Q3 2020 Earnings Call Transcript
Michael Roman & Monish Patolawala
October 27, 2020

Slide 1, Cover Page

Slide 2, Upcoming Investor Events
Bruce Jermeland, Vice President, Investor Relations

Thank you and good morning everyone. Welcome to our third quarter 2020 business review.

With me today are Mike Roman, 3M's chairman and chief executive officer, along with Monish Patolawala, our chief financial officer. Mike and Monish will make some formal comments and then we will open it up for questions.

Please note that today's earnings release and slide presentation accompanying this call are posted on our investor relations website at 3M.com under the heading 'quarterly earnings.'

Please turn to slide two.

Let me remind you to mark your calendars for our fourth quarter earnings call which will take place on Tuesday, January 26th, 2021.

Slide 3, Forward Looking Statement
Bruce Jermeland

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 10Q lists some of the most important risk factors that could cause actual results to differ from our predictions.

Finally, throughout today's presentation we will be making references to certain non-GAAP financial measures. Reconciliations of the non-GAAP measures can be found in the attachments to today's press release. Please note we have provided segment and total company adjusted EBITDA reconciliations for reference in today's press release attachments as part of our non-GAAP measures.

Please turn to slide four and I will hand it off to Mike.

Mike.

Slide 4, Key Messages
Mike Roman, Chairman and Chief Executive Officer

Good morning, everyone – I hope you and your families are staying safe and healthy, and I thank you for joining us.

As you have seen in our monthly sales reports, we saw a significant improvement sequentially in trends versus Q2 across businesses and geographies, and we returned to positive year-over-year organic growth.

While we remain in a highly uncertain economic environment, it is a credit to our team that 3M continues to execute well, deliver value to our customers, and fight the pandemic from every angle.

We continue to prioritize protecting our employees, frontline healthcare workers and the public, while supporting the reopening of economies around the world.

We have distributed 1.4 billion respirators year-to-date, on track to 2 billion by the end of 2020… and we will exit the year at an annual run rate of 2.4 billion as we continue to add capacity.

3M innovations are also supporting the development of new vaccines and lower-cost testing methods that can be mass-produced.

Our operational performance was strong, and we posted another quarter of robust cash flow, aggressively managed costs and further strengthened our balance sheet.

Though our focus remains on executing in this environment, we are also looking ahead and investing in both growth and productivity, while advancing our core values including sustainability, diversity and inclusion.

Overall, we are confident in our ability to lead in the economic recovery as we take actions to transform 3M and realize new opportunities from emerging customer needs and global market trends.

Please turn to slide five.

Slide 5, Q3 2020 Summary
Mike Roman

Companywide, total sales increased 5 percent year-over-year and 16 percent sequentially to $8.4 billion slightly above our estimates.

With respect to organic sales, we delivered growth of 1 percent year-over-year, with adjusted earnings of $2.43 per share.

In the third quarter demand remained strong in personal safety, along with areas such as home improvement, data centers and biopharma filtration and we see continued momentum in these end-markets into October.

While we saw improvement in other end-markets versus the second quarter, many remained down year-over-year… including healthcare elective procedures, auto OEM and general industrial.

Geographically we experienced notable improvement in the Americas, led by the U.S. up 5 percent organically, with strong growth in personal safety, consumer, and health care.

EMEA was flat, versus down 15 percent in Q2 while Asia Pacific was down 3 percent organically.

We delivered growth of 8 percent in China, with all business groups above 6 percent offset by Japan which continues to be challenged.

Our execution was strong as we posted adjusted EBITDA margins of 29 percent, with all business groups at or above 27 percent.

Our adjusted free cash flow increased to $2.2 billion in the quarter; year-to-date, we have expanded cash flow by 19 percent, and are on track to deliver another record performance in 2020.

Continued strong cash flow has enabled us to reduce net debt by $2.8 billion, while returning $2.5 billion in dividends to shareholders through the first nine months of the year.

Looking ahead, this continues to be an uncertain environment, and customers and channel partners remain cautious. We will stay focused on serving our customers, driving operational improvement and investing for the future.

Please turn to slide six.

Slide 6, Advancing 3M Advancing 3M Model Drive Growth and Productivity
Mike Roman

Over the past several months, customer and stakeholder trust in 3M has grown because of how we have delivered through the pandemic.

COVID-19 is rapidly changing the global economy, and the way people live, work and communicate.

Years' worth of changes are unfolding in a matter of months, creating opportunities to unleash the power of 3M science to drive sustainable, long-term growth.

