Q3 2015 Earnings Call Transcript
Inge Thulin & Nicholas Gangestad
October 22, 2015

Slide 1, Opening
Matt Ginter, Treasurer and Vice President, Investor Relations

Thank you and good morning everyone. Welcome to our third quarter 2015 business review.

On the call today are Inge Thulin, 3M's chairman, president and CEO, and Nick Gangestad, our chief financial officer.

Each will make some formal comments today and then we'll take your questions.

Today's earnings release and slide presentation are posted on our investor relations website at 3M.com. Please turn to slide 2 for a list of upcoming 3M investor events.

Slide 2, Upcoming Investor Events
Matt Ginter

On Tuesday, December 15th, we will discuss our 2016 business outlook on a conference call beginning at 8:00 a.m. central time.

Please note, we will not be hosting this year's outlook meeting in New York as has been our practice in recent years.

The conference call should last approximately 90 minutes, so please plan accordingly.

Also, on March 29th of next year, we will be hosting an investor day at our headquarters in St. Paul.

Lastly, note the dates for next year's quarterly earnings calls which are scheduled for January 26th, April 26th, July 26th and October 25th.

Slide 3, Forward Looking Statement
Matt Ginter

Please take a moment to read the forward-looking statement on slide three. During today's conference call, we will make certain predictive statements that reflect our current views about 3M's 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.

Please turn to slide four and I will hand off to Inge.

Inge.

Slide 4, Q3 2015 Highlights
Inge Thulin, Chairman, President and CEO

Thank you, Matt and good morning everyone, and as always, thank you for joining us.

3M delivered a solid operational performance in the third quarter.

In an external environment that remains soft, our team posted strong earnings, organic growth in all geographic areas, and expanded margins.

Equally important, we continue to make investments and take actions to build strength-on-strength and position 3M for long-term success.

Let me first take you through the quarterly numbers.

Earnings per share rose to $2.05, which is a 3.5 percent increase year-over-year.

Companywide, we delivered organic local-currency sales growth of 1 percent, with positive growth across all geographic areas.

Four of our five business groups grew organically, paced by Consumer at 5 percent and Health Care at 4 percent.

Acquisitions added one percent to sales in the quarter, as we deployed capital to drive growth and strengthen the business.

The strong U.S. dollar continued to impact our top line, reducing quarterly sales by more than 7 percent.

Total sales in the quarter declined 5 percent to $7.7 billion.

At the same time, we continued to generate strong productivity in the quarter by controlling those things within our control.

As a result, operating margins were 24.3 percent, up nearly a full percentage point year-on-year.

All five business groups delivered margins greater than 22 percent.

In the quarter, 3M also returned $2.2 billion to shareholders through dividends and share repurchases.

Now, please turn to slide number five.

Slide 5, Positioning 3M for the Future
Inge Thulin

At 3M, we always have one eye on the microscope, and one eye on the telescope.

The microscope view is about driving growth, productivity and efficiency day to day, quarter to quarter, and year to year.

The telescope view is about the long term, and making sure we are investing in the future.

The global economy continues to evolve, as do the needs for us and for our customers.

3M is evolving as well, building for a future that will be more competitive, more dynamic, and more challenging.

We are doing that, in large part, through our three strategic levers: Portfolio Management, Investing in Innovation, and Business Transformation.

Let me start by describing our efforts to strengthen and focus our portfolio, an ongoing process we began in 2012.

In the third quarter, we closed two important acquisitions to both complement organic growth and enhance two of 3M's core platforms: personal safety and filtration.

The integration of those businesses is off to a good start.

At the same time, earlier this month we announced the divestitures of our library systems business and our French license plate converting business both within our Safety and Graphics business group.

After extensive review, we concluded that these businesses were worth more to an outside owner versus remaining part of the 3M portfolio.

Selling the businesses resulted in the greatest value creation for the company and for shareholders.

Last month, we also announced that we are exploring strategic alternatives for our Health Information Systems business, which is an industry leader in health care coding software.

Options include spinning off, selling, or keeping the business.

Ultimately, we will choose the best path to benefit 3M, our stakeholders, and the business itself.

The selection of a strategic direction is anticipated by the end of Q1 in 2016.

