Q2 FY17 EARNINGS CALL COMMENTARY
NOVEMBER 22, 2016

Medtronic

Ryan Weispfenning
Thank you, Crystal. Good morning and welcome to Medtronic's second quarter conference call and webcast. During the next hour, Omar Ishrak, Medtronic Chairman and Chief Executive Officer, and Karen Parkhill, Medtronic Chief Financial Officer, will provide comments on the results of our fiscal year 2017 second quarter, which ended on October 28, 2016. After our prepared remarks, we will be happy to take your questions.

First, a few logistical comments: Earlier this morning, we issued a press release containing our financial statements and a revenue-by-division summary. We also issued an earnings presentation that provides additional details on our performance and outlook. You should note that many of the statements made during this call may be considered forward-looking statements, and that actual results might differ materially from those projected in any forward-looking statement. Additional information concerning factors that could cause actual results to differ is contained in our periodic reports and other filings that we make with the SEC, and we do not undertake to update any forward-looking statement. In addition, the reconciliations of any non-GAAP financial measures are available on our website, InvestorRelations.Medtronic.com. Unless we say otherwise, references to quarterly results increasing or decreasing are in comparison to the second quarter of fiscal year 2016, and all year-over-year growth rates and ranges are given on a constant currency basis, which adjusts for the effect of foreign currency. Other than as noted, our EPS growth and guidance does not include any charges or gains that would be recorded as non-GAAP adjustments to earnings during the fiscal year. These adjustment details can be found in the reconciliation tables included with our earnings press release. With that, I am now pleased to turn the call over to Medtronic Chairman and Chief Executive Officer, Omar Ishrak.

Omar Ishrak
Good morning and thank you, Ryan, and thank you to everyone for joining us. This morning, we reported second quarter revenue of $7.3 billion, representing growth of 3 percent. Q2 non-GAAP operating profit grew 9 percent, and non-GAAP diluted earnings per share were $1.12, growing at 15 percent and representing EPS leverage of 1,120 basis points.

Q2 revenue was disappointing and did not meet our expectations. We faced issues that affected our growth, including slower than expected revenue as we await new product introductions[1]. Despite this revenue shortfall, we produced a strong improvement in operating margins and double-digit earnings per share growth[2]. While some of the challenges that had an impact on revenue in Q2 could persist over the coming quarters, we remain confident in our ability to deliver mid-single digit revenue growth and double-digit EPS growth, not only in our current fiscal year, but on a sustained basis into the future[3].

Normally the diversity of our revenue base overcomes any quarterly challenges. However, there were enough unexpected and unrelated issues in Q2 to collectively affect our revenue and each of our growth vectors. Our New Therapies growth vector, which contributed approximately 195 basis points to our total company growth, not only just fell below our goal of 200 to 350 basis points, but was well below our trend and expectations, with the largest impact from CVG and Diabetes[4].

In CVG, revenue growth was 3 percent, below our targeted high-end of the mid-single digit range, and meaningfully below what we believe this business should be able to sustain. In our CRHF division, strong growth contributions from Diagnostics, Atrial Fibrillation, and our recently acquired HeartWare LVAD business were offset by weakness in our core cardiac rhythm implantables business, which declined in the low-single digits. While we continued to take share in the US ICD market, the market itself declined in the mid-single digits, driven by high-single digit market declines in high power device replacements. In the UK, our implantables revenue declined in the mid-teens, as the National Health Service is changing its procurement model to limit bulk purchases, causing a temporary disruption to normal buying patterns of the local trusts. We expect these pressures in CRHF to continue through the fiscal year.

Our CSH division was affected by transient market share losses due to the timing of new product cycles. For example, in the fast-growing TAVR market, we lacked – until recently – a large size version of our Evolut® R platform. And in drug-eluting stents, our new Resolute Onyx™ DES is not yet available in the US and Japan, driving declines in those markets to competitive DES products. However, at the end of this quarter, we did receive FDA approval for Evolut® R XL, which we expect to drive US growth in the back half of our fiscal year. In addition, we expect the introduction of Evolut® PRO and Resolute Onyx™ in the US around fiscal year end and Resolute Onyx™ in Japan in FY18.

In our APV division, solid mid-single digit growth was driven by our IN-PACT Admiral drug coated balloon, which continues to lead the market and drive mid-twenties growth. We expect this momentum to continue in the second half of our fiscal year.