For example, with people at home more, there is growing demand for products to both maintain and improve households.

This includes indoor air quality solutions where we've increased investments in our Filtrete portfolio, to introduce new innovative products and create additional capacity.

As a result, our air quality platform has grown double-digits year-to-date as we keep families healthier and more productive, and we expect this market trend to continue.

An increased focus in other areas like personal safety, automotive electrification, and biopharma filtration, to name a few, also open additional opportunities for 3M.

At the same time, end-markets like office, hospitality, and oil and gas have been highly impacted by COVID-19, and are declining as a result.

To strengthen our competitive edge, we will invest where demand is strong, pull back where needed, stay close to our customers, and create new innovations that address global market trends.

We execute these strategies in normal times, but in the unprecedented times we are in now, prioritization is especially important.

I am also encouraged with the benefits from the new global operating model we implemented this year… a significant step in our transformation designed to improve growth and efficiency, and allow us to adjust faster than ever to the external environment.

During COVID-19, the strength of our model has never been clearer – from our ability to deliver a 3-fold increase in global respirator production this year, to the reconfiguration of our supply chain that enabled us to import more than 200 million respirators into the U.S. from Asia Pacific.

In a matter of weeks, we also fully scaled up two new respirator lines at a plant in Sheboygan Falls, Wisconsin – a process that would normally take several months.

Those lines are now operating at rates 30 percent above similar lines as we've incorporated significant new technologies and analytic platforms, and we continue to further optimize production volumes.

While we have made progress, more work remains to build a stronger and more agile enterprise.

Moving forward, we will continue to optimize our new model, digitize our operations, and improve the customer experience.

All of these actions, combined with relentless focus on operational execution, will enable us to deliver greater value for our customers, shareholders and all stakeholders as economies recover from the impact of COVID-19.

That wraps up my opening comments, and I'll turn it over to Monish to cover the details of the quarter and our perspective on Q4.

Monish.

Slide 7, Q3 2020 P&L Highlights
Monish Patolawala, Senior Vice President and Chief Financial Officer

Thank you Mike and I wish you all a good morning. Please turn to slide seven.

Companywide, third-quarter sales were $8.4 billion, up 4.5 percent year-on-year, with adjusted operating income of $1.9 billion, in-line with last year. Third quarter adjusted operating margins were 22.9 percent versus 23.8 percent last year.

As the company disclosed … and you may recall … we recorded a $58 million gain from the sale of real estate in Q3 last year. This gain produced a 70-basis point headwind year-on-year to adjusted operating margins.

Turning to this year's third quarter, our ongoing cost management and productivity efforts were more than offset by impacts from the COVID-19 pandemic. This resulted in a net 50-basis point reduction to margins versus last year.

Acquisitions and divestitures lowered margins by 20 basis points year-on-year which includes a negative 50 basis point headwind from the Acelity acquisition due to purchase accounting impacts.

Operationally, Acelity delivered a solid third quarter as healthcare elective procedures picked up sequentially. Based on Acelity's first-year performance and integration progress, we are confident in the long-term success of this business. Please note that Acelity will now be reported as part of our organic results starting in Q4.

Higher selling prices combined with lower raw material costs contributed 80 basis points to third quarter margins.

And finally, foreign currency, net of hedging impacts, decreased margins by 30 basis points.

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

Slide 8, Q3 2020 EPS
Monish Patolawala

Third-quarter adjusted earnings were $2.43 per share versus $2.58 per share last year.

The 15-cent year-on-year earnings decline is primarily due to two items. First, as discussed on the prior slide, the Q3 2019 $58 million real estate gain resulted in an 8-cent per share earnings headwind year-on-year.

And second … our third-quarter adjusted tax rate was 21.4 percent versus 19 percent last year … resulting in an 8-cent year-on-year headwind to earnings per share. This headwind is primarily a function of last year's tax rate.

Finally, acquisitions and divestitures contributed 1 cent to earnings.

Please turn to slide nine for a discussion of our cash flow and balance sheet.

Slide 9, Q3 2020 Cash Flow and Balance Sheet
Monish Patolawala

We delivered another quarter of robust free cash flow with third quarter adjusted free cash flow of $2.2 billion up 13 percent year-over-year.

The third quarter cash flow performance was driven by a significant improvement in working capital which contributed over $330 million of cash.

Of note, we delivered an underlying decline in inventory of $240 million since the end of Q2. This reduction was largely driven by the 16 percent sequential improvement in sales along with our continued work to improve inventory velocity.

