

Q3 2008 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. I would like to welcome to all investors and analysts to our third quarter 2008 business review.

As a reminder, please mark your calendars for the morning of December 8th. We will host a meeting in New York City, the primary purpose of which will be to discuss our 2009 business outlook. Stay tuned for full details.

As always, please take a moment to read the forward looking statements on slide 2. 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 be speaking today, and then we will get to your questions. During the Q&A, please limit yourself to one question and one follow up.

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

Patrick D. Campbell- Senior Vice President and CFO

Please turn to slide number 3.

Good morning everyone and thank you for joining us this morning. All information that I will present today will exclude special items, so allow me to summarize our special items quickly to get them out of the way. Last year's third-quarter results included a net gain of 3 cents per share from special items. GAAP-reported earnings-per-share was \$1.41 which included a net one cent per-share charge in 2008. While I recognize this charge is small on a net basis, it is important that you understand the pieces. First, as disclosed in our first and second quarter 10Q's, in March we entered into a sale-leaseback agreement related to our existing outdated office building in Italy. This was a lucrative transaction for us as the real estate was in a very desirable location and allows us to reinvest in a new very modern right sized facility over the next year. We recorded a \$41 million gain in Q3 as a result of this transaction. This gain was more than offset by nearly \$50 million of severance and exit activities in several of our businesses and corporate headquarters as we are aggressively balancing our business structure to a slower growth environment. Excluding these special items, Q3 2008 per-share earnings were \$1.42 as compared to \$1.29 per-share in last year's third quarter. Please refer to the attachment in today's press release for a complete discussion of special items.

We delivered record third quarter sales and all-time quarterly records for both operating income and earnings-per-share in the third quarter even in an increasingly challenging and more uncertain global economy. Sales for the third quarter increased 6.2 percent to \$6.6 billion, as five of our six business segments posted positive sales growth, led by double-digit growth in Safety, Security and Protection

Services, Health Care and Industrial and Transportation. On a local-currency basis, sales were up 4.4 percent over the same period last year and were in-line with the sales growth trends for the first half of the year.

Looking at the company geographically, third quarter sales growth was balanced across the globe with the U.S. growing 6.5 percent and International posting growth of 6.0 percent. International sales were led by double-digit sales increases in Latin America, and in the Asia Pacific region, excluding our Optical Systems business.

Operating income increased almost 9 percent to more than \$1.5 billion as all six segments posted greater than 20 percent operating margins and three segments saw double-digit, year-on-year operating income percentage gains. In this environment, this is pretty good performance.

Earnings per share in the third-quarter was \$1.42, up 10 percent year-on-year.

Our third quarter performance reinforced the strength of our customer focused diversified business and technology platforms, unparalleled geographic reach, and our relentless attention to operational excellence. These foundational pillars, along with our balance sheet strength, provide stability and consistency in an uncertain global economy.

Please turn to slide 4 for an in-depth review of our third quarter P&L performance versus the same quarter last year.

As in past quarters, we have isolated the impact of optical films in order to help you better understand our underlying results.

The strength and consistency of our global portfolio continued to drive sales in the third-quarter. Sales increased 6.2 percent, or nearly 10 percent excluding optical, versus the same quarter last year.

Gross margins increased 30 basis points due to a combination of selling price increases, foreign currency translation and a continuous focus on driving operational excellence which more than offset raw material inflation of nearly 5 percent.

Third quarter operating income was \$1.5 billion, up 8.7 percent, or almost 19 percent excluding optical.

You may have noticed in the attachments to today's press release that our Corporate and Unallocated had operating income of \$35 million this quarter. There are two primary reasons. First, we continue to reduce costs in our corporate overhead areas. Total Q3 overhead spending was down \$33 million, year-on-year, \$15 million of which resulted in a gain in Corporate and Unallocated. This is consistent with the strategy we have been driving for many years.

Second, as we have discussed in past quarters, we are experiencing a reduction in pension expense in 2008 versus 2007 to the tune of approximately \$24 million per quarter. Rather than allocate this benefit to all of our businesses, we elected to record this year-on-year improvement in Corporate and Unallocated.

Operating income margins for the quarter were 23.2 percent, up 60 basis points versus last year.

Net interest expense was \$24 million, up \$8 million year-on-year, primarily due to higher net debt balances.

The tax rate for the third-quarter was 32 percent, or 31.5 percent on a year-to-date basis, both of which were in-line with our expectations.