Within our Diabetes Group, we were pleased with the earlier than expected FDA approval of the MiniMed® 670G, which not only represents revolutionary technology toward a long-awaited closed loop insulin pump system, but also has been received with strong enthusiasm among the diabetes community. However, the earlier-than-expected approval has created a bigger-than-expected gap between product approval and shipment. As a result, we created a Priority Access Program for the 630G, which offers upgrade priority to the 670G when launched. We are seeing strong demand for this program, primarily from early adopters. We do expect the majority of customers to wait to purchase the 670G product once it launches in the Spring of 2017. In addition to this dynamic, which is driving lower-than-expected pump and consumable sales, a portion of our 630G revenue is now deferred until receipt of the upgrade. Going forward, we expect some improved revenue growth for the remainder of this fiscal year. And, we expect Diabetes to ultimately return to double digit growth once the 670G is fully on the market next fiscal year.

Our Minimally Invasive Therapies Group grew 4 percent in Q2, consistent with our goal of mid-single digit revenue growth, driven primarily by our Open-to-MIS growth driver, including strong product sales of our recently launched Valleylab™ FT10 energy platform and continued performance of our Endo stapling specialty reloads. Surgical Solutions came in slightly below our expectations, primarily driven by the impact of competitive reprocessing of our Advanced Energy vessel sealing disposables in the US. We are confident in our ongoing strategies and new product launches designed to address this headwind. Looking ahead, MITG expects to launch more than 15 new products in the second half of the fiscal year to drive growth, including a new powered stapling platform called Signia and new vessel sealing enhancements. This pipeline gives us confidence that MITG can continue to grow in the mid-single digits in the back half of the fiscal year.

Next, our Restorative Therapies Group grew 3 percent this quarter, and our Spine division continued to show improvement. Overall Spine growth was 1 percent, our strongest growth in 7 quarters, as we gained global Spine share[5]. Our U.S. Spine business grew 3 percent, driven by continued adoption of INFUSE® and strong adoption of our "Speed-to-Scale" launches and "Surgical Synergy" strategy, resulting in share gains along with sales of our navigation and imaging equipment in Neurosurgery. RTG did suffer from a voluntary recall of certain Neurovascular products, which affected revenue. Some of these products will remain off the market in certain geographies for a period of time, but the most substantial impact of this recall is behind us as we bought back existing distributor inventory in Q2.

Across all of our groups, our product pipeline remains robust. We have important, new growth catalysts that we expect to lead to improved second half growth. Some of these products have already launched and others are coming to market in the coming months. We are confident we can drive sustainable growth of our New Therapies growth vector, and expect to be well within our 200 to 350 basis point goal in the back half of the year and over the longer-term.

Next, let's turn to Emerging Markets, which grew 10 percent and contributed approximately 120 basis points to our total company growth, slightly below our goal of 150 to 200 basis points. The primary driver was a shortfall in the Middle East, where our revenue declined in the mid-single digits, as governments are dealing with an increasing deficit affected by declining oil prices. In Saudi Arabia, the largest market in the region and where we have a strong market leadership position, our overall business declined by approximately 40 percent, mostly impacting our CRHF, Surgical Solutions, and Spine divisions. We expect continued pressure in the Middle East for the remainder of the year, but we also believe that the basic demand for our critical lifesaving therapies will eventually rebound strongly.

On the positive side, our businesses in South Asia, ASEAN, Eastern Europe, and Latin America all grew in the mid-teens or higher[6]. China, our largest emerging market, grew 11 percent with double-digit growth in MITG and Diabetes, and high-single digit growth in CVG and RTG. In South Asia, of which India is the largest market, we grew again in the low-twenties, with strong growth coming from key tender wins in MITG. In ASEAN, growth was broad-based, with double-digit growth in Thailand, Singapore, Vietnam, Indonesia, and the Philippines. In Eastern Europe, we grew over twenty percent in Russia as a result of strong momentum in CVG and MITG. Latin America also had strong, double-digit growth in Brazil, Colombia, Mexico, Chile, and Argentina, driven in part by new tender wins and continued channel optimization efforts. We expect current Emerging Market performance levels to be sustained in the back half of the year, and continue to believe strongly that the penetration of existing therapies into Emerging Markets represents the single largest opportunity in MedTech over the long-term.

Turning now to our third growth vector, Services & Solutions, which contributed approximately 20 basis points to Medtronic growth. While this overall result was below our goal of 40 to 60 basis points, Services & Solutions continues to achieve solid revenue growth, mostly from CVG-related offerings. We expect to further improve our growth contribution as new models are created and expanded across all our regions. We continue to see success in our Hospital Solutions business, through which we provide expertise in creating operational efficiency in both cath labs and operating rooms. We are also continuing to grow our chronic care models, including Diabeter for type 1 diabetes and NOK for morbid obesity, by pursuing global expansion opportunities. Finally, we formally launched our Orthopedic Solutions business earlier this month, a comprehensive program to help providers meet their CJR requirements in the US[7].

