Q107 Earnings 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 I would like to welcome all investors and analysts to our first quarter 2007 business review. Allow me to make a few brief comments before we begin.

As usual, 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 10K lists some of the most important risk factors that could cause actual results to differ from our predictions. George Buckley, our CEO, and Pat Campbell, our CFO, will both make some formal comments today, and then we will get to your questions.

We know how busy you all are during the earnings season, so we will do everything in our power to keep today's call at about one hour. You can help us during the Q&A by limiting yourself to one question and one follow-up, so that all questions can be properly addressed. And remember, Bruce and I are available all day to answer your specific follow-up questions.

I also would like to remind you that we will host our next investor meeting in St. Paul on the evening of October 9th and on the following day, October 10th. The meeting will include a combination of business presentations, several opportunities for informal conversations with management, and a plant tour at one of our nearby manufacturing sites. A formal invitation will be out very soon, but please mark your calendars accordingly.

So now I'd like to turn the program over to George Buckley.

George Buckley- Chairman, President and CEO

Good morning everyone;

As you can see from our press release, it's a very good morning indeed!

It goes without saying that we had a fabulous quarter. Sales reached an all-time high of $5.9 billion, up almost 10 percent up on last year, with the operating portion of EPS at $1.28, up 14.3 percent if I correct for 2006 lost sales from pharma. And we did this despite challenging year-over-year comparisons. You will recall that we had over 8 percent organic growth in Q1 of last year. And here we achieved another 5.6 percent of purely organic volume growth this quarter. I think this is absolutely stupendous.

I am especially pleased with the breadth of our strength – all of our businesses posted positive sales growth. There was a near endless procession of good results from such important 3M units as OH & ES, dental, medical and industrial tapes and adhesives. When they do well, the company does well.

This performance is especially pleasing given what we had seen in much slower growth in the United States and some parts of Asia in December. Earnings not only exceeded our own expectations, but we more than overcame the loss of Pharmaceuticals sales and earnings in our numbers. You will recall that, because we retained a small activity to supply key pharmaceutical ingredients to the new owners, accounting rules prohibited giving us discontinued operations status for this sold business.

I'd like to tell you first about general business conditions with the intention of demystifying the complex set of moving parts in a company like 3M.

In general terms, the US still remains a tale of two economies. Sales into aerospace and energy markets were very positive and robust and, from this weeks durable goods order report, look likely to continue. Sales into the US housing market were mixed, with some positive and some negative signals. Beyond those factors though, growth for 3M was pretty strong everywhere.

Currency was our friend in many places, but its positive contributory effects were often completely offset by a combination of negative price and cost inflation.

As for the world economy, international sales growth was overall very strong, though with a few pockets of weakness as you'd expect. For example, sales in China rose nearly 30 percent, Russia by 42 percent, India by 32 percent and the Gulf region by 36 percent. Even big countries like Germany were up 9 percent, the UK by almost 46 percent and Italy by 10 percent. Latin America also did very well, with sales up by a hefty 9 percent. And before you think this Latin America growth is off a small base, full year sales in 2006 were about $1.3 billion. This is the power of 3M's international distribution at work and testimony to the entrepreneurship and creativity of the people working there in driving growth.

We did see pockets of slower growth in Japan and Taiwan, with these countries being more or less flat on sales as a whole. Some of this is driven by movement of products traditionally manufactured in those markets to new manufacturing bases in China. Taiwan appears to be the most affected also by softer sales in consumer electronics.

LCD TV markets remained very strong for us and are gradually showing more stability as this market continues down its long pathway to eventual maturity. I'm pleased to say that there is lots more discipline in this market now. As one might expect, we are seeing a little more seasonality in Optical Systems division as LCD TV films becoming a larger part of their sales, and monitors less so. This is all very normal. Outside the LCD TV markets, component sales into electronics related markets were a little softer, though some of that challenge was driven by end of life products in phones and printers.

Gross margin for 3M declined in the quarter by 200 basis points, but some of this is just an arithmetic peculiarity. Pharma was responsible for just over 100 basis points of this decline and was wholly expected. So the gross margin, sequentially, is a marked improvement over what we saw in Q4. Commodity inflation and currency were responsible for most of the balance. Pressure on commodities will be a fact of life going forward and in many cases we are reformulating products to use far less of these key raw materials.

