Q2 FY20
EARNINGS CALL COMMENTARY
NOVEMBER 19, 2019

Medtronic

Ryan Weispfenning
Thank you. Good morning and welcome to Medtronic's fiscal year 2020 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 25, 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 second quarter of fiscal year 2019 after adjusting for foreign currency. References to "organic" revenue growth exclude the impact of our Titan Spine acquisition and currency. Reconciliations of 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 another quarter of solid results with organic revenue growth and EPS both coming in ahead of Street expectations, reflecting our continued focus on executing to our commitments across Medtronic.

Q2 revenue grew 4.3% constant currency and 4.1% organic, an acceleration from the first quarter, with outperformances in RTG, MITG, and Diabetes. We also delivered another quarter of double-digit growth in emerging markets.

Our adjusted operating margin expanded approximately 20 basis points, in-line with expectations, and included key investments ahead of several major new product launches. Our Enterprise Excellence initiatives, where we leverage our size and scale to improve our effectiveness and efficiency, continue to benefit our P&L, particularly on the SG&A line. On the bottom line, our diluted EPS grew 7.4%, or 9.0% at constant currency, despite the headwind on EPS growth from the increase in our non-GAAP nominal tax rate.

Overall, our broad-based performance this quarter demonstrates the consistency of our execution, the strength of our innovation, and the benefit of our business and geographic diversification.

Let's take a look now at the drivers of our quarterly performance, starting with our Restorative Therapies Group. RTG delivered a particularly impressive performance, posting 6.0% organic growth, which was 150 basis points ahead of our expectations. Strong sales in Spine and Brain Therapies more than offset slower growth in Pain Therapies. Our Surgical Synergy strategy for spine surgery, which combines the enabling capital equipment in our Brain Therapies division with the implants in our Spine division, is having an exceptional and sustained impact on RTG's growth.

Our Spine division grew 5.5% organic in the U.S. and 3.5% organic globally. This excludes the early contribution from our Titan Spine acquisition, which is off to a good start. Organic revenue growth in Spine hit its highest level in two and a half years, with strong double-digit growth in Infuse™ bone graft sales, as well as 3% organic Core Spine growth, both globally and in the U.S. This was driven by our Surgical Synergy strategy, where surgeon use of our capital equipment, in particular our Mazor™ robot, is resulting in increased sales of our core spine implants. In fact, when you combine our Spine division sales with the sales of our capital equipment from our Brain Therapies division that are used in spine surgery – which is how our spine competitors report results – our Spine division grew a robust 6.7% organic, with our U.S. Spine business growing 7.7% organic, well above the market.

As I just mentioned, our Surgical Synergy strategy is also benefitting our Brain Therapies division, which sells the capital equipment used in spine surgery. Brain Therapies delivered another above-market quarter of 11.3% growth. In Neurosurgery, we had double digit growth in all three of our offerings –robotics, navigation, and imaging. Our Midas Rex™ powered surgical instruments also grew double digits, as we fully launched the new Midas Rex™ MR8™ system in the U.S. during the quarter.

In Brain Therapies, our market-leading Neurovascular business also had a very strong quarter with high-teens growth reflecting strength in both Ischemic and Hemorrhagic Stroke. Our Ischemic Stroke business grew in the high-twenties on strong adoption of our Solitaire™ X stent retriever, Riptide™ aspiration system, and React™ catheters. In Hemorrhagic Stroke, we grew low-double digits, as the expanded indications for our Pipeline™ Flex flow diversion system continue to drive growth.

This was Geoff Martha's last quarter leading RTG, before taking over as President of Medtronic earlier this month. Over his four year tenure, Geoff revitalized the group. He implemented a strong strategy, built a robust management team, and invested in an innovative pipeline. It is also noteworthy that he named his successor from within RTG. Brett Wall has done an outstanding job leading our Brain Therapies division, and he has played a vital role in the turnaround of RTG. We look forward to his leadership of the Group.

