Q3 2021 Earnings Call Transcript
Michael Roman & Monish Patolawala
October 26, 2021

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

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

With me today are Mike Roman, 3M's chairman and chief executive officer, and Monish Patolawala, our chief financial and transformation 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, January 25th 2022.

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, Strong Q3/YTD Performance in a Dynamic Environment
Mike Roman, Chairman and Chief Executive Officer

Thank you, Bruce. Good morning, everyone, and thank you for joining us.

In a dynamic environment, our performance throughout 2021 has shown the skill of our people around the world, the resiliency of our business model, and the relevance of our technologies.

In the third quarter and year-to-date, we have delivered broad-based organic growth across all business groups and geographic areas, along with good margins and strong cash flow.

Q3 organic growth was over 6 percent as we drove innovation across our market-leading businesses with margins of 20 percent, and earnings of $2.45 per share.

Geographically, growth in the quarter was led by the Americas, up 7 percent, with the United States up 6 percent. Growth in APAC was 6 percent, with China up 3 percent, and Japan up 6 percent while EMEA grew 4 percent.

With respect to the macro environment, overall end-market demand remains strong, though the semiconductor shortage continues to impact many markets, most visibly in electronics and automotive.

As we navigate near-term uncertainty, we continue to invest in growth, productivity and sustainability – which I will discuss shortly.

We are also actively managing disruptions in the global supply chain, with a relentless focus on customer service.

Looking at our performance through nine months, we have executed well and delivered 11 percent organic growth – with all business groups above 10 percent – along with margins of 22 percent and earnings of $7.81 per share.

Today we are updating full-year expectations for organic growth to a range of 8 to 9 percent, and EPS to a range of $9.70 to $9.90 reflecting our results to date, and ongoing supply chain challenges.

I would like to make a few comments on how 3M is actively managing those challenges.

As you know, many companies are facing supply chain disruptions – the result of a convergence of issues including the Delta variant, strong demand, energy and labor shortages, and extreme weather events.

For example, ocean freight costs have more than doubled over the last year, and the number of containers on the water is up 70 percent because of port congestion. Suppliers are challenged to provide consistent and predictable supply – on any given day, we are working with more than 300 suppliers with critical constraints.

With manufacturing sites in 35 countries around the world, and as a $5 billion annual exporter out of the United States, we are working tirelessly to serve our customers.

The cornerstone of 3M's response is our expertise and deep relationships across the supply chain… along with our local-for-local manufacturing and supply chain strategy, which helps us move with agility and keep our factories running.

We have daily meetings with suppliers to strengthen our planning, and in some instances are strategically prioritizing geographies, end markets and portfolios – hard, but necessary decisions to ensure we meet the most critical needs of our customers.

We are moving product in different ways – such as expanding our use of rail, shipping out of more flexible ports, and increasing our use of charter flights by over 40 percent – while deploying new capabilities to better track our flow of goods in real time.

Maintaining talent is also key, and we are using several tactics to attract new workers, while protecting the health and safety of all of our employees.

Some of our actions have impacted our productivity and gross margins, which Monish will touch on – but we will do what is necessary to take care of customers.

The combination of strong demand, along with supply chain challenges, is also contributing to broad-based inflation. We are taking multiple actions to help offset inflationary pressures, including price increases, dual sourcing and improving factory yields – with more work to do.

Ultimately, the duration of these supply chain challenges is difficult to predict. We remain focused on serving customers, managing backlogs and making good on our commitments – delivering the unique, high-quality products that are the hallmark of 3M.

Please turn to slide 5.

Slide 5, Areas of Investment Aligned to Key Global Trends
Mike Roman

While we execute day-to-day, we are investing to drive long-term growth and capitalize on trends in large, attractive markets.

In home improvement, for example, we have multiple half-a-billion-dollar-plus franchises that keep families healthier and more productive – including our fast-growing Command damage-free hanging solutions, and Filtrete home filtration products.

These brands leverage 3M's deep expertise in adhesives and nonwoven materials – the same technologies helping drive success in our automotive business, which consistently outgrows build rates. Auto electrification sales are up 40 percent year-to-date, on the strength of new innovations, including advanced display technologies, as automobiles become the next consumer electronic device.

In health care, the biopharma market is growing more than 10 percent annually, with our business up more than 30 percent year-to-date as 3M science has supported the unprecedented pace of advancement over the past 18 months to develop therapeutics and vaccines, and scale manufacturing to help address the pandemic.

