

Q1 2016 Earnings Call Transcript Inge Thulin & Nicholas Gangestad April 26, 2016

Slide 1, Opening Bruce Jermeland, Director of Investor Relations

Thank you and good morning everyone. Welcome to our first quarter 2016 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 and then we'll take your questions.

As a reminder, please mark your calendars for upcoming earnings call dates July 26rd and October 25nd. Also, take note of our next investor meeting scheduled for December 13th. More details will be available as we get closer to that date.

Today's earnings release and the slide presentation accompanying this call are posted on our investor relations website at 3M.com.

Slide 2, Forward Looking Statement Bruce Jermeland

Please take a moment to read the forward-looking statement on slide two. 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 three and I will hand off to Inge.

Slide 3, Q1 2016 Highlights Inge Thulin, Chairman, President and Chief Executive Officer

Thank you, Bruce.

Good morning everyone, and thank you for joining us again.

We had the opportunity to see many of you last month at our Investor Day, when we laid out 3M's new 5-year plan.

We also updated you on the 3M playbook, and how it is being executed across our enterprise to deliver efficient growth both today and into the future.

In the first quarter the 3M team continued to execute our playbook, and delivered another strong operational performance.

We increased margins more than a full percentage point, and improved our cash flow generation by 20 percent year-over-year.

At the same time, we continued to invest in the business – including opening a new, world-class laboratory in the United States – while also returning cash to our shareholders.

Looking at the numbers, we posted first-quarter earnings of \$2.05 per share, which is an increase of 11 percent year-over-year.

Please note that this includes a 10-cent earnings benefit related to a new accounting standard that 3M adopted in the first quarter and Nick will provide more details during his comments.

Adjusting for this impact, we delivered Q1 earnings of \$1.95 per share.

Companywide, organic growth was down slightly, at minus 1 percent.

Three of our business groups grew organically in the quarter led by Health Care at 6 percent, with strong organic growth across all its businesses.

Our Consumer business which is home to some of 3M's most iconic brands also delivered a good quarter of organic growth.

I am pleased that our two domestic-driven businesses Health Care and Consumer continue to do well and are off to a good start in 2016.

Safety and Graphics also posted solid organic growth, with particular strength in commercial solutions and personal safety.

Organic growth in our Industrial business was down low single digits, which was similar to last quarter and as expected, Electronics and Energy declined low double digits.

Electronics and Energy continues to be impacted by softness in the consumer electronics market, which we expect to persist through the first half of the year.

Acquisitions, net of divestitures, added 2 percentage points to first-quarter sales while foreign exchange reduced sales by 3 percent.

As a result, our company's total sales were \$7.4 billion, down 2 percent year on year.

Our ability to consistently deliver premium margins remains a hallmark of 3M, and it is an important element of our focus on driving efficient growth.

In the first quarter, we posted margins of 24 percent, up more than a full percentage point versus last year.

Without the impact from last year's fourth quarter restructuring, we have expanded margins year over year for 10 consecutive quarters.

Also in the quarter, we returned nearly \$2 billion to our shareholders through dividends and share repurchases.

This includes an 8 percent increase in our first-quarter dividend, which marks 3M's 58th consecutive year of dividend increases.

All in all, we had a good start to the year, with results that were in line with our expectations.

Please turn to slide 4.

Slide 4, Strategic Levers Drive Enhanced Value Inge Thulin

In addition to a strong financial performance in the quarter, we also made good progress on our three key levers starting with Portfolio Management.

After a strategic review of our Health Information Systems business, we decided that we could create the greatest value by retaining and further investing in that business.

In fact, we plan to accelerate investments across our entire global Health Care business in research and development, health economics, and commercialization capabilities to build strength on strength in both developed and developing markets.

In February, we sold the Polyfoam business which was a small, non-core segment within our Industrial business group.

Earlier, I mentioned the ongoing softness in the electronics market.

As you may know, over the last few years we have consolidated a number of businesses within Electronics and Energy, which has made us more relevant to customers, more agile and more efficient.

Today, we are announcing further actions to build upon that work.

These actions will reduce 250 positions worldwide with the majority of reductions on the electronics side of the business and result in an estimated Q2 charge of \$20 million.

This will further position Electronics and Energy for long-term success and going forward the business will continue to stay close to customers, advance its technology capabilities and increase productivity.

Investing in Innovation is the second lever, and in the first quarter we invested nearly half-a-billion dollars in research and development.

