24-Apr-2018

3M Co. (MMM)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Bruce Jermeland
Director-Investor Relations

Inge G. Thulin
Chairman, President & Chief Executive Officer

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

Michael F. Roman
Chief Operating Officer & Executive Vice President

OTHER PARTICIPANTS

Scott Davis
Melius Research LLC

Steven Winoker
UBS Securities LLC

Joe Ritchie
Goldman Sachs & Co. LLC

Stephen Tusa
JPMorgan Securities LLC

Andrew Kaplowitz
Citigroup Global Markets, Inc.

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Deane Dray
RBC Capital Markets LLC

Julian Mitchell
Barclays Capital, Inc.

Laurence Alexander
Jefferies LLC

Jeffrey Todd Sprague
Vertical Research Partners LLC

MANAGEMENT DISCUSSION SECTION

Bruce Jermeland
Director-Investor Relations

NON-GAAP FINANCIAL MEASURES

- Please note that throughout today's presentation, we'll be making references to certain non-GAAP financial measures, in particular measures which exclude the impact of the measurement adjustment for the Tax Cuts and Jobs Act and the previously disclosed legal settlement with the State of Minnesota
- Reconciliations of the non-GAAP measures can be found in the appendix of today's presentation and press release

Inge G. Thulin
Chairman, President & Chief Executive Officer

BUSINESS HIGHLIGHTS

Opening Remarks

- Coming off a strong 2017, our team opened the new year with broad-based organic growth across all business groups
- We expanded margins and posted a double-digit increase in EPS while continuing to invest in our business and return cash to our shareholders

Earnings, Sales and Organic Growth

- Looking at Q1 numbers, we delivered earnings of $2.50 per share, a 16% increase y-over-y
- Total sales rose to $8.3B, which is an all-time high for our enterprise
- Companywide, organic growth was 3%
- Three of our business groups, Safety and Graphics, Electronics and Energy, and Consumer all posted good growth that was within or above their expected full year ranges

Safety and Graphics

- Safety and Graphics delivered another robust performance with 7% organic growth coming off 6% growth in 2017
- As you know, we have significantly adjusted the Safety and Graphics portfolio over the last several years, and those actions continue to pay off in terms of improved growth and margins

Electronics and Energy

- Electronics and Energy posted 2% growth in the quarter with strong growth in data center and semiconductor markets
- Within this business group, we have also adjusted the portfolio in recent years, and we now see, in addition to growth, continued and sustained improvements in margins
- Consumer also delivered 2% organic growth, its fourth straight quarter of positive growth with particular strength in our home improvement business

Health Care Group

- Our Health Care and Industrial business groups, which grew 3% and 2%, respectively, each had many areas of strength but also a few areas of softness that temper overall growth
- Within Health Care, we delivered good growth in medical consumables, health information systems and food safety
    - We saw flat growth in oral care, and sales in drug delivery were down against a tough comparison

Industrial Business Group

- Turning to our Industrial business group, Industrial opened the year with 2% growth with good performance in abrasives and industrial adhesives and tapes
- Automotive OEM business also grew well and once again outperformed global auto builds despite negative build rates for the total automotive industry
- Finally, growth in our automotive aftermarket business was softer than we anticipated going into the year

Geographical Perspective

- Looking at our entire company's performance from a geographical perspective, we continue to capitalize on opportunities in developing markets
- In Q1, we posted 7% growth in developing markets including double-digit growth in China along with strong growth in India, Southeast Asia and Brazil

Margin

- Turning to margins, our team expanded margins to healthy 23% with four of our five business groups at 23% or higher
- We also continued to build for the future including investing 10% of sales into the combination of research and development and CapEx while returning significant cash to our shareholders

Shareholders and Dividend

- In the quarter, we returned $1.7B to our shareholders through both dividends and share repurchases
- And as a reminder, we increased our Q1 dividend by 16%, which marks 60 consecutive years of dividend increases

SUMMARY

Organic Growth and EPS

- In summary, we delivered good growth in the quarter throughout much of the portfolio, while a few markets were softer than we anticipated going into the year
- As a result, today, we're adjusting the top end of our full-year guidance for organic growth and EPS
    - We expect organic growth of 3% to 4% vs. 3% to 5% previously along with EPS of $10.20 to $10.55 against the prior range of $10.20 to $10.70
- Going forward, we remain confident in our ability to keep generating premium value for our customers and premium return for our shareholders
- We will continue to execute the 3mm playbook and strengthen our competitiveness and are well positioned to deliver strong results in 2018 and beyond

