or 5.8% to sales.

Third-quarter net interest expense was $24 million versus $7 million last year, primarily related to increased debt levels supporting our share repurchase activities, which we believe was a good use of cash.

The sequential quarterly P&L comparison is found on slide number five.

Sales were up 3.0% versus the second-quarter, with the largest increases in Consumer and Office, driven by the back-to-school shopping season in mass retail and the do-it-yourself retail channel, along with Display and Graphics, as LCD film volumes accelerated in Q3 due to strong consumer demand for LCD TV's.

Operating income increased 10.6% sequentially, as a result of sales leverage, good cost discipline and a 4.4% sequential reduction in stock options expense.

On a sequential basis, net income increased 9.4% and earnings-per-share increased by 11.4%. Stock option expense was $0.04 per share in the third quarter versus $0.07 per share in the second quarter.

Please turn to slide 6 for a quick review of our year-to-date performance.

In addition to delivering consistent quarterly performance, it is critical that we remain focused on delivering solid performance over the long-term to deliver increasing value to our shareholders.

In terms of operational metrics, we are performing at levels very similar to last year, which was an outstanding year for the company. Year-to-date we have been able to leverage the top-line growth of 8.2% into earnings-per-share growth of 9.0%, excluding special items in each year. On a year-to-date comparative basis stock options had a negligible impact. Operating margins remain at a very healthy 23%.

We have delivered these results while simultaneously accelerating investments to faster grow the business.

Please turn to slide seven where I will recap our third quarter segment results.

Our Industrial and Transportation business had a very strong quarter, with 6.9% top-line local-currency growth and a 16.1% profit growth. Of that revenue growth, acquisitions contributed 2.4% in the quarter, primarily from one month of CUNO sales, which we have now anniversaried.

Organic sales growth in the quarter was led by Industrial Adhesives and Tapes business, Abrasives business, Energy and Advanced Materials business as well as Automotive Aftermarket business which sells products into body shops for vehicle repairs. Growth was muted in the quarter by our business that serves all tiers of the global automotive OEM market. New car builds continue to remain soft, particularly in the U.S. Geographically speaking, Asia Pacific led the way in Industrial and Transportation this quarter with double digit local-currency growth.

Operating income in the third-quarter was $340 million.

Our Health Care business, which supplies a broad portfolio of products and solutions to hospitals, clinics, dentists and orthodontists, generated sales of almost $1 billion in the quarter.

The underlying fundamentals in Health Care remain very strong, driven by aging populations and the continued trend toward western health care practices in emerging economies. We are investing in sales and marketing and R&D while adding products and technologies via acquisitions in our core strength areas, such as infection prevention, wound care, dental and orthodontic products and systems.

Organic local currency growth was 5.1%, with acquisitions adding an additional 90 basis points of growth. Growth was led by our medical supplies, dental and drug delivery businesses.

Many of you know that we are currently seeking strategic alternatives for our pharmaceuticals business and, while I have nothing new to report today, I am hopeful that we will bring closure to the project soon. Excluding pharmaceuticals, which is approximately 20% of Health Care revenues, third quarter local currency growth in Health Care was approximately 8.0%.

Geographically, Health Care's revenue growth was strongest in Europe followed by Asia Pacific and the U.S.

Operational income was up almost 10% in the third quarter including a 1.1 percentage point negative impact from stock options expensing. We achieved this growth in income even as we are moving some of our medical business supply chains to locations that will give us much lower cost in the long term.

Let's move now to Display and Graphics.

Local currency sales growth was 8.2% in the third quarter, driven largely by optical films.

Third-quarter operating income was $300 million, as operating margins returned to 30%-plus levels. Profits improved by $59 million sequentially.

As anticipated, we saw an acceleration in the LCD industry due to strong consumer demand for LCD TV's in advance of the upcoming holiday season. Our optical films business posted record sales, as volumes increased greater than 20% and selling price declines were in line with our expectations.

This business remains one of 3M's jewels, combining an unmatched intellectual property portfolio with advanced manufacturing process technologies to meet the long term cost and performance requirements of the fast-growth flat panel display market.

Many of you know that there are two other very large, market-leading businesses within Display and Graphics, and both are growing very nicely. Our commercial graphics division posted double-digit volume growth in the quarter, and sales volumes in traffic safety systems increased at a mid-single-digit clip.

In Consumer and Office, we continue to penetrate our large key accounts, primarily in the US, with an array of unique, highly functional products featuring customer-inspired designs. The team here has developed a strong track record of introducing innovative new products by leveraging technology and process capabilities across the company.

Local-currency sales growth in this business was 5.8% in the quarter, led by our construction and home improvement division, which serves the large do-it-yourself retail channel. We also posted very good sales growth in the mass retail channel in conjunction with the back to school season. Operating income in Consumer and Office was $181 million, up 6.9%.

