Q1 FY20 EARNINGS CALL COMMENTARY

AUGUST 20, 2019

Medtronic

Ryan Weispfenning

Thank you. Good morning and welcome to Medtronic's fiscal year 2020 first 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 first quarter, which ended on July 26, 2019. 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 today's earnings call, many of the statements made may be considered forward-looking statements, and actual results may 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.
- For this call, unless we say otherwise, rates and ranges are given on a constant currency basis, which compares to the first quarter of fiscal year 2019 after adjusting for foreign currency. References to "organic" revenue growth exclude the impact of material acquisitions and currency. Reconciliations of these, and all non-GAAP financial measures, can be found in the attachment to our earnings press release or on our website at InvestorRelations.Medtronic.com.
- Finally, our EPS 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?

Omar Ishrak

Thank you, Ryan, and thank you to everyone for joining us.

This morning, we reported solid quarterly results, and we are off to a good start to the fiscal year. Despite tough comparisons, we delivered revenue growth, operating margin, and EPS all ahead of Street expectations. Q1 revenue grew 3.5% constant currency, with outperformances in CVG, MITG, and RTG, while Diabetes matched our expectations. This reflects the success in the market of our innovation and the benefit of our business and geographic diversification.

Our adjusted operating margin expanded 90 basis points including currency and 70 basis points constant currency, as we continue to see the benefits of our Enterprise Excellence initiatives, particularly on the SG&A line. On the bottom line, we grew diluted EPS 7.7%, or 9.4% at constant currency, despite a 230 basis point headwind on EPS growth from the increase in our non-GAAP nominal tax rate.

Let's discuss some of the more important drivers of our performance, starting with our Minimally Invasive Therapies Group, which delivered another strong quarter and surpassed our expectations, growing 4.8%. Through diversifying our sterilization supplier network, we overcame the challenges related to a supplier's sterilization facility shutdown in February, returning to full sterilization capacity during the quarter. In Surgical Innovations, Advanced Stapling grew mid-single digits and Advanced Energy high-single digits. This was driven by new innovations in our Tri-Staple™ and Ligasure™ franchises, including our new EEA™ circular stapler with Tri-Staple™ technology and our Ligasure™ Exact dissector. Respiratory, GI, and Renal also had a strong quarter, led by double digit growth in GI Solutions and mid-single digit growth in Respiratory & Patient Monitoring.

In CVG, we grew 1.4%, which was ahead of our expectations. CVG's growth continues to be tempered by challenges in drug-coated balloons, LVADs, as well as CRM replacement devices, given the longer-life batteries we launched several years ago. Regarding DCBs, we are encouraged by our better-than-expected performance, as our case volume increased following the FDA panel in June. We were also encouraged by the path forward outlined by the FDA in their letter to physicians earlier this month.

In CRHF, our Pacing business is strong, growing 5%, as our disruptive innovation, the Micra™ single chamber transcatheter pacing system, is taking share and expanding the market. Our U.S. single chamber pacemaker share is now over 65%, with our revenue share over 80%. In TAVR, we saw both the market and our growth accelerate to the mid-teens in Q1 on the back of the Low Risk data presentations at ACC. CMS published the final TAVR NCD memo in June, and we expect this will result in approximately 200 new TAVR centers in the U.S. We are already in active negotiations with about half of these centers, which are ready to start, as we aim to become their preferred partner in TAVR devices.

In CVG, it is also worth noting the double digit growth contributions from our Valiant Navion™ thoracic stent graft, our VenaSeal™ closure system, and also our TYRX™ absorbable antibacterial envelope, which continued to accelerate post the WRAP-IT data presentation at ACC. In addition, both our Reveal LINQ™ insertable cardiac monitor and Arctic Front™ cryoablation products grew in the high-single digits.

In Diabetes, we grew 5.4%. And, this was despite our U.S. business declining mid-single digits, because of competitive challenges and the difficult comparisons versus the prior year when our U.S. business grew 33%. Our International business, which represents approximately half of our Diabetes revenue, grew 20%. The MiniMed™ 670G, which drove strong growth in the U.S. last year, is now experiencing that same strong consumer demand internationally as we launch into new markets. We now have approximately 200 thousand people using the 670G system globally. In addition, we experienced strong adoption of the Guardian™ Connect Smart CGM system, which grew in the high-80s.

In RTG, we had another strong quarter, growing 4.6%, as we successfully offset declines in our Pain Therapies business. Our Brain business continues to deliver exceptional results, growing 11.4%, with strength in both Neurovascular and Neurosurgery. In Neurovascular, we grew in the mid-teens; our market leading share improving through the strong adoption of our recently launched Solitaire™ X stent retriever, as well as our Riptide™ aspiration system and React™ catheters.

