Q2 2021 Earnings Call Transcript
Michael Roman & Monish Patolawala
July 27, 2021

Slide 1, Cover Page
Bruce Jermeland, Senior Vice President, Investor Relations

Thank you and good morning everyone and welcome to our second-quarter earnings conference call.

With me today are Mike Roman, 3M's chairman and chief executive officer, and Monish Patolawala, our chief financial officer. Mike and Monish will make some formal comments then we will take your 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 2.

Slide 2, Upcoming Investor Events
Bruce Jermeland

As we have done throughout the year, I would like to remind you to mark your calendars for next earnings call which will take place on Tuesday, October 26th.

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

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

Mike.

Slide 4, Q2 … continued strong growth and execution
Mike Roman, Chairman and Chief Executive Officer

Thank you, Bruce, and good morning everyone.

3M's performance in the second quarter was strong, as we posted organic growth across all business groups and geographic areas.

Our team executed well and delivered increased earnings, expanded margins, and robust cash flow.

From a macro perspective, the global economy continues to improve, though uncertainty remains due to COVID-19 and heightened concern over the increase in Delta variant cases.

We saw ongoing strength in many end-markets including home improvement, oral care and general industrial, along with a pick-up in health care elective procedures.

We continue to work to mitigate ongoing inflationary pressures and supply chain challenges as well as end-market dynamics, such as the semiconductor shortage impacting automotive build rates and electronics.

We are also beginning to see a decline in pandemic-related demand for disposable respirators, which I will discuss on the next slide.

Looking forward we will stay focused on investing in emerging growth opportunities, improving productivity and advancing sustainability.

We are confident in our ability to continue executing well in the face of COVID-19 uncertainties, and are raising our full-year guidance for organic growth to 6 to 9 percent, and earnings-per-share to $9.70 to $10.10.

Please turn to slide 5.

Slide 5, Q2 2021 Summary
Mike Roman

In the second quarter we delivered total sales of $8.9 billion.

We posted organic growth of 21 percent, versus a 13 percent decline in last year's second quarter along with earnings of $2.59 per share.

We expanded adjusted EBITDA margins to over 27 percent and increased adjusted free cash flow to $1.6 billion, with a conversion rate of 103 percent.

Strong cash flow allowed us to further strengthen our balance sheet, while returning $1.4 billion to shareholders through dividends and share repurchases.

I am proud of our team's execution in a dynamic environment. We are finding new ways to innovate for customers and improve our operational performance.

In addition to our strong day-to-day execution, we are investing to capitalize on favorable market trends and serve emerging customer needs. I want to share a few impactful examples:

In health care, our innovative Prevena Therapy incision management system is the first and only medical device indicated by the U.S. FDA to help reduce surgical site infections in high risk patients, helping lower the costly financial burden of complications delivering on both improved clinical outcomes and cost savings for the healthcare system.

In automotive electrification, we are building on 3M's long history in consumer electronics, and now expanding our solutions for the future of transportation, including new display technologies for both electric and internal combustion engines, helping us drive above-market growth in our automotive business.

In home improvement, we are building out a suite of innovations to help consumers personalize their homes, including our fast-growing line of Command damage-free hanging solutions, a half-a-billion-dollar franchise that leverages our world-class adhesives platform, with even greater opportunities ahead.

We have increased opportunities across our businesses to apply 3M science and drive long-term growth, and we will continue to invest and win in those areas.

As you all have seen, the ongoing impact of COVID-19 is highly variable across geographies.

Since the onset of the pandemic we have increased our annual respirator production 4-fold to 2.5 billion – by activating idle surge capacity and building additional lines – while shifting 90 percent of distribution into health care to protect nurses, doctors and first responders. One of our strengths is to quickly adapt to changing marketplace needs.

Global demand reached its peak in Q1 of this year, which included stockpiling from governments and hospitals.

We are now seeing a deceleration in overall health care demand, and are adjusting production, increasing supply to industrial and consumer channels while continuing to prioritize health care workers in the geographies seeing increased COVID-19 cases and elevated hospitalization rates. As we do this, we are reducing overall output to meet end-market trends.

Like we have in the past, we are prepared to rapidly increase production in response to COVID-19 related needs or future emergencies when needed.

As I reflect on the first half, I am pleased with our performance. We delivered strong sales and margin growth, along with good cash flow while building for the future, and advancing sustainability with significant new carbon, water and plastic commitments.

In the second half – in addition to investing in growth, productivity, and sustainability – we also must navigate ongoing COVID-19 impacts and continue taking action to address inflationary pressures and supply chain challenges. We will do this by driving an unrelenting focus on operational performance, which includes improving service, quality, operating costs and cash generation.