Earnings-per-share increased 10.1 percent to \$1.42, or up approximately 20 percent excluding optical

Please turn to slide number 5 where I will breakdown our third quarter sales growth performance.

Worldwide sales grew 6.2 percent with the U.S. rising 6.5 percent and International up 6 percent. Third quarter local-currency growth was 4.4 percent including 4 percent from acquisitions. Selling prices increased 60 basis points, which if you exclude selling price reductions in our optical films business, would have more than offset raw material inflation in the third quarter. Organic volumes declined slightly in the quarter.

Foreign currency added 2.1 percent to worldwide sales, which was less than one-half of the benefit that we saw in the second quarter. Using current exchange rates, we expect the sales impact from foreign currency to be in the range of negative 3 to negative 4 percent in the fourth quarter. Excluding optical, worldwide local-currency sales increased 7.8 percent as organic volumes increased 1.6 percent, selling prices increased 1.8% and acquisitions added 4.4 percent.

As mentioned, third quarter sales in the U.S. increased 6.5 percent, led by Safety, Security and Protection Services and Health Care. Four of our six business segments delivered positive sales growth in the quarter. We increased prices nearly 3 percent in Q3, which was needed to offset U.S. raw material inflation of just over 5 percent. Consistent with the first half of the year, organic volume growth in the third quarter continued to remain challenging in the U.S. declining 2.5 percent. We continue to find outstanding bolt-on acquisitions in the U.S., however, which are helping to bolster many of our core businesses. In aggregate, acquisitions added 6.8 percent to U.S. growth.

International sales on a local-currency basis increased 2.7 percent in the third quarter. Organic volumes increased 1 percent with five of six businesses posting positive organic volume growth. The lone exception, of course, was Display and Graphics, which is living through the secular transition of optical films. Selling prices declined 70 basis points, but would have increased 110 basis points excluding anticipated price declines in Optical Systems. Acquisitions added 2.4 percent to international local-currency growth in the quarter.

Excluding optical international local-currency sales growth was 8.2 percent including 4.4 percent from organic volumes, 2.7 percent from acquisitions and, as mentioned, 1.1 percent from selling prices. Regionally speaking, local-currency sales growth was led by Latin America at 18 percent, followed by Canada at 9 percent and Europe at 4 percent. Local-currency sales declined 3 percent in Asia Pacific, heavily impacted by a 34 percent decline in optical. Excluding optical, Asia Pacific sales in local-currencies increased by more than 10 percent over the same quarter last year.

We are facing into the challenges of slow U.S., Western European and Japanese economies, and are making disciplined decisions to maintain our focus on operational excellence and using our healthy balance sheet to become an even stronger company in the future.

Before we move to the business segment highlights, please turn to slide 6. Here is a quick synopsis of our year-to-date progress.

Through the first three quarters, year-to-date sales were up 8 percent, with operating income up 7 percent and earnings per share up almost 11 percent to \$4.19. Excluding optical, year-to-date sales were up 11.5 percent and profits increased a healthy 16.4 percent. And finally, year-to-date free cash flow was up 8 percent versus the prior year.

All things considered, these are very good results under these economic conditions.

Please turn to slide 7 for a review of the balance sheet and cash flow metrics for the third-quarter.

Free cash flow for the quarter was a strong \$792 million, which included a \$200 million U.S. pension contribution. Third quarter is typically when we make this contribution. We converted 80 percent of net income to free cash flow this quarter, or a full 100 percent if you adjust for the pension contribution, so cash flow remains very strong.

Working capital remained stable at about 5.0 turns.

Capital expenditures totaled \$376 million, which was about flat year-on-year and up \$42 million sequentially. We are on track to invest about \$1.3 billion to \$1.4 billion in 2008.

Dividend payments for the quarter were \$348 million and share repurchases totaled \$515 million, both consistent with recent quarters. Weighted average shares outstanding were 703 million, down nearly 4 percent year-on-year and 1.3 percent sequentially.

Please turn to slide 8. Given the credit markets turmoil, I thought it would be helpful to provide some more insight into our liquidity position at quarter-end.

The strength of our capital structure and consistency of our cash flows provide a real competitive advantage at times like this, as they afford us stability when many of our competitors face uncertainties and constraints. They also allow us to continue to invest in our businesses, strengthening our competitiveness and aggressively pursuing new business, which is exactly what we are doing.