In the Minimally Invasive Therapies Group, we had another very strong quarter, growing 6.1% and ahead of expectations, driven by very good performances in both Surgical Innovations and RGR. In Surgical Innovations, we grew mid-single digits in both Advanced Stapling and Advanced Energy. Advanced Stapling growth was driven by new products in our Tri-Staple™ line, including our EEA™ circular stapler and Tri-Staple™ 2.0 reloads. Advanced Energy growth benefitted from continuous innovation in our Ligasure™ franchise, including our Ligasure™ Exact dissector.

Respiratory, GI, and Renal delivered another exceptional quarter, growing 6.1%. The GI Solutions business grew high-single digits, led by strong sales of Bravo™ calibration-free reflux systems, EndoFLIP™ imaging systems, and Pillcam™ systems. Respiratory & Patient Monitoring also grew high-single digits on strength in Nellcor™ pulse oximetry, Microstream™ capnography and BIS™ brain monitoring consumables, Puritan Bennett™ 980 ventilators, and McGRATH™ video laryngoscopes.

In our Cardiac & Vascular Group, we grew 1.3% this quarter, which was in-line with our expectations. CVG has gone through a series of below trend quarters, which we believe are coming to an end. CVG's growth this quarter reflects the challenges of the last few quarters in LVADs and DCBs, as well as the sustained headwind in CRM replacement devices, given the longer-life batteries we launched several years ago. In addition, during the quarter, we implemented a number of changes to our manufacturing processes for our TYRX™ product line, which temporarily limited supply and affected our revenue growth in CRHF high power.

We are seeing clear signs of overcoming these headwinds. U.S. DCBs and LVADs both grew in the teens quarter-over-quarter. We have now passed the one-year anniversary of the step-down in LVADs, and we expect to anniversary the DCB challenges in March. With our CRM replacement devices, both pacemakers and CRT-D replacement implants grew sequentially for the first time in several years. We expect CRM replacement devices to be a net neutral impact to CRHF growth next fiscal year after several years of being a headwind to growth. Regarding TYRX™, we launched our new manufacturing process late last month, and expect production volumes in Q3 to return to normal levels.

Despite these areas of pressure on CVG growth, we are seeing strong performance in other CVG businesses, including Pacing and TAVR, which combined represent over 25% of CVG revenue. Our Pacing business grew mid-single digits globally and high-single digits in the U.S., as our Micra™ single chamber transcatheter pacing system continues to take share and expand the market. Beyond Micra™, our global pacemaker share is benefitting from unique feature differentiation in our conventional pacemakers, including our Reactive ATP™ feature, which resulted in differential reimbursement in Japan, as well as the increasing popularity of HIS bundle and Left Bundle Branch pacing, where Medtronic offers unique lead and lead delivery products that enable such procedures.

In our TAVR business, we grew in the low-twenties, with mid-twenties growth in the U.S., driven by expansion into the low risk patient population. We launched our Evolut™ Pro Plus TAVR system in the U.S. late in the quarter, and this drove some of the highest procedural implant volumes that we have ever had in the final two weeks of the quarter.

We see an accelerating growth profile for CVG over the back half of our fiscal year with the anniversary of the LVAD challenges, improving sequential growth in DCBs, improvements in pacemaker and CRT-D replacement volumes, and the benefit of multiple important new product launches.

In Diabetes, we grew 4.3%, slightly ahead of our expectations. Our U.S. business declined in the high-single digits, which was anticipated and resulted from competitive challenges, while we await our new products. At the same time, our International business, which represents just under half of our Diabetes revenue, grew 19%. The MiniMed™ 670G, which drove strong growth in the U.S. last year, is experiencing that same strong consumer demand as we launch and receive reimbursement in select international markets. This demand is not only driving double digit growth in insulin pumps, but it is also resulting in double digit growth in recurring revenue from CGM and other consumables.

Late last month, we announced that Sean Salmon, who has successfully led our Coronary and Structural Heart division, is taking over leadership of the Diabetes Group. Sean has an excellent track record in developing and executing competitive business strategies, including the successful launches of several important new technologies for Medtronic. Sean is actively engaged, and we look forward to the impact that he will make on the business.