---

Nicholas C. Gangestad

Chief Financial Officer & Senior Vice President

FINANCIAL HIGHLIGHTS

Tax Cuts and Jobs Act

- Please turn to slide 5
- Let me begin with two topics that impacted GAAP earnings in Q1 that Bruce touched on at the beginning the call
- Recall that following the passage of the Tax Cuts and Jobs Act, we recorded a provisional tax expense in Q4
- As expected, the IRS has issued subsequent guidance resulting in updates to these amounts
- As a result, we booked an additional tax expense of $217mm or $0.36 per share in Q1

- We expect further IRS updates throughout the year
- Also, we incurred an $897mm charge for the legal settlement, which amounted to $1.16 impact to EPS
  - This charge is reflected within Corporate and Unallocated

Earnings

- Excluding these impacts, first quarter earnings were $2.50 per share, an increase of 16% year-on-year
- Please note that the balance of my prepared remarks today will exclude the impact of both items on 2018 earnings

Sales Growth

- Please turn to slide 6 to review first quarter sales
- Sales growth in Q1 was 2.8% organically
- Selling prices increased 70BPS in Q1
- Excluding our Electronics businesses, selling prices were up 90BPS and were positive across all geographic areas
  - This marks our strongest underlying price performance in several years

U.S

- The net impact of acquisitions and divestitures contributed 70BPS to growth in the quarter
- In addition, foreign currency translation increased sales by 4.2 percentage points
- All in, first quarter sales in U.S. dollars increased 7.7% vs. last year
- In the U.S., organic growth was 2.3% with selling prices up 80BPS.
- Growth was led by Safety and Graphics and Consumer

EMEA

- EMEA was flat in Q1 with West Europe down 1%
- Asia Pacific delivered mid-single-digit organic growth, led by Safety and Graphics and Health Care
- Organic growth was 11% in China/Hong Kong
- Japan was flat or up 3% excluding Electronics

Organic Growth

- Finally, Q1 organic growth in Latin America/Canada was 3.5%, led by Health Care and Safety and Graphics
- At a country level, Canada and Brazil delivered organic growth of 5%, while Mexico was up 3%

P&L HIGHLIGHTS

Sales and Sales

- Please turn to slide 7 for Q1 P&L highlights
- Companywide, first quarter sales were $8.3B with operating income of $1.9B, up 9.3%
- First quarter operating margins were 23%, up 30BPS y-over-y

Margin Performance

- Let's take a closer look at the components of our margin performance in Q1
- Leverage on organic growth, productivity and lower year-on-year portfolio and footprint actions contributed a combined 120BPS to margins
- Acquisitions net of divestitures reduced margins by 40BPS
- Selling price benefits more than offset raw material inflation, adding 10BPS to operating margins
- Foreign currency net of hedging impacts reduced margins by 40BPS
- And higher retirement benefit costs decreased operating margins by 20BPS

EPS

- Let's now turn to slide 8 for a closer look at EPS
- First quarter earnings were $2.50 per share, up 16% y-over-y
- The benefits of organic growth, productivity and lower year-on-year portfolio and footprint actions added a combined $0.17 to per share earnings in the quarter
- Foreign currency impacts net of hedging added $0.05 per share
- Other expenses decreased earnings by $0.07 per share due to higher year-on-year net interest expense and retirement expense

Tax Rate

- Our underlying Q1 tax rate was 17.6%, in line with our expectations, which increased earnings by $0.18 per share
- The lower tax rate was driven by tax reform and continued benefits from our supply chain centers of expertise

CASH FLOW ITEMS

FCF

- Please turn to slide 9 for a look at our cash flow performance
- First quarter FCF was a minus $161mm, impacted by the legal settlement that I referred to earlier
- The net impact from the legal settlement and tax reform adjustment decreased FCF conversion by 72 percentage points

CapEx

- First quarter CapExs were $304mm, up $17mm year-on-year
- For the full year, we continue to anticipate CapEx investments in the range of $1.5B to $1.8B.

