

Q2 FY23 Earnings call commentary



[Ryan Weispenning](#)

Good morning. I'm Ryan Weispenning, Vice President and Head of Medtronic Investor Relations, and welcome to snowy Minneapolis. I appreciate that you're joining us today for Medtronic's fiscal year 2023 second quarter earnings video webcast.

Before we go inside to hear our prepared remarks, I'll share a few details about today's webcast:

- Joining me are Geoff Martha, Medtronic Chairman and Chief Executive Officer and Karen Parkhill, Medtronic Chief Financial Officer. Geoff and Karen will provide comments on the results of our second quarter, which ended on October 28, 2022, as well as our outlook for the remainder of the fiscal year. After our prepared remarks, the Executive VPs for each of our four segments will join us, and we'll take questions from the sellside analysts that cover the company. Today's program should last about an hour.
- Earlier this morning, we issued a press release containing our financial statements and divisional and geographic revenue summaries. We also posted an earnings presentation that provides additional details on our performance. The presentation can be accessed in our earnings press release or on our website at InvestorRelations.Medtronic.com.
- During today's program, many of the statements we make 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.

- Unless we say otherwise, all comparisons are on a year-over-year basis, and revenue comparisons are made on an organic basis, which excludes the impact of foreign currency and revenue from our Q1 acquisition of Intersect ENT.
- References to sequential revenue changes compare to the first quarter of fiscal '23 and are made on an "as reported" basis, and all references to share gains or losses refer to revenue share in the third calendar quarter of 2022 compared to third calendar quarter of 2021, unless otherwise stated.
- Reconciliations of all non-GAAP financial measures can be found in our earnings press release or on our website at InvestorRelations.Medtronic.com.
- And 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, let's head into the studio and hear about the quarter.

OPENING VIDEO TRANSITION

[Geoff Martha](#)

Introduction and Key Messages

Hello everyone and thank you for joining us today as we discuss our Q2 results and outlook. Our Q2 organic constant currency revenue growth of 2.2% came in about a point below expectations due to a slower than expected recovery in both procedure volumes in certain markets and in our supply chain. In terms of reported revenue, the continued strength of the dollar over the course of the quarter drove over half of the difference to expectations. Now despite the topline results, we were able to control expenses and deliver EPS at the high end of our guidance range.

We also issued guidance for the back half of our fiscal year this morning. We expect continued acceleration in our organic revenue growth in the second half, although less than previously anticipated, and this partially flows through to EPS. Now this is something that I don't take lightly. Delivering on our expectations is important to building and maintaining trust and credibility with you. Karen will walk you through the details, but some of our markets and our some of our supply constraints recovered more slowly than we expected in the quarter, and that, along with incremental China volume-based procurements, led us to reduce our expectations.

While the current operating environment remains challenging, we had strong growth in several businesses and geographies where our strategy, our operating model, and execution are yielding solid results. We have near-term product catalysts in our pipeline. We are decisively allocating capital internally and selectively making focused acquisitions. We're making improvements to the operational health of the company. And we're streamlining the company structure and taking cost out. All of this gives us confidence that we're on the path to creating durable growth and shareholder value.

Q2 Challenges

Now, diving deeper into our Q2 results. For reported revenue, as I said earlier, currency drove over half the miss to consensus. Organically, the miss was primarily split evenly between two challenges: one, procedure volumes in some markets have been slower to return to normal levels. And two, some of our supply challenges have persisted longer than we anticipated.

With regard to procedure volumes, in addition to an incremental China VBP, we are still seeing lower volumes in elective coronary PCI, GI procedures, TAVR, spinal cord stim, and some less emergent surgical procedures. The slower than anticipated recovery in procedure volumes primarily occurred in developed markets, as healthcare systems continue to work through staffing and other challenges.

Now with regard to supply, we've made meaningful recovery and many of the most acute issues are now behind us including the acute packaging issues, which we highlighted last quarter. But some of the improvements did come later than we expected in Q2. And as a result, we missed cases in businesses like Surgical Innovations, and it has delayed our expected momentum.

Q2 Bright Spots

Now focusing beyond challenges impacting our markets and product availability, we have a number of businesses where our strategy and execution are yielding results. Recall that when we moved to the new operating model two years ago, we created highly focused, accountable, and empowered operating units that could move with greater speed and decisiveness. And today, we're clearly seeing the benefit of this model across many of our businesses.