During recent dislocations in the financial markets, we have successfully issued commercial paper, and in fact have been able to place commercial paper with 2009 maturities since the end of September. We have achieved this at interest rates we had seen well-before this recent market malaise. We also raised \$850 million via a long-term debt issue in August at a very attractive rate. So for now anyway, we have weathered the storms very safely.

Our cash and debt position is displayed on the left hand side of this chart. At third-quarter-end, we had \$3.6 billion of cash and marketable securities on hand. Short-term debt was \$2.3 billion including \$1.7 billion of outstanding commercial paper. Long-term debt was \$4.8 billion.

Debt maturities for the next 5 quarters are detailed in the middle of the slide. As you can see, \$950 million of debt will mature through the end of 2009. This amount includes a \$350 million dealer re-marketable

security, classified as short-term debt, that is due for re-marketing in December of this year. The majority of our longer-term debt balance of \$4.8 billion does not mature until 2012 or later.

So while credit markets remain volatile, our capital structure remains very strong and continues to differentiate us from weaker competitors. We will continue to manage this asset very carefully.

Now let's turn briefly to an examination of the performance for each of our segments in the third quarter. Please turn to slide 9 for a summary of our results for our largest segment –Industrial & Transportation.

With broad-based revenue growth across the portfolio, Industrial and Transportation delivered an outstanding quarter, with sales up 10 percent to almost \$2 billion. Operating income rose 8 percent versus same quarter last year.

Sales growth was led by our industrial adhesives and tapes business, followed by our automotive aftermarket, abrasives and closure systems for personal hygiene products. Local currency sales increased 7.1 percent, including 4.2 percent from acquisitions. Year-to-date sales and profits were both up about 14 percent and operating margins held steady at 21.2 percent for the year.

All geographic regions drove sales growth in the quarter, led by double-digit growth in Asia Pacific and Latin America, and even in this tough U.S. economy we managed to generate positive sales growth in the U.S. We continued to drive strong market penetration in emerging economies, especially the high growth BRICP countries, where the business drove strong double digit local currency growth.

Now please turn to slide 10, for a look at the third quarter highlights for our Health Care business. This is an absolutely fabulous and underappreciated part of the 3M portfolio, where we provide the health care community with technology driven innovative solutions to improve patient lives and the productivity of health care providers.

Health Care drove strong sales growth of 10.7 percent. All major businesses within Health Care drove positive growth in the quarter, led by oral care and medical. Local currency growth was 9.2 percent, with 2.7 percent coming from acquisitions. Profits in the quarter rose 17.2 percent, to \$304 million.

Our Health Care team drove double digit sales growth in Asia Pacific and Latin America and mid single digit sales growth in both the U.S. and Europe. No doubt this was another fine quarter for the global Health Care business.

Year-to-date, sales have increased 11.9 percent, profits have risen 16.1 percent and margins improved by a full point from 2007 levels to 28.7 percent.

Please turn to slide 11 for a recap of our fastest growing segment Safety, Security and Protection Services.

Sales in this business rose an outstanding 27 percent in the third quarter to \$1 billion. Our recent acquisition of Aearo Technologies contributed 19 points of growth in the quarter. Aearo is a great fit with 3M as it broadens our personal safety product offerings in a market that we know very well, and thus far it has proven to be everything we thought it was and more. Organic sales was an impressive 9 percent, led by growth in personal protection solutions, protective window films, and cleaning solutions for commercial buildings.

Operating income for the quarter rose 42 percent, while margins increased 2.3 points year-on-year to 22.8 percent. Year-to-date, sales have increased 23.7 percent, with profits up 27.3 percent and margins holding steady above 22 percent.

Sales were strong across the globe, led by double-digit sales increases in the U.S. and Asia Pacific . Profits rose at double-digit rates in all geographic regions to round out another outstanding quarter for this business.

Now please turn to slide 12, for details about our Consumer and Office business, home to some of our best known category defining brands and enduring franchises.

Consumer and Office sales increased 5.2 percent to \$946 million in the third quarter. Local currency sales were up 3.7 percent, with half a percent from acquisitions. Profits were up 12.7 percent with operating income margins of 22.9 percent. Year-to-date sales and profits were up 5 percent year-on-year, which we feel is an outstanding result in the current business climate.