Dividend

- As Inge mentioned earlier, we increased our first quarter per share dividend by 16%, resulting in $810mm in cash dividends paid to shareholders during the quarter
- We also returned $937mm to shareholders through gross share repurchases
- With this in mind, we are increasing our full year range to $3B to $5B vs. $2B to $5B previously

Business Group Performance

INDUSTRIAL

- Let's now review our business group performance, starting with Industrial on slide 10
- The Industrial business group delivered first quarter sales of $3.1B, up 2.2% organically
- Within Industrial, growth was led by abrasives, up mid single-digits and industrial adhesives and tapes, up 3%
- Our automotive OEM business was up over 3%, outpacing growth in global car and light truck builds by over 400BPS
- In automotive aftermarket, we saw good growth in our products and solutions for retail car care, which was more than offset by softer demand from auto body shops

GEOGRAPHIC BASIS

- On a geographic basis, Industrial's organic growth was led by a 5% increase in Asia Pacific followed by low single-digit growth in both Latin America/Canada and the United States
- Industrial delivered first quarter operating income of $719mm, up 7.3% with an operating margin of 22.9%

Safety and Graphics

- Please turn to slide 11
- First quarter Safety and Graphics sales were up 6.9% organically to $1.8B with growth across all businesses and geographies
- Our personal safety business continued to post excellent growth, up double-digits in the quarter
    - This business continues to see strong global demand for our personal protective equipment across all end markets

Commercial Solutions and Roofing Granules Business

- The commercial solutions and roofing granules business were both up mid-single-digits
- Transportation safety also posted positive growth driven by our core sheeting and pavement marking segments
- In addition, this business recently won contracts with the State of California to upgrade their infrastructure and enable the roadway of the future
- Geographically, organic growth was led by high single-digit increases in both Asia Pacific and the U.S. with mid-single-digit growth in both EMEA and Latin America/Canada
- Operating income was $483mm and operating margins of 27.1%, up 140BPS year-on-year

Health Care Business

- Please turn to slide 12
- Our Health Care business generated first quarter sales of $1.5B, up 2.7% organically
- Growth was led by a high single-digit increase in both food safety and health information systems
- Our medical consumables business, which represents the largest segment within Health Care, posted mid-single-digit growth in Q1
- Oral care was flat with continued good growth internationally, particularly in developing economies, offset by softness in the U.S

Geographic Basis

- On a geographic basis, Asia Pacific led the way, up 8%, followed by 5% growth in Latin America/Canada
- We saw continued strength in developing markets, which were up 10% in the quarter, led by China/Hong Kong and Brazil
- Health Care's first quarter operating income increased 7% to $460mm, and operating margins were nearly 30%

Electronics and Energy

- Next, let's cover Electronics and Energy on slide 13
- Electronics and Energy organic sales growth was 1.7% in Q1
- Sales were $1.4B.
- The Electronics side of the business grew 3% organically including low double-digit growth in Electronics materials solutions
- Growth continues to be very strong in semiconductor manufacturing and data centers with robust demand for cooling fluids and interconnect solutions
- Partially offsetting this growth was a decline in display materials and systems due to softness in consumer electronics

TELECOMMUNICATIONS BUSINESS

- Our Energy-related businesses were down low single-digit organically with electrical markets flat and telecommunications down
- Please note we continue to expect to close on the sale of our telecommunications business later this year

GEOGRAPHIC BASIS

- On a geographic basis, organic growth was led by a 4% increase in Asia Pacific
- First quarter operating income for Electronics and Energy was $337mm with operating margins of 24.9%

Consumer

- Please turn to slide 14
- First quarter sales in Consumer were $1.1B, and organic growth was 2.1% year-on-year
- Our home improvement business grew high single-digits organically, building on its track record of strong performance over the past several years
- Home care also delivered positive growth in the quarter while consumer healthcare declined
- Looking at Consumer geographically, growth was led by a 4% increase in the U.S. followed by 3% growth in Latin America/Canada

FILTRETE AND POST-IT

- We continue to invest and expand our category leading brands such as Filtrete and Post-it
- During Q1, we launched the first ever Bluetooth-enabled Filtrete smart air filter
- We also launched Post-it Extreme notes which are designed to hold to rough surfaces even in challenging conditions

OPERATING INCOME

- Finally, operating income was $218mm with operating margins of 19.3%
- Operating margins were impacted by y-over-y portfolio and footprint actions along with the investments associated with the new product launches I previously mentioned
- For the year, we expect margins to be in the low 20s, similar to 2017
    - That wraps up our review of first quarter results

