

Q2 2007 Earnings Call Transcript

Matt Ginter- Vice President, Investor Relations and Financial Planning & 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 second quarter 2007 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 forms 10K and 10Q 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.

Again, 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.

Again, I'll remind you that we will host our next investor meeting in St. Paul on the afternoon of October 9th and on the following day, October 10th. The meeting will include a combination of business presentations, informal conversations with management, and a plant tour at one of our nearby manufacturing sites. Look for an email in the next few weeks with specific details.

So now please go to slide number three, and I'd like to turn the program over to George Buckley.

George W. Buckley- Chairman, President and CEO

Thank you, Matt. Good morning everyone, and thank you very much for joining us this morning.

I'm pleased to report another very strong quarter for 3M. More importantly for the longer term, our growth agenda continues to gain momentum and deliver the results we had planned and hoped for.

So let me start the call by thanking the people of 3M for their outstanding work again this quarter. Without their help, none of this good stuff can happen, so we're very grateful for that.

Obviously, we're very pleased with the quarter. Sales topped \$6 billion for the first time in our history, up 8 percent over last year, and up almost 12 percent when adjusted for the Pharma disposal. In a company our size, that's fabulous growth. Excluding special items, earnings were \$1.23 per share, up more than 17 percent year-on-year, achieved by the combination of great growth and continued operating discipline.

Again, the breadth of 3M's strength was evident – excluding Pharma all of our six business segments posted positive sales growth, though it was a little tougher to do in our Electro and Communications area. The list of successes from our important large business units continued, in fact, sales grew at double-digit rates in each of our largest global divisions of 3M, namely Automotive Aftermarket, Industrial Adhesives and Tapes, Medical Products, Occupational Health and Safety, and Optical Systems. We haven't seen this in a long time.

Along with that, we drove explosive sales growth in several developing countries around the world. For example, sales grew 40 percent-plus in Russia and India, 30 percent-plus in Poland and Turkey and a hefty 27 percent in China, just to name a few, with organic unit growth being the primary driver. And, we drove outstanding sales growth in some of our largest well-established subsidiaries such as Germany at 12 percent and the United Kingdom who grew at a whopping 53 percent, driven by a combination of acquisitions, organic volume and, of course, some positive currency.

Progress in the first half of the year gives us continued confidence in our strategic plan for growth which, as you know, calls for some investments above the rates we've seen in recent years.

The investments include increased funding for R & D, and that's baked into the earnings numbers you are seeing, plus acquisitions and more localized manufacturing capacity to serve customers better, all of these are designed to advance the reputation of our brands and build our enduring franchises.

We also continue to invest heavily – but prudently – in technology development, particularly that in our core. So far this year, we are investing in R&D at a rate that will result in greater than an 11 percent increase over last year, when adjusted for the divested Pharmaceuticals business.

Similarly, our capacity investments are on track and will soon start generating positive results. This is another one of the real keys to our success in the future. A couple of weeks ago I participated in the opening of our new respirator plant in Korea – the fastest build of any new plant in 3M's history - just 11 months from breaking ground to start up. Just for your information, a new 3M plant will typically get past the break-even point about three quarters after opening. But this plant opening was an absolutely fabulous

achievement by our Project Manager John Bloom and his team of people from Korea and St Paul, who I want to recognize publicly.

As you know, 3M has a number of other new plants or plant extensions under construction. We have now successfully knocked off four of them, all on time and on cost. We had some small time slips in our plan, both in Russia and in China, where some frustrating permitting delays have pushed back the opening by a few months. But none of this was down to 3M, only down to local government issues.

You've heard me talk before about the importance of streamlining our supply chain, and these new facilities will give us a good start on this multi-year undertaking. In addition to the Korean plant I already mentioned this quarter, we've opened an Optical Film plant in Poland, a mixed Industrial Plant in Southern China and a Construction and Home Improvement tape plant in Canada that will open in June. On the other side of the ledger, we've also exited several high-cost underutilized manufacturing facilities in Japan, France, Italy and the U.S. and streamlined several of our U.S. supply chains by relocation of equipment from one facility to another. This is in addition to the streamlining achieved through plant construction.

On the acquisition front, we have now completed eight acquisitions since the beginning of the year as we continue our steady diet of relatively small, low risk, bolt-ons. These acquisitions are building strength on strength in many of our market-leading businesses right in the core heartland of 3M.