Research and development supports our organic growth and premium returns and as you recall, we continue to step up investments in R&D from 5.5 percent of sales closer to 6 percent.

In March, we also opened our new laboratory in the United States which many of you had the opportunity to see at our Investor Day.

It will house 750 of our scientists, who will leverage our 46 technology platforms to create unique, cuttingedge solutions for our customers.

Finally, in the first quarter we continued to march forward with Business Transformation, which is our third lever.

We had a successful ERP deployment in Germany, and remain focused on executing the rollout plan across West Europe.

Business Transformation which starts and ends with our customers is important for our future, especially as it relates to efficient growth.

We expect these efforts to result in \$500 to \$700 million in annual operational savings by 2020, and another half-a-billion dollars in working capital improvement.

Overall, as I look at the quarter, we continued to execute the 3M playbook and delivered a strong performance in terms of both financial results and building our enterprise for the future.

With that, I will turn the call over to Nick, who will take you through the details.

Nick.

Slide 5, Q1 2016 Sales Recap Nick Gangestad, Senior Vice President and Chief Financial Officer

Thanks, Inge, and good morning everyone. I'll start on slide five with a recap of our first-quarter sales change.

Organic local currency sales declined 0.8 percent in the first quarter with volumes down 1.7 percent, partially offset by a 0.9 percent increase in selling prices.

Acquisitions, net of divestitures, added 1.6 percentage points to sales. This impact includes the acquisitions of Capital Safety, Membrana and Ivera Medical along with the divestitures of Library Systems, Polyfoam, and a license plate converting business in France.

Finally, foreign currency translation reduced sales by 3.0 percent.

In U.S. dollars, total sales declined 2.2 percent versus the first guarter of 2015.

In the United States, organic growth was up 0.3 percent with strong performances in our domestic-oriented businesses – namely, Health Care and Consumer.

Industrial production in the U.S. declined 1.3 percent in Q1, which impacted growth in parts of our Industrial business.

Organic growth in Asia Pacific was down 5.6 percent. Three of five business groups posted positive growth in the region – again led by Health Care and Consumer.

Soft end-market demand and excess channel inventories in consumer electronics resulted in a double-digit organic growth decline in Electronics and Energy.

Within Asia Pacific, organic growth was down 4 percent in China/Hong Kong and declined 8 percent in Japan. Excluding our electronics business, Japan and China Hong Kong were both flat.

Moving to EMEA, organic growth increased 1.7 percent. West Europe was up slightly and the combination of Central/East Europe and Middle East/Africa was up high-single digits.

Finally, organic growth in Latin America/Canada increased 4.2 percent.

Mexico again had a strong quarter with 10 percent organic growth and Brazil also posted positive organic growth of 2 percent.

Please turn to slide six for the first-quarter P&L highlights.

Slide 6, Q1 2016 P&L Highlights Nick Gangestad

First-quarter sales were \$7.4 billion dollars. Operating income increased more than 3 percent to \$1.8 billion and earnings rose 10.8 percent to \$2.05 per share.

As Inge mentioned, we had another strong margin performance in the first quarter, up 130 basis points to 24.1 percent.

Let's take a closer look at the first-quarter margin improvement.

The combination of lower raw materials and higher selling prices added 110 basis points to first quarter margins. We continue to benefit from both lower commodity prices and from our global Sourcing team's ongoing efforts to reduce costs.

Lower pension and OPEB expense increased margins by 100 basis points.

Productivity gains related to last year's fourth quarter restructuring contributed 40 basis points to margins.

Strategic investments reduced margins 10 basis points as we began to take actions on our manufacturing footprint and increased growth investments.

Foreign currency, net of hedge gains, brought margins down another 10 basis points and first-year acquisitions reduced margins by 20 basis points.

The year-on-year decline in organic volume reduced margins by 30 basis points.

And finally, utilization and other, was a net 50 basis point headwind to margins. This included the impact of lower asset utilization particularly in our electronics and Industrial businesses which was partially offset by divestiture gains in the quarter.

Also, we continue to increase investments across the business to drive growth and strengthen our competitiveness going forward.

All in, we have started the year on a positive note with respect to margins and continue to expect approximately 150 basis points of margin improvement for the full year, which reflects our focus on delivering efficient growth.

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

Slide 7, Q1 2016 EPS Nick Gangestad

As stated earlier, earnings for the first quarter were \$2.05 per share an increase of 10.8 percent.

Margin expansion, net of organic sales declines, contributed \$0.04 to earnings in the guarter.