GUIDANCE

Organic Growth and Earnings

- Please turn to slide 15 and I'll review our updated 2018 guidance
- As Inge summarized in his opening remarks, we are updating our full year organic growth expectation to a range of 3% to 4% vs. previous guidance of 3% to 5%
- With respect to earnings, we now expect full year adjusted EPS to be in the range of $10.20 to $10.55 vs. a prior range of $10.20 to $10.70
- Our full year expectations for return on invested capital and FCF conversion remain unchanged

QUESTION AND ANSWER SECTION

Scott Davis
Melius Research LLC
Q

Is this Inge's last call that he's hosting before he becomes Chairman, the special new job thingy?

Inge G. Thulin
Chairman, President & Chief Executive Officer
A

No, it's not. I will be here in July as well. So I own the next quarter as well. So I'm not going away.

Scott Davis
Melius Research LLC
Q

Well, good. Well, we're glad to keep you or have you still around but...

Inge G. Thulin
Chairman, President & Chief Executive Officer
A

Well, thank you.

Scott Davis
Melius Research LLC
Q

Anyways, I've got two questions, and one just on the business and one really on secession. But first on the business, Electronics, is price decelerating in Electronics? Is there some sort of change in supply dynamic or supply demand dynamic or is it on the same, really, curve that it's been on now for several years?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President
A

Yeah, Scott, what we're seeing in price in the Electronics and Energy business, I'd say there's no discernible trend of it getting better or worse. It's typically a slight decline in price as we compete on the Electronics side of the business. We've been seeing that and we continue to expect that going forward, but not a trend of it accelerating down nor accelerating up. It's pretty constant, Scott.

Scott Davis
Melius Research LLC

Q

Right. And just as a follow-on, I mean, Inge, what has Mike Roman been working on? And what's the focus? Any early read on kind of CEO transition of what might change or be different?

Inge G. Thulin
Chairman, President & Chief Executive Officer

A

Yeah, Mike is here, so he will give some comments around that. He has a couple of comments. The transition is going very well. Mike and I – first of all, we have worked together for many years as you know. I think we – first time we worked together was back in Europe, early 2000s, I think 2003 or so. And then Mike was also working with me on the strategies that we laid out in 2012 and 2013. And currently, we talk every day, we text – I feel like we text every hour, and are totally aligned with what needs to be done. But he is here, so he should make some comments relative to his initial thought and so forth. But most importantly, he is very much focused on delivering Q2 together with all of us, and of course, also what he did in Q1. So, Mike, would you like to add some comments.

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, Scott, that's where I would start too. I'm focused on delivering 2018 starting with Q2 now. But over those 15 years, I've really enjoyed working with Inge, especially the last six years. I've been proud to be part of his leadership team that has helped advance the company, and we've accomplished a lot under his leadership. And so I would say, what I focus on is the things that we've been building, and really where we have a lot of similarities and our focus is on our playbook and the commitment to that playbook, including the opportunities we have in portfolio management, in the innovation and business transformation as we move ahead. So that's where the focus is right now.

Scott Davis
Melius Research LLC

Q

Okay. Well, good luck to you, Mike and Inge, I'm glad we got you for another quarter. So see you, guys.

Inge G. Thulin
Chairman, President & Chief Executive Officer

A

Okay.

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

See you.

Steven Winoker
UBS Securities LLC

Q

Just wanted to make sure I understood the reduction at the high end of guidance. Is that whole $0.15 just sort of high incrementals on the 1% reduction at the high end?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, Steve, the EPS change in guidance really is a result of what we're doing on the adjustment to our outlook for organic growth and really making that adjustment from 3% to 5% to 3% to 4% and doing that really focused on those businesses and markets where we saw some of the specific market softness as we came through Q1.

Steven Winoker
UBS Securities LLC

Q

Okay. And that market softness, mostly in this discussion what I heard sounds like, maybe a little more clarity around Western Europe, what's going on there in terms of what you're seeing on the short cycle side?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, if you look at West Europe, organic growth came in as expected, and I would stay – come back to what we talked about in the past that we're taking portfolio and footprint actions in West Europe to improve our growth in margins. And we're going to continue to do that. It's part of our plan and our focus on delivering on that 20% income margin by 2020, and so that's built in. We still see West Europe tracking with our expectations to be low single-digits.

