Q3 FY17 EARNINGS CALL COMMENTARY

FEBRUARY 21, 2017

Medtronic

Ryan Weispfenning

Thank you, Paula. 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 fiscal year 2017 third quarter, which ended on January 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. You should note that many of the statements made during this call may be considered forward-looking statements, and that 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 2016, and all year-over-year growth rates and ranges are given on a constant currency basis. Other than as noted, our EPS growth and guidance does not include any charges or gains that would be recorded as non-GAAP adjustments to earnings during the fiscal year. These adjustment details can be found in the reconciliation tables included with our earnings press release. 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 third quarter revenue of $7.3 billion, representing growth of 6 percent. Q3 non-GAAP operating profit grew 10 percent, and non-GAAP diluted earnings per share were $1.12, growing at 10 percent and representing EPS leverage of 480 basis points.

In Q3, we achieved solid results across all of our groups, with mid-single digit growth in CVG, MITG, and RTG, and high-single digit growth in Diabetes. Geographically, we also demonstrated solid performance[1], with mid-single digit US growth, high-single digit growth in the non-US developed markets, including Western Europe and Japan, and double-digit growth in emerging markets. At the same time, we delivered meaningful operating profit growth, executing on our synergy programs from the Covidien integration and our operating excellence initiatives[2]. Our revenue and operating profit growth resulted in continued strong free cash flow. As stated before, we expect to deploy this capital by balancing returns to shareholders with disciplined reinvestment in our business. We remain confident in our ability to deliver mid-single digit constant currency revenue growth and double-digit constant currency EPS growth[3], not only in our current fiscal year, but also into the future.

Our solid revenue performance resulted from crisp execution on our three growth strategies: therapy innovation, globalization, and economic value. These strategies are designed to create competitive advantages for Medtronic by capitalizing on the long-term trends playing out in healthcare: namely, the continued desire to improve clinical outcomes; the growing demand for expanded access to care; and the optimization of cost and efficiency within healthcare systems. When combined with the demographics of an aging population, they produce secular growth tailwinds that we believe will create sustained long-term opportunities for Medtronic[4].

Now, let's discuss each of our growth strategies. In Therapy Innovation, we are seeing strong adoption of our innovative new products across all our businesses.

In our Cardiac & Vascular Group, which grew 6 percent, our new therapies are helping to create important, rapidly growing MedTech markets, such as LVADs, TAVR, drug-coated balloons, AF ablation, and insertable diagnostics. At the same time, our innovations are driving share growth in some of our base businesses. In cardiac rhythm implantables, we believe we are capturing share as a result of our differentiated 3T MRI technology, our unique diagnostic and therapeutic algorithms, and our proprietary TYRX® anti-infection envelopes.

In TAVR, we had strong growth, both sequentially and year-over-year, on the launch of the Evolut® R 34mm valve. Looking ahead, we expect to present our SURTAVI data at ACC next month, which we will use to support our submission for TAVR indication expansion into the US intermediate risk patient population.

In Coronary, we are anticipating FDA approval of the Resolute Onyx™ drug-eluting stent around fiscal year end, which we expect will turn the mid-twenties US DES sales declines into meaningful growth for FY18.

And in cardiac rhythm implantables, we expect the recent CMS reimbursement coverage for Micra®, the world's smallest pacemaker, to accelerate our sales in the US, driving both pacemaker market growth and share capture.

In our Minimally Invasive Therapies Group, which also grew 6 percent, we had strong high-single digit growth in Surgical Solutions, as we focus on moving surgical procedures from open to minimally invasive, driven by our ongoing new product launches in Advanced Energy and Advanced Stapling. While we continue to experience some pressure from reprocessing in Advanced Energy, it has been tempered by the launch of additional LigaSure™ instruments, as well as the continued rollout of our Valleylab™ FT10 energy platform.

In Advanced Stapling, Q3 results were driven by the continued adoption of our endo stapling specialty reloads. To drive growth going forward, we just announced the launch of Signia™, our powered surgical stapler, representing a major advance in stapling technology by providing surgeons with real-time feedback on tissue variability coupled with automated response by adjusting the stapler's speed.

In our Patient Monitoring & Recovery division, we not only had solid growth from the continued adoption of the PB980 ventilator and strength of our Nellcor™ pulse oximetry products, but also benefitted from the Bellco acquisition with growth in dialyzers and other consumables.

Our Restorative Therapies Group grew 4 percent this quarter, with strong contributions from our Spine, Brain, and Specialty Therapies divisions. Our Spine division again showed improvement, growing 3 percent, the strongest rate in over 7 years, as we continue to gain share[5]. The improvement is being driven by an initiative we first told you about on our earnings call one year ago called "Speed to Scale," which involves faster innovation cycles and launching a steady cadence of new products at scale with sets immediately available for the entire market. We are also seeing success in our "Surgical Synergy" strategy, resulting in spine implant growth in conjunction with strong sales of our navigation and imaging equipment in Neurosurgery.