In Neurosurgery, our capital equipment sales continue to be robust. This is led by our Mazor X™ Stealth navigated robotic system, which not only is meaningfully outpacing the competition, but is also resulting in strong pull-through of our other market-leading and differentiated capital equipment. Sales of our StealthStation™ navigation system grew over 20% this quarter, and our O-arm™ surgical imaging system grew close to 30%.

In Q1, our organic Spine revenue growth was the highest in 9 quarters. In addition, when you combine our Spine division sales with the sales of our capital equipment from our Brain Therapies division used in Spine surgery – our Spine division grew 4.7%, with our U.S. Spine business growing at 6.0%. This is how our competitors report, and it represents a strong indication that our strategy of offering our enabling capital equipment with our spine implants is working, as we are growing well above the Spine market growth.

Now, turning to Emerging Markets, which represents 16 percent of our revenue. We continue to drive strong growth in these markets as we optimize the distribution channel, and in some markets, localize R&D and manufacturing. In Q1, we grew Emerging Markets 12%, with strength coming from markets around the globe. China grew 11%, Eastern Europe 23%, including 28% growth in Russia, and the Middle East & Africa grew 15%. In addition, South Asia grew 13%, Southeast Asia 12%, and Latin America grew 9%. Our strategy of emerging market diversification around the world is working, as evidenced by our consistent delivery of double digit growth every quarter, overcoming economic cycles over the years in these different countries.

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As a result of this quarter's outperformance and confidence in our outlook, we raised EPS guidance this morning. Q1 was clearly a good quarter, despite several headwinds and otherwise tough comparisons. As we look forward, we're <u>even more excited</u> about what lies ahead, as we expect the investments we've made in our pipeline to begin to pay off with multiple pipeline catalysts, accelerating revenue growth, and value creation for our shareholders.

In CVG, upcoming launches include a TAVR Low Risk indication, which we just received last week, our next-generation Evolut® Pro Plus TAVR valve, and our DCB AV Fistula indication. CVG also has several launches coming up in CRHF, including the Reveal LINQ 2.0 insertable cardiac monitor, the DiamondTemp™ ablation system in Europe, and our Micra® AV pacemaker.

In MITG, we are excited to host analysts in Hartford next month at one of the world's leading robotic centers, where the analysts will experience a robotic assisted surgical procedure that is part of our development and clinical testing process using our soft tissue robotics system.

In RTG, we are launching the Midas Rex™ MR8™ drill platform this quarter, and continue to advance our Pelvic Health pipeline having started the regulatory approval process for InterStim® II with MRI recharge-free system and our InterStim® Micro with MRI, which is 3cc in volume and rechargeable. We expect to launch both of these products next spring. In addition, we have next-generation products in Neurovascular and Spinal Cord Stimulation, all of which are launching or preparing to launch in the next couple of quarters.

In Diabetes, we've submitted our non-adjunctive labeling application to the FDA, and we're preparing for the launch of the MiniMed™ 780G, our Advanced Hybrid Closed-Loop System with Bluetooth connectivity, in the second half of this fiscal year. We are also making good progress on our pivotal trial for Zeus, our next-generation iCGM sensor that will reduce fingersticks by 95%.

There are, of course, several more product launches that we are preparing for across the company. I won't cover them all today, but I will say that we are making great progress across the portfolio, and we'll keep you updated as we progress through this fiscal year.

And I'll leave you with what I noted last quarter, that we expect our growth rate to accelerate over the course of FY20, with the second half growing faster than the first, as we anniversary recent headwinds, and bring multiple new products to market over the next several quarters. Moreover, we expect our topline momentum to build in FY21, with each of our four groups having the potential to accelerate revenue growth next fiscal year, as we get the increasing benefit of the FY20 product launches, as well as the benefit from the products slated to launch in FY21.

Let me now ask Karen to take you through a discussion of our first quarter financials. Karen?

Karen Parkhill
Thank you.

As Omar mentioned, we delivered first quarter revenue growth of 3.5 percent, and adjusted EPS was a dollar, 26, growing 7.7 percent. While we came in 8 cents above the midpoint of our guidance, it's worth noting that 2 cents resulted from better than expected FX, which – at current rates – we'll give back over the balance of the year. The other 6 cents was operational outperformance, including better than expected revenue and operating margin expansion and a modest benefit from tax.