Now, turning to Emerging Markets, which represent 16% of our revenue:

In Q2, we grew Emerging Markets 12%, with contributions from geographies around the globe. China grew 13%, South Asia grew 14%, as did Eastern Europe, which included 20% growth in Russia. In addition, Southeast Asia grew 12%, the Middle East & Africa 10%, and Latin America 9%. We continue to drive strong growth in these markets as we optimize the distribution channel, and in certain markets, localize R&D and manufacturing. In addition, the diversified growth in markets around the world is important. We believe the geographic breadth of our business and the rapid expansion of healthcare across these markets typically insulates us from country-specific economic cycles. As a result, we expect continued and consistent double digit growth in Emerging Markets.

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The first half of this fiscal year has gone well, as we've executed to our commitments and delivered better-than-expected results. Now, as we look forward, we're <u>even more excited</u> about what lies ahead, as the investments we've made in our pipeline begin to pay off by accelerating our revenue growth and creating value for our shareholders.

In CVG, as I mentioned earlier, we just launched our next-generation Evolut® Pro Plus TAVR valve, and we expect to see a full quarter's contribution, starting in Q3. In addition, we're expecting imminent U.S. approval for our IN.PACT™ Admiral™ AV fistula indication. As we look to the fourth quarter and into the start of fiscal 21, we're anticipating U.S. approval and launch of our Micra™ AV pacemaker, our next-generation Cobalt and Chrome families of ICDs and CRT-Ds, and our Reveal LINQ 2.0 insertable cardiac monitor. Outside the U.S., we're also expecting multiple new product introductions, including the European launch of our DiamondTemp™ ablation catheter, and Japanese approvals for our Valiant Navion™ thoracic stent graft, our Percepta™ Quad CRT-P family, and the Attain Stability™ Quad active fixation CRT pacing lead.

In MITG, as we discussed in September during our event in Hartford, we are starting the global launch sequence of our soft tissue robotic system, with first-in-human use and commercial sales commencing later this fiscal year. Next fiscal year, we plan to submit for CE Mark in Q1, as well as submit for U.S. IDE approval in the first half, which, when approved, will allow for system placements and surgeon training so we can begin gathering clinical data in the United States.

In RTG, as I mentioned earlier, the Midas Rex™ MR8™ drill platform is being launched now in the U.S. and will be introduced to international markets in the back half of this fiscal year. We are also planning to launch our Stealth™ Autoguide™ cranial robotic system in Q3. In Pelvic Health, we filed our PMA supplement with the U.S. FDA last month for our InterStim™ SureScan™ MRI leads and our InterStim™ Micro with MRI, which is 3cc in volume and rechargeable. In ENT, we're preparing for a fiscal year end launch of our next generation intraoperative nerve monitoring system, NIM Vital. In Pain Therapies, we plan to unveil our next-generation spinal cord stimulator at the NANS conference in January.

In Diabetes, we continue to prepare for the launch of the MiniMed™ 780G, our Advanced Hybrid Closed-Loop System with Bluetooth connectivity. We expect our 780G pivotal data to be presented at the ATTD conference in February. Earlier this month, to bridge the time before our next-generation technology is available in the U.S., we put in place a "Next Tech Pathway" program, which allows customers who are out-of-warranty or new to pump therapy to purchase a MiniMed™ 670G while accessing our next-generation of pump technology at no additional cost, when it becomes available.

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These are some of the highlights from our pipeline. There are, of course, several more product launches that we are preparing for across the company, while we continue to invest in building out a robust, long-term pipeline of continuous innovation, invention, and disruption.

As I've noted before, we expect our growth rate to accelerate, with the second half of FY20 growing faster than the first, as we anniversary recent headwinds and launch multiple new products. And, in FY21, we expect our topline momentum to accelerate, as we get the increasing benefit of the FY20 product launches, as well as the products slated to launch next fiscal year.

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

Karen Parkhill
Thank you.