Looking ahead, we will continue to adjust our manufacturing production and inventory levels to meet changing customer demand trends as the impact of the pandemic on the economy evolves.

While the working capital progress is encouraging, the team continues to work on improving operating rigor through daily management to drive sustainable long-lasting improvement.

Year-to-date, we have generated adjusted free cash flow of $4.6 billion, up 19 percent versus last year.

Third quarter capital expenditures were $368 million and nearly $1.1 billion year-to-date. For the full year, we now anticipate capex in the range of $1.4 to $1.5 billion versus approximately $1.4 billion previously

During the third quarter, we returned $847 million to our shareholders via dividends. Share repurchases remained suspended throughout the quarter, given the continued global economic uncertainty.

Our strong third quarter cash flow generation and disciplined capital allocation enabled us to continue to strengthen our capital structure.

We ended the quarter with $4.6 billion in cash and marketable securities on-hand and reduced net debt by $1.3 billion, or 8 percent sequentially. Year-to-date, we have improved our net debt position by $2.8 billion, or 16 percent, since the start of the year.

Looking ahead, our priorities remain unchanged as we continue to focus on driving strong cash flow performance, maintaining disciplined capital allocation while continuing to strengthen our financial flexibility to invest in our business and to return cash to our shareholders.

Please turn to slide ten where I will summarize the business group performance for Q3.

Slide 10, Q3 Business Group Performance

Monish Patolawala

I will start with our Safety and Industrial business which posted organic growth of 6.9 percent year-on-year in the third quarter.

Personal safety posted double-digit organic growth year-on-year as we continue to experience unprecedented levels of demand for respirators globally in response to the pandemic.

Automotive aftermarket improved sequentially and was up 1 percent year-on-year as auto body shops reopened after the economic shutdowns in Q2.

The strong growth in the residential housing market continued to drive good performance in our roofing granules business which was up low-teens organically versus Q3 of last year.

The balance of the Safety and Industrial portfolio namely abrasives, closure and masking systems, adhesives and tapes, and electrical markets improved sequentially, but remained down year-over-year organically as customers and channel partners remain cautious given the continued macroeconomic uncertainty.

Looking geographically, the Americas grew 11 percent organically with the U.S. up low teens. EMEA also grew 8 percent while Asia Pacific was down low-single digits.

Safety and Industrial's third quarter segment operating margins were 27.2 percent up 430 basis points driven by sales growth continued strong productivity and spending discipline.

Moving to Transportation and Electronics third quarter sales were down 7.1 percent organically compared to last year.

Our electronics-related business was up 1 percent with continued strong growth in semiconductor, factory automation and data centers which was partially offset by year-on-year weakness in consumer electronics, particularly in smartphones.

Our auto OEM business was down 4 percent year-on-year compared to the 3 percent decline in global car and light truck builds. Year-to-date, our automotive business has outperformed global builds by approximately 400 basis points.

Beyond automotive builds, the pandemic also continues to have negative effects on end-markets such as hospitality, oil and gas, advertising and highway infrastructure due to social distancing and work-from-home protocols. These soft end-market trends resulted in year-on-year organic sales declines in our commercial solutions, transportation safety, and advanced material businesses.

Geographically, Asia Pacific declined 3 percent while the Americas declined 11 percent and EMEA was down 16 percent.

Transportation and Electronics third-quarter operating margins were 23.9 percent negatively impacted by the 7 percent decline in organic sales which was partially offset by continued cost discipline.

Turning to Health Care both organic growth and operating margins in this business improved from Q2 levels as elective healthcare and oral care procedure volumes improved after experiencing significant pandemic-related challenges and disruptions across the industry in the second quarter.

Overall, our Health Care business delivered Q3 organic sales growth of 8.1 percent year-on-year with operating margins of 23.5 percent.

Medical solutions grew mid-teens, including the impact from continued strong pandemic-related demand for disposable respirators to protect front-line healthcare workers. Excluding the respirator impact, this business declined low-single digits as elective procedures remain significantly below 2019 levels.

Our oral care business returned to positive growth in Q3 up low-single digits organically driven by the re-opening of dental offices globally and the rebuild of channel inventories.

Looking ahead, while we have seen improvement in both medical and dental procedures, currently procedures are leveling off and are forecasted to remain below pre-COVID levels through the end of 2021.

Our separation and purification business increased low-teens year-on-year. This business continues to experience strong demand for biopharma filtration solutions in support of the pharmaceutical industry's research and manufacturing efforts to develop vaccines and therapeutic treatments for COVID.

Turning to health information systems this business declined mid-single digits organically in the quarter as hospitals remain cautious relative to their information technology investments.

