# Q2 FY18
# EARNINGS CALL COMMENTARY
NOVEMBER 21, 2017

Final

Medtronic

**Ryan Weispfenning**
Thank you, Krystal. 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 second quarter, which ended on October 27, 2017. 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 second 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 second quarter financial results, including revenue of $7.1 billion. Non-GAAP diluted earnings per share were $1.07, growing 2 percent, or 5 percent after adjusting for the approximate 3 cent impact from Hurricane Maria.

These financial results are very encouraging, when considered in the context of a quarter in which we faced three hurricanes and the California wildfires. Hurricane Maria, in particular, significantly affected our manufacturing operations in Puerto Rico. The lives of thousands of our employees were affected by these natural disasters. Yet the resiliency, dedication, and persistence of our team to overcome these challenges was remarkable.[1]

Against this backdrop, which resulted in not only a quantifiable impact to our quarter, but also an unquantifiable impact from the disruption to our teams, we delivered 3 percent comparable, constant currency revenue growth, or 4 percent excluding the direct impact from Hurricane Maria. Our performance continues to be driven by our growth strategies of therapy innovation, globalization, and economic value.

In therapy innovation, as I noted last quarter, we have entered a period of clear acceleration in our innovation cycle. We are seeing increased revenue momentum from several important new product launches, which we expect will continue into the second half of the fiscal year.[2] In Q2, organic growth in our Cardiac & Vascular Group was 6 percent, a sequential improvement of approximately 340 basis points and the main driver of our total company organic growth acceleration.

Overall, CVG grew 7 percent year-over-year, leveraging the breadth of its products and services, as well as its strong positions in important, rapidly expanding markets to drive sustainable growth. In CRHF, which grew in the mid-single digits, we are maintaining market share in the core pacing, ICD, and CRT product lines, while creating new markets that are meaningfully enhancing our weighted average market growth. This past quarter, combined revenue from our high growth CRHF product lines, representing about a third of our CRHF business, grew organically in the mid-twenties. Specifically, these product lines included our infection control, diagnostics, transcatheter pacemakers, AF Solutions, and mechanical circulatory support systems.

Similarly, our CSH business is shifting its revenue mix toward the higher growth transcatheter valve market, which now represents about one third of total CSH revenues. In TAVR, we delivered low-forties growth in the US and high-thirties growth in international markets, as we see both strong adoption around the world for our recently introduced Evolut® PRO valve, as well as expansion into additional US TAVR centers and US share capture resulting from our new intermediate risk indication. In Coronary, our DES product line returned to growth as we gained low- to mid-single digits points of market share sequentially in both the US and Japan, driven by the recent launch of our Resolute Onyx™ in these markets.

Next, our Minimally Invasive Therapies Group grew 2 percent, less than initially expected given the impact from Hurricane Maria. In Surgical Innovations, our 4 percent growth was driven by new products in Advanced Stapling and Advanced Energy. In Advanced Stapling, growth was driven by our endo stapling specialty reloads with Tri-Staple™ technology, as well as Signia™, our new, single-handed powered surgical stapling system that provides surgeons with real-time feedback during surgery. And in Advanced Energy, we experienced strong growth, as we continue to rollout new LigaSure™ instruments and our Valleylab™ FT10 energy platform.

These innovations are providing momentum to the transition from open surgical procedures to minimally invasive surgery, or MIS, resulting in better patient outcomes and lower healthcare costs. As we look ahead, we see the opportunity to expand the availability of MIS procedures through the use of our surgical robot platform. The development team continues to drive toward first-in-human use by the end of this fiscal year. We look forward to offering a more comprehensive value proposition to our customers across all key surgical areas: open surgery, traditional MIS, robotic surgery, and services.[3]

Next, our Restorative Therapies Group grew 2 percent this quarter, less than initially expected given the impact of Hurricane Maria. Our Brain Therapies division had a very strong quarter with 13 percent growth. This was driven by high-twenties growth in Neurovascular, with strength across the entire stroke portfolio, and mid-teens growth in Neurosurgery.

Our Spine division declined 1 percent, a reflection of the hurricane impact as well as a continued modest deceleration in the global spine market. Excluding the impact of Hurricane Maria, our Core Spine business performed better than the market.[4] We attribute this to the ongoing success of our "Speed-to-Scale" product launch initiative, as well as our Surgical Synergy strategy, which combines our enabling technologies – such as imaging, navigation, power instruments, nerve monitoring, and now Mazor robotics – with our spine implants to deliver integrated procedures. In fact, the combination of our enabling technologies, which are reported in our Neurosurgery business, with our Spine revenue, resulted in 2 percent growth in Q2. We believe this is an indication of our overall growth in Spine procedures and a more relevant comparison of our Spine results against several of our competitors.