In the third quarter we drove positive growth in all divisions, with home care and do-it-yourself leading the way. We drove 2 points of sales growth in the U.S. this quarter, which is impressive considering the state of the U.S. consumer and the retailers. Our international subsidiaries continued to drive growth again this quarter, with double digit sales increases in Latin America and Asia Pacific.

Please turn to slide 13 for a review of third quarter results for our Display and Graphics.

As you well know, our results in this business have been impacted in 2008 by our optical systems business, which is in the midst of a transition from a hyper-growth business to a more commoditized business. The good news here is that the LCD TV film business appears to have stabilized sequentially and is now running in-line with our expectations. Forecasting LCD films is no walk in the park by any means, but predictability has improved immensely, and the operating team is really driving to get their arms around the business and drive cost out at levels never seen before

We posted sales of \$853 million in Display and Graphics in the third quarter. Sales declined 16 percent, but were up 2 percent excluding optical. We drove positive sales growth in both Traffic Safety Systems and Commercial Graphics. Optical Systems sales declined 34 percent year-on-year, but improved by 5 percent sequentially.

Operating margins were down year-on-year, but it was encouraging that they held constant sequentially at 21.2 percent.

On the new product front, 3M's MPRO 110, an ultra compact, LED-based projection engine for business and entertainment use, is now in production, with sales beginning in October.

I will wrap up my comments on slide 14, where I'll provide a brief overview of results for our Electro and Communications business.

Sales for the quarter increased nearly 3 percent versus the same quarter last year. Profits rose 7.5 percent, driven by outstanding cost discipline producing margins of 21.4 percent. Sales in local currency increased slightly.

Our Electro and Communications team drove double-digit growth in two of its businesses: namely Electrical Markets and Electronic Markets Materials. Geographically speaking, growth was led by our International operations in Asia Pacific and Latin America.

Year-to-date performance in Electro and Communications has been outstanding, with sales up nearly 7 percent and profits up 11 percent. Year to date margins have improved 80 basis points to 20.6 percent.

That concludes my formal comments so now I will turn the program over to George.

George.....

George W. Buckley- Chairman, President and CEO

Thank you Pat.

Good morning everyone and welcome to 3M's third quarter 2008 conference call.

As it turned out, our earnings were well ahead of expectations, delivering an operating EPS of \$1.42, despite a significant reversal of currency and softer demand in some sectors and locations. The global financial crisis, which happened right towards the end of the quarter, caused a number of last minute cancelled orders from distributors and retailers in their own understandable "just-in-case" attempts to preserve cash. But for that, earnings would have been even a little bit better.

An obvious reality of being a short cycle company is that we see the effect of demand reductions more or less immediately right across 3M's product portfolio. We live right on the edge of that razor blade. When they are just temporary blips, rather than trends, they also pass through the system very quickly. 3M is a company that can be impacted by downturns quickly but it's also one which usually recovers quickly also.

Housing and consumer durables have come to the forefront of people's minds again. I must say though that, because of the nature of our business, apart from the financial crisis, there is little really new market news in this for us, or in what's going on in the broader world economy today. We've been experiencing and dealing with the impacts of a slow US housing market, a tough retail environment, a slow US automotive market and softer industrial manufacturing for a long time, about two years in fact. When you add to this the impact of the reinvestment burden we carried and the commoditization taking place in the LCD TV market, it has been a very challenging operating environment for us and one which I think has been well handled by 3M's management team.

As you know, at the beginning of 2006 we began to vigorously rebuild 3M's core. We added the manufacturing capacity that we needed, we in-sourced core products that had been outsourced and were creating competitors, we invested a lot more on R&D and in new products and we reopened our adhesives research lab that had been closed in 2002. We used acquisitions to help speed up the rebuilding process.

After three years of doing this, the rebuild is now mostly completed; we are now gaining share in every one of our core businesses, margins have remained at their previous levels and despite some pressure from a weakening dollar in 08, returns have stayed in premium territory. I tell you this story only to drive home the point that the innate underlying strength of 3M has improved dramatically in the past three years. This is not your father's Oldsmobile, as they used to say.

We have some excellent competitors, whom we respect a great deal, but we are now making them feel 3M's competitive presence everywhere and I can assure you we intend to do that continuously. We now have the strength and products to do it. It is this fact that is going to equip us well to deal with some circumstances that are likely to be even tougher in 2009.

