Q3 FY20 EARNINGS CALL COMMENTARY

FEBRUARY 18, 2020

Medtronic

Ryan Weispfenning

Thank you. Good morning and welcome to Medtronic's fiscal year 2020 third quarter conference call and webcast. During the next hour, Omar Ishrak, Medtronic Chairman and Chief Executive Officer, Karen Parkhill, Medtronic Chief Financial Officer, and Geoff Martha, Medtronic President, will provide comments on the results of our third quarter, which ended on January 24, 2020. 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 third 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 results for the third fiscal quarter. Revenue growth was light this quarter, reflecting a series of largely transient issues, which I'll walk you through in a minute. The good news, however, is that this was more than offset by 90 basis points of operating margin expansion, well ahead of our expectations, resulting in strong EPS and free cash flow growth, both ahead of plan. Importantly, despite the top-line shortfall this quarter, our Q4 outlook is unchanged, as we expect significant revenue growth acceleration, excluding any impact from the Coronavirus.

Q3 revenue grew 2.9% constant currency and 2.6% organic. Revenue growth fell short of our expectations, driven in part by customers curbing their purchasing ahead of our new product launches, principally in CVG and RTG. In MITG, we upgraded the group's ERP system in the US and Canada to our company-wide system, resulting in a temporary slowdown in our ability to supply customers, which in some cases resulted in lost procedures, and lasted longer in the quarter than we anticipated. That upgrade is now complete, and as of early this quarter, we are in the process of returning to full supply.

All of these items led to our quarterly revenue underperformance. We weren't able to offset these issues, given that many of them emerged late in the quarter. I'm not happy with this top-line performance, and we are focused on quickly addressing the dynamics that led to this result. Geoff will provide a little more color on this later in the call.

Looking down the P&L, we drove significant operating leverage despite the softer topline. Our adjusted operating margin expanded 90 basis points, as we continue to see the benefits of our Enterprise Excellence initiatives, particularly on the SG&A line. We also had strong financial leverage, driven in part by the debt refinancing that we completed earlier this fiscal year. This resulted in adjusted EPS of $1.44, which was 6 cents above the midpoint of our guidance and up 11.6% year-over-year.

Let's take a look now at the drivers of our group performances, starting with our Restorative Therapies Group, which grew 3.6% organic this quarter. RTG's performance was affected by customer buying patterns in BMP and the continued market slowdown and slight share loss in Pain Stim ahead of our DTM™ therapy launch.

On an organic basis, our overall Spine division was flat this quarter, reflecting customer drawdown of Infuse™ inventory. Despite this, our Core Spine business grew 2%, both globally and in the US. In addition, when you include sales of enabling technology sold by our Brain Therapies division, which is how our competitors report, Core Spine grew 5% organically, both globally and in the US, well above market.

Our Surgical Synergy strategy is resulting in increased sales of our Core Spine implants, driven by surgeons' use of our capital equipment, in particular our Mazor™ robot. It is also benefitting our Brain Therapies division, which sells the capital equipment used in spine surgery. Brain Therapies delivered another above-market quarter of 9.2% growth. In Neurosurgery, which grew low-double digits, we had strong growth in Mazor™ robotics, where we are meaningfully outpacing the competition, as well as in StealthStation™ navigation, O-arm™ imaging, and our new Midas Rex™ MR8™ systems.

In Brain Therapies, our market-leading Neurovascular business had another strong quarter with mid-teens growth, driven by mid-twenties growth in Ischemic Stroke on strong adoption of our Solitaire™ X stent retriever, Riptide™ aspiration system, and React™ catheters.

In Pain Therapies, the pain stim market had another sluggish quarter, and we had some slight share loss ahead of the launch of the Stimgenics DTM™ therapy on our Intellis™ platform. We're excited about the response we've received from physicians and the broader SCS community following the acquisition announcement and Stimgenics data presentation last month at NANS, as well as on our 9 year battery warranty on Intellis™. We continue to be optimistic about the outlook for the pain stim market and have begun training physicians on the DTM™ waveform.