In addition to portfolio investments in the quarter, we continue to invest in organic growth through research and development, in close partnership with our customers and the market.

Technology conversion will remain a key driver of the global economy into the future, and our investments will strengthen 3M's scientific edge.

And at our Investor Day in St. Paul next March, we look forward to taking you through our new, state-of-the-art research laboratory.

Finally, to make 3M more competitive, more productive and more efficient, we are transforming our business processes.

The backbone is a new, global ERP system.

As you recall, we are implementing this system on a regional basis, starting in Europe.

3M made good progress in the third quarter, including a successful deployment across the Nordic countries.

Our team is focused on continuing to execute our rollout plan in West Europe, with the United States to follow.

By 2020 our business transformation efforts will result in estimated operational savings of $500 to $700 million annually, and a reduction in working capital of $500 million.

Beyond our three strategic levers, we are taking other steps to increase our competitiveness and strengthen 3M for the future.

Today we announced a restructuring plan that will result in the reduction of 1,500 positions.

Reductions will be primarily focused on structural overhead largely in the U.S. along with slower growing markets, with particular emphasis on Europe/Middle East/Africa and Latin America.

On a pre-tax basis, we will take a charge of approximately $100 million in the fourth quarter related to this plan, with savings of approximately $130 million in 2016.

Each and every day as I look across our enterprise, I grow more confident in our future.

We are taking action to build a stronger, more agile and more focused company that will compete and win not just today, but well into the future.

Thank you, and now Nick will go through more details on the quarter.

Nick.

Slide 6, Q3 Sales Recap
Nick Gangestad, Senior Vice President and Chief Financial Officer

Thank you, Inge and good morning everyone. Please turn to slide six where I will cover the elements of third-quarter sales growth.

Q3 organic growth was 1.2 percent, largely driven by higher selling prices. Volumes were up slightly in the quarter.

All geographic areas posted positive organic growth in the quarter.

In August, we completed the acquisitions of Capital Safety and Polypore's Separations Media business.

The net impact from acquisitions and divestitures added 1 percentage point to sales growth in Q3.

Foreign exchange impacts reduced sales by 7.4 percentage points, with notable year-on-year declines in the Euro, Yen and Brazilian Real. These currencies devalued versus the U.S. dollar by 15 percent, 14 percent and 37 percent, respectively.

In dollar terms, worldwide sales declined 5.2 percent versus the third quarter of 2014.

The United States delivered organic growth of 1.5 percent led by Consumer, Health Care and Safety and Graphics.

Our U.S. Industrial business, which experienced softer end-market conditions and a challenging year-on-year comparison, declined organically.

Asia Pacific organic sales increased 0.4 percent in the quarter, where four of our five business groups posted positive growth.

Organic growth was led by Health Care and Safety and Graphics, while Electronics and Energy declined year-on-year.

Within Asia Pacific, Japan increased 1 percent organically or 5 percent excluding electronics. As you may recall, last fall we acquired the remaining 25 percent interest in our Sumitomo Japan subsidiary. The 3M Japan team continues to execute well and is delivering strong results in 2015.

China/Hong Kong's organic growth was down 2 percent or up 3 percent excluding electronics.

Moving to EMEA, we saw organic growth of 1.5 percent with West Europe flat, Central/East Europe up double-digits and Middle East/Africa down slightly.

Finally, Latin America/Canada delivered organic growth of 2.3 percent versus last year's third quarter.

Mexico continued its trend of strong double-digit organic growth, increasing 13 percent while Brazil declined 2 percent.

Please turn to slide seven for the third-quarter P&L highlights.

Slide 7, Q3 2015 P&L Highlights
Nick Gangestad

Companywide, third-quarter sales were $7.7 billion dollars with operating income of $1.9 billion dollars.

Operating margins were 24.3 percent an increase of 90 basis points year-on-year.

As you see on the right hand side of the slide, the combination of lower raw material costs and higher selling prices contributed 170 basis points of margin expansion.

Productivity added another 20 basis points to margins as we continue to prioritize investments, benefit from past portfolio actions and drive operational efficiencies through lean six sigma.

Foreign currency impacts net of hedge gains increased margins by 20 basis points.