Like everyone else who consolidates in the US, we had some welcome help from currency in, but it has been this rebuilding of 3M's core which has allowed us to perform consistently well even with gale force economic headwinds and a commoditizing LCD TV business.

I want you again to look at the sales and earnings numbers Pat showed you, with and without Optical. That clearly shows you the power of 3M's wonderful core businesses and I think the importance of that great base will ultimately be recognized one day.

I will continue to say this while there is breath in my body, but the diversity of 3M, and its geographic spread are what allows us to put in this kind of performance in this kind of time. Take a look at Consumer and Office results also please. They delivered 2% organic growth in the US at a time when every normal expectation for them would be negative. That doesn't happen by accident, it comes from a string of innovative new products they've released and industry leading customer service.

As Pat outlined, the same is true almost all across 3M, the only tight spot being Display and Graphics. Their numbers were heavily colored by the LCD TV commoditization and slow traffic sign sales because of the delayed highway bill. But I think our numbers again show the merit of investing in our great core franchises right across the board.

Despite having done well in the face of some pretty tough challenges, we are far from feeling complacent about what lies ahead. This is going to be a tough period for everyone. But we aren't scared of it either. This is what we are paid to do, operate well in a range of environments. So the \$64, 000 question is this, what can we sensibly say about the future and what are we doing to prepare for it?

On the first question, you know we don't give quarterly guidance except, defacto, for the fourth quarter. The challenge now is to give you a plausible forecast for Q4 at a time when volatility makes the future almost impossible to predict with any degree of precision. So I am not going to give you any sales projections for Q4. But operating margins came in strong again in Q3 and we believe year over year margins will hold reasonably steady in Q4 and even going on into 2009.

Given that we are always affected quickly by the economy, the quality of our Q4 earnings will no doubt be colored by the strength of the Christmas season and on currency and the impact of tight credit on various end markets. But I don't think Christmas will get canceled this year, even if it turns out a little more muted than normal.

The economic turmoil and skittish customer environment suggests there is more downside risk for now than there is upside opportunity, but I don't expect this to be large. We are not immune from the economic pressure, but I also think 3M will show a lot of economic resilience and will gain share during this time.

We are still expecting to grow EPS in the range 8.5% - 10 % for 2008. Specifically, we think earnings will be in the band \$5.40 to \$5.48 for Q4, assuming exchange rates remain around where they are today.

We will give you a more in depth view of 2009 in December as Matt already mentioned. Apart from the obvious worries about the US, the biggest headwinds that we see for now are a reversal of currency gains and slowing economies in Western Europe, Canada and Japan. Absent optical, Asia remains reasonably strong for now, as does Latin America, the Middle East and Eastern Europe. Cost pressure on commodities has eased somewhat and, with varying degrees of success, we are clawing back prices that were oil or commodity based.

To the second point – how we are preparing – in fact we've been preparing and taking action for some time. We've been working to get well ahead of the cost curve and have eliminated about 1000 positions spanning the US, Europe and Asia, with Asian reductions being heavily focused on optical. And we will continue with similar productivity improvements in Q4 as we continue to work to stay ahead of a bumpy business environment.

For now, we continue to operate our company very tightly. Here are some of the things we are doing.

We are in cash preservation and build mode and not in the market for stock in any meaningful way, we have slowed capital expenditures, stopped all hiring in the US, Canada, Japan and Western Europe except for replacing key sales and production positions. We have also embargoed US acquisitions for the time being until we see how the end markets play out. We are closely watching receivables for negatives trends....none so far I might add...and we had already reduced our capital budget for 2009 by about \$200 million. Inventory has also been a focus. We will do more in all these cases, if circumstances require it.

All discretionary spending has been put on hold, though we have opted not to slow R&D expenditure. That is our company's future, and we want to make sure it's there when we need it! Prudence and careful tending of our company's economic garden has always been the order of the day and it will remain so.

That said, this is not the time to play figurative corporate tortoise in any sense of the word. By that I mean being slow moving or pulling our heads back inside our shells. This is the time to be vigorously working with our customers and moving fast to capture as much business as we can. We are going to do everything we sensibly can to get sales and continue to win share, operate excellently and manage our cash well.

Trouble is not the only thing born in these times; opportunity is born also, especially for strong companies who can use it as a platform to grow stronger. We have planned for that and intend to take any sensible opportunities for growth that we can. Chance always favors the prepared mind.

With that, I'd like to turn the call over to questions.

Thank you very much for listening.