Our Minimally Invasive Therapies Group grew 3.2% organic, including flat results in the US. MITG's performance this quarter was affected by the upgrade of its ERP system in the US and Canada, which caused some temporary slowdown in our ability to supply customers with the full breadth of our products, and in some cases resulted in lost procedures. This was, however, a transient issue. The ERP upgrade is now complete, and the related supply slowdown are behind us as of this month.

Within MITG, our Surgical Innovations division grew 3.6% this quarter, driven by our Advanced Surgical business, particularly in Advanced Energy, which grew in the high-single digits on strength in our Ligasure™ franchise and sales of our Valleylab™ FT10 energy platform. Respiratory, GI, and Renal division grew 2.2%, driven by low-double digit growth in our GI Solutions business and high-single digit growth in pulse oximetry sensors and advanced parameter sensors.

In our Cardiac & Vascular Group, we grew 1.8% this quarter, which was below our expectations, due in part to customers holding back their purchasing ahead of new product launches in CRHF. We saw high-single digit declines in our high power business as customers awaited approval of our Cobalt™ and Crome™ devices, which have launched this month in Europe and are expected to launch in the US during Q1.

In Heart Failure, although our LVAD business has anniversaried the headwinds we have faced over the past year, the business declined in the low-single digits and hasn't returned to the growth levels we were expecting.

The other driver of our below expectation CVG performance was our US TAVR business, which grew 13% this quarter, below the market growth rate. While the TAVR market has been rapidly expanding, we currently have fully experienced field support coverage in a little more than two-thirds of the approximately 700 US centers performing TAVR. We began aggressively hiring and training new field personnel months ago. However, our data shows that it's taking longer than expected for our new reps to reach full productivity. We plan to certify an additional 70 field personnel by the end of this fiscal year. We expect our US TAVR performance to improve relative to the market going forward as our expanded field organization reaches full productivity, and we focus the market on the hemodynamic benefits of Evolut™ PRO+ platform and the launch of our new Confida™ sheath. Outside the US, our TAVR market share grew modestly in Q3.

Our Pacing business grew in the high-single digits, well above the market, driven by our exclusive Micra™ leadless pacemaker and Azure™ family of conventional pacemakers. We announced the Micra™ AV approval in the last week of our quarter and are excited about its growth potential, as it expands the Micra™ target population from 15% to 55% of pacemaker patients. While we did not have revenue from Micra™ AV in the third quarter, we are already seeing strong interest and early adoption of this new technology in the fourth quarter.

In Diabetes, we grew 0.8%, slightly ahead of expectations. Our US business declined in the low-double digits, which was anticipated and resulted from competitive challenges, while we await our new products. We are seeing strong enrollment in our Next Tech Pathway program, which allows purchasers of the MiniMed™ 670G to upgrade for free to our next generation pump when launched. Keep in mind that as a result of this program, we are currently deferring a portion of the revenue of our pump sales, which we will recognize when patients trade in their 670G for the next generation pump.

In markets outside the United States, which represents just under half of our Diabetes revenue, we had solid, mid-teens growth, driven by the continued adoption of the MiniMed™ 670G. This demand is not only driving strong growth in our installed base, it is also resulting in double digit growth in recurring revenue from CGM and other consumables.

Now, turning to Emerging Markets, which represented 17% of our revenue:

In Q3, we grew Emerging Markets 14%, with contributions from geographies around the globe. China grew 14%, as did Southeast Asia, and Eastern Europe grew 16%, which included 39% growth in Russia. In addition, South Asia grew 13%, as did the Middle East & Africa, and Latin America grew 12%. We continue to drive strong growth in these markets as we optimize the distribution channel, and in certain markets, localize R&D and manufacturing.

Regarding the Coronavirus, our top concern is the health and well-being of our employees in China and across the globe. We have activated response teams in China, the Asia Pacific region, and globally, and we remain vigilant in monitoring the virus and taking action as necessary. All of our manufacturing operations are up and running in China. We are committed to helping the Chinese government and Chinese physicians address this crisis. As the Chinese healthcare system is focused on containing the spread of the virus, hospitals in China have experienced a slowing of medical device procedure rates, and we are seeing procedure delays. We do expect this to have a negative impact on our fourth quarter financial results, but given the fluidity of the situation, the duration and magnitude of the impact are difficult to quantify at this time.