We remained cautious in our spending patterns given a potentially wobbly US economic outlook and tough year-over-year comparisons. It has been our very deliberate and determined strategy to leverage corporate overhead spend and avoid adding headcount in that area. I don't expect to see any change in our approach there; in fact I expect it will gather momentum as the year goes forward as sales increase and we hold corporate costs as close to constant as we can.

At the same time, we continue to invest heavily in R & D and are working very hard on several breakthroughs in industrial, optical and electronic technologies that we hope to show investors at our meeting with you in October that Matt mentioned earlier. Please be aware that previous Pharma spending in 2006 distorts our R & D spending comparisons somewhat.

We are also investigating the purchase of a couple of new technologies from outside our company for use in our core business as we push up the already high rate of technological development at 3M. While the areas we are looking at are not expensive in our terms, the potential purchases are just great ideas that will help build and protect the enduring core franchises of 3M. I am extraordinarily pleased at the way our scientists are helping us push the competitive envelope these days. Good for them and I'm very proud of them. This aspect of the old 3M is coming alive again faster and faster as every day goes by.

We have completed six small acquisitions since the beginning of the year as we continue our steady diet of small, low risk, bolt-ons. Some of them, like the pipeline coating business of E W Woods in the UK are very important to new markets in oil, gas and water. 3M's portfolio breadth allows an almost endless stream of these kinds of acquisitions and we expect to remain in this mode for the balance of the year. This will add 150 to 200 basis points to our annual sales growth rate. We have, by the way, been making these small acquisitions at very moderate multiples since they are mostly below the radar screen levels of private equity. Each of them plants a seed of higher growth in coming quarters and years.

We are very happy with the work we've done so far on bulwarking 3M's historical base. As opportunities arise we will bring additional focus and investment to our dental, medical and industrial safety segments to strengthen our enduring franchises in these areas. These investments will continue to build on the strong core of 3M's technology and manufacturing base.

A big question mark going into the quarter was how the US consumer would do. Our Consumer and Office business, which is roughly 60 percent US based, grew sales by a strong 10 percent and that growth was very broad based. We saw 7.1 percent growth in the US and slightly higher overseas. The long train of positives in C & O was led by our Construction and Home improvement Division whose sales in the quarter grew by 15 percent, all led by new products. Earnings were also up 15 percent. This has all been about the creativity of the C & O people and many new products which mitigated and overcame the underlying weakness in paint and drywall areas.

We believe there was some shelf restocking at major home improvement retailers in Q1 that complemented the destocking we saw in December and this probably gave us some extra lift in the quarter. But the primary influence right across this segment was driven by new products.

Automotive markets were a very pleasant surprise to us this quarter. Sales in our Automotive OEM unit rose 4.5 percent and earnings rose by 15 percent and we saw similarly very good sales growth in the automotive after market. Not bad at times like these. Sales in our two energy market businesses grew a combined 25 percent, all organic, and with great earnings leverage.

We've worked tirelessly to drive growth and change all across 3M, and even in these more bumpy economic times, it seems to be working. Understandably, you can't see inside 3M in the same way that we can, but I will tell you that 3M's people are universally inspired by the message of driving growth and the investments we are making in our company.

Even though we have a great deal still to accomplish, we are nevertheless very pleased with our progress. We are driving our growth agenda forward, and at the same time, reinvigorating all aspects of 3M, culturally, structurally and financially.

Conceptually, our growth model is quite simple. Growth can be thought of as a figurative pipeline delivering products to our customers. Our job is to make the sending end of that pipe more effective by using our legendary invention and innovation model to get the right new products and inventions ready quickly.

We also need to make the receiving end of the pipe better by delivering the right kind of customer service, products and brands to inspire customers and penetrate local distribution.

Then, we need to make the pipeline itself flow freely by keeping it short, direct, speedy, leak free and of large enough capacity to deliver the needed volume. Acquisitions help all three elements of this simplified mental model.

The big piece of the heavy lifting here is restructuring our supply chain. It's not glamorous work but it is vital ingredient in the mix of our growth strategy and it's needed to get our effective tax rate down. By doing this, we get what Americans would call a three-for; working capital, cost and growth all at one time. Most of you know we have a pretty complex supply pipeline with back feeds and re-entrant loops - jug handles as they are sometimes called in navigation parlance.