I would like to thank 3Mers for your commitment and resilience as we bring together people, ideas, and science to help transform businesses, solve customer challenges and improve lives around the world.

That wraps up my opening comments, and I'll turn it over to Monish to cover more details on the quarter, and our updated guidance.

Monish.

Slide 6, Q2 2021 Adjusted margins and EPS
Monish Patolawala, Executive Vice President and Chief Financial Officer

Thank you, Mike, and I wish you all a very good morning.

Please turn to slide 6.

Companywide, second-quarter sales were 8.9 billion dollars, up 25 percent year-on-year, or an increase of 21 percent on an organic basis.

Sales growth, combined with operating rigor and disciplined cost management drove adjusted operating income of 2 billion dollars, up 40 percent with adjusted operating margins of 22 percent, up 240 basis points year-on-year.

Second quarter GAAP and adjusted earnings per share were 2 dollars and 59 cents up 44 percent compared to last year's adjusted results.

On this slide you can see the components that impacted both operating margins and earnings per share as compared to Q2 last year.

Our strong year-on-year organic volume growth along with ongoing productivity, restructuring efforts, and other items added 4.1 percentage points to operating margins and 89 cents to earnings per share year-on-year.

Included in this margin and earnings benefit were a few of items of note.

First, during the quarter the Brazilian Supreme Court issued a ruling that clarified the calculation of Brazil's federal sales-based social tax — essentially lowering the social tax that 3M should have paid in prior years. This favorable ruling added 91 million dollars to operating income, or 1 percentage point to operating margins and 12 cents to earnings per share.

Next, as you will see later today in our 10Q, we increased our "other environmental liability" by nearly 60 million dollars and our "respirator liabilities" by approximately 20 million dollars as part of our regular review.

In addition, we also incurred a year-on-year increase in ongoing legal defense costs. We are currently scheduled to begin a PFAS-related trial in Michigan in October along with the next step in the combat arms earplug multi-district litigation, with one trial in September and one in October.

And finally, during the second quarter we incurred a pre-tax restructuring charge of approximately 40 million dollars as part of the program we announced in Q4 of last year.

Second-quarter net selling price and raw materials performance reduced both operating margins and earnings per share by 140 basis points and 17 cents, respectively.

This headwind was larger than forecasted as we experienced broad-based cost increases for chemicals, resins, outsourced manufacturing, and logistics as the quarter progressed.

As a result of these increasing cost trends, we now forecast a full-year raw materials and logistics cost headwind in the range of 65 to 80 cents per share versus a prior expectation of 30 to 50 cents.

As we have discussed, we have been and are taking multiple actions including increasing selling prices to address these cost headwinds.

As a result, we expect continued improvement in our selling price performance in the second half of the year.

However, given the pace of cost increases, we currently expect a third-quarter net selling price and raw materials headwind to margins in the range of 50 to 100 basis points which we anticipate will turn to a net benefit in the fourth quarter as our selling price and other actions start catching up to the increased costs.

Moving to divestiture impacts, the lost income from the sale of drug delivery in May of last year was a headwind of 10 basis points to operating margins, and 2 cents to earnings per share.

Foreign currency, net of hedging impacts, reduced margins 20 basis points while benefitting earnings by 8 cents per share.

Finally, three non-operating items combined had a net neutral impact to earnings per share year-on-year. This result included a 6-cent earnings benefit from lower other expenses that was offset by a higher tax rate and diluted share count which were each a headwind of 3-cents per share versus last year.

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

Slide 7, Q2 2021 Cash Flow and Balance Sheet
Monish Patolawala

We delivered another quarter of robust free cash flow with second quarter adjusted free cash flow of 1.6 billion dollars up 2 percent year-on-year along with conversion of 103 percent.

Our year-on-year free cash flow performance was driven by strong double-digit growth in sales and income which was mostly offset by the timing of an income tax payment of approximately 400 million dollars in last year's Q3, which is traditionally paid in Q2.

Through the first half of the year, we increased adjusted free cash flow to 3 billion dollars versus 2.5 billion dollars last year.

Second quarter capital expenditures were 394 million dollars and approximately 700 million dollars year-to-date. For the full-year, we are currently tracking to the low-end of our expected cap-ex range of 1.8 to 2 billion dollars given vendor constraints and the pace of capital projects.