The fundamental strengths of 3M – our unique technology platforms, advanced manufacturing, global capabilities, and leading brands – position us to win, and we will continue to invest in these areas.

In a similar way, we are driving productivity by advancing digital capabilities across our operations, allowing us to expand our use of data and data analytics.

In sustainability, we have achieved 50 percent renewable electricity use in our operations, four years ahead of our timeline on our way to 100 percent.

We are advancing the environmental goals we announced earlier in the year, making the investments to accelerate our ability to achieve carbon neutrality, reduce water use, and improve the quality of water returned to the environment from our industrial processes.

In addition, we are proactively managing PFAS, making our factories and communities stronger and more sustainable.

In Cottage Grove, Minnesota, we recently announced that we are closing our incinerator, and partnering with a leading disposal company to more efficiently manage our waste streams.

We just broke ground to add new filtration technology in Cordova, Illinois.

In Zwijndrecht, Belgium, we are working with government officials to resolve issues related to PFAS, and will invest up to 125 million euros over the next three years to improve water quality around our factory.

These proactive initiatives and others are accelerating 3M's ability to go beyond current regulatory standards and deliver on our commitments.

With respect to the PFAS Strategic Roadmap announced last week, 3M remains committed to working with the Biden Administration, EPA and others in taking a science-based approach to managing PFAS.

Let me also touch on a few litigation updates. Last week we announced a collaborative agreement to resolve litigation related to PFAS near our facility in Decatur, Alabama – the impact is included in our previously disclosed reserves.

On combat arms, there have been four bellwether trials so far, with six additional trials here in the fourth quarter – we are early in this litigation, and will continue to actively defend ourselves, including through the appeal process.

As always, we encourage you to read our 10-Q for updates on all litigation matters.

To wrap up, we are driving strong results in a challenging environment, investing in attractive end markets, and positioning 3M for continued growth. I am proud of our 3M team, which is united by a common purpose: unlocking the power of people, ideas, and science to reimagine what's possible and create what's next.

Now I will turn it over to Monish, who will cover the details of the quarter.

Monish.

Slide 6, Q3 2021 Adjusted Margins and EPS
Monish Patolawala, Executive Vice President and Chief Financial and Transformation Officer

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

Please turn to slide six.

As I look back on the quarter, the 3M team demonstrated the resilience of our business model and the relevance of our technologies as we executed well in a very challenging environment, effectively navigating the supply chain disruptions while serving and innovating for our customers. Though manufacturing, raw materials and logistics challenges persisted throughout the quarter, we continued to invest in the business while driving operating rigor and managing costs.

Turning to the third-quarter financial results sales were 8.9 billion dollars, up 7.1 percent year-on-year, or an increase of 6.3 percent on an organic basis.

Operating income was 1.8 billion dollars, down 6 percent with operating margins of 20 percent, coming in at the top-end of the range which we had previously communicated in mid-September.

Third quarter earnings per share were 2 dollars and 45 cents which was similar to last year.

On this slide you can see the components that impacted both operating margins and earnings per share as compared to Q3 last year.

Our strong year-on-year organic volume growth was more than offset by the headwinds resulting from the global supply chain challenges, investments in growth and sustainability and litigation related costs. Combined these impacts lowered operating margins by 1.4 percentage points and earnings per share by 2-cents year-on-year.

The restructuring program we announced in Q4 of last year remains on track.

As part of this program, we incurred a pre-tax restructuring charge of 50 million dollars in the third quarter. This charge was offset by the benefits we achieved this quarter.

Moving to price/raw materials, as expected, increases in selling price gained traction as we went through the quarter with year-on-year selling prices up 140 basis points in Q3 versus 10 basis points in Q2.

However, we continued to experience higher costs for raw materials, logistics and outsourced manufacturing which outpaced the increase in selling prices.

Thus, third-quarter net selling price and raw materials performance reduced both operating margins and earnings by 130 basis points and 12 cents per share, respectively versus Q3 last year.

Looking at Q4, we expect our selling price actions to continue to gain traction as we work to mitigate the raw material and logistics inflationary pressures we have experienced throughout the year.

Next, foreign currency, net of hedging impacts, reduced margins 20 basis points and earnings by one cent per share.

Also, three other non-operating items impacted our year-on-year earnings per share performance.