Steven Winoker
UBS Securities LLC

Q

Okay. But then in that case, just broadly speaking, the weakest organic growth on the short cycle basis that you saw globally, can you just nail that down for us?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Well, I think we called out several specific markets, so automotive aftermarket, oral care, and I would say our consumer electronics is tracking as we expected as we come into the year.

Joe Ritchie
Goldman Sachs & Co. LLC

Q

Can we maybe talk on the organic growth guidance, the step down to 3% to 4%? We spent some time together in March. It still seems like the higher end of the range was going to be achievable for the year, so I'm just wondering from a near-term perspective, have things changed at all? Have things gotten off to a little bit of a slower start than originally expected in April?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Joe, I would take you back to March. We started to see the softness in Q1 coming through as we went through the month, and we signaled that. And it was, even at that point, it was specific to the market segments that we called out, and those played out as we thought they would through March. If you look at April, April is starting in line with our expectations, and so I think that the adjustment to the range was really looking at those specific markets that we saw coming through Q1. And we expect to see some improvement in a couple of those areas, but it's really – that's what's driving the adjustment.

Joe Ritchie
Goldman Sachs & Co. LLC

Q

Okay. Fair enough. If I were to maybe just touch on price cost for just a second, so clearly, pricing is coming through a little bit better-than-expected, but also from a cost inflation standpoint, it seems like it's a little bit more difficult this year to try to offset with substitute products. Maybe just an update on the expectations for the year for both pricing and also on the cost inflation side.

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Yeah, Joe, you're picking up on those two points accurately. We see ourselves as off to a good start with our selling prices with it up 70BPS and positive across all geographies. And for the year, we expect price growth to remain strong and that it will more than offset raw material inflation. But to that end on raw material inflation, we are seeing some increases in raw material prices, in fact, more than what we originally estimated when we gave the guidance back in December. It's particularly around crude derivatives and transportation and logistics expenses.

For the year, we're still expecting our stronger price growth to more than offset the raw materials. And if you think back to the guidance that we set out for raw materials, and this may answer a little bit of Steve's earlier question too, we started the year expecting raw materials, commodity prices to be about a push, somewhere between $0.05 benefit to $0.05 headwind, depending on net of the projects that we do to offset that. Right now, we see that somewhere between $0.05 to $0.10 headwind, so that's part of what we're seeing impacting our earnings for the year, but that's being more than offset by the higher pricing that we're now also expecting for the year.

Joe Ritchie
Goldman Sachs & Co. LLC

Q

That's helpful, Nick. Maybe one clarification there. Does the new like kind of $0.05 to $0.10 range, from a headwind perspective, does that include the increased freight cost as well?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Yes, it does.

Stephen Tusa
JPMorgan Securities LLC

Q

Congratulations to all on the announcements with management. So just could you give us maybe a little bit of color on how we're going to trend kind of over the course of the year from a growth perspective? I know that you had the Easter timing here in Q1, you had called out before. How does that play into second quarter? And then how do we – is there any lumpiness or volatility in growth in H2 as well around the third and Q4, high level?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Yeah, Steve, as I look out over the rest of the year, April, we're seeing off to a strong and expected start for us. So, as I look at the three remaining quarters of the year, I don't really see any discernible trend difference amongst those three. All of them coming in, in line now with our expected 3% to 4% organic growth for the year, I don't really see any lumpiness there.

Stephen Tusa
JPMorgan Securities LLC

Q

Okay. Is there anything that you think abnormally impacted the seasonality of Q1 here? Maybe, your – I mean, the price cost was still kind of neutral-ish. So I wouldn't think it would be price cost, but anything in the quarter here that depresses the result from a seasonal perspective?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Other than the one thing we mentioned with the timing of Easter, that's – as far as anything else seasonal, I don't think we see anything like that, Steve.

Andrew Kaplowitz
Citigroup Global Markets, Inc.

Q

So, in Health Care, growth has been solid over the last couple of quarters, but maybe a little below expectations. You mentioned oral care obviously has been – it was flat, a little weaker than the last couple of quarters. You did seem to outperform in oral care last year but kind of improved this year. What could get better in Health Care to reaccelerate as the year goes on? We know your long-term expectations for Health Care growth are above the high 2% range that you reported in the quarter.