I want to point out that, while we are accelerating investments in growth for the future, we are maintaining strict discipline on spending on administrative areas. While important to the company, they do not grow in line with sales.

The bottom line is this: we're driving our growth agenda forward, investing as we said we would, and we are encouraged with the results so far. We have a great deal still to accomplish, but there is every reason to be very pleased with our progress to date.

There was lots of good news this quarter for 3M, which is bound to be encouraging for all of us. But before we get ahead of ourselves and get accused of only telling you the happy news, I want to give you a balanced sense of perspective. Not everything goes right in a company like ours all the time. This quarter was no different.

For example, we saw continued softness in our roofing granules businesses, with sales down 13 percent year-over-year, although it was up sequentially. While we did very well in Construction and Home improvement, we did so based on commercial construction and winning new SKU placements and market share; the underlying residential construction market is still fragile and I expect it to continue so for the foreseeable future. We also saw very weak markets in electronic interconnects, with sales down 10 percent year-over-year. But the diversity of our portfolio is what overcomes this kind of issue. 3M's strength comes from its technological prowess, yes, but it also comes from its broad market and wide geographical diversity.

As I mentioned, while commercial construction is robust, residential construction remains weak. At the beginning of the year, I think most of us believed that we'd see some betterment in the second half of 07, but this will probably prove to be too optimistic.

Growth was strongest internationally, as I mentioned, at 11.7 percent. Growth in the U.S. was more modest with sales up only 6.2 percent year-over-year if I take out last years divested Pharma sales, and this included about 2.8 percent from acquisitions. Health care, safety, aerospace and energy markets are the leaders as Pat will show you in a moment. There was a time not long ago when we'd celebrate this kind of U.S. growth rate, but not now. So we'll be doing our best to drive for better growth in the coming quarters.

Now I'll turn it over to Pat for a more in-depth discussion of our second quarter results.

Patrick D. Campbell- Senior Vice President and CFO

Thank you George and good morning everyone. As George has already indicated, not only did we continue to execute on our growth plan with greater than \$6 billion dollars in sales in the quarter for the first time in company history, but we were able to maintain exceptional margins and returns while we continued to invest in future growth opportunities. So clearly our growth plan is on track and I feel very good about our performance this year.

As explained in our press release this morning and shown on slide number five, second quarter reported earnings per share were \$1.25. Included in this result are three special items, which I would like to explain in some detail for you. First, we announced that we would phase out operations at our Belle Mead, New Jersey facility which produces roofing granules for the asphalt roofing shingle industry and a number of auxiliary products. The closing was driven by a significant reduction in demand from shingle manufacturers in the Northeastern part of the United States. Remaining production from Belle Mead will be consolidated with other 3M facilities.

Second, we signed a consent agreement with the state of Minnesota to address potential sources of perfluorochemicals near legacy waste disposal sites.

Lastly, we recognized a gain from the sale of our Opticom Priority Control Systems and Canoga Traffic Detection businesses to TorQuest Partners, Inc. This business was in our Display & Graphics segment.

After adjusting for these three items, earnings for the second quarter were \$1.23 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 divested Pharmaceuticals business as a discontinued

operation; therefore it creates a year-on-year comparability issue. Q2 2006 revenues for the pharmaceutical business were \$196 million, and operating income excluding special items was \$60 million, impacting earnings per share by \$0.05 per share.

Adjusting for Pharma and special items, earnings per share increased 23.0 percent year-on-year.

On slide number six, we compare our second quarter P & L versus last year's second quarter.

Excluding special items, earnings-per-share were \$1.23, a year-on-year increase of 17.1 percent, on sales growth of 8 percent. Adjusting for Pharma, earnings increased 23 percent on sales growth of nearly 12 percent. Operating income was up 12.3 percent to \$1.4 billion or up 18.1 percent, excluding Pharma. Operating margins were 22.4 percent, up 90 basis points.

Gross margins were 48.8 percent, down 130 basis points from last year's second quarter, in line with the impact related to the Pharma divestiture.

As George already noted, our expenditure on research and development was up 11 percent year-over-year, ex Pharma, to support our overall strategy to reinvigorate our core business.

SG & A expense was flat year-on-year at \$1.3 billion, or up 5 percent adjusted for Pharma, reflecting our continued investment in sales and marketing to support our growth markets, while constraining administrative costs.

Please turn to slide seven for a recap of our second quarter top-line performance.