First, lower other expenses resulted in an 8-cent earnings benefit. Consistent with prior quarters non-operating pension was a 5-cent benefit, along with a 2-cent benefit from net interest due to our proactive early redemption of debt.

Secondly, a lower tax rate versus last year provided a 9-cent benefit to earnings per share. The tax rate was lower due to favorable adjustments this year related to impacts of U.S. international tax provisions. Our year-to-date tax rate is 18.8 percent; therefore, we now expect our full-year tax rate in the range of 18.5 to 19.5 percent versus 20 to 21 percent, previously.

And finally, average diluted shares outstanding increased one percent versus Q3 last year, lowering per share earnings by 2 cents.

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

Slide 7, Q3 2021 Cash Flow and Balance Sheet
Monish Patolawala

Third quarter adjusted free cash flow of 1.5 billion dollars was down 29 percent year-on-year with conversion of 107 percent.

Adjusted free cash flow year-to-date was 4.5 billion dollars, which was similar to last year with free cash flow conversion of 98 percent.

The decline in our year-on-year free cash flow performance was primarily driven by higher inventory balances due to strong customer demand, along with raw material inflation and more goods in transit as a result of the ongoing global supply chain challenges.

Third quarter capital expenditures were 343 million dollars and one billion dollars year-to-date. For the full-year, we now expect cap-ex investments in the range of 1.5 to 1.6 billion dollars versus being at the low-end of our prior range of 1.8 to 2 billion dollars.

We continue to step up investments in growth, productivity and sustainability however the pace of projects continues to be impacted by supply chain and vendor constraints.

During the quarter, we returned 1.4 billion dollars to shareholders through the combination of cash dividends of 856 million dollars and share repurchases of 527 million dollars.

Year-to-date we have returned 3.8 billion dollars to shareholders in the form of dividends and share repurchases.

Our net debt position, strong cash flow generation capability, and disciplined capital allocation 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 Q3.

Slide 8, Q3 Business Group Performance
Monish Patolawala

I will start with our Safety and Industrial business which posted organic growth of 6.1 percent year-on-year in the third quarter. Organic growth was driven by continued robust industrial manufacturing activity along with prior year pandemic-related impacts.

First, our personal safety business declined 4 percent organically up against a 40 percent pandemic-driven comparison a year ago.

Third quarter disposable respirator sales decreased 7 percent organically year-on-year and 15 percent sequentially. 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 led by double-digit increases in adhesives and tapes, abrasives, and electrical markets.

In addition, closure and masking was up high single digits, automotive aftermarket up low-single digits, while roofing granules declined against a strong comparison from last year.

Safety and Industrial's third quarter operating income was 620 million dollars, down 20 percent versus last year. Operating margins were 19.2 percent, down 650 basis points year-on-year as leverage on sales growth was more than offset by ongoing increases in raw materials, logistics, and litigation-related costs along with manufacturing productivity impacts.

Moving to Transportation and Electronics, which grew 5.1 percent organically, despite the continued impact of semiconductor supply chain constraints.

Our auto OEM business was flat year-on-year, compared to the 20 percent decline in global car and light truck builds.

This outperformance was due to a few factors.

First, we continue to grow our penetration by driving 3M innovation onto new automotive platforms.

Second, we saw a notable increase in channel inventories at tier suppliers given the dramatic reductions in OEMs' build forecasts through the quarter.

Lastly, we benefitted from a vehicle model mix standpoint as auto OEMs produced more premium vehicles which tend to have higher 3M content.

Our electronics-related business declined low-single digits organically with declines across consumer electronics, particularly smartphones and TV's, as OEM's faced production challenges due to ongoing semiconductor constraints and COVID-related impacts. These declines were partially offset by continued strong demand for our products and solutions in semiconductor and factory automation end-markets.

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

Third-quarter operating income was 465 million dollars, down 9 percent year-on-year. Operating margins were 19 percent, down 320 basis points year-on-year, driven by strong leverage on sales growth, which was more than offset by increases in raw materials and logistics costs, along with manufacturing productivity impacts.

Turning to our Health Care business, which delivered third quarter organic sales growth of 3.3 percent.

Our medical solutions business declined low-single digits organically impacted by the continued decline in demand for disposable respirators along with the pace of hospital elective procedure volumes which came in at the low end of industry expectations of 90 to 95 percent for the quarter.