And finally, food safety declined low-single digits as the pandemic and related prevention protocols continue to negatively impact the food services industry.

Looking geographically, the Americas grew 13 percent. EMEA also grew 9 percent while Asia Pacific declined 4 percent.

As I mentioned, Health Care's third quarter operating margins were 23.5 percent, down 320 basis points year-on-year. Margins were negatively impacted by the Acelity acquisition and investments in productivity and growth, which were partially offset by ongoing cost discipline. Looking sequentially, operating margins improved 670 basis points … with 60 percent sequential leverage on 18 percent growth in sales.

Lastly, second quarter organic growth for our Consumer business was up 5.5 percent.

Organic sales growth within Consumer continued to be led by our home improvement and home care businesses … each up low-double digits organically. Growth in these businesses was driven by strong customer demand for our Filtrete air filtration products, ScotchBlue painter's tapes, Command wall hanging products, Meguiar's car care products, and Scotchbrite cleaning products and solutions.

Stationery and office declined double digits as a result of many business offices and schools remaining partially or fully closed due to the pandemic.

Looking at Consumer geographically, the Americas led, up 7 percent organically and EMEA grew 5 percent, while Asia Pacific declined 1 percent.

Consumer's operating margins were 25.3 percent up 200 basis points on strong organic sales growth and cost discipline. Looking ahead, we expect to continue to step up investments in advertising and merchandising and new product innovation to address changing consumer demand trends.

That wraps up my review of our third-quarter business performance. In summary, we continue to execute well in a highly fluid and uncertain macro environment. We returned to positive organic sales growth, delivered solid operating margins of nearly 23 percent, increased adjusted free cash by 13 percent, reduced net debt by 8 percent, while also investing in both growth and productivity.

Please turn to slide eleven, and I will discuss our thoughts on Q4.

Slide 11, Q4 2020 Insights
Monish Patolawala

As we enter the fourth quarter, significant economic and end-market uncertainty continues to persist as both global GDP and IPI are currently forecasted to remain negative year-on-year.

Therefore, we remain cautious as the impact of the pandemic on the global economy and end-markets continues to evolve.

From an end-market perspective, we do expect continued strength in certain end-markets namely personal safety, home improvement, general cleaning, semiconductor, data centers, and biopharma filtration.

At the same time, year-on-year declines across many end-markets such as healthcare and oral care elective procedures, automotive OEM, general industrial, consumer electronics, hospitality, and office supplies are expected to persist through the balance of this year.

In fact, many of these end-markets are not expected to recover to pre-COVID levels until well into 2021 or beyond.

Turning to our business, we currently estimate October total company sales growth to be flat to up low-single digits, which incorporates the anticipated impact of one fewer business day year-on-year.

Please note, relative to business days that there is no year-on-year impact for the fourth-quarter. However, on a sequential basis, we will have two fewer business days in Q4 as compared to Q3 this year.

As we have done over the past several months, we will provide our monthly sales information through the end of the year due to the continued global macroeconomic uncertainty. Therefore, we will report October sales once we have finalized those results in a few weeks.

Regarding disposable respirators, we expect continued strong demand which we anticipate will contribute approximately 300 basis points to companywide Q4 total sales growth.

And, as a reminder, we will have a negative fourth-quarter sales impact year-on-year of approximately $100 million, or 130 basis points, from our May 2020 divestiture of drug delivery.

From an operational standpoint, we will maintain a strong focus on cost management while continuing to invest in both growth and productivity.

With this in mind, we expect our fourth quarter adjusted operating margins of approximately 21 percent.

Finally, we remain focused on generating strong cash flow, disciplined capital allocation and strengthening our balance sheet and financial flexibility.

To wrap up, I would like to thank all 3Mers for the hard work this quarter and the progress that we have made! In the spirit of continuous improvement, there is always more we can do. Our team remains focused on fighting the pandemic from all angles, relentlessly serving our customers, delivering growth in revenue, margin and cash, strengthening our balancing sheet, and driving operating rigor through daily management.

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

Slide 12, Q&A
Mike Roman

To wrap up, our operational performance was strong in the third quarter as we executed well, innovated for our customers and continued to fight the pandemic from all angles.

In a highly uncertain economic environment, our team delivered robust cash flow, strong margins and returned to positive organic sales growth.

Looking ahead we will continue to invest in both growth and productivity, and we remain confident in our ability to lead the economic recovery, deliver greater value for our stakeholders and realize new opportunities from emerging market trends.

Thank you for joining us.