Sales in local currency increased towards the upper end of our targeted range at 9.3 percent worldwide, with 6.2 percent from the U.S. and 11.3 percent from our International operations. The biggest driver of this sales growth was organic, with worldwide organic volume up 6.9 percent, led by a 9.9 percent increase in International. Acquisitions contributed 2.8 percent across the board and prices were down slightly. The Pharmaceutical divestiture decreased sales by 3.8 percent and currency translation added 2.5 percent.

We are particularly pleased with the growth performance of our International operations this quarter. Within International, Europe turned in the highest local currency growth at 15.8 percent, 9.5 percent of that was organic. Rounding out International, Latin America and Canada grew at 10 percent, while Asia grew at 8.1 percent.

Before we move to the business segment highlights, please refer to slide eight, where I'd like to comment on our year-to-date progress against our key strategic financial goals. We have described our multi-dimensional strategy—to accelerate our sales growth

without degradation of our operating margins, drive double-digit earnings per share growth and continue to deliver premium returns on capital.

Excluding Pharma, sales were up almost 11 percent, and we drove outstanding leverage, with operating income up more than 14 percent and earnings per share up nearly 18 percent. And we continue to create value for our shareholders by investing wisely and generating good returns on our investments, evidenced by a year-to-date return on capital of 22.7 percent, up 80 basis points from last year's comparable period, adjusted for Pharma.

As you can see, through six months, our plan is working extremely well.

Now please turn to slide nine where I will review our quarterly and year-to-date results by business segment starting with the Display and Graphics segment.

For the second quarter, Display and Graphics sales were up 10.2 percent to more than \$1 billion—the first time in this segment's history. Local currency growth was up nearly 9 percent and was largely organic. Margins were an impressive 28.7 percent for the quarter and 30.3 percent on a year-to-date basis. Year-to-date, Display and Graphics sales have increased more than 5 percent, with profits up more than 10 percent.

Optical Systems continues to focus on market segmentation, with strong penetration in handhelds, computer displays and LCD televisions. Both sales and profits for Optical Systems were up double-digits over the second quarter of last year.

Our new optical film converting facility in Poland is online, supporting LCD panel manufacturers as they move their operations to Eastern Europe. We also are on schedule in scaling up the productivity and capacity of our DBEF manufacturing facilities here in the United States. We expect to see continued accelerated growth over the second half of the year, as seasonal LCD TV demand gears up for the holidays.

Commercial Graphics posted another solid quarter with strong sales growth. We saw an uplift in the vehicle wrapping market where we provide films, inks and other products for this "rolling billboard" industry. Likewise, Traffic Safety Systems posted noteworthy seasonal growth, driven largely by the road construction season, with particularly strong showings in Europe and Latin America.

Please turn to slide ten for a summary of results for our largest segment—Industrial & Transportation business.

Industrial and Transportation had another excellent quarter, with sales up 8.5 percent to \$1.8 billion. Local currency sales increased 5.6 percent, including one percent from acquisitions. Margins improved 70 basis points year-on-year, coming in at 20 percent for the quarter. Year-to-date sales are up 7.6 percent over the first half of last year while profits increased 10.4 percent. Through the first six months of the year, Industrial and Transportation's margins were 21.5 percent, or up 50 basis points versus the same time

period last year. Strong operational discipline and cost control made this margin improvement possible. On a worldwide basis, Industrial and Transportation business continues to grow faster than their end markets and, not surprisingly, our international growth continues to outpace the U.S.

The largest divisions within Industrial and Transportation posted solid sales growth, including notable performance from our Automotive Aftermarket, Energy Markets, Automotive, Industrial Adhesives and Tapes and our Abrasives Systems divisions.

Growth within our Automotive Aftermarket division was driven largely by abrasives, masking and refinishing products, where our branded line of products is the preferred choice of body shops around the world. For the car care market, our NASCAR sponsorship continues to strike a chord with the growing number do-it-yourself car-care enthusiasts.

Finally, our Automotive division delivered good results in the second quarter led by attachment systems and structural adhesives for mirrors, body moldings and panels that are used by automotive OEMs.

On the investment front, we have recently increased R & D spending to strengthen our core Adhesives and Pressure Sensitive Tapes technologies. In addition, we have added 5 relatively small but highly strategic gap fill acquisitions in the last two quarters to continue to strengthen our core tapes and adhesives platforms.

Please turn to slide 11, for details on our Consumer and Office business, where we've seen outstanding results, both for the second quarter as well as year-to-date.