You also know that we are vigorously investing in capacity to address unmet demand and grow our traditional core and are building these pipelines in the market, to supply directly to the market. We think growth can accelerate as this new capacity comes on stream and as we deliver that capacity to the market with much better customer service and with more efficiency, both in terms of costs and working capital usage.

3M currently has under construction 19 new plants or plant extensions. And there will be more to do once we've digested this stage of our rebuilding. We aren't doing this because we secretly want to be in the construction business. We are doing it because we got behind and our customers are demanding it and we can't afford to grow, working capital-wise, with our historical supply chains hundreds of days long. You can see that in our numbers, and equally importantly, we need to meet our customers' requirements.

I've read some research that questions why some of this plant construction is occurring in the United States. But I would only humbly point out that we still have growth in the US, albeit at slower rates than internationally. We are not building new plants in the United States, just extending existing plants and doing it where the core manufacturing competency for that product lies. It is no more sensible to send product to the US through long and convoluted supply chains from the far-east, than it is the opposite way round. We are putting capacity where the demand is, to try to keep customer service levels up and working capital demands low, we need that to drive ROIC, subject to getting the best cost and tax structure we can. Moreover, some businesses, like Optical Systems, do not scale well, and live on a large technical ecosystem within a company like 3M. So apart from converting operations, the US is still the most logical place for much of the investment in jumbo manufacturing today.

Construction of the new OH & ES facility in Korea, on which we have invested about $140 million, is going very well. About a month ago, I got my first trial samples of respirator masks from this new facility. This will be the fastest build of a major new facility in 3M's history – it's due to start up in July of this year.

We have also been dealing with the other side of this equation too. We announced the closure of our manufacturing facility in Eau Claire, Wisconsin, plus a small plant in Japan. Their costs were included in our restructuring puts and takes that you saw in this quarter. Because of growth, we do not expect to close very many plants in the United States, but from time to time you will see us doing this where it makes economic good sense. And even then it will be done slowly and over time.

We are renewing our focus on and investment in R & D. Our scientists and manufacturing process engineers are indisputably world class in their fields, and their creativity, combined with continued investment in technology, remains fundamental to our growth agenda. We're working hard to create new technology and product platforms in such promising fields as electrical power transmission, renewable energy, minerals extraction, air and water quality as well as strengthening our traditional core businesses.

We also see considerable opportunity to localize not only the manufacturing we've already discussed, but also our brand presence around the world through product customization and use of local brands. As we gain distribution access, we are able to pull through our mega brands such as 3M™, Scotch™, Scotch Brite™ and Post-it™ and drive preference in local customers for those brands.

For the rest of 2007, our main priorities are clear. Firstly, to increase the horsepower of our growth engine and leverage it to the bottom line. Secondly, continue the drive of factory cost and gross margin improvement. And thirdly, flawless startup of our new manufacturing lines and plants.

For the second quarter we expect to see similar economic conditions and sales patterns to Q1, with perhaps the end to shelf restocking in the home improvement market. We do not expect to see any large rebound in the US or Japanese economy until later in the year. Nor, on the other hand, do we expect to see any recessions.

Home construction markets will likely remain weak here in the United States for the foreseeable future and the forecasts are for automotive unit production in the United States to be at the lowest level since 1992. So a level of caution is in order for now in those markets.

Toward the end of the second quarter, I expect year-over-year comparisons to be getting better on roofing granules. If, for no other reason, the low levels of business we began to see at this time last year. That will contribute positively to our performance.

LCD TV construction is likely to be quite a bit stronger than last year in the second quarter, though there will be continued and expected downward pressure on price as the market reaches maturity. As a matter of interest for you, to offset this, we have successfully experimented with a new manufacturing approach that will double the capacity on our newest optical film line in Decatur with essentially no capital investment to speak of. This change will provide us with higher yields in large format TVs and add to the strength 3M has in this segment of the market. We have also successfully developed a way of recycling waste from optical films to use as feedstock for some consumer and office products that will cut down on the cost of raw material as well as being very environmentally responsible. This will save us millions of dollars when we launch it fully.

So, in conclusion, overall, we are not expecting large swings in the mix of sales in Q2, though there is reason to believe that the slower Asian sales will pick up somewhat as component pipelines drain as we move into the second half of the year.

