Q3 2007 Earnings Conference Call

Matt Ginter- Vice President, Investor Relations and Financial Planning & Analysis

Good morning, this is Matt Ginter, head of investor relations for 3M. Welcome all investors and analysts to our third quarter 2007 business review. And let me say is was good to see many of you at our Investor Day in St. Paul last week. I have a few announcements before we begin today's meeting.

As in prior quarters, we will be doing a powerpoint presentation today, the slides are posted on our website at 3m.com, so you can pull them up there. These slides will remain on our website, along with an audio replay of today's call for an extended period of time.

During the call today, 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.

On our call today we have George Buckley, our CEO, and Pat Campbell, our CFO, both will make some formal comments, and we will get to your questions.

There are a number of other companies reporting today, and we all know how busy you are during the earnings season, so we will keep the call today to one hour. We will move swiftly and answer as many questions as we can. If you could please limit yourself to one question and one follow-up, and if you have an additional question after that, get back in the queue, and we'll do everything in our power to get to you. If not, we'll be around all day to answer any follow up questions.

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 very much Matt, and good morning everybody.

First, I want to thank the many of you who were able to join us at our meeting in St. Paul last week. I appreciate your participation and your interest in this great company. I know the time commitment you gave to us was significant and we are very grateful for that.

From my point of view, we had two very productive days, and I hope you now have a better idea about why we are so optimistic about 3M's long-term future. We will obviously avoid repeating here what we told you just a few days ago.

From your point of view, I hope that we helped remove some of the mystery about our company, and provided some insight into our approach to operational excellence and discipline, into our commitment to invest in technology, innovation, and new products; and into how the underlying strength of our broad and diverse portfolio carries us forward. The access that we provided to our scientists and engineers, to our manufacturing people, to our various product specialists, and to management also, should have been very helpful.

So let's now turn to the third quarter. This was clearly another good quarter for 3M. Obviously not everything went perfectly, it never does, but given some tough end markets in the U.S., many things did. The strength of our portfolio was evident again in the third quarter results. All of our businesses posted positive worldwide local-currency sales growth on our way to record third quarter sales of $6.2 billion.

I'd have preferred growth a little bit above 9.4 percent absent sales lost from divestitures we saw in the third quarter; we clearly continue to move in the right direction. It was, over all, a strong quarter and especially strong in Health Care, which grew 20.6 percent. Europe and Latin America also exhibited similar strength, with both regions posting double-digit sales growth.

I'm also pleased with our EPS growth of more than 10 percent, especially in the context of the extra investments that we've been making in R & D, supply chain, and in advancing our brands. We have shown that we are indeed able to maintain premium margins while accelerating our investments, giving us additional confidence that our longer term plan in on track. To stay on track, it's important that we continue those investments in growth, especially internationally. In these numbers we absorbed a total of $35 million of commodity inflation in the quarter.

So, as we reminded you last week, we continue to work our long-term growth plan while getting the job done in the short term also.

We know well enough that eggs today are still sometimes better than chickens tomorrow. Having said that, investment in R & D is tracking to end the year with an increase of more than 10 percent over last year.

We're also working hard to drive international growth through brand building, and making use of local and regional brands where they make sense. This also seems to be working well.

Our supply chain is being strengthened and streamlined. We're investing 35 percent more in capex than last year, and so far have brought on stream this year five new plants outside the United States.

We also announced two further acquisitions in the month of September. This makes 15 acquisitions year-to-date, and I wouldn't be surprised if we announce a few more before the year is out.

So, all in all, a strong third quarter. We continue to work our plan and we're as confident as ever in our long-term future.

At our investor meeting, we highlighted that 3M's success over the long-term is defined by our ability to apply ongoing innovation to build enduring franchises; franchises like Scotch brand tapes, Post-it brand Notes, Trizact brand abrasives and Scotchlite brand reflective sheeting.

We also explained at our investor day, we're working hard today to extend our enduring franchise in our Optical Film business. Similar to the other examples, we invented the basic technology. As the market changed, we historically moved to serve all market segments from the bottom to the top of the market.

So today, we are also doing the same thing in Optical. We don't foresee any technological substitution of LCD TVs in particular in high volume for many years to come, so this is a great long-term market. But it is essential that we better serve all segments – including the faster growing, more turbulent bottom of the market where we can expect further pricing and margin pressure over time. For now, this is the area of highest growth as customers seek out perceived higher value.