Consumer and Office sales increased 8.2 percent to \$832 million in the second quarter. Local currency sales were up 6.1 percent, including 1.3 percent from acquisitions, primarily due to the October 2006 acquisition of Nylonge, a global provider of household cleaning products, including cellulose sponges. For the first time in many quarters international growth outpaced our outstanding U.S. market performance. Profits rose 21.3 percent and margins jumped 2 percent compared to the second quarter last year to almost 20 percent. Year-to-date, sales are up 9 percent and, compared to the first half of 2006, profits were up almost 20 percent.

Leading the charge for Consumer and Office were our Office Supplies, Construction and Home Improvement and Home Care divisions. At the same time, growth and penetration continued in our core businesses in Europe and Japan. Scouring products, wipes, handles and cleaning products led the way for Home Care in mass retail outlets.

As many of you know, the third and fourth quarters in our Consumer and Office business are heavily dependent on having successful sell-through during the back-to-school and Christmas periods. This will require increased investment in advertising and promotion during the second half of the year.

Please turn to slide 12.

Safety, Security and Protection Services delivered an exceptional and broad-based quarter of growth, with sales up nearly 21 percent over last year's second quarter. Growth in local currency was up nearly 17 percent, including approximately two-thirds from acquisitions. Acquired growth was primarily from Security Printing Systems, Ltd, a leading provider of finished, personalized passports and secure cards, and E Wood, PLC, a manufacturer of high-performance protective coatings for the oil, gas, water, rail and automotive industries, both of these are based in the U.K.

Operating income rose an impressive 21.9 percent, with margins at 21.2 percent, slightly higher than the second quarter of 2006. Year-to-date, sales have increased nearly 20 percent, with profits up 18 percent.

As I mentioned earlier, we saw across-the-board growth, led by corrosion protection, respiratory protection, and protective window films and cleaning solutions for commercial buildings, where we are seeing a strong increase in commercial construction in many parts of the world, which is driving increased demand for our fire protection and window films

We continue to experience strong demand for personal safety products, and we are pleased that our new respiratory protection plant in Korea celebrated its grand opening on July 11th, which was right on schedule.

In addition to the growth in personal safety products, we are seeing explosive growth in our corrosion protection business, where we provide our customers with pipe coating technology solutions that extend the life of both underground and above-ground pipelines. With the recent acquisition of E Wood, we can now apply our technologies to both new and existing oil, gas and water pipelines. Both sales and profit growth for this division were strong double-digits.

During the second quarter we continued to see modest improvement in our Industrial Minerals business for residential asphalt shingles. However, our business was still down year-on-year, which negatively impacted Safety, Security and Protection Services' second quarter sales and operating profit growth by approximately 2 percent versus last year. As George mentioned, we continue to expect residential construction to remain weak so an element of caution is required for the Industrial Minerals division.

Please turn to slide thirteen to review second quarter results for our Electro and Communications business. The results in this business were very mixed—while we continue to experience strong growth in Electrical Markets and Communications Markets, the consumer electronics market has faced significantly slower sales, adversely affecting both our Electronic Solutions division and our Electronics Markets Materials divisions.

Overall, the Electro and Communications business has taken the necessary corrective actions to respond to the slower consumer electronics market. At the same time, our Electrical Markets and Communications businesses delivered strong double-digit bottom line growth, offsetting the weakness we saw in the consumer electronics markets.

Sales were up 3.4 percent over the second quarter last year, with local currency growth of 1.2 percent, driven by acquisitions. Outstanding discipline continues to generate profits that increased 16 percent over the same period last year, with margins up 2 percentage points to 19.1 percent.

Year-to-date, sales are tracking with the quarter, with an increase of 3.5 percent and profits increasing 12 percent versus the first half of 2006.

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

Health Care had another outstanding quarter. Local currency growth including acquisitions was 19.5 percent in the quarter, largely organic, with 4.4 percent from acquisitions. Of the organic growth, 5.6 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. A large part of the acquisition-driven local currency sales came from two recent acquisitions: Biotrace International, PLC, a U.K.-based manufacturer and supplier of microbiology products, and SoftMed, a Maryland-based provider of health information software. We also acquired DMS Chile, a Santiago-based manufacturer of disposable surgical gowns, drapes, packs and kits.

Excluding Pharma, sales were up 23.1 percent with profits increasing over second quarter 2006 by 32.3 percent, to \$277 million. Margins improved two percent to 28 percent. Year-to-date performance has been equally impressive, with sales up 23.7 percent overall in the first half of the year, and profits up 22 percent, all excluding the sale of Pharma.

