Q4 FY18 EARNINGS CALL COMMENTARY
MAY 24, 2018

Medtronic

Ryan Weispfenning
Thank you, Shelby. Good morning and welcome to Medtronic's fourth 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 fourth quarter and fiscal year 2018, which ended on April 27, 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 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. In addition, the reconciliations of any non-GAAP financial measures are available on our website, InvestorRelations.Medtronic.com. References to quarterly results increasing or decreasing are in comparison to the fourth quarter of fiscal year 2017, and references to annual results increasing or decreasing are in comparison to fiscal year 2017. References to organic revenue growth exclude the impact of material acquisitions, divestitures, and currency. References to pro-forma exclude the impact of material divestitures. Unless we say otherwise, quarterly and annual rates and ranges are given on a comparable, constant currency basis, which adjusts for material divestitures, as well as the impact of foreign currency. All of 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. I am pleased to announce that this morning we reported strong fourth quarter financial results. Revenues grew 6.5 percent organic, coming in 100 basis points above the high end of our guidance range. This marks the second straight quarter of 6.5 percent organic top line growth, enabling us to more than overcome a tough first half of the year.

Q4 non-GAAP operating profit grew 8 percent pro-forma and 9 percent adjusted for currency, while non-GAAP diluted EPS grew 14 percent and 15 percent, respectively. The operating margin expanded 80 basis points pro-forma, constant currency, and as we enter FY19, currency at current rates looks to be a tailwind to both margins and earnings for the first time in years.

For the full fiscal year 2018, revenue of $30.0 billion grew 4.6 percent organically with a further 40 basis points from acquisitions. Non-GAAP diluted EPS grew 9 percent pro-forma and 10 percent constant currency. The second half of the year was particularly strong, overcoming several first half challenges – including an IT disruption, multiple hurricanes, fires in Santa Rosa, and supply constraints in Diabetes. Despite all of this, we recovered well and came in at the high end of both the revenue and EPS guidance we established at the start of the year. We also continued to drive margin expansion, reduce debt leverage, and return $4.3 billion to shareholders.

We made significant progress against each of our growth strategies. In Therapy Innovation, we executed a number of meaningful product launches and advanced a pipeline of increasingly groundbreaking medical technology[1]. We are creating new markets, disrupting existing markets, and leading in several of the fastest growth markets in MedTech[2]. In Globalization, we continue to lead our industry in expanding access into markets around the world, including delivering another year of double-digit growth in Emerging Markets. In Economic Value, we continue to develop new partnerships and business models to accelerate adoption of our innovative therapies.

Our ability to overcome multiple challenges to deliver at the level we did in the second half of the year reflects the dedication of our 86,000 employees around the world, each of whom make a difference to benefit patients and fulfill the Medtronic Mission[3]. In FY18, together with our physician partners, we served over 71 million patients – or more than two patients every second[4].

In the fourth quarter, each of our operating groups delivered strong results, with mid-single digit revenue growth in CVG, MITG, and RTG and over 20 percent growth in Diabetes. Geographically, it was a strong, diversified performance, with 5.3 percent growth in the US and 4.6 percent growth in non-US developed markets, including 4.4 percent growth in Western Europe and 5.5 percent growth in Japan. We also had a strong finish to the year with 15.5 percent growth in Emerging Markets.

At the same time, we expanded our operating margin and delivered 290 basis points of operating leverage. This helped drive EPS growth of 14 percent pro-forma and 15 percent constant currency. As we look to FY19 and beyond, we have increasing confidence in our ability to deliver operating leverage and margin expansion as a result of our Enterprise Excellence program, which is now fully underway[5].

Looking now at our group results in the quarter, our Cardiac & Vascular Group grew 5.4 percent, delivering sustained growth by leveraging the breadth of its products and services, as well as its strong positions in important, rapidly expanding markets. In Cardiac Rhythm & Heart Failure, we had a very good quarter in Pacing, with high-single digit growth driven by the continued rollout of our Micra® transcatheter pacing system, as well as the recent launch of the Azure™ next-generation family of pacemakers. We also continued to see strong growth in infection control, AF solutions, and our Mechanical Circulatory Support business.

Coronary & Structural Heart delivered impressive 12.8 percent growth, driven by the rollout of our Resolute Onyx™ drug-eluting stent in the US and Japan, as well as low-twenties growth in transcatheter aortic valves. This was driven by continued strong global demand for our Evolut® PRO valve and expanded indications in the US, which has resulted in above-market levels of growth for the past five quarters.