First-year acquisitions and divestitures added \$0.07 to earnings per share. This result was driven by solid performances from Membrana, Capital Safety and Ivera, along with divestiture gains in the quarter.

Foreign-currency impacts net of hedging reduced pre-tax earnings by \$48 million or the equivalent of \$0.05 a share.

Higher balance sheet leverage led to an increase in net interest expense year-on-year, reducing per share earnings by \$0.02.

The first-quarter tax rate was 26.8 percent versus 29.5 percent in the comparable quarter which increased Q1 earnings per share by \$0.07. The lower Q1 tax rate includes the adoption of a new FASB accounting standard which I will walk through in a moment.

Finally, average diluted shares outstanding declined by 4 percent year-on-year which added 9 cents to first-quarter earnings per share.

Please turn to slide eight.

Slide 8, Adoption of FASB ASU 2016-09 Nick Gangestad

On March 30th of this year, the Financial Accounting Standards Board issued an accounting standards update related to employee share-based payments.

This new standard changes the recording of additional tax savings or charges when employees realize benefits from stock-based compensation. The additional tax impact is a result of the change in the value of stock-based compensation, from the time it is granted to an employee, to the time it is realized by the employee.

Previously, these additional tax impacts were recognized in the equity section on the balance sheet.

Going forward, they will be recognized on the income statement.

All U.S. public companies are required to adopt the new accounting standard no later than the 2017 fiscal year.

We chose to adopt this new standard in the first quarter of 2016 which created a first-quarter tax benefit of \$0.10 per share, net of tax cost related to global cash optimization actions.

For the full-year, we expect no impact to our tax rate and earnings per share guidance as additional actions we chose to implement to further optimize our global cash position will increase our income tax expense in the last three guarters of the year.

Let's now turn to our first-quarter cash flow performance on slide nine.

Slide 9, Q1 2016 Cash Flow Nick Gangestad

Overall, we posted another solid cash flow performance in Q1.

Free cash flow conversion was 74 percent, up 8 percentage points versus the same period last year. As a reminder, Q1 is typically our lowest conversion rate of the year.

We generated \$1.3 billion of operating cash flow in the quarter, a \$180 million increase versus Q1 in 2015. The primary drivers of the increase were improved inventories and accounts receivable along with lower cash taxes.

Capital expenditures were \$314 million as we continued to invest in the business to drive efficient growth. As a reminder, we continue to expect cap-ex investments in the range of \$1.3 to \$1.5 billion for the year.

The strength of our business model allows us to invest in growth, and also return cash to shareholders.

As you heard earlier, we increased our first-quarter per-share dividend by 8 percent which increased our payout to \$672 million in the quarter.

In addition to dividends, we returned \$1.2 billion to shareholders through gross share repurchases.

Let's now review our first-quarter performance on a business-by-business basis. Please go to slide ten.

Slide 10, Industrial Nick Gangestad

Our Industrial business group posted quarterly sales of \$2.6 billion.

First quarter organic growth in our Industrial business was down 1.9 percent with mid-single digit declines in the U.S. and Asia Pacific.

As mentioned earlier, the U.S. industrial production index was down 1.3 percent in the first quarter which impacted parts of our Industrial business.

Our advanced materials business declined low double-digits, impacted by ongoing weakness in the oil and gas end market.

Conversely, our automotive OEM business grew high-single digits, continuing its strong track record of outpacing global car and light truck builds.

We also posted positive organic growth in our automotive aftermarket business in the quarter.

The acquisition of Membrana, net of the Polyfoam divestiture, added 1.9 percent to Industrial's sales growth.

We are pleased with the smooth integration of Membrana into 3M, and the business continues to exceed its financial performance objectives.

Industrial increased its margins 150 basis points to 23.9 percent, posting operating income of \$617 million.

Please turn to slide eleven.

Slide 11, Safety and Graphics Nick Gangestad

First-quarter sales in Safety and Graphics were up 2.4 percent organically, to \$1.4 billion dollars.

Commercial solutions delivered solid organic growth, with particular strength in Latin America and the U.S.

Personal safety, one of our "Heartland" businesses, also had a good quarter of organic growth, led by EMEA and Asia Pacific.

Our roofing granules business also posted strong growth in the quarter.

Acquisitions, net of divestitures, added 4.5 percentage points to sales growth in the quarter.

This result includes Capital Safety, along with the impact from the divestitures of Library Systems and the license plate converting business in France.

