

3M's Telecom Equipment Business Benefits from Telephone Industry Upgrades

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03/09/2001

KRTBN Knight-Ridder Tribune Business News: Saint Paul Pioneer Press - Minnesota

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The telecom revolution is going underground -- literally. And that's a good thing for **3M Co.**

As upstart telecom service companies rein in spending on the latest optical equipment amid a massive cash crunch, the stalwarts of the telephone industry -- including the offspring of Ma Bell -- are spending billions to upgrade their copper cable. That's putting a shine on 3M's telecom equipment business at a time when many optical equipment giants are slashing forecasts and laying off workers.

While many people recognize 3M mostly for its Post-it Notes and Scotch tape, the Maplewood industrial giant has been selling equipment to the telephone companies for 40 years, officials note. 3M is not immune to the spending slowdown that has pummeled many tech firms -- in fact, it sells complex components and specialty fibers to suffering tech titans like Nortel Networks and JDS Uniphase.

But it also sells equipment that lets big phone companies maintain, test and improve the more than 700 million installed lines of copper cable worldwide. 3M's diversity -- including products for less-glamorous copper cable in the ground and in the air -- is proving a huge asset. So is 3M's international reach.

"Our breadth is spread across three (industry) segments. Our markets are spread out geographically. Broadband is going gangbusters in Europe and Asia, with Deutsche Telekom and France Telecom investing a lot in plants," said Tom Bludau, strategic planning and analysis manager for 3M Telecom. Added Matt Fagan, a public relations manager: "We still have that slowdown, but there are other areas that keep it from stopping abruptly."

Even in the United States, where equipment spending has slowed most dramatically, Qwest, Verizon, SBC and others are improving their copper networks so they can sell DSL -- which offers high-speed Internet access -- to residential and small business customers. SBC's "project pronto," unveiled in 1999, commits \$6 billion to improvements in its network.

3M will get a slice of that business through its closures and connectors as well as its Dynatel testing equipment, a brand that's so ubiquitous, Fagan said, repair folks have made it a verb. "It's like, 'Go Dynatel that line,'" he said.

Overall, sales by 3M's so-called electro and communications markets group -- which accounted for 15 percent of overall revenue last year -- may slow some in 2001 from last year's pace, according to John Roberts, an analyst with Merrill Lynch. But he expects the division will still probably grow at a double-digit rate,

excluding acquisitions -- a solid showing in the current environment.

If 3M does manage that kind of growth in its high-tech businesses, it will be a vindication of sorts of the firm's strength-through-diversity strategy. Over the years, critics have said that, with 50,000 products in six major market segments, 3M was too unwieldy to turn in the kind of growth Wall Street demanded. With the real economy cooling, 3M's strategy suddenly looks more attractive.

3M's stock may even get a bounce as big institutional investors that sold their stakes in Cisco, Corning, Nortel and others look for places to put the money.

But the key will be delivering the results. And in the high-tech arena -- where 3M's growth has been the fastest -- things are ugly.

The most profound shift has come in the telecom equipment industry, which many last year thought would be immune to a downturn. The reasoning then was that the Internet would force a host of telecom service providers -- from upstarts backed by venture capitalists to big regional Bell companies -- to invest in more fiber and equipment to carry the traffic.

Using light waves, optical fiber can carry much more information than traditional copper wires. By adding devices called DWDMs, carriers break the light into different colors, or wavelengths, and cram still more information over the fiber. Between 1998 and 2000, spending on optical fiber nearly doubled, according to a new Telecommunications Industry Association report. DWDM sales rose more than 40 percent.

Now that torrid growth is slowing. Hundreds of upstart telecom companies, called CLECs, spent hundreds of millions of dollars to build rival networks only to find fierce competition for customers and reluctance by investors to continue funding big losses. Some have filed for bankruptcy, and others have cut back spending.

Big carriers, meanwhile, have cut capital spending plans. A Feb. 8 report from Merrill Lynch predicts modest growth overall in spending in 2001, but spending levels may fall in the first quarter.

That's forced layoffs at big optical equipment companies. Corning, which makes optical fibers, will lay off 825 people; Nortel will cut 10,000 jobs. The industry is still growing at enviable rates, just less than expected. Fiber optic sales are estimated to grow 13 percent in 2001, less than one-third of what it was last year.

3M hasn't been forced to cut staff in Austin, Texas, where the high-tech businesses are based, though it plans to not fill open jobs across the company to lower costs. But officials acknowledged that sales of products that go into DWDMs, like specialty fibers, are slowing.

The weakness in the telecom area is compounded by the fact that the semiconductor industry is also suffering. That slowdown is tied in large part to the drop in demand for personal computers and other consumer electronics products.

3M doesn't make computers, but it sells a lot of products to companies that are part of the computer industry, from films for laptop screens to chemicals for

manufacturing computer chips.

One of its big businesses is Microflex circuitry, a flexible tape with dense circuitry that allows for miniaturization of consumer products. The circuits are also sold to chipmakers who use it to create a better-protected integrated circuit "package" that then fits on a circuit board. Makers of computer disk-drives are also 3M customers. Its closest rival in Microflex is Innovex, based in Maple Plain.

Bill Murnane, president and chief executive officer of Innovex, said sales stalled in late January. In February, he and senior executives began thinking, "This is not a week or two slowdown, this is a little longer."

The problem? Demand. "I don't think anybody is holding a lot of inventory," said Murnane, whose firm this week announced it would not meet its expected sales in the current quarter. "I think demand is just slow."

Murnane figures 3M is feeling the same pinch, though 3M owns the market for flexible circuitry on print cartridges in ink jet printers, an area that may be less volatile. In its first-quarter report, Hewlett-Packard, a leader in the ink-jet market, said its imaging division was flat but sales remained strong for some products including color ink-jet printers. Fagan declined to discuss the division's performance directly. HP declined to be interviewed.

But the weak products in the 3M high-tech portfolio probably won't force 3M to issue revisions for its 2001 earnings, according to analysts. In part, that's due to the products that test and rehabilitate copper wires and high-tech products sold to less volatile industries such as utilities. It's also greatly helped by 3M's international reach. European and Asian carriers are investing heavily to bring DSL to customers, Bludau said. The electro and communications group gets more than half its sales from outside the United States.

Many of the big optical makers don't have that kind of international exposure, noted Shawn Narancich, a research analyst in the Portland office of D.A. Davidson & Co. Last year, Nortel got 61 percent of its sales from the United States. And 3M will benefit from the rebound of euro against the dollar.

"Keep in mind that the dollar has been weaker, so the money they're making overseas is worth more in dollars," he said. "That's been a drag on them in the past."

And since 3M has set a relatively low bar for revenue growth in 2001 -- just 5 percent excluding acquisitions -- the firm doesn't need tremendous growth in its U.S. businesses, said Peter Enderlin, an analyst at Ryan Beck.

"I figure the optical segment is 5 percent of total revenue, maybe not even that much," he said. "Given that some of the stuff is less high-tech, mundane components, they can probably avoid this pretty severe slowdown. Not avoid, but minimize it."