Our Pain Therapies division recently received FDA approval and CE Mark for our Intellis™ spinal cord stimulator. While the initial rollout was affected by Hurricane Maria, the product has been received positively by our customers, and we do expect Intellis™ to reverse the declines we have been experiencing for several quarters in the Pain Stim business. Finally, the FDA lifted its distribution requirements on our implantable drug pump last month, and its warning letter earlier this month. The warning letter had affected not only our Pain Therapies division, but also our Brain Modulation and Pelvic Health businesses.

Turning to Diabetes, revenue growth declined 2 percent, better than we had anticipated due to strong demand from patients willing to purchase the MiniMed® 670G pump ahead of the paired CGM sensors. Although sensor supply constraints hampered overall growth, our ability to meet increasing patient demand has improved, and our sensor capacity expansion plans are on track.

Last month, JNJ announced that they are exiting the insulin pump market, and we were pleased that they selected us as their partner-of-choice to facilitate the transition of their Animas patients. While the majority of the approximately 90,000 existing Animas patients are currently under warranty, we are actively working to ensure their smooth transition to Medtronic, should they elect to do so.

Looking ahead, we expect Diabetes revenue growth to increase in the third fiscal quarter, now that we have finished shipping pumps for the Priority

Access Program, and then continue to accelerate when we complete our sensor capacity expansion in the fourth fiscal quarter. In addition, our Diabetes innovation pipeline remains robust across all three of its divisions.[5] We are preparing for the international launch of the 670G and the U.S. launch of our stand-alone CGM system, Guardian® Connect with Sugar.IQ™, both later this fiscal year, and our new Professional CGM, iPro®3, in FY19.

Next, let's turn to our Globalization growth strategy. Emerging markets again grew 12 percent this quarter, in line with our long-term double-digit growth expectations as we continue to expand access to our products and services around the world.[6] Latin America grew 18 percent, with Brazil, our largest market in the region, growing in the mid-twenties. We continue to drive our channel optimization strategy in Latin America, expanding our direct operations.

In the Middle East & Africa, we grew 13 percent, as recovery in the region continues with strong growth in Saudi Arabia and Turkey. Southeast Asia grew 12 percent, with strength in our Spine, Brain Therapies, and Coronary & Structural Heart divisions.

Greater China also grew 12 percent, with high-teens growth in RTG, mid-teens growth in MITG, and low-double digit growth in CVG. We have been outperforming the China market now for the past few years, and believe we can continue this momentum over the coming quarters.

Let's turn now to our third growth strategy, Economic Value. As mentioned previously, we are seeing strong growth in our TYRX® value-based program for infection control in implantable devices, nearly tripling the accounts under contract in the quarter to over 900 hospitals. This past quarter, over 20 percent of our US CRHF implantables revenue was covered under a TYRX-related value-based healthcare arrangement that links total payment to patient infection outcomes. In the past two quarters, we have rolled out additional value-based programs in CVG, linking payment to improved patient outcomes that result directly from our innovative therapies. Specifically, as part of these programs, a portion of our payment is tied to reducing re-interventions when using our AF ablation, AAA, and DCB therapies, and reducing re-hospitalizations when using our ICD, CRT, and AF ablation technologies.

We are aggressively developing other unique, value-based solutions across each of our groups and regions. We remain focused on leading the shift to healthcare payment systems that reward value and improved patient outcomes over volume.[7] We are increasingly partnering with additional stakeholders in the healthcare value chain, as we believe medical technology has a key role to play in delivering better outcomes while improving efficiency for healthcare systems. As always, we expect to do this in a way that benefits patients and healthcare systems – as well as our shareholders.

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

**Karen Parkhill**
Thank you.

As Omar mentioned, our second quarter revenue of 7 billion, 50 million dollars represented a 4 percent decrease as reported, and growth of approximately 3.4 percent on a comparable, constant currency basis, or 4.3 percent when further adjusting for Hurricane Maria. Foreign currency had a positive 35 million dollar impact on second quarter revenue. And tuck-in acquisitions contributed approximately 30 basis points to revenue growth.

While all four of our groups have some level of manufacturing in Puerto Rico, the direct financial impact of Hurricane Maria was limited to MITG and RTG. As Omar mentioned, through the hard work and determination of many colleagues, we utilized alternate manufacturing sites, directed field inventory movement, and ultimately were able to restore operations more quickly than anticipated.

GAAP diluted earnings per share were a dollar, 48 cents. Non-GAAP was a dollar, 7 cents. After adjusting for the divestiture, the 1 cent positive impact from foreign currency, and 3 cent negative impact from Hurricane Maria, non-GAAP diluted EPS grew 5 percent.

The operating margin for the quarter was 26.6 percent on a comparable, constant currency basis, representing a year-over-year decline of 100 basis points. As expected, our operating margin declined in the quarter as we supported new product launches and experienced the temporary impact of lighter revenue in our Diabetes Group. In addition, the infusion set recall in Diabetes and impact of Hurricane Maria further affected our second quarter operating margin.