I want to reinforce what I told you last week: it's our firm intention to protect and build our Optical franchise in order to extend and strengthen our position over the long term; to apply our technology, our market knowledge and our manufacturing prowess in the same way that we built the enduring platforms I mentioned earlier.

So thanks for your attention, I'll now turn it over to Pat for a more in-depth discussion of the results.

Patrick D. Campbell- Senior Vice President and CFO

Thank you George and good morning everyone. As George indicated this quarter we demonstrated the strength of our portfolio from both a business and geographic perspective. For the second consecutive quarter, we had sales greater than $6 billion. We maintained strong operational discipline while at the same time continued investment in the business to drive long term sustainable shareholder value – all consistent with the themes we talked about in last week's Investor meeting.

As explained in our press release this morning and shown on slide number five, third quarter reported earnings per share were $1.32. Included in this result are two special items, which I would like to explain in some detail for you. First, we made the strategic decision to consolidate our global flexible circuits manufacturing operations from two plants, one in Columbia, Missouri, the other in Singapore, into our Singapore plant, to better serve our customers who are primarily in Asia.

Second, as I mentioned during our investor meeting last week, we expect to have a handful of real estate sales over the next several quarters as we actively manage our real estate portfolio. During the third quarter we sold our current lab facility located in Suwon, Korea which happened to be located on a very valuable piece of property, and we are currently building a new state of the art customer oriented R&D facility closer to Seoul and many of our major customers for only 40% of what we sold the property for.

After adjusting for these two items, earnings for the third quarter were $1.29 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 pharmaceutical business as a discontinued operation; therefore it creates a year-on-year comparability issue. Q3 2006 revenues for the pharmaceutical business were $201 million, and operating income excluding special items was $73 million, or $0.07 per share.

Adjusting for pharma and special items, earnings per share increased 17.3 percent year-on-year.

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

As you can see on this slide our results this quarter are very much in line with our overall goals of accelerating top-line growth, maintaining our strong operating margin position, while at the same time investing in growth for the future to drive long-term shareholder value.

Excluding special items, earnings-per-share were $1.29, a year-on-year increase of 10.3 percent, on sales growth of 5.5 percent. Adjusting for divestitures, mainly pharma, earnings increased 17.3 percent on sales growth of 9.4 percent. Operating income was up 3.3 percent to $1.4 billion or up 9.3 percent, excluding divestitures.

Gross margin and operating income margin were 47.8 percent and 22.6 percent, respectively, or in line with last year's third quarter after adjusting for the impact of divestitures.

R & D and related expenditures were up 10 percent year-over-year, excluding divestitures, to support our overall strategy to reinvigorate our business core.

SG & A expense was up 3.8% year-on-year at $1.2 billion, or up over 9 percent adjusted for divestitures, as we stepped up investments in sales and marketing including an increase in advertising and merchandising to drive growth in many of our businesses.

Our third quarter tax rate was 30.8 percent, or down 1.9 percentage points versus last year. The lower tax rate in the quarter was principally due to a one-time cumulative impact of tax rate changes for several of our European subsidiaries. We now expect our full year tax rate to be in the range of 32 percent to 32.5 percent as a result of this quarter's lower tax rate.

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

Worldwide sales in local currency increased 6.3 percent, with 8 percent from our International operations and 3.6 percent from the U.S. Organic volume worldwide was up 4.2 percent, led by a 7.1 percent increase in International.

Internationally, Europe turned in another very strong quarter led by Safety, Security and Protection, Health Care and Consumer and Office businesses with local currency growth of 11.8 percent, 8.1 percent of which was organic. Rounding out International, Latin America and Canada and Asia Pacific regions saw local currency growth at 11 and 4.1 percent, respectively.

Organic volume growth in the U.S. was up slightly as strong growth in Health Care and Electro and Communications was offset by weaknesses in a handful of businesses that are impacted by the slowdown in the U.S. housing, road construction and mass retail markets, namely our Industrial Minerals, Protective Materials, Traffic Safety and Office Supplies businesses

Worldwide, acquisitions contributed 2.1 percent while prices were flat versus last year's third quarter. Divestitures, primarily pharma, decreased sales by 3.9 percent and currency translation added 3.1 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 performance.