Before I turn the call over to Karen, let me reiterate that we are disappointed with our Q2 revenue performance. That said, we also believe that these headwind events were largely temporary in nature, and we remain confident in our ability to deliver mid-single digit revenue growth and double digit EPS growth for the full year. What should not be lost in this discussion is that, despite revenue challenges this quarter, our organization delivered strong improvements in operating margins, including improvements in our gross margin and SG&A, and met our goal of delivering double-digit EPS growth. Karen will now take you through a more detailed look at our second quarter financial results. Karen?

Karen Parkhill
Thank you, Omar.

Our second quarter revenue of 7 billion, 345 million dollars increased 4 percent as reported, or 3 percent on a constant currency basis. Foreign currency had a positive 50 million dollar impact on second quarter revenue, and acquisitions and divestitures contributed approximately 120 basis points net to revenue growth.

GAAP diluted earnings per share were 80 cents. Non-GAAP was $1.12. After adjusting for the 6 cent impact from foreign currency, non-GAAP diluted EPS grew 15 percent. Strong operating performance helped offset the revenue shortfall in the quarter. And, the majority of a tax benefit during the quarter was offset by a worse-than-expected impact of foreign exchange on earnings.

In addition to the 385 million dollar adjustment for amortization expense, non-GAAP adjustments to earnings on an after-tax basis were:

- a 24 million dollar charge for the HeartWare acquisition fair market value inventory step-up; and
- a 35 million dollar restructuring charge and a 2 million dollar charge for acquisition-related items, both stemming mostly from our continued integration of Covidien, along with expenses related to our acquisition of HeartWare, offset by a net gain from the adjustments of our contingent consideration on prior acquisitions.

Our operating margin for the quarter was 28.9 percent on a constant currency basis, representing a strong, 150 basis point year-over-year improvement. Efficiencies in both the gross margin and SG&A, largely a result of execution on our Covidien synergies, drove the increase. We remain on track to deliver 225 to 250 million dollars of synergy savings this fiscal year, and expect to deliver on our commitment of 850 million dollars of savings by the end of fiscal year 18. Our efforts to realize the Covidien synergies are also serving as enablers to other leverage programs designed to deliver additional long-term margin expansion.

Net Other Expense was 89 million dollars compared to 57 million dollars in the prior year, reflecting about 90 million dollars in reduced foreign exchange gains versus the prior year, primarily due to our hedging program, partially offset by a 48 million dollar reduction in the US Medical Device tax. While we hedge the majority of our operating results in developed market currencies to reduce earnings volatility from foreign exchange, FX can create modest volatility to the P&L above the operating margin line. In addition, a growing portion of our profits are unhedged, especially emerging market currencies, which can create modest volatility throughout the P&L.

Looking ahead, we remain committed to our plans to generate 130 to 210 basis points of improvement in our operating margin this fiscal year.

Below the operating profit line, Net Interest Expense was 173 million dollars. At the end of the second quarter, we had 32.4 billion dollars in debt and 11.3 billion dollars in cash and investments, of which approximately 6 billion dollars was "trapped".

Our non-GAAP nominal tax rate on a cash basis was 14.7 percent. This was an improvement to our forecast and included 42 million dollars of operational net tax benefits, primarily related to the write off of a deferred tax liability associated with the prior impairment of an investment in a foreign subsidiary. While we have had tax benefits in both Q1 and Q2, we continue to forecast a tax rate of approximately 17 percent for the second half of the fiscal year.

Free cash flow was 1.2 billion dollars. We are deploying our capital strategically, consistently, and with discipline, with a focus on reinvestment, debt reduction, and return to our shareholders. We paid 593 million dollars in dividends and repurchased a net 985 million dollars of our ordinary shares in the second quarter. This represented a total payout ratio of 101 percent on non-GAAP net income and 142 percent on GAAP net income. Keep in mind, our payout ratio is elevated as we not only return 50 percent of our annual free cash flow to shareholders, but also execute on our commitment to return 5 billion dollars through incremental share repurchases by the end of fiscal year 18. At quarter end, we had remaining authorization to repurchase approximately 39 million shares. Second quarter average daily shares outstanding, on a diluted basis, were 1 billion, 393 million shares.