During the quarter, we returned 1.4 billion dollars to shareholders through the combination of cash dividends of 858 million dollars and share repurchases of 503 million dollars. Year-to-date we have returned 2.5 billion dollars to shareholders in the form of dividends and share repurchases.

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

We ended the quarter with 12.7 billion dollars in net debt a reduction of 3.5 billion dollars since the end of Q2 last year. As a result, our net debt to EBITDA ratio has declined from 1.9 a year ago to 1.3 at the end of Q2.

Our net debt position, along with our strong cash flow generation capability, continues to provide us financial flexibility to invest in our business pursue strategic opportunities and return cash to shareholders while maintaining a strong capital structure.

Please turn to slide eight where I will summarize the business group performance for Q2.

Slide 8, Q2 Business Group Performance
Monish Patolawala

I will start with our Safety and Industrial business which posted organic growth of 18 percent year-on-year in the second quarter driven by improving industrial manufacturing activity and prior year pandemic impacts.

First, starting with our personal safety business. We posted double-digit organic growth in our head, face, hearing and fall protection solutions as demand in general industrial and construction end-markets remained strong.

However, this growth was more than offset by a decline in our overall respiratory portfolio due to last year's strong COVID-related demand, resulting in an organic sales decline of low-single digits for our personal safety business.

Within our respiratory portfolio, second quarter disposable respirator sales increased 3 percent year-on-year but declined 11 percent sequentially as COVID-related hospitalizations declined. Looking ahead, we anticipate continued deceleration in disposable respirator demand through the balance of this year and into 2022.

Turning to the rest of Safety and Industrial, organic growth was broad-based led by double-digit increases in automotive aftermarket, roofing granules, abrasives, adhesives and tapes, and electrical markets.

Safety and Industrial's second quarter operating income was 718 million dollars, up 15 percent versus last year. Operating margins were 22.1 percent, down 130 basis points year-on-year, as leverage on sales growth was more than offset by increases in raw materials, logistics and ongoing legal costs.

Moving to Transportation and Electronics, which grew 24 percent organically, despite sustained challenges from semiconductor supply chain constraints.

Organic growth was led by our auto OEM business, up 76 percent year-on-year, compared to a 49 percent increase in global car and light truck builds.

This outperformance was due to several factors.

First, the regional mix of year-on-year growth in car and light truck builds were in regions where we have higher dollar content per vehicle.

Second, a year-on-year increase in sell-in of 3M products versus the change in build rate.

Lastly, we continue to apply 3M innovation to vehicles, gaining penetration onto new platforms.

Our electronics-related business was up double digits organically with continued strength in semiconductor, factory automation and data centers, along with consumer electronic devices, namely tablets and TV's.

Looking ahead, we continue to monitor the global semiconductor supply chain and its potential impact on the electronics and automotive industries.

Turning to the rest of Transportation and Electronics, advanced materials, commercial solutions, and transportation safety each grew double-digits year-on-year.

Second-quarter operating income was 546 million dollars, up over 50 percent year-on-year. Operating margins were 22.0 percent, up 340 basis points year-on-year, driven by strong leverage on sales growth, which was partially offset by increases in raw materials and logistics costs.

Turning to our Health Care business, which delivered second quarter organic sales growth of 23 percent.

Organic growth was driven by continued year-on-year and sequential improvements in healthcare elective procedure volumes as COVID-related hospitalizations decline.

Our medical solutions business grew mid-teens organically, or up approximately 20 percent excluding the decline in disposable respirator demand. I am pleased with the performance of Acelity, which grew nearly 20 percent organically in the quarter, as it helps us build on our leadership in advanced wound care.

Sales in our oral care business more than doubled from a year ago as patient visits have nearly returned to pre-COVID levels.

The separation and purification business increased ten percent year-on-year due to ongoing demand for biopharma filtration solutions for COVID-related vaccine and therapeutics along with improving demand for water filtration solutions.

Health information systems grew high-single digits driven by strong growth in clinician solutions.

And finally, food safety increased double digits organically as food service activity returns along with continued strong growth from new product introductions.

Health Care's second quarter operating income was 576 million dollars, up over 90 percent year-on-year. Operating margins were 25.3 percent, up 880 basis points. Second quarter margins were driven by leverage on sales growth, which was partially offset by increasing raw materials and logistics costs along with increased investments in growth.

Lastly, second quarter organic growth for our Consumer business was 18 percent year-on-year with strong sell-in and sell-out trends across most retail channels.

Our home improvement business continues to perform well, up high-teens organically on top of a strong comparison from a year ago. This business continued to experience strong demand in many of our category leading franchises, particularly Command, Filtrete, and Meguiar's.