Sales in our oral care business grew low-double digits year-on-year as patient visits continued to be near pre-COVID levels.

The separation and purification business increased high-single digits year-on-year due to ongoing demand for biopharma filtration solutions for COVID-related vaccine and therapeutics.

Health information systems grew low-double digits driven by strong growth in clinician solutions.

And finally, food safety increased double digits as food service activity returns.

Health Care's third quarter operating income was 529 million dollars, up 7 percent year-on-year. Operating margins were 23.5 percent, up 70 basis points. Third quarter margins were driven by leverage on sales growth, which was partially offset by increasing raw materials and logistics costs, manufacturing productivity impacts, along with increased investments in growth.

Lastly, third quarter organic growth for our Consumer business was 7.6 percent year-on-year with continued strong sell-in and sell-out trends across most retail channels.

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

Stationery and office grew double-digits organically in Q3 as this business laps last year's COVID-related comparisons. We also had strong back-to-school consumer demand and holiday-related sell-in for Scotch-branded packaging and shipping products, Post-It solutions, and Scotch-branded home and office tapes.

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

And finally, our consumer health and safety business was up high-single digits as we lap COVID-related impacts from a year ago.

Consumer's operating income was 332 million dollars, down 3 percent year-on-year. Operating margins were 21.7 percent, down 260 basis points, as increased costs for raw materials, logistics, and outsourced hardgoods manufacturing, 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

As we reflect on the macro economic environment, we expect demand to remain strong across most end-markets. However, uncertainty persists given the ongoing impacts of the pandemic along with the well-known global supply chain, raw materials and logistics challenges that all companies are working through.

Looking ahead we remain focused on our customers and doing what is necessary to serve them as we continue to navigate the fluid environment.

Turning to guidance, we are increasing the bottom end of our expectations for organic growth. We now project our full-year organic growth to be in the range of 8 to 9 percent versus our prior range of 6 to 9 percent.

With respect to earnings, we anticipate a range of nine dollars and seventy cents to nine dollars and ninety cents per share as compared to our prior range of nine dollars and seventy cents to ten dollars and ten cents.

And finally, we expect to continue to generate strong free cash flow therefore we are maintaining our free cash flow conversion range of 90 to 100 percent.

This updated outlook implies a wider than normal fourth-quarter range, accounting for ongoing impacts of COVID and the uncertain supply chain environment.

For example, from a growth perspective, the well-known constraints in semiconductor chip supply are impacting more and more end-markets, most notably automotive and consumer electronics as reflected in their lower production forecasts for the year.

We anticipate global elective healthcare procedure volumes to stabilize with recent trends.

Relative to disposable respirators, we expect continued impacts from the decline in healthcare-related demand along with elevated inventory levels in the industrial channel.

And finally, we expect our pricing actions to continue to gain traction as we work to mitigate raw material and logistics cost pressures.

Turning to operations, as have discussed, we are actively managing inefficiencies in global supply chains, with a relentless focus on customer service.

Therefore, we are adjusting demand plans with greater frequency and as a result incurring more manufacturing production changeovers along with expediting shipments. All of these actions are impacting both costs and productivity, but we are taking the necessary steps to ensure we meet the most critical needs of our customers.

We continue to make progress relative to our December 2020 restructuring announcement. To date we have incurred over 240 million dollars in pre-tax restructuring charges and anticipate an additional 25 to 50 million dollars in Q4. We now expect total pre-tax restructuring charges of 300 to 325 million dollars versus our original expectation of 250 to 300 million dollars. These actions are now largely forecasted to be completed by the first quarter of 2022.

In addition, we expect to incur higher costs related to our ongoing litigation matters along with increases in other indirect related costs like travel expense.

And finally, we continue to invest in the business for the long-term, and therefore anticipate increased investments in growth, productivity and sustainability.

To close, I would like to take a moment to thank our customers who have placed their faith in us, our vendors who are tirelessly working with us to ensure continuity of supply and most importantly our 90,000 plus 3Mers who continue to deliver for our customers. We have a very steady eye on the long term to deliver growth, margin and cash thru strong operating rigor while continuing to navigate the uncertainty in the short run.

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 team is performing well in a challenging environment – delivering broad-based growth, good margins and strong cash flow. We will stay focused on managing supply chain constraints, investing in attractive market trends to drive growth, and creating greater value for our customers and shareholders.

Thank you for joining us.