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, thank you, Andy. You look at Health Care, we had good growth in our medical consumables business, our food safety, our health information systems businesses, and we expect that trend to continue as we go through the year. Oral care was flat. We did see good growth internationally, especially in developing economies, but that was offset by some softness in the U.S. So, if you look at that playing out, we expect to see some improvement there, but that is what's weighing down the organic growth in Q1. We also – our drug delivery business, as you know, is a project-based business, and that can be up and down quarter-to-quarter. And we saw Q1 down year-on-year against a strong comp that we had last year. So that was maybe more of a first quarter issue, but oral care flat was the real focus.

Andrew Kaplowitz
Citigroup Global Markets, Inc.

Q

Okay. And then maybe just shifting to Industrial, there, you did have relatively strong momentum in H2. You already talked about auto aftermarket slowing. What's interesting, obviously, is that you also mentioned last quarter you were pulling back on rebates in Industrial. And obviously, you had good pricing growth. Do you think that had anything to do with sort of the slowing in Industrial? Have you maybe overpriced at all in Industrial? And how do you look at it sort of going forward?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, as you heard, we had good growth in abrasives and industrial adhesives and tapes and auto OEM over build rates. And all of those were part of that price performance as well. So I think that's a broad part of our portfolio, and that didn't see any volume fall off because of price. In automotive aftermarket, which was the decline in Q1, we saw strong growth in our products and solutions for retail car care. It was really the declines in auto body, and so a very specific market. We saw no indications of a pull-in ahead of any price increases and really no changes. It was just a soft market for us as we went through the quarter. So it was really that. So I think we continue to see strong growth across the broader Industrial portfolio.

Andrew Kaplowitz
Citigroup Global Markets, Inc.

Q

Okay. And so you don't think it's share loss or anything like that aftermarket?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

No, we don't see any indication of that at all, Andy.

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Q

I think following up on Andy's line of questioning, obviously, you've got some decent price in the U.S., definitely Q1, I think it was slide 18, plus 80BPS there, but you did see some weakness. And if you think about your overall kind of formula for leveraging global IPI and having some decent strength in the U.S., don't you think it's fair to say you under-indexed in the U.S.? And don't you think it raises some questions that maybe some parts of your product portfolio you might be facing some level of commoditization, and consumer, and some consumer healthcare? How do you react to that aside from probably defiance?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

So, Rob, again, I go back to, we do see broad growth relative to those markets and overall economic backdrop. And so I think it's really isolated to specific market segments, and that's what we're seeing in the U.S. right now. And it's really been when you look broadly across the portfolio in the U.S., it's automotive aftermarket, it's oral care, and it's a couple of project-based businesses. We had some y-over-y comps with a couple of project-based businesses. Those are not price value kinds of changes.

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Q

And then just maybe coming at it a different way, obviously, your gross margin contracted y-over-y by about 60BPS, just any narrative there you can kind of give us in terms of mix price costs? What's going on there that's kind of the main driver if you look at slide 19 in terms of your Q1 P&L on a consolidated basis?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Rob, one of the bigger things in there that you may not be seeing visibility to is what FX is doing to our gross margin. Clearly, we get some benefit to our EPS from a weaker U.S. dollar, but that's partially offset by our hedging strategy that offsets some of our risk from FX. All of those hedging losses become part of our cost of goods sold. And that brought down gross margin in Q1 2018 as well is bringing down operating margin by 40BPS.

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Q

Should we think about that currency translation drop-through kind of like low teens? Is it like a 10% drop-through by definition of the rolling of the hedges and structurally? Or how do we think about the incremental margin coming from FX growth?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

The incremental margin. Rob, I haven't quite thought of it in that direction. Generally, what we...

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Q

Sorry, sorry. The drop-through from FX to the bottom line.

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Yeah, it will vary depending where we are in the cycle with FX movements. Right now, we're at a point where we're going against a comp a year ago where we were having hedging gains. Now we're having hedging losses with the weaker U.S. dollar. So it's not, I can't put out one metric like that because it will vary quarter-to-quarter.

Robert Paul McCarthy
Stifel, Nicolaus & Co., Inc.

Q

Well, I traffic an oversimplification.