Neurovascular also had a solid Q3, growing 13 percent, driven by strong performance in flow diversion and coils. As we forecasted, our Pain Therapies business results are still declining. However, we were pleased by the initial physician enthusiasm with our new Evolve℠ Workflow, which balances high dose and low dose settings for spinal cord stimulation. We are also expecting approval of our next-generation spinal cord stimulator, the Intellis™ System, in the first half of next fiscal year. We expect Intellis™ to be the smallest rechargeable spinal cord stimulator on the market.

Turning to our Diabetes Group, which grew 7 percent, we had strong sequential improvement in our US business, with our highest insulin pump growth in 10 quarters. We are capturing share and experiencing strong US clinician and consumer demand for our 6 series pumps, through purchases of the innovative MiniMed® 630G insulin pump system as well as enrollment in the 670G Priority Access Program. This program gives users first-in-line access to our MiniMed® 670G hybrid closed loop system when it begins to ship this spring. While difficult to predict, it is worth noting that our Diabetes growth could slow somewhat in Q4 due to postponed purchases as we get closer to the full launch of the 670G. As mentioned last quarter, we do expect Diabetes to deliver double digit growth next fiscal year once the 670G is fully launched.

Our product pipeline remains robust across all of our groups. We have a number of important near-term growth catalysts, as well as a deep pipeline of innovation that we expect to bring to market through the balance of the decade[6]. We remain confident that our New Therapies can drive sustainable growth, both over the coming quarters and over the longer-term.

Next, let's turn to Globalization. Emerging markets grew 11 percent. We continue to make progress in structuring both public and private partnerships aimed at rapidly increasing patient access, as well as our ongoing efforts to optimize our distribution channels. We feel that these initiatives have the ability to accelerate growth and lead to sustained market outperformance.

The Middle East macroeconomic environment challenges persisted in Q3, and our revenue declined in the low-single digits. In Saudi Arabia, our largest market in the region, revenue continued to decline on a year-over-year basis, although we saw some sequential improvement.

That said, we had strong results in other parts of the world. China, Latin America, and Eastern Europe showed sustained strength, growing in the mid-teens or higher. In China, our largest emerging market, we grew in the mid-teens with MITG in the low-twenties on the strength of our Advanced Stapling platform, and CVG in the double-digits as we capitalized on our market development efforts in private hospitals and Tier 2 and Tier 3 cities. Latin America had mid-twenties growth, driven by key tender wins and channel optimization programs, specifically in Brazil, Mexico, and Argentina. Eastern Europe also grew in the mid-teens, with strength in Russia, where we started shipping our coronary stents and balloons as part of the public partnership agreement we reached last year.

Overall, the consistency of our Emerging Market performance benefits strongly from increased geographic diversification, reducing dependence on any single market. We continue to believe that the penetration of existing therapies into Emerging Markets represents the single largest opportunity in MedTech over the long-term.

Turning now to our third strategy, Economic Value, we continue to see success in our Hospital Solutions business, which grew in the high teens. Hospital Solutions delivers annuity revenue by providing expertise and creating efficiency in managing cath labs and operating rooms for more than 100 customers. We continue to expand our Hospital Solutions offering globally, beyond Europe, with 30 accounts now in the Middle East, Africa, Latin America, and Canada. It is also worth noting that in Q3, we signed our first US contract with University Hospitals in Cleveland.

We continue to grow our chronic care management business models, including Diabeter for type 1 diabetes and NOK for morbid obesity. We are aggressively pursuing global expansion opportunities for each of these unique, value-based healthcare businesses. While we are still early in the journey to value-based healthcare, we remain focused on fully understanding and leading the shift to healthcare payment systems that reward value and patient outcomes over volume. As always, we expect to do this in a way that creates value for healthcare systems as well as for our shareholders[7].

With that, let me ask Karen to now take you through a more detailed look at the drivers of our third quarter financial results. Karen?

Karen Parkhill
Thank you, Omar.

Our third quarter revenue of 7 billion, 283 million dollars increased 5 percent as reported, or 6 percent on a constant currency basis. Foreign currency exchange had a negative 40 million dollar impact on third quarter revenue, and acquisitions and divestitures contributed approximately 150 basis points net to revenue growth.

GAAP diluted earnings per share were 59 cents. Non-GAAP was $1.12. After adjusting for the 5 cent impact from foreign currency, non-GAAP diluted EPS grew 10 percent.

Our operating margin for the quarter was 29.1 percent on a constant currency basis, representing a strong, 130 basis point year-over-year improvement. With the impact of currency included, our third quarter operating margin also improved, increasing by 40 basis points year-over-year. And, we continue to cover the earnings dilution from our recent acquisitions, which means we maintain operating profit expectations while realizing incremental acquisition revenue. Taking into account acquisitions that we have done in the past year, our operating margin improvement on an organic basis would have been approximately 170 basis points in the quarter.