In addition, during this past quarter, we received approval for our global pivotal trial of the Symplicity Spyral™ – a new therapy for treatment-resistant hypertension. With its innovative Adaptive Bayesian trial design, which leverages prior enrollments in our previously reported "Off Med" clinical study cohort, patient enrollment is now well underway. Positive results of our Symplicity Spyral "On Med" clinical trial were presented yesterday at the EuroPCR meeting in Paris, validating the role this therapy can have in patients with treatment-resistant hypertension as an adjunct to medical therapy.

Our Minimally Invasive Therapies Group grew 4.8 percent, led by 5.9 percent growth in Surgical Innovations, with strength in Advanced Stapling and Advanced Energy as we capitalize on the conversion of surgical procedures from open to minimally invasive. Our innovative products are improving outcomes and driving growth, including our Signia™ powered surgical stapling system, which uses our Tri-Staple™ 2.0 reloads, as well as our Valleylab™ FT10 energy platform and new iterations of our LigaSure™ vessel sealing instruments.

Our Restorative Therapies Group grew 6.1 percent this quarter, its best quarter of organic growth since we established the group 8 years ago. This is despite the well-known challenges in the Spine market and reflects strong execution and robust growth, in particular in our Brain and Pain divisions. In Brain Therapies, we are leading the development of the endovascular therapy market for the treatment of ischemic stroke, resulting in high-teens growth in Neurovascular. We also had a great quarter in Neurosurgery, with low-double digit growth reflecting strong demand for our StealthStation® S8 navigation system, the Mazor X™ robotic guidance system for spine surgery, and our Visualase® MRI-guided laser ablation system.

In Pain Therapies, the turnaround is officially underway with back-to-back quarters of strong growth. Our Spinal Cord Stimulation business grew mid-teens this quarter, including high-teens in the US. We are seeing great acceptance of our new offerings in Spinal Cord Stim, including our Intellis™ stimulator, our Evolve℠ workflow algorithm, and our Snapshot™ reporting. This is a dramatic turnaround for a business that declined in the mid-single digits in FY17 and low-double digits in the first half of the year.

In Spine, we grew 1 percent, better than the global market, which we estimate is slightly declining. We are seeing emerging strength in our differentiated spine products and procedures, including high-single digit growth in BMP and OLIF, strong double-digit growth in Prestige LP™ cervical discs, and strong customer adoption of our new Solera® Voyager® 5.5/6.0 fixation system and ARTiC-L™ 3-D printed titanium cage. In addition, when coupling our Spine revenue with the Spine enabling technologies that are reported in our Neurosurgery business, our combined revenue grew 2.7 percent. We believe this is a more relevant comparison of our Spine results against our competition and an indication that our Surgical Synergy strategy is working – and driving our overall growth in Spine procedures.

Diabetes had a very strong finish to the year, with low-twenties growth driven by US patient demand for our MiniMed® 670G hybrid closed loop system. We now have over 70 thousand trained, active users on our 670G system, and we continue to get positive feedback with real-world results in line with the pivotal study data. Importantly, we have completed upgrades to our sensor manufacturing lines, and now have capacity to meet expected global demand going forward.

Outside the US, we continue to see strong demand for our 640G system. We experienced another quarter of strong performance in Europe, and recently received regulatory approval for the 640G in Japan. All of this led to our IIM division growing in the mid-twenties internationally.

Based on the strength of the 6-series systems, IIM share grew sequentially to 70 percent of all durable and consumable pumps globally. In addition, our sensor attachment rates continue to increase as we shift our customer base from stand-alone pumps to sensor-augmented systems. As this happens, our business is seeing an increasing revenue mix from CGM sensors, which creates a strong, consistent annuity stream for our Diabetes group.

We are also excited about our entry into the $1 billion standalone CGM market with our Guardian® Connect system. As our sensor capacity increased, we ramped up our commercial efforts for this product in Europe this quarter, and expect to continue commercial expansion into the new fiscal year. In the US, we recently received FDA approval for Guardian® Connect, and intend to start our broad launch in the first quarter. Guardian® Connect is the only stand-alone sensor that transmits directly to a smartphone. It features unique predictive alerts and, in the US, will utilize Sugar.IQ™, which is based on 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, grew 15.5 percent. It is important to point out that it is not just one market driving growth, but several and reflects our broad diversification. Latin America, the Middle East & Africa, Eastern Europe, and China all grew double digits in the fourth quarter. China, our largest emerging market,

grew 12.7 percent in the fourth quarter and finished the year with over $1.8 billion of revenue. This is a significant increase from the less than half a billion dollars of revenue in the region when I joined Medtronic 7 years ago. Our differentiated strategies of public and private partnerships, optimizing the distribution channel, and driving local manufacturing and R&D, are making a difference, not only in China but in our emerging markets around the world. We are investing to build strong, leading businesses in emerging markets, as they continue to collectively represent the single largest opportunity in MedTech.