Excluding divestitures, mainly pharma, sales were up 10.4 percent year-to-date with operating income up 12.5 percent and earnings per share up over 17 percent. Capital efficiency is equally important to growth and margins. Our return on capital was 22.2 percent, up 40 basis points from last year's comparable period, adjusted for divestitures, mainly pharma.

As you can see, through nine months, we continue to execute against our plan of accelerating growth, maintaining margins and investment returns, while delivering double digit earnings growth. Overall, our plan continues to remain on track.

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

Driven by broad based growth across the portfolio, our Industrial and Transportation business delivered another great quarter with sales growth of 9.3 percent and operating income growth of 11.4 percent.

Sales growth was led by our Industrial Adhesives and Tapes business followed by automotive OEM, automotive body shop solutions and Abrasives businesses. Organic local currency sales increased 4.2 percent with an additional 1.2 percent of growth coming from acquisitions. Year-to-date sales are up 8.2 percent with operating income growth of 10.7 percent as the business continues to drive strong productivity programs with operating margin up 50 basis points year-on-year to 21.3 percent, a record profit margin for this business.

Some of the products driving growth in the third quarter were specialty chemicals for the oil and gas markets; paint preparation systems that deliver productivity in paint booths for body shops; laminating adhesives providing attachment solutions in industrial applications; and packaging tapes just to name a few.

Strong market penetration in emerging markets, particularly the BRICP countries, continued in the third quarter. Europe, Middle East, Africa as well as Latin America regions all showed strong local currency growth.

The Industrial and Transportation business continues to invest in R & D to strengthen its core technologies while adding strategic complementary acquisitions to boost our core adhesives, tapes and abrasives platforms and to expand into adjacent markets. Recently we announced the acquisition of Venture Tape Corporation, a global provider of pressure sensitive adhesive tapes based in Rockland, Massachusetts. Venture Tape manufactures a broad range of tapes used in construction, oil and gas, HVAC, electronics, aerospace, marine and appliance markets. This acquisition broadens our pressure sensitive adhesive tape platform, bringing new channels to 3M, and allows us to expand into adjacent markets such as the global construction market.

Please turn to slide 10 for a review of third quarter results for our Display and Graphics segment.

For the third quarter, Display and Graphics sales were up 2 percent, or over $1.0 billion-a record quarter. Sales growth was negatively impacted by over 2 percent due to the divestiture of our Opticom and Canoga loop business along with product rationalizations in a couple of our other businesses. Local currency growth was 1 percent. Year-to-date, Display and Graphics sales have increased more than 4 percent, with profits up nearly 6 percent.

Our market leading Optical Systems business continues to focus on market segmentation, with strong penetration in handhelds, computer displays and LCD televisions. We did experience attachment rate loss in LCD desktop monitors and LCD TV segments in Q3 as competition continues to intensify in this market. We also noted a slowing in the mix shift from 720p to 1080p LCD TV's which impacts our business as 3M films are used more heavily in the 1080p sets. As the market leader, we will continue to compete aggressively, balancing product innovations, price and volumes across the entire brightness enhancement film product pyramid. This means continued price down to meet our customers' cost down requirements. Our continued commitment to invest in this business has led to a solid stream of new products that our customers are very excited about that will allow us to continue to maintain our market leadership in brightness enhancement films. 3M's brightness enhancement films provide an environmental solution through reduced energy consumption – a rapidly increasing requirement from retail customers and government units.   We also are on schedule in scaling up and improving the productivity of our manufacturing facilities.

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, in Traffic Safety Systems, they posted continued seasonal growth internationally, driven largely by the road construction season. The U.S. highway construction market work slowed in the third quarter sequentially from the first half of the year as the industry is facing substantial material inflation for cement and asphalt which is driving more of their spend into construction materials for road surfacing versus other spend such as sign sheeting.

Please turn to slide 11, where we will discuss the third quarter highlights for our Health Care business.

Once again, Health Care had a great quarter, with broad-based, double-digit growth across all divisions, excluding pharma. Local currency growth including acquisitions was 16.6 percent, with 4.6 percent from acquisitions. Of the remaining organic growth, 4.5 percent resulted from our recent supply agreements related to the sale of our branded pharmaceuticals business, in which our Drug Delivery Systems business became a supplier to the acquiring companies. Of the 4.6 percent of growth from acquisitions, much of it came from two deals—Biotrace International, PLC, a UK-based provider of microbiology products, and SoftMed, a Maryland-based provider of health information software solutions. We also acquired Neoplast, a Bangkok-based manufacturer and distributor of consumer and professional skin and wound care products.