Our adjusted operating margin was 28.2 percent, reflecting improvement of 90 basis points with currency or 70 basis points constant currency. We delivered a very strong improvement in SG&A, as we continue to implement and drive efficiencies and improvements across the company under our Enterprise Excellence program. In addition, we are seeing the benefits of the recent inclusion of operating margin as a component of our annual incentive plans across our groups and regions, which is driving increased focus on this important metric across the organization.

In the first quarter, we successfully executed a 5 billion Euro debt offering and used the proceeds to reduce U.S. dollar denominated debt. This followed the similar 7 billion Euro transaction we executed in the fourth quarter. The combined 12 billion Euro issuances carry a weighted average coupon of less than 1 percent. The result of the combined fourth and first quarter transactions is an annualized reduction to our net interest expense of over 300 million dollars, a savings that will benefit Medtronic for years to come.

Our adjusted nominal tax rate was 15.1 percent, lower than expected, due to the increased benefits associated with the finalization of taxes owed on certain returns and changes in operational results by jurisdiction.

Generating strong free cash flow remains a priority across the company. First quarter free cash flow was 1.2 billion dollars. We continue to target an 80% conversion rate – above our peer average – over our long-range plan.

We remain committed to disciplined capital deployment, balancing investment in R&D and tuck-in acquisitions, with returning a minimum of 50 percent of our annual Free Cash Flow to our shareholders in the form of dividends and net share repurchases. In the first quarter, we returned over 800 million dollars, or 70 percent of the cash we generated, resulting in a total shareholder payout of 50 percent on adjusted net earnings.

We also increased our dividend by 8 percent in June, making this our 42nd consecutive year delivering a dividend increase. In fact, our dividend has grown by 77 percent over the past 5 years.

Before turning the call back to Omar, I would like to update our annual revenue growth and EPS guidance.

For the fiscal year, we continue to expect organic revenue growth to be approximately 4 percent. While the impact of currency is fluid, if recent exchange rates hold, foreign currency would have a negative impact on full year revenue growth of approximately 80 to 120 basis points.

Looking at annual organic growth by group, we now expect CVG to grow 2.5 percent, a 50 basis point increase from our prior expectation of 2 percent, plus or minus. For RTG, we continue to expect growth of 4 to 4.5 percent, and for Diabetes, we're comfortable at the lower end of our 6 to 8 percent range. Finally, for MITG, we now expect growth of 5.0 percent, an increase versus our prior expectation of 4.5 to 5.0 percent.

We expect our second quarter organic revenue growth to look similar to the first quarter, with currency having a negative impact of 70 to 130 basis points at recent rates. By group, we expect organic growth in CVG and RTG to look similar to the first quarter, for Diabetes to grow low-single digits as we await new product launches, and for MITG growth to accelerate to 5.5 to 5.75 percent, driven by new products. And, as I noted last quarter, we continue to expect our total company organic revenue growth to accelerate north of 4 percent in the second half of the fiscal year.

Turning to margins, we continue to expect operating margin expansion in the full fiscal year of approximately 40 basis points on a constant currency basis, driven by our Enterprise Excellence initiatives. For the second quarter, we would expect a more modest improvement in operating margin, offset by a slight currency headwind, as we invest ahead of multiple new product launches.

Given our recent Euro debt offerings that I mentioned earlier, we expect our non-GAAP interest expense to be in the range of 170 to 180 million dollars per quarter for the remainder of the year. In addition, we continue to expect our adjusted nominal tax rate to be in the range of 16 to 16.5 percent per quarter for the remainder of the year, which, when combined with our Q1 non-recurring benefit, would imply an annual range of 15.8 to 16.2 percent. We remain focused on optimizing our underlying operating tax rate over time as U.S. tax reform regulations are finalized.

With respect to earnings, we are increasing our fiscal year 20 EPS guidance to a range of $5.54 to $5.60, a 10 cent raise from the prior range of $5.44 to $5.50. This includes a negative 10 cent impact of currency at recent rates, with a slightly worse impact over the balance of the year offsetting a better than expected benefit in the first quarter. For the second quarter, we expect EPS of $1.27 to $1.29, including a 2 cent currency headwind at recent rates.

Now I will return the call back to Omar.

Omar Ishrak

Thanks, Karen. Let's now move on to Q&A. In addition to Karen, our four group presidents, Mike Coyle, Bob White, Geoff Martha, and Hooman Hakami, are also here to answer your questions. We want to try to get to as many questions as possible, so please help us by limiting yourself to 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 on our Q2 earnings call, which we currently anticipate holding on Tuesday, November 19th. Thank you.