Traditionally, the second quarter for 3M is stronger than the first. But seasonality in LCD TVs will be a more normal feature going forward. So, undoubtedly the second quarter will be stronger than last year as we benefit from easier comps, but we have a lot to do in rebuilding our company and we see no upside at this stage to increase our annual guidance without another firm data point. So while we are cautiously optimistic and our plans are conservative, we remain committed to our current annual guidance.

Finally, I'd like to thank 3M employees around the world for their outstanding performance and results this quarter. They did a simply wonderful job.

Now for a more complete picture of the first quarter, I'd like to turn the microphone over to Pat Campbell…Pat.

Patrick Campbell- Senior Vice-President and CFO

Thank you George and good morning everyone. As George has already indicated, it was truly a great quarter for 3M, from both a top and bottom-line perspective.

As explained in our press release this morning and shown on slide number two, first quarter reported earnings per share are $1.85. Included in this result are three special items. First, in January of 2007, we completed the sale of our branded pharmaceuticals business in Europe, which resulted in an after-tax gain of $506 million, or $0.68 per share.

Second, we undertook some business-specific restructuring actions that included headcount reductions, asset write-downs and other costs pertaining to the sale of the pharma business in Europe. In total, these items reduced net income by $9 million, or a penny per share.

Finally, various environmental regulatory developments occurred during the first quarter of this year, including increased regulatory activity in Minnesota and the receipt of a permit to begin work addressing perfluoronated compounds in the soil and groundwater at our manufacturing facility in Decatur, Alabama. During the quarter, we completed a comprehensive review with environmental consultants regarding our other environmental liabilities which include the estimated costs of addressing trace compounds of perfluoronated compounds in drinking water sources in the City of Oakdale and Lake Elmo, here in Minnesota, as well as presence in the soil and groundwater at our manufacturing facilities in Decatur, Alabama and Cottage Grove, Minnesota and at several former disposal sites in the state of Minnesota. As a result of these regulatory developments and of our comprehensive review, we increased accrued liabilities by $121 million in the first quarter of 2007 to address these planned remediation activities. We expect that most of the spending will occur over the next three to seven years.

After adjusting for these items, earnings for first quarter are $1.28 per share. Please refer to today's press release for a more detailed discussion of these special items.

As we discussed in last quarter's earnings call, generally accepted accounting principles prevent us from classifying the pharmaceuticals business as a discontinued operation; therefore it creates a year-on-year comparability issue. Q1 2006 revenues for the pharma business were $193 million, and operating income was $60 million, or $0.05 per share.

Adjusting for pharma in the 2006 base, earnings per share increased 14.3 percent year-on-year.

On slide number three, we compare our first-quarter P & L versus last year's first quarter.

The 3M team rose to the challenge in the first quarter and delivered truly outstanding results. Our objective of accelerating top-line growth while maintaining superior financial performance played out in the first quarter as we posted record sales, operating income, and earnings-per-share for any quarter in 3M's history. Excluding the impact of pharma shown in the far right column and special items, earnings-per-share increased 16 cents, or 14.3 percent on sales growth of almost 10 percent. Operating income was up 10.6 percent to $1.4 billion with operating margins of 24.4 percent, up 20 basis points year-on-year on an excluding basis.

Gross margins were 49.3 percent, down 2.1 percentage points from last year's first quarter. Approximately half of this decline is the impact of the sale of our pharmaceuticals business which was a very high gross-margin business. The remaining decline was largely due to the weaker US dollar and higher raw material costs, and somewhat on selling prices.

SG & A expense remained at $1.2 billion, down 2.6 percent versus last year. Excluding pharma, sales and marketing expenses were up in line with local-currency growth year-on-year as we invested in sales and marketing resources to drive accelerated growth while our aggressive focus of managing our administrative expenses continues to pay off.

R&D and related expenditures were 5.5 percent to sales in the first quarter versus 5.8 percent last year. But please keep in mind that pharma required heavy investment in R&D, in the range of 15-20 percent of sales, therefore we expected our percent to sales to decline. Excluding the divestiture, R & D and related costs were up 12 percent year-on-year, as we continue to aggressively invest in growth opportunities.