Excluding pharma, sales in Health Care were up 20.6 percent over third quarter 2006, and profits were up 13.7 percent, ex pharma, to $259 million. Year-to-date margins were 27.7 percent. Overall, sales are up 22.7 percent year-to-date and operating income is up 19.1 percent, both excluding the sale of pharma.

Within the segment, each business delivered double-digit sales growth. Our Drug Delivery Systems business, where we leverage multiple 3M technologies, global regulatory expertise, and manufacturing precision, led the way.   We also saw strong growth in Health Information Systems, where we are the worldwide expert in healthcare funding and performance management solutions.

In dentistry, we continue to deliver a steady stream of new products and have been voted "most innovative dental company" two years running. In fact, we just recently launched a new product in Dental which is a new to the world technology that creates the lowest shrinking composite filling material available along with two new state of the art adhesives for better bonding and patient comfort.

In orthodontics, where self-ligating brackets are the fastest growing segment in that market, 3M's exclusive SmartClip™ braces system is leading the way, and we saw impressive double-digit growth in their business again this quarter.

Please turn to slide 12, for details on our Consumer and Office business.

Consumer and Office sales increased 5.9 percent to $898 million in the third quarter. Local currency sales were up 3.5 percent, including 1.1 percent from acquisitions, primarily due to the October 2006 acquisition of Nylonge, a global provider of household cleaning products, including cellulose sponges. Profits were $192 million with operating income margins of 21.3 percent. The Consumer and Office business is having an outstanding year with year-to-date sales up almost 8 percent and operating profits up 12 percent. Year-to-date growth is being led by the consumer mass retail and the do-it-yourself retail channels.

Strong growth in Home Care came from Scotchbrite scouring products. In Construction and Home Improvement, growth came from Filtrete air filtration for the U.S. residential HVAC systems along with Command mounting and fastening products in the third quarter. As previously mentioned, sales growth was tempered by weakness in Protective Materials and the office mass retail channel in the U.S. Geographically, 3M's international subsidiaries continued to drive growth again this quarter, with double digit-growth in all regions led by Europe.

During the quarter we stepped up investment in advertising and merchandising to drive growth in the back-to-school season. We will continue to invest in advertising during the fourth quarter to accelerate growth during the holiday season.

Please turn to slide 13 for a recap of our third quarter performance by Safety, Security and Protection Services.

Led by growth in respiratory protection, corrosion protection and building and commercial services, we delivered sales growth of nearly 11 percent. Third quarter growth in local currency was 6.7 percent. Overall segment year-on-year sales growth was held back by almost 2 percent due to our Industrial Minerals business which supplies mineral used on asphalt shingles for the U.S. residential housing market. As you are aware, housing in the U.S. remains very sluggish, and our Industrial Minerals business is really a U.S. centric business.

Geographically, sales growth was led by strong double digit growth in Europe, followed by Latin America and Asia Pacific.

For those of you that attended our Investor meeting last week you got the opportunity to see the products and technologies of Rochford Thompson Equipment Limited., a recent acquisition by our Security business. Rochford Thompson is a manufacturer of optical character recognition passport readers used by airlines and immigration authorities, headquartered in Newbury, U.K. The addition of Rochford Thompson enhances 3M's secure document scanning solutions portfolio and allows expansion into transportation markets such as international airlines.

Operating income increased almost 11 percent as the business continued to maintain consistent operating margins in excess of 20 percent. Year-to-date sales have increased 16.6 percent with profits up 15.7 percent.

Please turn to slide 14 to review third quarter results for our final segment, Electro and Communications.

The results in this business continue to be mixed. However, the financial results continue at record levels. We continue to experience strong growth in Electrical Markets and Communications Markets, which has been somewhat offset by declining growth in some of the products we supply into the consumer electronics market which are in devices that have come to end of life, adversely impacting sales in our Electronic Solutions division. Electronics Markets Materials division started to see some recovery in the third quarter in consumer electronic applications, fueled by demand for fluids

Overall, the Electro and Communications business has taken the necessary corrective actions to respond to the slowing consumer electronics market. As mentioned earlier, Electronic Solutions Division announced a consolidation of manufacturing operations and reductions in structure to allow the business to strengthen their competitive position. 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 piece.