Geographically, organic growth in Safety and Graphics was broad-based paced by a mid-single digit increase in Asia Pacific.

Operating income for the business was \$345 million and operating margins were a solid 24.5 percent.

Please turn to slide twelve.

Slide 12, Health Care Nick Gangestad

Our Health Care business delivered an outstanding quarter from top to bottom.

The business generated sales of \$1.4 billion, and led our company's organic growth at 6.2 percent.

Growth was broad-based, with all businesses and geographic areas up mid-single digits or greater year-onyear.

Health information systems and food safety both posted strong double-digit growth in the quarter.

And, our medical consumables and oral care businesses each delivered solid mid-single digit growth in Q1.

The Ivera Medical acquisition added 90 basis points to first-quarter sales growth year-on-year. This business is performing well and exceeding its financial performance objectives.

Our Health Care business delivered 13 percent organic growth in developing markets in the quarter with particular strength in China/Hong Kong, Mexico and Russia.

Operating income was \$455 million, up 12 percent versus last year's first quarter and margins were strong at 32.9 percent.

As you can see from this quarter's results, our Health Care business continued its track record of strong performance.

And as Inge mentioned, we are increasing investments across the business to drive efficient growth into the future.

Next, let's cover Electronics and Energy on slide thirteen.

Slide 13, Electronics and Energy Nick Gangestad

First-quarter sales in Electronics and Energy were \$1.1 billion, down 11.7 percent organically and in-line with what we communicated at our March investor day.

On the electronics side of the business, organic sales were down 18 percent. The decline was due to a combination of factors including soft end market demand, elevated channel inventory, and a challenging year-on-year comparison.

Our team remains focused on increasing relevance with customers and driving spec-in wins to deliver organic growth as the industry improves.

Our energy-related businesses were down 1 percent organically with growth in electrical markets being offset by declines in telecom, as well as renewable energy.

As a reminder, in last year's Q4 we took portfolio actions within the renewable energy business. These actions negatively impacted Q1 organic growth but have improved profitability in this business.

Within electrical markets, our ACCR overhead conductor business posted strong double-digit growth.

On a geographic basis, organic growth was down double-digits in Asia Pacific, where our electronics business is concentrated.

First-quarter operating income for Electronics and Energy was \$208 million with margins of 18.2 percent, down 330 basis points largely volume related.

Looking toward the full year, we now expect Electronics and Energy to decline organically in the low- to midsingle digit range.

As Inge mentioned, we are taking actions in the second quarter to further position the business for long-term success.

I'll finish with our Consumer business on slide fourteen.

Slide 14, Consumer Nick Gangestad

Consumer had another solid quarter, with sales of \$1.0 billion and organic growth increasing 2.8 percent year-on-year.

Sales grew organically in three of our four businesses, led by home improvement and consumer health care. Across the bottom of this slide, you see just a few of the market-leading brands that are powering our Consumer portfolio.

Within the home improvement business, our Command[™] damage free mounting products posted strong double-digit growth, as accelerated investments continue to pay off. Scotch Blue[™] painter's tape and Filtrete[™] filters also delivered strong growth in the quarter.

Our consumer health care business posted solid first-quarter organic growth, as the growing trend of active lifestyles continue to drive strong demand for our ACE^{TM} and FuturoTM braces and support products.

Geographically, organic growth was paced by Asia Pacific, driven by double-digit growth in China/Hong Kong along with solid mid-single digit growth in the U.S.

Operating income was \$238 million, with operating margins of 22.7 percent both similar to last year's first quarter.

Slide 15, Reaffirm 2016 Guidance Nick Gangestad

On slide 15 we are reaffirming our 2016 planning estimates.

We estimate earnings in the range of \$8.10 to \$8.45 per share, an increase of 7 to 11 percent year-overyear.

Organic growth is expected to be up 1 to 3 percent with acquisitions, net of divestitures, adding an additional 1 percent to sales.

We estimate that foreign currency translation will reduce sales by 1 to 3 percent.

Finally, our tax rate is still expected to be 29.5 to 30.5 percent with free cash flow conversion in the range of 95 to 105 percent.

With that, I thank you for your attention and we will now take your questions.

Slide 16, Q&A

Conclude and Sign off Inge Thulin

To wrap up, we had a strong start to the year highlighted by good earnings, margins and cash flow.

Going forward, we will continue to execute the 3M playbook to drive efficient growth, and create even greater value for our customers and shareholders.

Thank you for joining us, and we look forward to talking with you soon.

Have a good day.