The impact from recent acquisitions reduced Q3 operating margins by 60 basis points, as we began to absorb purchase accounting adjustments and work through integration plans for Capital Safety and Polypore's Separations Media business.

Strategic investments reduced margins by 10 basis points.
Finally, higher pension and OPEB expense reduced third-quarter operating margins by 50 basis points.

Through 9 months, we have increased total-company operating margins by 1 percentage point to 23.7 percent.

Let's now turn to slide eight for a closer look at earnings per share.

Slide 8, Q3 2015 EPS
Nick Gangestad

Third quarter earnings were two dollars and five cents per share an increase of 3.5 percent year-on-year.

The combination of organic growth and margin expansion contributed $0.11 to our earnings growth this quarter.

This result included a negative $0.04 impact from higher year-on-year pension and OPEB expense.

Our third quarter tax rate was 29.6 percent versus 30.3 percent in last year's comparable quarter, which increased earnings by $0.02 per share.

And average diluted shares outstanding declined by 4 percent year-over-year, which added $0.08 to third-quarter earnings per share.

The acquisitions of Polypore's Separations Media business and Capital Safety reduced earnings by $0.04 per share in the quarter, due to purchase accounting adjustments and one-time expenses and integration costs.

In the fourth quarter, we expect $0.02 per share of additional dilution from these transactions.

Foreign-currency impacts net of hedging reduced pre-tax earnings by approximately $95 million or the equivalent of $0.10 per share. For the full-year, we expect foreign currency impacts to reduce earnings by approximately $0.40 per share.

Now let's review cash flow performance on slide nine.

Slide 9, Q3 2015 Cash Flow
Nick Gangestad

We generated $1.7 billion of operating cash flow in the quarter, down slightly from last year.

Third quarter capital expenditures were $354 million, in-line year-on-year.

For the full year, capital expenditures are expected to be in the range of $1.4 to $1.5 billion versus a prior expectation of $1.4 to $1.6 billion.

We generated $1.3 billion of free cash flow and converted 101 percent of net income to cash.

Free cash flow conversion for 2015 is now expected to be in the range of 95 to 100 percent versus 90 to 100 percent previously. As a reminder, our fourth quarter free cash flow conversion is typically the strongest of the year.

We returned $2.2 billion of cash to shareholders in the third quarter, an increase of $369 million year-on-year.

Cash dividends were $635 million, and gross share repurchases were $1.5 billion dollars.

For the full-year, gross repurchases are now forecasted to be in the range of $5 to $5.5 billion dollars, versus a prior expectation of $4 to $5 billion dollars.

Now let's review our business group performance, starting on slide 10.

Slide 10, Industrial
Nick Gangestad

Industrial posted sales of $2.6 billion in the quarter, up slightly organically.

Our automotive OEM business grew mid-single digits, as we continue to gain share by increasing 3M's content per vehicle. This business consistently grows faster than the rate of global car and light truck production levels.

3M Purification, abrasives, and industrial adhesives and tapes also posted positive organic growth in the quarter.

Our advanced materials business declined, primarily due to weakness in the oil and gas market.

The acquisition of Polypore's Separations Media business added 70 basis points to Industrial's sales growth in the third quarter.

On a geographic basis, Industrial's growth was positive in Latin America/Canada, Asia Pacific and EMEA, while declining in the U.S.

The Industrial business delivered operating income of $580 million in the quarter.

And operating margins were 22.5 percent up 30 basis points year-over-year, or up 90 basis points excluding the Polypore Separations Media acquisition.

Let's now turn to Safety and Graphics on slide eleven.

Slide 11, Safety and Graphics
Nick Gangestad

Sales in Safety and Graphics increased 2.9 percent organically to $1.4 billion dollars.

Organic sales growth was strong across much of the portfolio, including commercial solutions and our 'Heartland' personal safety business.

The roofing granules business posted double-digit organic growth in Q3, while traffic safety and security systems declined year-on-year.

Complementing Safety & Graphic's organic growth was the acquisition of Capital Safety, which added 4.2 percent to sales in the third quarter.

On a geographic basis, organic growth was led by Asia Pacific, EMEA and the U.S., while Latin America/Canada declined.