Consistent with our expectations, the tax rate increased in the first quarter to 33.2 percent, or up 50 basis points.

Please turn to slide four for a recap of our first quarter top-line performance.

As mentioned, first quarter worldwide sales increased almost 10 percent prior to the negative impact of 3.8 percent due to the divestiture of the global branded pharmaceutical business.

Worldwide local currency sales increased 7.4 percent versus last year's first quarter, including 2.6 percent from acquisitions and global selling price declines of 80 basis points. Translation increased reported sales by 2.5 percentage points in the quarter.

In the United States, local currency sales improved 6.2 percent, equally split between organic and acquired growth. Selling prices were up 80 basis points for the quarter. The divestiture of the pharma business reduced U.S. sales growth by 4.2 percent. Therefore reported sales growth was closer to 2 percent.

In our international operations, local currency sales were up 8.2 percent including 5.8 percent organic and 2.4 percent from acquisitions. Selling prices declined 1.8 percent versus last year, largely due to our businesses that serve the consumer electronics industry, where price-down is a way of life but where there are high-volume growth and profit opportunities. The sale of our branded pharmaceuticals business decreased our reported growth in International by 3.5 percent. The impact of an overall weaker US dollar boosted sales by 4 percent in the quarter.

Europe delivered local currency growth of 13.3 percent. Safety, Security and Protection, Health Care and the Industrial and Transportation businesses were strong contributors to this growth. Europe's local currency result includes 5.4 percent of growth from recent acquisitions, primarily Security Printing Systems Limited and BioTrace International. The pharma divestiture negatively impacted local-currency growth in Europe by 7 percent, while currency translation increased sales by 8.7 percent.

Latin America and Canada combined posted local-currency growth of 9.1 percent including a point from acquisitions, led by our Industrial and Transportation, Health Care and Safety, Security and Protection Services businesses. The pharma divestiture reduced growth in this region by 2.5 percent, and currency impacts were negligible.

Local-currency growth in Asia Pacific was 3.9 percent, with Japan flat and the rest of the region up 6 percent. Solid sales growth in Industrial and Transportation and Consumer and Office businesses was offset by declines in flexible circuits and optical films. Again, the pharma divestiture had a 1.2 percentage point drag on sales growth, and currency translation added about one point.

So now let's dig into our business segment results. Please turn to slide number five.

Leading off with our Consumer and Office business, they delivered outstanding results in the first quarter, with sales up almost 10 percent to $814 million. Local-currency sales increased 8.2 percent, including 1.2 percent of growth from the Nylonge acquisition, a global provider of household cleaning products including cellulose sponges, scrub sponges and household wipes. The acquisition has two primary benefits: one, it expands our leading line of home cleaning and scrubbing products, and two, it quickly adds manufacturing capacity in a growing core 3M business.

Year-on-year growth was led by our construction and home improvement business serving the do-it-yourself retail channel with products such as Scotch blue masking tape for the professional paint trade along with the expansion of distribution of our Filtrete furnace filters where we have recently added capacity to drive added growth. Also leading growth in the quarter was our businesses supplying the consumer and office mass retail segment. In fact, our office supplies business was recently recognized by Staples as their Global Supplier of the Year.

In geographic terms we generated substantial sales growth in every major region of the world.

We leveraged the top line performance to drive year-on-year operating income growth of 18.1 percent, to $177 million. Profit margins increased 150 basis points year-on-year to 21.7 percent.

Safety, Security & Protection Services also had an outstanding quarter as shown on slide six.

Sales rose 19 percent to $758 million. Local currency sales growth was 15 percent, with two-thirds of that growth coming via our August 2006 acquisition of Security Printing Systems, Ltd. a leading provider of finished, personalized passports and secure cards, based in the UK. For many years 3M has had a niche position in the passport market with security laminates that prevent counterfeiting. This acquisition allows 3M to deliver a full range of border and civil security solution products.

Organic revenue growth continues to be driven by strong global demand for personal safety products, especially in respiratory protection. I have mentioned before our plans for a new respiratory plant in Korea supplying disposable respirators for the Asia Pacific market. This new plant is a testament of our overall strategy of simplifying and shortening supply chains by placing manufacturing closer to the customer. Things are progressing well as George mentioned, and in fact we are already doing some converting and. We are on track for a complete plant launch mid-year.