Our remaining growth strategy, Economic Value, is an accelerator for our therapy innovation and globalization strategies. We continue to make progress in creating new, value-based business models that directly link our therapies to improving outcomes[6]. With our TYRX®-related value-based healthcare arrangements, we now have over 1,100 hospitals under contract, covering over 30 percent of our US CRHF implantables revenue, helping to drive sequential market share gains in ICDs and CRT. This is one of the reasons why our performance in CRHF has been better than the Street was expecting 6 to 9 months back. The other is innovation, where we lead the development of several important and often disruptive technologies, such as Micra.

Finally, I want you to know that across Medtronic, execution is our top priority[7]. You have seen that in our results the past two quarters – in our resurgence following a string of challenges in the first half of the year – and in our ongoing commitment to cost management that began by achieving our Covidien cost synergies and is now being extended into our Enterprise Excellence initiative[8]. We know there is much work to be done, but we are excited – and optimistic – as our direction is clear, our pipeline is full, and our team has never been stronger[9].

With that, let me ask Karen to now take you through a discussion of our fourth quarter financials. Karen?

Karen Parkhill
Thank you, Omar.

As mentioned, our fourth quarter revenue of 8 billion, 144 million dollars represented a 2.9 percent increase as reported, and organic growth of 6.5 percent. Foreign currency had a positive 315 million dollar impact on fourth quarter revenue.

GAAP diluted earnings per share were a dollar, 7 cents. Non-GAAP earnings per share were a dollar, 42 cents. After adjusting for the divestiture, non-GAAP diluted EPS grew 14 percent pro-forma and 15 percent constant currency.

The operating margin for the quarter was 30.2 percent, representing an 80 basis point improvement on a pro-forma, constant currency basis. Gross margin was down 50 basis points, reflecting our sales mix in the quarter. The impact of mix on our gross margin this quarter was more than offset by a 150 basis point improvement in SG&A, on a pro-forma, constant currency basis, reflecting our company-wide initiatives on expense leverage.

Net Other Expense, which is included in our operating margin, was 188 million dollars. This was slightly higher than expected, primarily due to mark-to-market on some of our investments.

Foreign exchange in total had a 160 basis point negative impact on our operating margin in the quarter, primarily due to the year-over-year change in currency gains and losses related to our hedging program. But the good news is that based on current rates, we expect the currency headwind that's plagued us for several quarters on the operating margin to turn into a tailwind in fiscal 19, starting in the first quarter.

Our fourth quarter non-GAAP nominal tax rate was 14.9 percent, slightly better than expected given favorable IRS audit resolutions.

Fourth quarter average daily shares outstanding, on a non-GAAP diluted basis, were 1 billion, 366 million shares. As expected, this was roughly flat sequentially. Combining our 1.8 billion dollars of net share repurchases in fiscal 18 with the 2.5 billion dollars we paid in dividends over the same period, our total payout ratio was 65 percent on non-GAAP net income and 118 percent on free cash flow.

Free cash flow for fiscal 18 was 4.7 billion dollars, above our prior guidance range and after adjusting for a 1.1 billion dollar pre-payment to the IRS related to our Puerto Rico tax litigation. While the litigation is still in process, given our access to cash post tax reform, we elected to put as much of this potential 1.5 billion dollar liability as possible behind us. By pre-paying, we were also able to stop the accrual of significant interest.

In the quarter, we reduced debt by approximately 3 billion dollars, allowing us to now focus on other capital allocation priorities going forward. Given US tax reform, we will be continuing the liquidation of some of our investments overseas. Note that this will negatively impact interest income, but it will enable increasing access over the next several quarters to our formerly trapped cash on our balance sheet. We intend to put this cash to work by investing in our business and returning to our shareholders.

Now, looking at the picture ahead…

For fiscal year 19, we expect organic revenue growth to be in the range of 4 to 4.5 percent. By business group, we expect CVG, MITG, and RTG to grow 4 percent, plus or minus, with CVG likely on the minus side given the anniversary of major product launches in Coronary & Structural Heart, and MITG and RTG to be more in line with the 4 percent. We expect Diabetes to grow in the low-double digits, with a stronger first half off of low comparisons.

For the first quarter, we expect total company revenue to be consistent with our guidance for the year. In addition to CVG, we expect MITG to be on the minus side of their full year outlook given more difficult comparisons from endo stapling and capital sales, offset by more robust growth from Diabetes with continued 670G strength.

Turning to margins, we expect operating margin expansion in fiscal year 19 of approximately 50 basis points on a pro-forma, constant currency basis, driven by our Enterprise Excellence initiatives. For modeling purposes, we would assume a slight improvement in the first quarter, with increasing improvement through the remainder of the fiscal year.