Starting with Cranial & Spinal Technologies... CST grew 5%, and this is despite a large negative impact from China VBP. In fact, our US Core Spine business grew 15%. Additionally this quarter, we launched our spine technology ecosystem, which we call Aible™, at the NASS conference. From planning, to our best-in-class implants, to navigation and robotic assistance, to intraoperative imaging and surgical tools, up to and including patient follow up, Aible™ brings spinal surgery together, in one seamless and connected platform.

And another highlight was our Structural Heart business, where our TAVR business grew 15% globally, including 17% in the United States. The launch of our Evolut™ FX valve drove 18% sequential revenue growth in our US TAVR business, despite being at full market launch for only the last month of the quarter. So, we expect Evolut™ FX to drive momentum for us over the coming quarters.

Our Cardiac Rhythm Management business continues to execute and win share, with 4% growth in this quarter. Within CRM, our Pacing business grew 6%, well above the market, with 18% growth of our Micra™ family of leadless pacemakers. And we're

looking forward to the commercial introduction of our Aurora™ EV-ICD in the back half of this fiscal year.

Businesses we're improving

So while we have businesses where the changes we've made over the past couple of years are clearly having a positive impact, we're also focused on ensuring these efforts translate into improved performance in all of our businesses. It's worth highlighting a few businesses where we are making strong progress to drive future growth over the near- to mid-term, and some that already have immediate momentum.

Let's take Cardiac Ablation Solutions, a business that we expect to be a strong future growth driver. Pulsed field ablation represents a large market opportunity, and we're looking forward to seeing our PULSED AF pivotal trial results in the first half of next calendar year, putting us on the path to be one of the first companies with a PFA catheter in the US market, which we think is underappreciated. This is a meaningful growth opportunity for Medtronic in the next 18 to 24 months. And as you know, we closed our acquisition of Affera in August, and Affera's differentiated mapping and navigation system gives us the breadth and differentiation that we need to win share in cardiac ablation. And we expect to complete enrollment this quarter in the pivotal. This fully integrated system will be the first of its kind to offer a unique catheter that can perform high-density mapping and deliver both pulse-field and radiofrequency ablation in a single device.

Now in Diabetes, we remain focused on resolving our warning letter. We've now completed 100% of our warning letter commitments and have informed the FDA that we're ready for reinspection. We also remain in active review with the FDA on our submission of the MiniMed™ 780G system with the Guardian™ 4 sensor. And outside the US, we continue to receive positive customer feedback on the performance of the 780G, which is now available in over 60 countries. In Q2, 780G drove mid-teens growth for our Diabetes business in International markets. And

across Diabetes, we're investing heavily in the development of multiple next-generation insulin delivery and sensor technologies. And we remain focused on restoring strong growth to this important franchise over the coming years.

Turning to our Hugo™ surgical robot... now I'm sure we're going to get into this in Q&A, but we saw a lot of positive momentum this quarter as we scale manufacturing production, expand regulatory approvals, and ramp installations. In addition, we just received FDA IDE approval last week on our product enhancements. Now this allows us to start our US urology clinical trial by the end of the calendar year, and is a catalyst for continued progress with our international sales.

Now before I talk about capital allocation and portfolio management, let me share my thoughts on the RDN opportunity. Despite the impact we believe COVID and medication changes had on the ambulatory endpoint in ON MED, the totality of the data is compelling. The large drop in office blood pressure in the RDN arm was impressive, and it was consistent with what we've seen in our other trials. Importantly, the current standard of care for reducing blood pressure, it just isn't working, which was evident in the long-term SPRINT trial results published just last month in JAMA Cardiology. Patients don't seem to stay on multi-drug therapy for long periods of time and eventually just stop taking their medications. And that's the advantage of RDN - it's always on. We've demonstrated that our RDN procedure, it's safe, it's effective, and it's durable. Physicians are excited, and RDN is preferred by patients. Now we've submitted our PMA to the FDA, and we are looking forward to working with governments and payers in the US and around the world who are searching for improvements to control high blood pressure and avoid the costly and devastating consequences of this disease.