Sales were up 7.6 percent over the third quarter last year, with local currency growth of 4.3 percent, including 110 basis points of growth from acquisitions. Strong results continue in Europe and in the U.S. for Communication and Electrical Markets. Outstanding cost discipline continues to generate profits that increased 16.4 percent over the same period last year, with margins up 1.5 percentage points to 19.6 percent.

Year-to-date, sales reflect the slower first half, with an increase of 4.9 percent and profits increasing 13.5 percent versus the first nine months of 2006.

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 $693 million. This year over year cash flow drop is more than accounted for by higher tax payments. Third quarter free cash flow includes a $200 million U.S. pension contribution, which is the primary driver for the lower free cash flow from Q2.

Both year-on-year and sequential working capital turns have stabilized at 5 turns. Capital expenditures totaled $379 million, an increase of $67 million year-on-year and $31 million sequentially. Year-to-date we have invested greater than $1 billion in capital expenditures on track with our full year expectations of $1.4 billion to $1.5 billion.

Dividend payments to our shareholders were $343 million, and we continued to buy back stock during the quarter albeit at a slower pace than previous quarters, with gross share repurchases of $557 million. Weighted average diluted shares outstanding of 729.9 million were down 3.5 percent year-on-year, and down slightly sequentially.

And finally, our debt to capital ratio was 32.3 percent at the end of the third quarter.

This concludes my formal business review. Now I would like to turn the call back over to George for his closing comments.

George…

George W. Buckley- Chairman, President and CEO

Thank you very much Pat.

So let's speak now about the rest of the year. To set the scene, the third quarter was characterized by some ups and some downs, as there always are. For example, we saw good results in oil and gas, mineral extraction and aerospace. We also saw surprisingly strong results in Industrial Tapes and Adhesives, Abrasives and most of our global Automotive business. We also saw some late quarter rejuvenation in our electronics businesses, particularly those selling bonding and sealing materials, as that industry finally seems to have come out of the deep sleep that we've seen most of the year. Our Construction and Home Improvement business also did very well, posting 7.5 percent sales growth as we continue to win share and launch new products.

Our investments in R & D and in acquisitions are clearly paying dividends in all these areas.

On the other side of the equation, it would be no surprise to anyone that we saw continued softness in the roofing granules business, which continues to drift down slowly in sales. We do not expect to see growth improvement in this business any time soon, even though it is performing relatively well from an earnings standpoint.

The growth in optical films for LCD TVs is currently slower at the top of the market, where we our position is strongest. Consumers are driving the lower reaches of the market at faster rates right now. As we mentioned in our investor meeting, we have new products coming in Q4 and Q1 to broaden our offerings as we invest to defend and advance our leadership position in the market. As a practical matter, defending our position here will cost us some price in Q4, but the long-term effect will be to extend our optical franchise, which remains a very good business for 3M today and well into the future.

While consumer markets did moderately well in the quarter, with overall growth at 5.9 percent, we do see signs that replenishment orders, mostly for use in offices, are slowing. This is all a U.S. based phenomenon and international markets remain robust as Pat outlined.

So for the balance of the year we expect to see the pattern of absolute growth will remain at levels similar to what we've seen in Q3. The business environment in the U.S. market remains the biggest immediate challenge as we go forward. However, we remain committed to our 2X IPI goal. While the breadth of our portfolio helps us enormously, I think we all know that it cannot insulate us fully from economic effects. However, whatever economic scenario we might encounter in the U.S. going forward, we will retain the resolve and the means to fight hard for market share, growth and profitability. That's what we'll be doing.

So with respect to earnings, we expect to finish the full year between $5.54 and $5.62, up from last quarter's expectation of $5.40 - $5.60. These earnings include 60 – 65 cents in one-time gains from special items.

All in all, despite some end-market challenges, we expect to finish the year 2007 as a wonderful year for 3M, having done a great deal of fixing and rebuilding to accelerate growth while maintaining our outstanding returns.

We completely overcame the impact of sales loss from our pharmaceuticals business and I think its testimony to the resiliency of 3M and its people that we seem to have done so with ease, so congratulations to all of them. With that, I'd like to turn the call over for any questions that you might now have. Thanks a lot everybody.