We expect our tax rate to be between 14 and 15 percent, roughly in line with our fiscal 18 tax rate.

With respect to earnings, we expect fiscal year 19 non-GAAP diluted earnings per share in the range of 5 dollars and 10 cents to 5 dollars and 15 cents. This implies EPS growth of 10 percent at the midpoint of the range.

For the first quarter, we expect non-GAAP diluted EPS in the range of a dollar, 10 cents to a dollar, 12 cents off the fiscal 18 base of a dollar, 3 cents. We recognize that the Street didn't have the full picture on the first quarter comparisons, pro-forma for the divestiture – until we shared them last week in an 8-K… so hopefully that filing helped. Also, keep in mind we had a lower tax rate in the first quarter last year from benefits not expected to repeat, creating roughly a 3 cent headwind in the first quarter.

Finally, on free cash flow, we expect 4.7 to 5.1 billion dollars in fiscal year 19. This excludes a potential final 400 million dollar payment to Puerto Rico related to our pending litigation that I referenced earlier, the timing and outcome of which is uncertain. Over the next couple of years, we expect to make significant progress in improving our free cash flow conversion, as litigation and tax payments are expected to diminish, and we benefit from programs we have put in place to improve working capital.

While the impact from currency is fluid, if recent exchange rates hold, our full year revenue would be negatively affected by approximately 50 to 150 million dollars. Recall at the time of our third quarter earnings call, it was a 500 million dollar positive impact. However, despite this 600 million dollar swing, FX is still a modest positive to fiscal 19 margins, earnings, and free cash flow because of our hedging program. If recent rates hold, we would expect a reported operating margin of 28.5 percent for the year and a 5 cent tailwind to full year EPS.

For the first quarter, if recent rates hold, revenue would be positively affected by approximately 90 to 130 million dollars, operating margin would have a slight benefit, and EPS would have a 2 cent benefit.

Before I turn the call back to Omar, 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. We intend to discuss our long-term strategies and share our long-range plan at that time.

Now I will return the call back to Omar.

Omar Ishrak
Thanks, Karen.

To summarize, we have delivered two consecutive quarters of strong revenue growth to finish our fiscal year. We also expanded our operating margin and delivered meaningful EPS leverage.

Looking ahead, we feel good about the growth opportunities in our markets and our competitive position in these markets. We expect continued revenue growth and margin expansion. We are also focused on generating strong free cash flow conversion and making the right investments to drive shareholder value. Execution is our top priority.

Before we turn to Q&A, we had the benefit of Mike Weinstein joining us earlier this month. Given his recent transition, we thought it might be helpful for him to make some comments. Mike?

Mike Weinstein
Sure thing. I think for starters, it was a great quarter. There's a lot of work to do, and I certainly don't want the Street to get out ahead of us, but this was a good quarter. Six or nine months ago, when I was on the other side of this call, we on the Sellside were all worried about growth and the company's ability to execute in the face of competition . . . competitors introducing MRI compatible pacers and ICDs, deep brain stimulators, insertable cardiac monitors. And now here we are six months later, and Medtronic has delivered back to back quarters of 6.5% organic growth.

Again, I don't want everybody to extrapolate from that and start modeling 6.5% going forward. But it speaks to the breadth of the franchise and the number of growth drivers moving in the right direction, which honestly the Street, myself included, underestimated or missed six months back. RTG had its best quarter in years, growing 6% organic despite all the challenges in the Spine market. Neurovascular grew high-teens, Neurosurgery grew low-double digits, and the SCS (Pain Stim) business has had a dramatic recovery, posting mid-teens growth. Two quarters ago the SCS business was in decline. Diabetes obviously had a fantastic quarter, growing 20+%, well north of what the Street was modeling, and Guardian standalone hasn't launched yet in the US.

I could go on. In fact, all four operating groups – CVG, RTG, MITG, and Diabetes – did better than the Street was modeling. But the good news is not just the top-line. Margins are starting to go in the right direction (I emphasize starting). Gross margins beat by 20 bps, SG&A beat by 80 bps. The FX headwind to margins, which was severe this quarter (160 bps), <u>should</u> go away as we head into FY19 . . . obviously assuming current rates.

But there's a long way to go, and we know that. As Omar said: execution is the number one priority right now, and we're not going to let one or two good quarters go to our heads. But I feel good that we're clearly heading in the right direction, and the investor meeting on the 5th will give us a chance to talk about it more.

Omar Ishrak
Thanks, Mike. Let's now open the phone lines for Q&A. In addition to Karen and Mike, 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 discussing our long-range plan with you at our Investor Day in a week and a half on Tuesday, June 5th, and we also plan on holding our Q1 earnings call on Tuesday, August 21st. Thank you.