We also posted outstanding growth in two other businesses. First, sales were up more than 50 percent in our corrosion protection where we are aggressively penetrating the oil and gas market with unique pipe coating solutions for our customers. As you may recall, during the quarter we announced the acquisition of E Wood Holdings PLC, a UK-based manufacturer of high performance protective coatings. E Wood's expertise in liquid technologies for new pipes and rehabilitation coatings for existing pipes in the oil, gas and water markets complements 3M's core corrosion protection product offering of external powder coatings for new oil and gas pipelines. And finally, we drove double digit growth in our building and commercial services business as well.

Operating income was $181 million, up almost 15 percent versus last year's comparable quarter, and margins were a solid 23.9 percent.

Our market-leading roofing granules business posted strong sequential improvement as industry-wide inventories are now in better balance with demand. However, our business was still down year-on-year, which negatively impacted first quarter sales and operating income growth by almost 3 percent and 6 percent, respectively.

Please turn to slide seven.

Industrial and Transportation continued their strong performance in the first quarter. Sales grew 6.7 percent to $1.8 billion. In local currency terms, sales increased 4 percent including a point from complementary acquisitions that have helped to fill in gaps in our product lines. Most of our traditional industrial businesses - such as abrasives, industrial adhesives and tapes, automotive aftermarket and liquid filtration - grew sales at mid-single-digit rates in local currency, while our automotive OEM-related businesses grew at a low-single-digit clip. Our industrial products for the oil and gas and aerospace industries showed strong double digit growth and are expected to continue at that rate.

We believe there is a clear line of sight to more growth in this business and we are investing accordingly. We are strengthening our core businesses like tapes, abrasives and adhesives by increasing R & D expenditures and making complementary acquisitions. This business now has a strong pipeline of new products such as the next generation Acrylic Foam Tapes for automotive OEM applications. In this quarter this business made three bolt-on acquisitions in the adhesives, tapes and abrasives areas. Geographically, our industrial business is making significant investments in China, India, Poland and Brazil to better serve customers in areas of the world where growth is just exploding. Our Automotive Aftermarket business, where the collective family of 3M brands is the number one choice for body shops around the world, has launched a new line of consumer car care products for the do-it-yourselfer.

Finally, in the second quarter we will open a new laboratory and Customer Center in Houston, Texas, to bring 3M’s wide array of technologies and research capabilities to customers in the energy extraction industry. Throughout 3M's history, this level of customer intimacy has sparked innovation and growth.

First-quarter operating income was $411 million in Industrial and Transportation.

Please turn to slide eight for an overview of first quarter performance in Electro and Communications.

First quarter sales in this business were $668 million, up 3.6 percent, and profits increased 8.4% to $130 million. There are three primary takeaways from Electro and Communications' performance this quarter.

First, on the revenue front, we drove outstanding growth in both the electrical and communications businesses. The Electrical Markets division continues to deliver outstanding growth in a number of products and solutions for insulating, testing, sensing, and connecting to both power utilities and manufacturing OEMs. In the communications business, growth is being driven by the global deployment of enhanced broadband services, which require significant upgrades to existing communication networks to improve performance and expand the bandwidth needed to deliver enhanced services.

Second, we had a tough sales quarter in our electronic solutions business, due primarily to year-over-year declines in flexible connectors for inkjet printers and, to a lesser extent, semi-conductor and inter-connect customers reducing inventory in the channel.

Finally, despite some sales challenges in the quarter, this business did a phenomenal job of managing its costs in the quarter as profit margins were a record 19.5 percent.

Please turn to slide nine for a recap of first quarter performance for the Display and Graphics business.

Facing a tough year-on-year comparison, sales were up slightly versus the first quarter of 2006 and were a record for any first quarter in our history.

Commercial Graphics posted an outstanding first quarter with double digit increases in both sales and profits. Growth was broad based driven by the combination of new products, fleet and retail advertising, re-branding efforts related to merger and acquisition activity along with international penetration.