Before turning the call back to Omar, let me conclude with our outlook. As Omar mentioned, we continue to expect to deliver mid-single digit revenue and double digit EPS growth this fiscal year. And, we expect our revenue growth to improve from the disappointing growth this past quarter. However, given the issues we outlined in the second quarter, some of which could persist in the near term, we now expect our full year revenue growth to be within the mid-single digit range on a constant currency, constant weeks basis, as opposed to the upper half of that range signaled previously.

Moving to the back half of the fiscal year, we expect revenue growth to also be in the mid-single digit range on a constant currency basis. With regard to our business groups, we continue to expect MITG to grow in the mid-single digits. And we expect RTG to grow in the low end of the mid-single digit range, ramping in the back half of the year. While we expect improvement from the headwinds faced in CVG and Diabetes in the second quarter, we recognize that, until some of our important new products officially launch, revenue growth is likely to continue to be affected. For that reason, in the back half of this fiscal year, we expect CVG to deliver mid-single digit and Diabetes to deliver mid- to high-single digit revenue growth. Keep in mind that CVG had a strong finish last fiscal year, so on an annual comparison basis, we expect slightly slower growth in the fourth quarter. And, because we do not expect the 670G to be on the market until the end of this fiscal year, we expect growth in Diabetes to ramp through the back half, with stronger growth in the fourth quarter than the third. We continue to expect Diabetes to ultimately reach double digit revenue growth, as signaled in the past, once the 670G is fully on the market next fiscal year.

While the impact from currency is fluid – and therefore not something we predict – if current exchange rates, which include a $1.06 Euro and 110 Yen, remain stable for the remainder of the fiscal year, we expect our full year revenue to be negatively affected by approximately 20 to 60 million dollars, including an approximate 10 to 30 million dollar negative impact in the third quarter.

With respect to earnings, we continue to expect to deliver double digit EPS growth on a constant currency, constant week basis for the full fiscal year. For the back half of the fiscal year, we expect non-GAAP diluted EPS growth to be in the 8 to 10 percent range on a constant currency basis, given slightly less-than-previously expected revenue, a more normal 17 percent expected tax rate, and the loss of the year-over-year benefit from a lower medical device tax starting in December. Taking into account the estimated 8 to 10 cent impact from the extra week in the first quarter last fiscal year, as well as an estimated negative foreign currency impact to our full year EPS of 20 to 22 cents if current exchange rates remain stable, this EPS growth implies full year non-GAAP diluted EPS of $4.55 to $4.60.

Lastly, we are modifying our free cash flow outlook methodology. Recall that last quarter, we were forecasting an adjusted free cash flow of 6.5 to 7 billion dollars for fiscal year 17, a range that would exclude cash payments related to non-GAAP items that might occur during the year. Going forward, we will include these items to more closely align our free cash flow projection with the results we report each quarter. However, in light of the unpredictability of the precise amount and timing of cash payments, we are expanding the range. Given this, along with the revenue and net income expectations already discussed, we expect our free cash flow for the fiscal year to be in the range of 5 to 6 billion dollars.

Now, I will return the call back to Omar.

Omar Ishrak

Thanks, Karen. We will open the lines for Q&A, but before we do, I wanted to reiterate what for me are the three key points about our Q2 performance:

- First, we are disappointed in our revenue performance this quarter. The issues that caused the shortfall are identifiable and in many cases temporary. As I mentioned, we have several new product introductions in the back half of the year that we expect to drive our revenue growth back to our normal range.
- Second, despite our revenue challenges, our organization delivered on operational discipline – including driving the expected Covidien synergies – which led to strong operating margin improvement and double-digit EPS growth[8].
- And third, looking ahead, we remain confident in our ability to deliver mid-single digit revenue growth and double digit EPS growth, not only in our current fiscal year, but on a sustained basis in the future.

And, as always, we remain focused on creating long-term, dependable value for our shareholders.

We will now open the phone lines for Q&A. In addition to Karen, I've asked Mike Coyle, President of our Cardiac and Vascular Group, Bryan Hanson, President of our Minimally Invasive Therapies Group, Geoff Martha, President of our Restorative Therapies Group, and Hooman Hakami, President of our Diabetes Group, to join us. We want to try to get to as many people as possible, so please help us by limiting yourself to only one question, and if necessary, a related follow-up. If you have additional questions, please contact Ryan and our Investor Relations team after the call. Operator, first question please.

Following Q&A:

Omar Ishrak
OK. Thanks for your questions. On behalf of our entire management team, I would like to thank you again for your continued support and interest in Medtronic, and for those of you in the US, I want to wish you and your families all a very Happy Thanksgiving. We look forward to updating you on our progress on our Q3 call, which we currently anticipate holding on Tuesday, February 21st. Thank you.