Operating income was $324 million and operating margins declined 0.6 percentage points to 22.9 percent.

Excluding the Capital Safety acquisition, margins rose 1.3 percentage points to 24.8 percent.

Please turn to slide twelve.

Slide 12, Health Care
Nick Gangestad

The Health Care business generated third quarter sales of $1.3 billion, with organic growth of 3.7 percent.

Our medical consumables businesses namely, infection prevention and critical and chronic care along with our oral care business, were up mid-single digits year-on-year. Together, these businesses represent three-quarters of our Health Care business.

Health information systems and food safety enjoyed double-digit growth in Q3.

Drug delivery declined organically, as its challenging year-on-year comparisons continued into the third quarter.

The Ivera Medical acquisition added 90 basis points to quarterly growth. Integration of this business is going well and it is exceeding sales and profit objectives.

Our Health Care business grew organically in all geographic areas, led by Latin America/Canada, Asia Pacific and the U.S.

The business continues to drive penetration in developing markets, with 10 percent organic growth in the quarter.

Countries with notable strength included Taiwan, China/Hong Kong, India and Mexico all up double digits.

Health Care's operating income was $432 million, with margins of 32.1 percent, up 110 basis points year-over-year.

Next let's cover the third quarter performance of Electronics and Energy. Please turn to slide thirteen.

Slide 13, Electronics and Energy
Nick Gangestad

Sales for this business were $1.4 billion in the quarter, down 2.8 percent organically, while operating income increased slightly to $342 million.

Portfolio management actions, raw material benefits and the team's relentless focus on operational excellence drove a 240 basis point improvement in operating margins to 24.9 percent.

Organic sales declined 3 percent on the electronics side of the business, with electronics materials solutions up slightly, and display materials and systems declining.

In our energy-related businesses, organic sales were down 2 percent, similar to past quarters with growth in telecom more than offset by declines in electrical markets and renewable energy.

On a geographic basis, organic growth increased in EMEA, while the U.S., Latin America/Canada and Asia Pacific all declined.

Please turn to slide fourteen.

Slide 14, Consumer
Nick Gangestad

Third-quarter sales in Consumer were $1.2 billion, with organic growth of 5.0 percent.

Organic growth was led by our stationery and office supplies business with strong back-to-school sales in Scotch® home and office tapes, Post-it™ and Command™ products.

In the home improvement business, our Filtrete™ brand filters, which significantly improve air quality in the home also helped propel growth in the quarter.

Our home care business also delivered positive organic growth, while consumer health care declined slightly.

Looking at the Consumer business geographically, organic growth was led by the U.S., Asia Pacific and EMEA, while Latin America/Canada declined.

Operating income increased to $293 million and margins were 25.2 percent, up 2.0 percentage points year-over-year.

That wraps up our review of the third-quarter business results.

Please turn to slide fifteen where Inge will provide an update on our 2015 planning estimates.

Inge.

Slide 15, 2015 Planning Estimates
Inge Thulin

Thank you, Nick.

As we all know, the current economic growth environment remains challenging.

Against that backdrop, today we are updating our full-year outlook for 2015.

We now expect organic growth of 1.5 to 2 percent, versus prior guidance of 2.5 to 4 percent.

Foreign currency translation will reduce sales by approximately 7 percent, compared with a prior range of 6 to 7 percent.

Excluding the impact of restructuring, we expect full-year earnings per share in the range of $7.73 to $7.78.

We previously expected EPS in the range of $7.73 to $7.93.

On a GAAP basis, we expect EPS in the range of $7.60 to $7.65, which reflects the expected 13 cent restructuring charge in Q4.

We also now anticipate a free cash flow conversion rate of 95 to 100 percent up from a prior range of 90 to 100 percent.

Thank you for your attention, and we will now take your questions.

(Q&A)

(Host turns the call over to 3M)

Conclude and Sign off
Inge Thulin

Thank you, to wrap up we continue to deliver a solid operational performance in 2015, and I thank our whole 3M team for an outstanding effort.

This quarter we expanded margins and posted strong earnings, while taking many actions to strengthen our long-term competitiveness.

We are executing our plan, controlling what we can control, and building for the future.

Thank you again for joining us this morning, and have a good day.