As Omar mentioned, we delivered second quarter organic revenue growth of 4.1 percent, and adjusted EPS was a dollar, 31, growing 7.4 percent. We came in 3 cents above the midpoint of our guidance, driven by our operational outperformance.

Our adjusted operating margin was 28.1%, reflecting improvement of approximately 20 basis points. We delivered strong improvement in adjusted SG&A of approximately 90 basis points, as we implement and drive efficiencies and improvements across the company under our Enterprise Excellence program. Our improvement in SG&A was offset by declines in gross margin, reflecting the negative impact of foreign currency and China tariffs.

Below the operating profit line, our adjusted interest expense declined 32 percent, driven by our successful debt issuance and tender transactions earlier this calendar year. As you know, our cost of debt reduction is helping to offset an increase in our annual tax rate from U.S. tax reform.

Generating strong free cash flow remains a priority across the company. Second quarter free cash flow was 1.6 billion dollars, up 66% from last year. We are tracking nicely toward our full year conversion ratio target of 80% plus.

We remain committed to disciplined capital deployment, balancing investment in R&D and tuck-in acquisitions to drive future growth, with returning a minimum of 50% of our annual Free Cash Flow to our shareholders. In the second quarter, we returned over 1.1 billion dollars, or 71 percent of the cash we generated, resulting in a total shareholder payout of 64 percent on adjusted net earnings.

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

For the year, we continue to expect organic revenue growth to approximate 4 percent, with revenue growth accelerating in the back half relative to the first. 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.

With the strength we are seeing across several of our businesses – from Neurosurgery and Neurovascular to Spine, Surgical Innovations, and TAVR – we are raising the organic growth guidance for our three largest business groups. We now expect CVG to grow 2.5 to 3%, up from 2.5%, MITG to grow 5 to 5.5%, up from 5%, and RTG to grow 4.5 to 5%, up from 4 to 4.5% previously. These three groups combined contribute 92% of our revenue. In Diabetes, which represents 8% of our sales, we now expect low-single digit organic growth, reflecting competitive pressures in the U.S. while we await new product approvals.

For the third quarter, we anticipate organic revenue growth of 4% plus, with currency having a negative impact of 50 to 120 basis points at recent rates. By group, we expect CVG to accelerate to 3.5 to 4%, Diabetes to be flat to slightly down, and MITG and RTG to grow 4.5 to 5%, all on an organic basis.

As Omar mentioned, we are anticipating either U.S. or European approval on a long list of products, starting in the fourth quarter, and building into the early part of next year. Our Micra™ AV transcatheter pacemaker, Percept™ PC deep brain stimulator, InterStim™ Micro 3cc sacral nerve stimulator, MiniMed™ 780G advanced hybrid closed loop, DiamondTemp™ RF ablation catheter, an AV fistula indication for our IN.PACT™ Admiral™ drug-coated balloon, and next-generations for our Intellis™ SCS system, LINQ™ 2.0 insertable cardiac monitor, and Cobalt™ and Chrome™ family ICDs and CRT-Ds. I'm sure I left some off here, but as you can see, we have a lot that's coming, which is why we expect fourth quarter growth to accelerate as we begin to see the early impact of some of these launches.

Turning to margins, we continue to expect our full year operating margin to expand by roughly 40 basis points on a constant currency basis, driven by our Enterprise Excellence initiatives. For the third quarter, we would expect slight improvement in operating margin, offset by a currency headwind.

Below the operating line, we expect our quarterly non-GAAP interest expense to be similar to the second quarter for the remainder of the year. In addition, we now expect our third quarter adjusted nominal tax rate to be in the range of 15 to 15.25%, and an annual range of 15 to 15.5%. We remain focused on optimizing our underlying operating tax rate over time.

We are raising our fiscal year 20 EPS guidance to a range of $5.57 to $5.63, to reflect the second quarter's outperformance, a 3 cent increase from the prior range of $5.54 to $5.60. This includes a negative 9 cent impact of currency at recent rates. For the third quarter, we expect EPS of $1.37 to $1.39, including a 2 cent currency headwind at recent rates.

Now I will return the call back to Omar.