In Optical Films, we are very encouraged to see the LCD industry taking a more rational approach to better balancing supply with end-market demand. In the quarter this resulted in our optical film sales being down a few points year-on-year. Recall that last year's first quarter reflected a sizeable inventory build, that subsequently was corrected during the second and third quarter of 2006. We have also consciously made the decision to focus on markets where we add the most value. As a result, we have lost some penetration of optical films for low-end desk top monitors but continue to have strong penetration in handhelds and notebooks along with the fastest growing segment of the LCD industry – TV's. Selling prices were down in line with our recent experience. Our strategy here remains the same - that is, to carefully manage the price down requirements of the LCD industry while at the same time growing total sales and profitability. There is additional growth to come in this industry, and we are investing thoughtfully to support it.

We hope that this quarter's margin performance of 32.0 percent in Display and Graphics puts many of your concerns to rest. Our business teams have proven successful over many years at relentlessly driving productivity via six sigma and lean, and this quarter was no exception.

Looking ahead, we expect strong seasonal demand in the LCD industry in the second half of the year as LCD TV penetration starts approaching 40 percent of the overall global TV industry. It is very apparent that LCD technology will be the leading technology in the global TV market. We will be starting up our new optical film converting facility in Poland in the second quarter supporting panel manufacturers and OEMs as they move operations to Eastern Europe, and we also are seeing continued improvement of the new DBEF manufacturing line here in the United States. Both projects are tracking to their plans.

And lastly, please turn to slide ten where you will find the first quarter highlights for our Health Care business.

Health Care had an absolutely outstanding quarter. Local currency growth including acquisitions was 20 percent in the quarter, 15 percent of which was organic and 5 percent of which was acquired. Of the organic growth, 4 percent was the result of the new supply agreements related to the sale of our branded pharmaceuticals business in which our Drug Delivery Systems Division became a source of supply to the acquiring companies, and the balance of the portfolio grew at double digit rates. We spoke quite a bit during last year about accelerating investments in our core Health Care portfolio, and as you can see, these investments are delivering.

Sales growth was broad based across Health Care, with our drug delivery business leading the way. For those of you less familiar with this business, we are a leading technology provider of drug delivery solutions, partnering in many cases with drug companies by providing highly innovative components for both inhalation and transdermal delivery of medicine to patients.

During the quarter, we also saw solid sales in the clinic and hospital markets, both in terms of traditional stalwarts such as consumables for infection prevention and wound care, as well as innovative software solutions to enhance productivity and data accuracy in the hospital.

Sales grew at double digit rates in our dental business, which was recently recognized as the "Most Innovative Company" in the worldwide dental industry for the second consecutive year by the independent publication 2006 Dental Industry Review. This award commended 3M's track record of innovation, noting that the business led the industry with an average of 45 innovations per year over the past five years.

And finally, through acquisitions we have added some key businesses and technologies that will bolster our leadership position in infection prevention and detection as well as digital dentistry.

First quarter operating income was $269 million. Excluding the divested pharmaceuticals business from first quarter of last year, operating income increased by 12.7 percent.

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

Working capital grew slightly faster than sales during the quarter. As George discussed earlier, many of you are well aware of our efforts to streamline our supply chains to improve customer service and reduce working capital but this will take some time to fix.

Capital expenditures totaled $304 million, an increase of $114 million year-on-year and a decline of $100 million sequentially. Total capital expenditures for 2007 are expected to be approximately $1.4 billion to $1.5 billion as we invest in a number of growing and highly profitable businesses.

Free cash flow, excluding special items, in the quarter was $670 million.

Dividend payments to our shareholders were $350 million, and we aggressively bought back stock during the quarter, with gross share repurchases of $1.2 billion, over 4.5 times the amount purchased in last year's first quarter. In February our Board authorized a two-year $7 billion share repurchase program for the period from February, 2007 to February, 2009. As of the end of the first quarter, we had $6.1 billion remaining of the total authorization. Weighted average shares outstanding were down 3.6 percent year-on-year, and 1.0 percent sequentially.

And finally, our debt to capital ratio was 31 percent at the end of the first-quarter.

This concludes the formal part of today's program, but before we open it up for questions let me summarize the quarter. In the face of a tough year-on-year comparison we delivered an all time quarterly sales record of $5.9 billion, up almost 10 percent with earnings per share growth of over 14 percent after adjusting for the pharma divestiture. These outstanding results were broad-based, as every business posted positive sales growth. In short, we are successfully executing our strategy, which is to accelerate top-line growth, while maintaining superior financial returns. Now we would be happy to take your questions.