Q3 FY18
EARNINGS CALL COMMENTARY
FEBRUARY 20, 2018

Medtronic

Ryan Weispfenning
Thank you, Crystal. Good morning and welcome to Medtronic's third 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 third quarter, which ended on January 26, 2018. 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. During this earnings call, many of the statements made may be considered forward-looking statements, and 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 third quarter of fiscal year 2017, and rates and ranges are given on a comparable, constant currency basis, which adjusts for our recent Patient Care, DVT, and Nutritional Insufficiency divestiture, as well as the impact of foreign currency. These adjustment details can be found in the reconciliation tables included with our earnings press release. Finally, other than as noted, our EPS growth and guidance does not include any charges or gains that would be reported as non-GAAP adjustments to earnings during the fiscal year. With that, I am now pleased to turn the call over to Medtronic Chairman and Chief Executive Officer, Omar Ishrak.

Omar Ishrak
Good morning. Thank you, Ryan, and thank you to everyone for joining us. This morning, we reported our third quarter financial results, including revenue of $7.4 billion, representing growth of 7 percent. Q3 non-GAAP operating profit grew 8 percent, and non-GAAP diluted earnings per share were $1.17, growing 12 percent and representing EPS leverage of 580 basis points.

These results reflect a solid quarter for Medtronic, and as we expected, a strong turnaround from the first half of our fiscal year[1]. We continue to execute on our broad, sustainable growth strategy, driving therapy innovation and global market penetration, while delivering enterprise synergies to enable margin improvement.

Each of our four groups delivered strong results, with mid-single digit revenue growth in MITG and RTG, high-single digit growth in CVG, and low-teens growth in Diabetes. Geographically, we also had a strong, diversified performance, with mid-single digit growth in the US and non-US developed markets, and low-double digit growth in Emerging Markets[2].

At the same time, we completed our $850 million Covidien synergy commitment[3]. We recently launched a new program – Enterprise Excellence – designed to increase our effectiveness and enable reinvestment for growth, along with driving continued margin expansion and EPS leverage[4]. As we look ahead, we are confident in our ability to deliver meaningful EPS leverage on mid-single digit revenue growth this fiscal year, just as we have for the past five fiscal years.

In therapy innovation, we are seeing a clear acceleration, driven by several important new product launches across our four groups, as well as our strong positions in some of the fastest growing therapies in MedTech.

Our Cardiac & Vascular Group grew 7 percent again this quarter, delivering sustained growth by leveraging the breadth of its products and services, as well as its strong positions in important, rapidly expanding markets. CVG's impressive new products in infection control, diagnostics, transcatheter pacemakers, and AF solutions generated combined growth in the mid-twenties and now represent about a third of our Cardiac Rhythm & Heart Failure division. Mid-teens growth in our Coronary & Structural Heart division was led by the launch of our Resolute Onyx™ drug-eluting stent in the US and Japan, as well as our high growth transcatheter valve business. In TAVR, we grew in the low-thirties, with mid-twenties growth in the US and low-forties growth in international markets, driven by strong global demand for our Evolut® PRO valve and expanded indications for use.

Our Minimally Invasive Therapies Group grew 6 percent, driven by 7 percent growth in Surgical Innovations, with strength in new products, including our Signia™ powered surgical stapling system, our new LigaSure™ vessel sealing instruments, and our Valleylab™ FT10 energy platform.

Respiratory, Gastrointestinal, and Renal grew 3 percent, driven by broad based growth in GI & Hepatology, strength in Nellcor™ pulse oximetry sensors given the high incidence of flu in the US, and strong adoption of our MicroStream™ capnography monitoring products. This offset a decline in our Airway and Ventilation business.