Omar Ishrak

Thanks, Karen. As I mentioned earlier, Geoff Martha became President of Medtronic earlier this month, and at the start of next fiscal year, I will retire as CEO and Geoff will take my place. I am excited with the Board's selection of Geoff as the next leader of Medtronic. Geoff has proven himself as a leader who can execute and deliver strong financial performance, develop our people, and enhance our company's culture. I know he will take Medtronic to new levels of performance and growth. We are working together closely to ensure a very smooth transition. Before we go to Q&A, I've asked Geoff to say a few words. Geoff?

Geoff Martha

Thanks, Omar. Well, first I want to reiterate what an *honor* IT IS to have been selected by the Board as Medtronic's next CEO. And I am *really* looking forward to leading this great company.

Now looking at this past quarter's results, I'm particularly pleased to see our strategies are working in Spine, with strong growth in that business driven by enabling technology like our Mazor robot. And the transition with Brett as head of RTG has been incredibly smooth. While he *officially* took over earlier this month, *Brett* really led the execution down the stretch in Q2 for RTG. Look, RTG is in good hands, I'll say that.

Now as I look ahead, I'm *incredibly* excited about Medtronic's future. We have several product launches coming up, and you can be assured that executing on these is *top* of my list of priorities. Actually, the *entire* Medtronic leadership team is focused and committed to delivering on our pipeline, allowing us to build momentum as we head into the back half of this fiscal year and into the next.

Also during this transition period, I'm connecting with many important Medtronic stakeholders and thinking about how our strategy will evolve, and how we will achieve that next level of performance. For starters, I'm spending a lot of time meeting with our business leadership and customers beyond RTG. I *also* plan to meet with and listen to the investment community over the coming months.

The transition with Omar is going great. We've worked together for a long time, and we know how to build off each other's strengths. Additionally, I am *thrilled* with the support from the Board and my colleagues on the Executive Committee. Having continuity in a transition like this makes life a lot easier! While it's still too early to comment on specifics on how our strategy will evolve, I'd like to share a few *initial* thoughts.

First, one thing that won't change is our focus on the Medtronic Mission, which drives us to use technology to alleviate pain, restore health, and extend life. In fact, we're looking to place even *more* emphasis on <u>innovation-driven growth</u>. Technology has always been the lifeblood of this company… and growth is the name of the game in MedTech. We will be laser-focused on getting our organic revenue growth rates up, getting more aggressive with tuck-in M&A, and being decisive with capital allocation to the highest growth segments. All of this will increase our weighted-average market growth rate, or our WAMGR.

Reinvigorating our Diabetes business is also a priority. This is a *rapidly* growing market that has huge, long-term potential. And I am confident in our ability to leverage our strengths to get back to *leading* the innovation in this space. We have a strong foundation with which to work, and a really exciting pipeline of innovation on both the pump and the sensor side. Also, I am really confident that Sean, along with the rest of the Diabetes business, will get this right. Most importantly, he is committed to improving the patient experience. Now, as we do this, along with executing on our product pipeline, we expect to return to "share-taking mode."

In fact, we see opportunities for share gains throughout the Medtronic portfolio, and we'll be measuring ourselves on just that. I like to keep things simple… grow our WAMGR and measure our business performance on whether we are taking share or not. You'll hear more on these priorities over time, and I look forward to sharing our *full* plans with you when we host Medtronic's Investor Day next June.

So, at this point I'll now turn it back to Omar.

<u>**Omar Ishrak**</u>
Thanks, Geoff. Let's now move on to Q&A. In addition to Karen and Geoff, two of our group presidents, Mike Coyle and Bob White, are also here to answer your questions. As Brett Wall and Sean Salmon are new to their roles of running RTG and Diabetes, respectively, they won't join the earnings call until next quarter. Karen, Geoff, and I will answer the questions related to those two groups today.

As usual, 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.

<u>**Following Q&A:**</u>

<u>**Omar Ishrak**</u>
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 Q3 earnings call, which we currently anticipate holding on Tuesday, February 18th. Thank you.