Deane Dray
RBC Capital Markets LLC

Q

Just in terms of geographies, the China strength was impressive, up double-digits. Maybe give us a context about the end market drivers or the product drivers there. And part of the issue here, maybe there's just an overhang with all the headline news about trade war and protectionism and so forth is that if things came to a boil, any boycott of American brands would likely put 3mm at risk. And have you given any consideration to that potential development?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

So, Dean, I would say, we saw broad-based growth in China as you heard. And it was led again by our domestic-facing businesses. Talked a bit about the trend here and how we're taking advantage of that. So Health Care, personal safety, some of the domestic-facing parts of our Industrial businesses, industrial adhesives and tapes was a strong grower. We also are seeing continued strength in some key trends that are really taking advantage with our innovations. So air quality, water quality, food safety. And as we start the year, Electronics has been in line with the broader China growth, so broad-based growth led with a broader portfolio on the domestic businesses. When you look at the contingency plans for all the things that we can face in a particular market, part of it is our broader portfolio and how we think about it with our different customer set. But right now, we see, we're well-positioned with the China markets and the China customers to be in a good position, whatever the outcome is, or the outlook is for the economy there.

Deane Dray
RBC Capital Markets LLC

Q

Got it.

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Deane, this is Nick. Deane, I'll just add one thing. I think you're aware, our strategy in China has been we are putting local manufacturing there, that we manufacture within China for our Chinese customers. And that's – we think that's one other layer of protection we have in our strategy as we execute that in China.

Deane Dray
RBC Capital Markets LLC

Q

That's helpful. And then just as a follow-up, Nick, we see the increase in buybacks announced today. What's the expectation in terms of adding leverage? Beginning of the year, expected range of $1.5B to $4B being added, where do you expect to be on that range? And what kind of timing?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Deane, I am not updating the expected range on leverage. I would say M&A is the biggest variable on what that – where we'll end up with added leverage, and that's difficult to estimate the timing of that. The range we're seeing right now is our best estimate, the one we communicated in December. This adjustment in share buyback level doesn't impact our total estimated leverage that we expect to add for the year.

Julian Mitchell
Barclays Capital, Inc.

Q

Maybe just a first question on the sort of productivity aspect of the earnings or EPS roadmap that you'd laid out previously. If I look at that, you had maybe $0.60 or so in aggregate coming from portfolio and footprint business transformation and then productivity. So I just wondered in light of the raw material headwinds and also the shortfall on organic volume growth, if there was any increased urgency around extracting higher savings from productivity this year, whether just pulling some forward or increasing the amount for the year as a whole?

Nicholas C. Gangestad
Chief Financial Officer & Senior Vice President

A

Julian, for the year, we still estimate our productivity level at how we originally estimated that in December. Looking at first quarter with our margins in the underlying productivity, our margins at 23%, underlying productivity was positive, but for the year, we expect that to improve going forward. Our lower volumes in Q1, we think were one of the factors causing productivity to be slightly lower than what we're estimating for the total year, and as the year goes on, we're confident that we'll have productivity in the levels we estimated in December.

Julian Mitchell
Barclays Capital, Inc.

Q

Understood. Thank you. And then my follow-up would just be around the Electronics and Energy segment. Just trying to understand, you had guided, obviously, for a slow down there back at the end of 2017. We did see that slowdown very clearly manifest itself in Q1. So, as you look at the balance of the year, is there a sense that, that may start to accelerate from that Q1 low base as you move through 2018 or you think that the current growth rate is representative of the year?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, so I would say, Julian, that the outlook as we laid it out at the beginning of the year, it's playing out pretty much in line with that when you look at consumer electronics. We had strong growth in data centers and semiconductor markets and we see robust demand for our products, our fluid solutions, our interconnect solutions in those markets. And that's offset by that consumer electronics and the demand we see in those markets. But that's playing out as expected, and so we are right in our range for what we thought we would be doing as we come through the year.

Inge G. Thulin
Chairman, President & Chief Executive Officer

A

This is Inge. One more comment, yes, around that business group because I think it's important when you talk about volume going forward and so forth. You have to remind yourself – we have to remind ourselves the work that's been done there relative to the portfolio. So, if you go back many years ago now, we had tougher growth rate moving forward, we were really challenged on the margin side. And you can see now, quarter after quarter after quarter, and now a couple of years, that the structure is right and the relevance for the market is correct for us.