We are enthusiastic about the development of our surgical robotics platform, which we expect will strengthen our strategy of advancing minimally invasive procedures, and we continue to make progress toward its launch. While we had intended first clinical use in humans in the next couple of months, our final software and hardware integration and testing is taking longer than we initially expected; this is not unusual with systems of this complexity. We are excited about the product performance that we are already seeing and intend to update timelines as we near commercial launch. At our Investor Day in June, we intend to share incremental details on our system, and update you on our progress. As we have mentioned before, the expectation of meaningful revenue from this system will be dependent on regulatory approval in developed markets. Regardless, we remain confident in our ability to grow MITG in mid-single digits next year and over the longer term.

Our Restorative Therapies Group grew 5 percent this quarter, with robust growth in our Brain and Pain divisions. In Brain, the strength of our entire stroke portfolio drove high-teens growth in Neurovascular, and strong sales of our StealthStation® navigation and O-arm® imaging technologies led to low-double digit growth in Neurosurgery. In Pain, we are seeing very positive customer reaction from our Intellis™ platform and our Evolve℠ workflow algorithm, which together drove high-single digit growth, reversing the declines we have experienced for several quarters.

While our Spine division was flat this quarter, it was in line with the global spine market. Growth in BMP continued to offset declines in Core Spine. Also, when coupling our Spine revenue with the Spine enabling technologies that are reported in our Neurosurgery business, our combined revenue grew over 1 percent. We believe this is a more relevant comparison of our Spine results against our competition, and an indication of our overall growth in Spine procedures. We attribute this growth to the ongoing success of our Surgical Synergy strategy, which combines our enabling technologies – such as imaging, navigation, powered instruments, nerve monitoring, and Mazor robotics – with our spine implants to deliver integrated procedures.

As expected, Diabetes returned to double digit growth this quarter, driven by continued adoption of our MiniMed® 670G hybrid closed loop system in the US. We now have over 20 thousand patients on our 670G system and continue to receive highly positive feedback from patients on this groundbreaking technology, with real world results consistent with those reported in our pivotal study.

Our growth was further enhanced by strong international demand for our 640G system. Our sensor attachment rates with all of our 6-series systems globally remain strong, and as we continue to shift our customer base from stand-alone pumps to sensor-augmented systems, we expect sensors to be a key component of our growth. Our efforts to increase our sensor capacity are progressing well. We are now able to meet the sensor demand of our existing customer base, and remain on track to fully meet our predicted demand from both existing and new users in the fourth quarter. In addition, we benefited in the quarter from consumable revenue from legacy Animas users, and the transition of Animas users to Medtronic continued to progress well.

We are also excited about the prospects of our standalone CGM system, Guardian® Connect. Outside the US, we see strong utilization and retention of patients on the system, and with the expected increase in our sensor manufacturing capacity, we are preparing to increase our customer base. In the US, we have been closely collaborating with the FDA and expect to bring this innovative technology to market shortly. Guardian®

Connect features unique predictive alerts and, in the US, will utilize Sugar.IQ™ with the cognitive computing capability of IBM Watson to detect important patterns and trends for people with diabetes.

Turning now to our Globalization growth strategy. Emerging markets, which represent 15 percent of our revenue, again grew 12 percent, in line with our long-term double-digit growth expectations. Our consistent emerging market performance continues to benefit from geographic diversification, with strong, balanced results around the globe[5]. Southeast Asia, Eastern Europe, Latin America, the Middle East & Africa, and China all grew double digits. In addition to investing in traditional market development, our differentiated strategies of participating in public and private partnerships, as well as optimizing our distribution channels, are driving our sustained performance. Emerging Markets represent the single largest opportunity in MedTech.

Our remaining growth strategy, Economic Value, is a real accelerator for our therapy innovation and globalization strategies. We are pleased with our continued progress in creating new, value-based business models that directly link our therapies to improving outcomes. We now have over 1,000 hospitals under contract, and over 25 percent of our US CRHF implantables revenue is covered under a TYRX®-related value-based healthcare arrangement that links total payment to patient infection outcomes. Beyond TYRX®, we have also commercialized five other value-based healthcare programs, covering various therapies including ICDs, CRTs, AF ablation, drug-coated balloons and aortic stent grafts, where a portion of our payment is tied to specific patient outcomes. Collectively, these five programs, in addition to TYRX®, cover over $650 million in mostly US-based device revenue.