Stationery and office grew strong double-digits organically in Q2 as this business laps last year's COVID-related comparisons. We continue to see strength in consumer demand for Scotch-branded packaging and shipping products along with improved sell-in trends in Post-It solutions and Scotch-branded home and office tapes as retailers prepare for back-to-school and return-to-workplace.

Our home care business was up low-single digits organically versus last year's strong COVID-driven comparison.

And finally, our consumer health and safety business was up double-digits as we lap COVID-related impacts from a year ago, along with improved supply of safety products for our retail customers.

Consumer's operating income was 311 million dollars, up 12 percent year-on-year. Operating margins were 21 percent, down 160 basis points, as increased costs for raw materials, logistics, and outsourced hardgoods manufacturing, along with investments in advertising and merchandising, more than offset leverage from sales growth.

Please turn to slide nine for a discussion of our full-year 2021 guidance.

Slide 9, Updating Full-year 2021 Guidance
Monish Patolawala

While uncertainty remains, we expect global economic and end-market growth to remain strong however, continue to be fluid as the world wrestles with ongoing COVID-related impacts that we all see and monitor. Therefore, there are a number of items that will need to be navigated as we go through the second half of the year.

For example, we anticipate continued sequential improvement in healthcare elective procedure volumes.

Also, we expect ongoing strength in the home improvement market and currently anticipate students returning to classrooms and more people returning to the workplace.

Next, we remain focused on driving innovation and penetration with our global auto OEM and electronics customers. These two end-markets continue to converge as highlighted by the well-known constraints in semiconductor chip supply. This limited chip supply is expected to reduce year-on-year automotive and electronics production volumes in the second half.

As mentioned earlier, we expect demand for disposable respirators to wane and negatively impact second half revenues by approximately 100 to 300 million dollars year-on-year.

Turning to raw materials and logistics, as noted, we anticipate a year-on-year earnings headwind of 65 to 80 cents per share for the full year, or 40 to 55 cents in the second half, due to rising cost pressures. We are taking a number of actions including broad-based selling price increases to help mitigate this headwind.

And finally, the restructuring program we announced last December remains on track. As part of this program, we expect to incur a pre-tax charge in the range of 60 to 110 million dollars in the second half of the year.

Thus, taking into account our first half performance, along with these factors, we are raising our full-year guidance for both organic growth and earnings-per-share.

Organic growth is estimated to be 6 to 9 percent, up from the previous range of 3 to 6 percent.

We now anticipate earnings of 9 dollars and 70 cents to 10 dollars and 10 cents per share, against a prior range of 9 dollars and 20 cents to 9 dollars and 70 cents.

Also, as you can see, we now expect free cash flow conversion in the range of 90 to 100 percent, versus our prior range of 95 to 105 percent. This adjustment is primarily due to ongoing challenges in global supply chains, raw materials, and logistics which are expected to persist for some time.

Turning to the third quarter, let me highlight a few items of note:

First, we currently anticipate continued improvement in healthcare elective procedure volumes across most parts of the world.

Global smartphone shipments are expected to be down high-single digits year-on-year, while global car and light truck builds are expected to be down 3 percent year-on-year.

Relative to disposable respirators, we anticipate a year-on-year reduction in sales of 50 to 100 million dollars due to continued decline in global demand.

As mentioned earlier, we are anticipating a third quarter year-on-year operating margin headwind of 50 to 100 basis points from selling prices net of higher raw materials and logistics costs.

On the restructuring front, which I previously discussed, we expect a Q3 pre-tax charge in the range of 50 to 75 million dollars as part of this program.

And finally, we expect higher investments in growth, productivity, and sustainability in the quarter, along with higher legal defense costs as proceedings progress.

To wrap up, our team has delivered a strong first half performance, including broad based growth, good operational execution, robust cash flows and an enhanced capital structure. With that being said, there is always more we can do and will do.

We continue to prioritize capital to our greatest opportunities for growth, productivity, and sustainability … while remaining focused on delivering for our customers, improving operating rigor and enhancing daily management.

I want to thank our customers and vendors for their ongoing loyalty and partnership and especially our employees for their dedication, perseverance, and execution in these uncertain times.

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

Slide 10, Questions & Answers
Mike Roman

To wrap up, our second-quarter performance was strong… marked by broad-based growth, increased margins and robust cash flow.

I'm confident in our ability to continue executing well as we navigate COVID-19 impacts… and we will stay focused on taking advantage of market trends and overcoming supply challenges, while continuing to invest in growth, productivity and sustainability.

Thank you for joining us.