So the margins is now very positive for us and on a high end even for the enterprise and it's sustainable as we move ahead. And I think that's the important element of that business as part of 3mm. We manage that now very, very well despite some up and downs in volumes because we know there is some business there that is more volatile, right. But I think the portfolio work now has [indiscernible] (00:48:30) where we feel very, very good quarter-by-quarter in order to be able to deliver the return to you.

Julian Mitchell
Barclays Capital, Inc.

Q

Thanks, Inge. And maybe just on that point, would you characterize the sell-in and the sell-through in Electronics as being in good balance right now [indiscernible] (48:49)?

Inge G. Thulin
Chairman, President & Chief Executive Officer

A

Yes. It is.

Laurence Alexander
Jefferies LLC

Q

Two quick ones. Your comments were sprinkled with various end markets or various product lines that touched on construction. Is the traction that you're seeing there better spending or an increase in spending by your customers or is it innovation cycle on your side? And secondly, with respect to the litigation settlement, can you update us on where you are, what is outstanding, what you see as a timeline, if there are any issues to draw before we could reasonably expect to hear news of [ph] shoes, however small dropping (00:49:45)?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, so Laurence, on the construction side, so we continue to see strong growth from our home improvement business out of our Consumer business group. And that is – a big part of that is the construction, the growth we see in construction and the businesses that buy through that channel has been increasing and been big important part of that channel. It's a mix of strong growth in that market as well as the products that we are bringing to them. We put a lot of innovation into that part of our portfolio, have expanded it, and we position ourselves well for the growth that's coming in that end market.

Do you want...

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

So I'm sorry. So, Laurence, sorry, just on your second question, back to your second question on the follow-up to the NRD settlement, we are in the process of implementing the grant to the state, and we're working closely with the State of Minnesota as expected. We think we've got focus there and well positioned as we move ahead.

Laurence Alexander
Jefferies LLC

Q

And I guess maybe just to clarify, is that a precedent for other states or does it rule out any similar issues in other states? I mean just – there's been a lot of media mudslinging around different scenarios, most of which seem highly improbable. But maybe if you can just give your perspective on that.

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

No, this is a unique situation. Our home state and something that we've been working on with them for a number of years, so this is a unique situation in both the nature of the case as well as the grant and the process that we're working through with them.

Jeffrey Todd Sprague
Vertical Research Partners LLC

Q

Just two quick ones for me, if I could. Just back to the Consumer question. It is kind of interesting or perhaps concerning, some of the anecdotes you shared there. Do you see in your results potentially kind of a cracking in U.S. Consumer strength that perhaps is not readily apparent yet from a macroeconomic standpoint? Or do you actually think it is just some timing noise and other idiosyncratic things going on in couple of these channels?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

Yeah, Jeff, as you look at the U.S., that was actually one of the strengths of our Consumer business as we came through Q1. We saw stronger growth there, and as we talked about, it was led by home improvement, but our home care business was also positive. We continued to see some slight declines in our office channel, but it was broad-based, stronger growth in the U.S. markets. So, no, we're very much in line with the improvements in GDP and outlook for retail spending.

Jeffrey Todd Sprague
Vertical Research Partners LLC

Q

And then just very specifically on dental oral care, just kind of been a slog for you and Danaher others, all these kind of distribution changes and things going on. Do you see any opportunity there to change the business model, perhaps go direct, not go through these various distribution channels? Are you doing anything proactive there to maybe kind of reshape, reposition that business in any way?

Michael F. Roman
Chief Operating Officer & Executive Vice President

A

It's interesting. The channel for oral care has become more efficient over time. They've really changed how they manage it. You see that in a – maybe our balance in the channel and how our sell-in and sell-out is balanced in the channel. So we continue to work with I would say the changes that – kind of the constant change that's going on in our commerce channels more broadly. We see that across many of our businesses, oral care included. So I think that's – our focus always is creating new models to serve our customers. We're focused on those end use customers, and we work with our channel partners through their changes and really through new models that come as well. So we're focused on a broad range of strategies there and oral care and beyond.

Inge G. Thulin

Chairman, President & Chief Executive Officer

CLOSING REMARKS

- As I look at our first quarter performance, there are many positives
- Broad-based growth across all business groups, which included strong pricing, expanded margins, and a double-digit increase in EPS
- Equally important, we continue to evolve and build our enterprise for long-term success. 3mm is strong, and we have the experience, market position and capabilities to continue delivering sustained profitable growth in 2018 and well into the future.