This meaningful margin improvement was driven in part by efficiencies in SG&A, as we continue to deliver on our Covidien synergies. It is worth noting that our extensive effort to move Covidien onto Medtronic's global ERP system is underway and meeting our expectations. As we have outlined, this activity is an enabler, driving a portion of the cost savings we expect to realize in the latter half of the synergy period. We remain on track to deliver 225 to 250 million dollars of synergy savings this fiscal year, and expect to deliver on our commitment of 850 million dollars of savings by the end of fiscal year 18. Beyond our integration efforts, we will remain focused on driving additional operating excellence initiatives to deliver continued margin improvement.

Net Other Expense was 46 million dollars compared to 9 million dollars in the prior year, due in large part to lower net gains from our foreign exchange hedging programs.

Below the operating profit line, Net Interest Expense was 180 million dollars. At the end of the third quarter, we had 32.1 billion dollars in debt and 11.5 billion dollars in cash and investments, of which approximately 6 billion dollars was "trapped."

Our non-GAAP nominal tax rate on a cash basis was 17 percent, in line with our expectation for the second half of the fiscal year.

Free cash flow was 1.8 billion dollars. We paid 590 million dollars in dividends and repurchased a net 566 million dollars of our ordinary shares in the third quarter. This represented a total payout ratio of 74 percent on non-GAAP net income and 141 percent on GAAP net income. Keep in mind, our payout ratio is elevated as we have been continuing to not only return 50 percent of our annual free cash flow to shareholders, but also execute the 5 billion dollar incremental share repurchase commitment we made through fiscal year 18. We did accelerate our share repurchase activity by shifting the vast majority of our remaining activity for the fiscal year into the third quarter, given our share price. Third quarter average daily shares outstanding, on a diluted basis, were 1 billion, 383 million shares.

Regarding our dispute with the IRS related to Puerto Rico transfer pricing, the tax court issued their final ruling late last month. Under the terms of the decision, we would experience an increase to our annual accessible cash generation of approximately 225 million dollars as well as the movement of approximately 3 billion dollars of cash on our balance sheet from trapped to accessible. The decision could be appealed, but if it is not, we could begin to see movement of a portion of the trapped cash in fiscal year 18. As stated previously, we intend to use the cash released to pay down our debt.

Second to our dividend, debt paydown remains a near-term capital allocation priority as we remain committed to a strong balance sheet and target an A credit profile. We also expect to maintain our disciplined approach to pursue value-creating, tuck-in acquisitions. And, of course, share repurchase is another tool we will continue to employ to provide meaningful return to shareholders when our cash flows and business reinvestment priorities allow.

Before turning the call back to Omar, let me conclude with our revenue outlook, EPS guidance, and free cash flow outlook, which has not changed for the full fiscal year. Consistent with our long range expectations, we continue to expect full year revenue growth to be in the mid-single digit range and EPS growth to be double digits, both on a constant currency, constant week basis.

For the final quarter of the year, we expect revenue growth to be in the lower half of the mid-single digit range on a constant currency basis. This is solid growth, especially when you consider the strong 6 percent constant currency growth we delivered in the fourth quarter last year. We expect both CVG and MITG to continue to grow in the mid-single digits. However, keep in mind that CVG had a particularly strong fourth quarter last year, with peak levels of customer bulk purchases of cardiac rhythm implantables, which we do not expect to repeat. And, MITG will no longer benefit from the inorganic revenue contribution of the Bellco acquisition starting in the fourth quarter. We expect RTG to grow in the low end of the mid-single digit range, consistent with the third quarter. And, we expect Diabetes to grow in the mid- to high-single digits with the potential for postponed purchases that Omar mentioned earlier.

While the impact from currency is fluid – and therefore not something we predict – if current exchange rates, which include a $1.06 Euro and 113 Yen, remain stable for the remainder of the fiscal year, we expect fourth quarter revenue to be negatively affected by an estimated 20 to 40 million dollars and EPS by an approximate negative 5 cents.

Regarding cash flow, we continue to expect our free cash flow for the fiscal year to be in the range of 5 to 6 billion dollars.

While we intend to give our fiscal year 18 guidance on our fourth quarter earnings call in May, it is worth noting that if current exchange rates remain stable through next fiscal year, we would expect fiscal year 18 revenue to be negatively affected by approximately 100 to 300 million dollars, an improvement from the update we gave in January. Given this improvement, we would now expect the FX impact on fiscal year 18 EPS to be in the range of 5 to 15 cents, again if current exchange rates remain stable through next fiscal year.

Now, I will return the call back to Omar.

Omar Ishrak
Thanks, Karen. To conclude:

- Q3 was a solid quarter, and I was pleased by the revenue growth and sequential improvement in our groups and regions.
- Along with the revenue growth, our organization delivered meaningful operating margin improvement and double-digit constant currency EPS growth, as well as growth in free cash flow.

Looking ahead, we remain confident in our ability to deliver mid-single digit constant currency revenue growth and double digit constant currency EPS growth, not only in our current fiscal year, but also in the future. With our differentiated growth platforms, leadership in strong end markets, and disciplined capital allocation, we believe we are well positioned to create long-term, dependable value for our shareholders.

We will 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. We look forward to updating you on our progress on our Q4 call, which we currently anticipate holding on Thursday, May 25th. Thank you.