Across Medtronic, we remain focused on leading the shift to healthcare payment systems that reward value and improved patient outcomes over volume. We are increasingly partnering with additional stakeholders in the healthcare value chain, including payers, providers, and other interested organizations, to lead the change from fee-for-service models to value-based programs. It is our strong belief that Medtronic is uniquely positioned to leverage our global technical, clinical, and disease state expertise to deliver better outcomes to patients while improving efficiency for healthcare systems around the world[6]. And, we are doing this in a way that we expect to benefit our shareholders as well.

With that, let me ask Karen to now take you through a discussion of our third quarter financials and outlook for the remainder of the fiscal year. Karen?

Karen Parkhill

Thank you, Omar.

As mentioned, our third quarter revenue of 7 billion, 369 million dollars represented a 1 percent increase as reported, and growth of 7 percent on a comparable, constant currency basis, which adjusts for both foreign currency and the Patient Care, DVT, and Nutritional

Insufficiency divestiture. Foreign currency had a positive 177 million dollar impact on third quarter revenue.

GAAP diluted loss per share was a dollar, 3 cents. Non-GAAP earnings per share were a dollar, 17 cents. After adjusting for the divestiture and the 1 cent negative impact from foreign currency, non-GAAP diluted EPS grew 12 percent.

The majority of our non-GAAP adjustments were driven by a 2.2 billion dollar tax charge primarily related to the transition tax on our accumulated foreign earnings as part of US tax reform. This tax will be paid over the next 8 years, with less of a cash impact in the first 5 years.

Medtronic has been advocating for US tax reform for many years, and we are pleased that the final package included the ability to gain access to our future earnings outside the United States. We now will have access to the vast majority of our cash flow, and we expect to deploy it with discipline, in accordance with our capital allocation strategy of balancing reinvestment for future growth and providing meaningful returns for our shareholders.

The operating margin for the quarter was 28.8 percent on a comparable, constant currency basis, representing a year-over-year improvement of 30 basis points. This was primarily driven by a 40 basis point improvement in SG&A.

As announced last month, we reached our goal of delivering 850 million dollars of synergies from the Covidien acquisition. We also unveiled our Enterprise Excellence plan that is expected to deliver over 3 billion dollars in annual gross run-rate savings over the next 5 years. We expect this to enable reinvestment for future growth, as well as drive continued operating margin expansion and EPS leverage.

Non-GAAP Net Other Expense, which is included in our operating margin, was 94 million dollars versus 20 million dollars on a comparable basis in the prior year. The change was driven primarily by increased expense related to our currency hedging program.

Foreign exchange in total had an approximate 90 basis point negative impact on our operating margin. This was more than expected given currency market volatility in the last month of our quarter, which resulted in a large foreign exchange impact on our inventory in late January, as well as increased expense due to net balance sheet remeasurement on certain foreign currency denominated balances. These were also the primary reason for the mismatch between the FX benefit on our revenue and FX headwind on EPS.

Our third quarter non-GAAP nominal tax rate was 15.6 percent. Based on our current estimates of the impact of US tax reform, we continue to expect our fourth quarter tax rate to be between 15 and 16 percent.

Third quarter average daily shares outstanding, on a non-GAAP diluted basis, were 1 billion, 365 million shares. As expected, this was roughly flat sequentially. And we expect our share count to remain roughly flat for the remainder of the fiscal year. Combining our 1.6 billion dollars of year-to-date share repurchase activity with the 1.9 billion dollars we paid in dividends over the same period, our total payout ratio was 76 percent on non-GAAP net income.

Before turning the call back to Omar, I would like to reiterate our annual revenue and EPS growth guidance. Unless specified, all of my guidance comments are comparable, constant currency.