Capital allocation and portfolio management

In addition to advancing our pipeline, we're focused on decisively allocating capital and streamlining the company to deliver durable growth. We're freeing up resources to invest more in R&D, feeding our fast-growing businesses and areas where we see

the strongest returns. Cardiac Ablation Solutions and Diabetes are two clear examples of this. We're also making moves with our portfolio to focus our company and our capital on opportunities that are better aligned with our long-term growth acceleration strategies. Over the past two quarters, we've announced our intent to separate three businesses that we believe will thrive outside the company.

With our Renal Care Solutions business, we're progressing on the separation, forming a new kidney health technology company, together with DaVita. We continue to expect this transaction to close in calendar 2023. And last month, we announced our intention to separate our combined Patient Monitoring and Respiratory Interventions business.

We remain focused on active portfolio management, evaluating both potential additions and subtractions to further accelerate our growth and create value for our shareholders.

Now with that, I'll turn it over to Karen to discuss our second quarter financial performance and our guidance. Karen?

Karen Parkhill

Thank you, Geoff.

Q2 Financial Recap

Our second quarter organic revenue increased 2.2%, up significantly from Q1 but below our guidance range given the challenges Geoff mentioned. Yet with a focus on expenses, our adjusted EPS of \$1.30 landed at the upper end of our guidance range. Currency had a significantly unfavorable impact of 5.8% on our reported revenue growth. Our FX hedges mitigated that impact on the bottom line with EPS down only 1 cent, or 80 basis points, from currency.

Looking at our results from a geographic perspective, our US revenue grew 1%, our Non-US Developed increased 3%, and Emerging Markets grew 4%. Our Emerging Markets growth continued to be affected by China, which declined 9% given the impact of a national tender in our spine business and several provincial tenders in certain other businesses. However, we continue to see strong, double-digit growth in our other markets, including mid-twenties growth in Eastern Europe and mid-teens growth in Latin America. In fact, excluding China, our Emerging Markets grew 15%.

Turning to our margins, our adjusted gross margin of 67.6% declined 120 basis points from inflationary pressures in materials, direct labor, freight, and utilities. We expect these inflationary pressures to continue, and to impact the back half of this fiscal year more than what we experienced in the first half.

Our adjusted operating margin of 26.6% declined 40 basis points, including a 120 basis point benefit from our currency hedging program. Compared to the first quarter, our operating margin improved 270 basis points, given accelerated revenue growth. We expect sequential improvement throughout the fiscal year.

We continue to maintain a strong balance sheet. I would note that the vast majority of our debt is fixed at low rates as we move into a higher rate environment. Regarding our capital allocation, we continue to balance investing for the future with returning capital to shareholders. And we remain committed to our dividend and to returning a minimum of 50% of our free cash flow to our shareholders.

FY23 & Q3 Guidance

Now, turning to our guidance...

Today we set our second half revenue guidance at 3.5 to 4% organic, which excludes currency movement and revenue from our Intersect ENT acquisition. If recent exchange rates hold, foreign currency would now have a negative impact on our back half revenue of \$930 million to \$1.03 billion.

Our back half guidance translates into a reduction of our annual guidance - driven by a slower pace of market and supply recovery. On market, we are expecting incremental provincial tenders in China, particularly in Stapling and Cardiac Ablation. And Geoff referenced earlier that some procedure volumes in the second quarter didn't recover as quickly as we were expecting. So at this point, we are assuming no incremental improvement in the back half. On supply, while we have had a meaningful recovery, it came later than anticipated, particularly in SI and Cardiac Diagnostics, and that simply delays our pace of recovery ahead.

By segment in the back half, the majority of the reduction is in our Medical Surgical Portfolio which we now expect to be flat to up 0.5%. We expect Cardiovascular to grow 5.25 to 5.75%; Neuroscience to grow 6% to 6.5%; and Diabetes to decline in the low-single digits, all on an organic basis.

Our total company revenue guidance does assume continued revenue growth acceleration, which we saw in each month of the second quarter. We expect the third quarter growth rate to be better than the second, and fourth quarter better than the third. We will have easing comparisons in ventilators, improving supply in certain businesses like Cardiac Diagnostics and SI, and the benefit from product launches, like Evolut™ FX and EV-ICD.

In the third quarter, we expect organic revenue growth in the range of 2.5 to 3%, an acceleration from the second quarter. And assuming recent exchange rates hold, the third quarter would have a currency headwind between \$460 and \$510 million.