Despite the net decline, we continue to deliver on our Covidien synergies, and expect to reach our goal of delivering 850 million dollars of synergies this fiscal year. As we have mentioned in the past, we expect to continue our focus on margin improvement, even after delivery of the synergies, and intend to provide detail on those ongoing activities in the near future.

Non-GAAP Net Other Expense, which is included in our operating margin, was 96 million dollars compared to 65 million in the prior year, and negatively affected our operating margin by 20 basis points on a comparable, constant currency basis. The change was impacted by increased expense related to our currency hedging program, as well as a prior year gain from our equity investment in HeartWare. Looking ahead, we expect Net Other Expense to be approximately 75 million dollars per quarter, including approximately 20 to 30 million dollars net per quarter related to our currency hedging program based on recent exchange rates.

Our non-GAAP nominal tax rate was 15 percent, better than initially expected given the year-to-date impact of our recent divestiture on our annual tax rate. We now expect our tax rate to be between 15 and 16 percent for the remainder of the year.

Second quarter average daily shares outstanding, on a diluted basis, were 1 billion, 366 million shares. We repurchased a net 568 million dollars of our ordinary shares in the second quarter. As we enter the second half of the fiscal year, we continue to expect shares to stay roughly flat. Combining our share repurchase activity with the 622 million dollars we paid in dividends in the second quarter, our total payout ratio was 82 percent on non-GAAP net income and 59 percent on 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. This would imply second half growth of approximately 4.5 to 6.5 percent, a range we would expect for both the third and fourth quarters.

Looking at full year revenue growth by our business groups:

- Given the strength of its new products, we continue to expect CVG to grow in the range of 5.5 to 7 percent, with growth weighted to the third quarter due to more favorable prior year comparisons.
- For MITG, we now expect growth to be in the range of 3 to 3.5 percent, given the lower growth in the first half due in part to Hurricane Maria. This implies accelerated second half growth of 3.5 to 4.5 percent, which is consistent with our prior guidance range.
- We continue to expect RTG to grow approximately 3 percent, balancing the impact of Hurricane Maria and a spine market that is flat to slightly down with continued strength in Brain Therapies.
- Finally, in our Diabetes Group, we expect growth to significantly improve in the second half, given the completion of the Priority Access Program, as well as an expected increase in sensor supply by the fourth quarter, resulting in mid- to high-single digit growth for the full year.

Regarding margins for the remainder of the year… we expect our gross margin to be roughly flat year-over-year and our operating margin to reflect improvement in the third quarter and stronger improvement – of over 100 basis points – in the fourth quarter.

With respect to earnings, we continue to expect non-GAAP diluted earnings per share to grow in the range of 9 to 10 percent. As I have previously noted, we expect EPS growth to accelerate in the back half of the fiscal year and would expect third quarter EPS growth to be at the midpoint to upper end of the annual 9 to 10 percent range.

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 275 to 375 million dollars, including an approximate 155 to 175 million dollar tailwind in the third quarter;
- Our third and fourth quarter operating margins would be negatively affected by approximately 50 to 100 basis points, with the fourth quarter impact greater than the third; and

- Our full year EPS would be affected by approximately negative 2 cents, including a positive impact of approximately 1 cent in the third 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.

Regarding free cash flow, we continue to expect it to grow in the high-single digits, compounded annually, from fiscal year 16 to 18, on a comparable basis given the divestiture, which removes the tax and transaction costs, as well as the loss of free cash flow generated by the divested businesses.

Lastly, while we intend to give our fiscal year 19 guidance on our fourth quarter earnings call in May, I know that many of you are starting to think about your forward models. At this point, I would encourage you to keep in mind our longer term mid-single digit revenue growth outlook as well as our long-range plans to drive continued operating margin expansion. While CVG is expected to ease back into mid-single digit growth next fiscal year given prior year comparisons, we are expecting MITG and RTG to grow in the mid-single digits and Diabetes to deliver double-digit growth. We intend to give our fiscal year 19 growth guidance on a comparable basis that excludes the impact of the divestiture from the first quarter of fiscal year 18 and has the effect of lowering the base revenue by approximately 550 million dollars and EPS by approximately 7 cents. It is also worth noting that if current exchange rates remain stable through next fiscal year, we would expect a positive impact to revenue – up to 100 million dollars – and a slightly positive impact on EPS.

Now I will return the call back to Omar.

**Omar Ishrak**
Thanks, Karen.

I would like to conclude by noting that I realize that our shareholders are expecting consistent execution and reliable results from Medtronic. Know that your management team and board expect the same. Over the past few quarters, our performance has been affected by some extraordinary events, which have masked the improving overall fundamentals of our business. That said, we aspire to be a company that can manage through even extraordinary events – similar to those we have recently faced – so we are keenly focused on solid execution as well as leveraging our diversification and scale around the world to deliver dependable results for our shareholders.

Let's now open the phone lines for Q&A. In addition to Karen, I've asked Mike Coyle, President of CVG, Bryan Hanson, 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, 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 20th. Thank you.