All businesses within Health Care delivered double digit growth. Leading the way was our drug delivery systems, where we are a leading provider of inhalation and transdermal drug delivery solutions. We also saw strong growth in our Health Information Systems business, where we are a leading provider of advanced software and services that help healthcare organizations capture, classify and manage healthcare data. We recently signed an agreement with the state of Maine to build one of the nation's first statewide healthcare information-sharing networks.

In our dental business, we launched a new product called Pro Temp, a preformed, malleable crown material that delivers a custom fit for patients in less than four minutes. We also acquired the rights to the PERIDEX brand of periodontal rinse from Zila, Inc. We expect to continue to build the brand through extensive research and development in the preventive dentistry field.

And finally, we are continuing to make progress on our commercialization efforts of the digital dentistry technology we acquired with the Brontes acquisition. The product is on track for market test in the fourth quarter with commercialization planned for early 2008. The team is working hard and we are very excited about bringing new products and solutions that will enhance the patient experience and drive productivity to the dental professional.

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

Excluding tax payments related to the gain on sale of the branded pharmaceutical business, free cash flow in the quarter was \$866 million, or approximately 95 percent of Net Income.

Year-on-year working capital turns were down 0.2 turns versus second-quarter last year and flat sequentially. As we have discussed with you, we are streamlining our supply chains to improve customer service and reducing working capital- this is a top priority.

Capital expenditures totaled \$348 million, an increase of \$87 million year-on-year and an increase of \$44 million sequentially. We continue to expect total capital expenditures to be approximately \$1.4 billion to \$1.5 billion as we invest in a number of growing and highly profitable businesses.

Dividend payments to our shareholders were \$346 million, and we aggressively bought back stock during the quarter, with gross share repurchases of \$1.0 billion. As of the end of the second quarter, we had \$5.2 billion remaining of the total \$7.0 billion authorization that runs through the end of February of 2009. Weighted average diluted shares outstanding were down 5.0 percent year-on-year, and 1.3 percent sequentially.

And finally, our debt to capital ratio was 30.2 percent at the end of the second-quarter.

This concludes my formal business review. Now I would like to hand it back over to George for a First Half 2007 Scorecard and his closing comments.

George...

George W. Buckley- Chairman, President and CEO

Thank you, Pat. Please turn to slide 16 where you will see a quick recap of our 2007 progress against the outlook that we provided you in January of this year. I think you will see that this slide underlines the confidence that Pat and I share for the second half of 2007.

As I told you during the first quarter call, our main 2007 priorities are clear; firstly, increase the horsepower of our growth engine and leverage it to the bottom line,

secondly, continue the drive for stable factory costs and gross margin improvement, and thirdly, have flawless startup of our new manufacturing lines and plants.

So far this year, we are doing rather better than our forecasts. Therefore, we are raising both our sales and EPS forecasts for the year. Through six months we have delivered local-currency growth of 8.4 percent. We now are expecting full year local currency sales growth of between 7 to 10 percent from a prior expectation of 6 to 10 percent. Reported earnings-per-share are now expected to be in the range of \$5.40 to \$5.60 up from the previous range of \$5.20 to \$5.45, including a net benefit from special items of \$0.60 to \$0.70.

Year-to-date operating margins are currently running at 23.4 percent, quite a bit ahead of our full-year expectation of 22 to 22.5 percent. Our effective tax rate for the first six months is 32.9 percent, within the range of our expectations, but we may well see a slight up tick for the last half of the year.

Lastly, we expected capital expenditures of between \$1.4 and \$1.5 billion for the year, on track with our estimates from the beginning of the year. Capital expenditures through six months were \$652 million dollars and we continue to expect full-year cap ex to fall within our originally stated range.

As far as the third quarter goes, we have tougher year-over-year percentage comps, but in absolute sales dollars we expect more of the same. We also have some planned increases in spending year-over-year, partly in plant start ups, partly in higher advertising and merchandising and some in higher R & D investments.

Some folks will probably accuse us of being conservative with our outlook, but we think sufficient uncertainty remains in the Asian electronic markets and U.S. residential construction markets, plus a mostly sideways moving U.S. economy, that we are planning a route of careful and prudent but nevertheless steady progress.

With that, I'd like to turn the call over for questions. Thank you so much for listening.