For the full fiscal year, we continue to expect revenue growth to be in the range of 4 to 5 percent, and non-GAAP diluted earnings per share to grow in the range of 9 to 10 percent from the prior year comparable of $4.37.

For the fourth quarter, we would expect total company revenue growth to be in the range of 4.5 to 5.5 percent. Looking at the expected fourth quarter revenue growth by our business groups:

- We expect CVG to deliver 4.5 to 5.5 percent growth, and MITG to grow in the range of 3 to 3.5 percent, both driven by continued strength from new products amidst more difficult fourth quarter comparisons.
- We expect RTG to grow in the range of 3 to 4 percent, balancing the impact of a slower spine market with continued growth in Pain Therapies and strength in Brain Therapies.
- Finally, in our Diabetes Group, as we have been forecasting for some time, we expect double digit growth in the fourth quarter given increased sensor supply and the strength of the 670G launch in the United States.

With respect to earnings, we delivered strong EPS leverage in the third quarter, and we expect this to continue in the fourth, with EPS growth of 11 to 13 percent off the prior year comparable of $1.25.

While the impact from currency is fluid – and therefore not something we forecast – if recent exchange rates remain stable for the fiscal year:

- Our full year revenue would be positively affected by approximately 480 to 500 million dollars, including an approximate 300 to 320 million dollar tailwind in the fourth quarter;
- Our full year operating margin would be negatively affected by approximately 70 basis points, including approximately 150 basis points in the fourth quarter; and
- Our full year EPS would be negatively affected by approximately 4 cents, including a negative impact of approximately 2 cents in the fourth quarter.

Keep in mind the effect of FX on revenue, margin, and EPS can differ due to the magnitude of the year-over-year change in expense related to our currency hedging program along with the timing difference of FX in cost of goods sold reflecting inventory turns on our balance sheet.

While we intend to give our fiscal year 19 guidance on our fourth quarter earnings call in May, the fiscal year 19 commentary that I provided on last quarter's earnings call still stands. Also, while we expect to continue to drive operating margin improvement and EPS leverage, keep in mind the following headwinds to our projected EPS growth:

- We expect less interest income reflecting planned positioning of our investments for greater flexibility and liquidity in support of capital allocation;
- We will anniversary the full year benefit from the accounting change on stock-based compensation; and
- We expect to begin to transition services related to our divestiture to Cardinal Health, eliminating the income in the back half of the fiscal year.

Combined, this could amount to a few hundred basis points headwind to EPS growth, which we will be working to partially offset.

In addition, given recent changes to exchange rates, if current exchange rates remain stable through next fiscal year, we would now expect an approximate 500 million dollar positive impact to fiscal year 19 revenue and over ten cents of benefit to EPS.

Finally, I would like to note that we plan to hold our biennial Institutional Investor and Analyst Day on Tuesday, June 5th, in New York City.

Now I will return the call back to Omar.

Omar Ishrak
Thanks, Karen.

To conclude, Q3 was a solid quarter where our innovation and technology, strong positions in the fastest growing markets in MedTech, and enterprise synergies produced solid returns. We have driven a strong turnaround from our first half results, and we remain confident in our ability to deliver mid-single digit revenue growth and meaningful EPS leverage, this fiscal year and beyond. We expect this to lead to robust free cash flow generation that we can deploy with discipline.

Finally, we remain keenly focused on executing to deliver dependable results for you, our shareholders, as we continue to leverage our global diversification and scale to fulfill our Mission of alleviating pain, restoring health, and extending life for millions of people around the world.

Let's now open the phone lines for Q&A. In addition to Karen, I've asked Mike Coyle, President of CVG, Bob White, President of MITG, Geoff Martha, President of RTG, 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. We look forward to updating you on our progress and the results of our full year on our Q4 call, which we currently anticipate holding on Thursday, May 24th. Thank you.