By segment and on an organic basis, we expect Medical Surgical to be down 2% to 2.5%, an improvement from the second quarter given lesser vent headwinds and the impact of the flu season; Cardiovascular to grow 4.75% to 5.25% on the continued rollout of Evolut™ FX and LINQ II™; Neuroscience to grow 5.75% to 6.25%,

improving from the prior quarter with less VBP impact in Spine; and Diabetes to decline in the low-single digits.

On the bottom line, we are driving significant expense reductions throughout the company to help offset the lower revenue and continued inflation impact and now expect fiscal '23 non-GAAP diluted EPS in the range of \$5.25 to \$5.30. That range includes an unfavorable impact of currency of approximately 18 cents at recent rates.

For the third quarter, we expect non-GAAP diluted EPS to be in the range of \$1.25 to \$1.27, including an FX headwind of about 5 cents at recent rates.

Karen Closing Remarks

Amidst the macro-environmental headwinds we face from inflation, China VBP, softer procedure volumes in certain markets, and currency, we are laser focused on driving operational and expense efficiencies. We are also committed to invest appropriately for the long term, allocating capital to our most promising growth drivers and executing tuck-in acquisitions, designed to reach more patients and create value for our shareholders.

As we approach Thanksgiving, I want to share my gratitude to our employees who have been committed - particularly during these challenging times - to deliver on our Mission to alleviate pain, restore health, and extend life for millions of people around the world.

Back to you, Geoff.

Geoff Martha

Thank you, Karen.

Geoff Closing Remarks

Now before we open the lines for questions, I want you to know that our growth rate and our consistency are not where we want them to be. That's why I shared with you our aggressive agenda to transform this company two years ago when I became CEO. We embarked on a plan of implementing a new operating model, eliminating the bureaucracy of our groups and forming more nimble operating units, while at the same time learning to leverage our scale. We set in motion a new performance-driven culture, and we changed our incentive plans to reward new behaviors and performance. We brought in new leaders to inject new ways of thinking in the organization. And we implemented new capital allocation and portfolio management processes.

Now these changes take time. And we've faced setbacks along the way that have slowed us down...some are environmental like COVID recovery rates, raw material shortfalls, and Chinese procurement policy. While other setbacks are of our own doing, like our quality and operational challenges, and the pace of improvement we anticipated.

Look I know we have more work to do here. But we understand the root causes that led to the years of underperformance from this company, and our aggressive transformation agenda is designed to fix these issues. I know we will get this right. Choosing the right markets... being more efficient and productive with our resources... empowering businesses and increasing accountability... improving our quality, our manufacturing, and our supply chain... and turning our size and scale into an advantage.

And I know we are on the right path - the progress we've made so far gives me that confidence. We have experienced leaders, a compelling pipeline, and positions of strength in some of the most attractive medtech markets, which address significant unmet needs for patients. We will execute on our plan to deliver durable growth that

we began two years ago... and as we do, we will create tremendous value for all of our stakeholders.

Now let's move to Q&A. We're going to try to get as many analysts as possible, so we ask you to limit yourself to just one question, and only if needed, a related follow-up. If you have additional questions, you can reach out to Ryan and the Investor Relations team after the call.

With that, Brad, can you please give the instructions for asking a question?

Brad Welnick

For the sellside analysts that would like to ask a question, please select the "Participants" button and click "Raise Hand." If you're using the mobile app, press the "More" button and select "Raise Hand." Your lines are currently on mute. When called upon, you will receive a request to unmute your line, which you must respond to before asking your question. Lastly, please be advised that this Q&A session is being recorded.

For today's session, Geoff, Karen, and Ryan are joined by:

- Sean Salmon, EVP and President of the Cardiovascular Portfolio;
- Bob White, EVP and President of the Medical Surgical Portfolio;
- Brett Wall, EVP and President of the Neuroscience Portfolio; and
- Que Dallara, EVP and President of the Diabetes Operating Unit.

We'll pause for a few seconds to assemble the queue...

FOLLOWING Q&A

Ryan Weispenning

Geoff, please go ahead with your closing remarks.

Geoff Martha

OK. Thanks for the questions. We appreciate your support and continued interest in Medtronic. We look forward to updating you on our progress on our Q3 earnings broadcast, which we anticipate holding on February 21st. So, with that, thanks for tuning in today, please stay healthy and safe, and for those of you in the US, I'd like to wish you and your families a very Happy Thanksgiving!