Safety, Security and Protection Services business had another outstanding quarter. Local currency sales increased 17.1% including 6% from acquisitions. You may have seen that in August we acquired Security Printing and Systems, Ltd., a leading provider of finished, personalized passports and secure cards, based in the UK. The addition of Security Printing Systems, Ltd. to our line of products for secure documents will allow us to deliver a full range of border and civil security solution products.

Once again, organic growth in the business was driven by strong global demand for personal safety products, especially respiratory protection. We continue to invest in additional respirator capacity to support ongoing growth that we see in this business, including our recent announcement of a new respirator manufacturing facility in Korea, which will serve the Asia Pacific region.

We also posted outstanding growth in our corrosion protection division, a smaller but growing business supplying coatings for all types of commercial and industrial applications in a variety of industries.

Geographically, local-currency growth was positive across all regions of the world, led by Europe and the U.S.

Operating income was $148 million in the third quarter, up about 8% versus last year, including a 1.1 point negative impact from stock options. Profits grew nicely in most parts of this business, with the exception of roofing granules, which was impacted by higher copper costs and greater freight equalization expenses.

In Electro and Communications, organic local-currency growth was 1.4% versus last year, and profits were up just slightly at $124 million, or almost 20% to sales. Year-on-year differences in stock option expense hurt profit growth by 1.3%. Operating margins continue to be impacted by rising raw material costs specifically copper in our electrical and communications markets businesses.

We generated good top-line growth in our electrical markets division, which sells a number of insulating, testing, and connecting products and solutions to both power utilities and manufacturing OEMs. We continue to see good growth from our electronic markets business driven by double digit growth in our semi conductor and assemblies businesses. Partially offsetting this was some sales softness in our U.S. communications markets business due to the higher copper costs.

Acquisitions added 2.0 points of growth as we have acquired a few small but fast-growth products and technologies to complement our flexible circuit and static protection businesses.

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

Net working capital turns were 5.1, down slightly versus the second quarter, and down 0.4 turns versus the third quarter of 2005. As is typically the case, receivable turns were down slightly in September versus June due in large part to traditionally strong September month-end sales that ultimately are collected in the fourth quarter. Inventory turns, on the other hand, improved slightly versus June but are lower than year-ago levels.  As mentioned on previous calls, we have built inventory in 2006 in many businesses in order to improve service levels, and in fact in many of our businesses service metrics have gotten much better. On the whole, however, we still significant opportunities in this area, and of course our lean manufacturing initiative is aimed squarely at this it.

Capital expenditures totaled $312 million, an increase of $104 million year-on-year and $51 million sequentially. To date we have spent $763 million of our expected $1.1 billion in capex 2006 as we continue to invest in a number of growing businesses.

Free cash flow in the quarter was a solid $787 million, up 11%.

Dividend payments to our shareholders were $342 million, up over 6% versus third quarter of last year.

And we aggressively bought back stock during the quarter, with gross share repurchases of $1.2 billion, almost double the amount purchased in last year's third quarter. As I previously mentioned, during Q3 our Board of Directors authorized an additional $1 billion in share repurchases, raising the total authorization to $3 billion for the period from February 2006 to February 2007.  As of the end of the third quarter, we have almost $1 billion remaining of the total authorization.

This concludes our discussion on the quarter, now I would like to turn the call over to George, who will address our expectations going forward. Please turn to slide nine. George…

**George Buckley- Chairman, President and CEO**

Thank you very much Pat, and good morning everybody.

Before I address our forward outlook, let me make a few brief comments about our third quarter results. We made significant progress on many fronts during the quarter. Our efforts to accelerate the sales growth of the company continue to progress, as we delivered our third consecutive record quarterly sales and added some exciting new products and technologies to the company through acquisitions. In LCD films, we saw continued manufacturing process improvements in this business as the quarter progressed and the new production line is now behaving in line with our expectations. We continue to invest in additional capacity in many new core growth businesses. Finally, during the quarter, we used our strong balance sheet and cash flow position to opportunistically buy back $1.2 billion of our own stock, in addition to distributing over $300 million of dividends to our shareholders. All in all, this was a good quarter for 3M.

Looking forward to the fourth quarter, we see nothing at the moment that would steer our ship off-course, and economic conditions appear to resemble those in recent quarters. For our business, we expect organic local-currency sales growth in the range of 4 to 8%, with acquisitions adding an additional 1.5% or so of growth.

Fourth quarter earnings per share are expected to be in the range of $0.97 to $1.04, including the effect of an estimated $0.12 to $0.13 per share of one-time acquisition costs related to the purchase of Brontes Technologies, Inc., an acquisition which we announced on Monday of this week. Also included in our fourth quarter earnings is $0.04 per share cost from stock options expensing.

As in the past two quarters, we will likely incur some additional expenses associated with our efforts to seek strategic options for our pharmaceuticals business, and if we consummate a transaction in the fourth quarter, we will incur some restructuring-related costs associated with selling that business. None of those charges are included in our fourth quarter guidance.

That concludes our formal comments. We would now be happy to take any questions. Thanks a lot everybody.