Now, turning to our product pipeline… as we look forward, we're excited about what lies ahead, as the investments we've made in our product pipeline begin to pay off by accelerating our revenue growth and creating value for our shareholders.

We have recently received approval or launched a number of new products, that we expect to contribute to our growth going forward. I mentioned earlier the US approval of our Micra™ AV pacemaker and the launch that is now underway. We also received US approval for our IN.PACT™ Admiral™ AV fistula indication, which expands the market potential of our drug-coated balloons. We received US approval and are launching our Stealth™ Autoguide™ cranial robotic system. In Europe, we recently received CE Mark approval for our Cobalt™ and Crome™ portfolio of BlueSync™-enabled high power devices, our InterStim™ Micro rechargeable implantable sacral neuromodulation device and InterStim™ SureScan™ MRI Leads, as well as our Percept™ PC DBS device with BrainSense™ technology.

And over the next few quarters, we expect approval and launch of a number of additional new products. We expect US approval of the Cobalt™ and Crome™ high power devices, Reveal LINQ™ 2.0 insertable cardiac monitor, InterStim™ Micro and InterStim™ SureScan™ MRI leads, and our Percept™ PC DBS device. We're also expecting European launch of the MiniMed™ 780G and our DiamondTemp™ ablation catheter. Regarding our MiniMed™ 780G in the US, we intend to file our adult clinical data with the FDA in March, which will push expected approval beyond the fiscal year-end. In Pain Stim, we unveiled DTM™ spinal cord stim last month at the NANS conference and are now training our field force on this novel waveform, with an expected limited launch in Q4 and full launch in Q1.

In MITG, we continue to make progress on our soft tissue robotics program. Last week, we announced the acquisition of Digital Surgery, a pioneer in artificial intelligence and analytics for surgery. They lead the industry with their unique Touch Surgery ecosystem of products, including AI that identifies surgical steps and instrumentation. These products can be leveraged to provide insight into procedure time, cost, and process to improve surgical care. We're excited about utilizing the strength and capability of Digital Surgery to advance our minimally invasive and robotic surgery platforms.

We also have a number of important upcoming data presentations, starting with use case data under extreme conditions for our advanced hybrid closed loop algorithm at ATTD later this week. Next month, ACC will be a big conference for us. Data from our OFF-MED renal denervation pivotal trial will be presented, as will data for both low risk bicuspid and leaflet immobility for our TAVR program. Also, we will share risk stratification data for our TYRX anti-infection product. And finally, in June at ADA, we expect to present the US pivotal data for our MiniMed™ 780G advanced hybrid closed loop system.

These are just some of the nearer term highlights from our pipeline. Importantly, we are continuing to invest in building out a robust, long-term pipeline of continuous innovation, invention, and disruption.

I mentioned earlier that we expect significant acceleration in our fourth quarter revenue growth, driven in part by our pipeline and excluding the impact of the Coronavirus. And as we look to FY21, we expect our topline momentum to continue, 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 third quarter financials and forward outlook. Karen?

Karen Parkhill
Thank you.

As Omar mentioned, we delivered third quarter organic revenue growth of 2.6 percent, and adjusted EPS was a dollar, 44, growing 11.6 percent. We ultimately came in 6 cents above the midpoint of our guidance and would attribute 2 cents to better-than-expected foreign exchange and 4 cents to operational outperformance, including tax.

Our adjusted gross margin was 69.7%, down year-over-year due in part to increased China tariffs. We more than offset that decline with strong operating leverage, as we continued to implement and drive efficiencies and improvements across the company, while at the same time making investments ahead of upcoming product launches. This led to an adjusted operating margin improvement of 90 basis points, or 70 basis points excluding the impact of currency.

Below the operating profit line, our adjusted interest expense declined 36 percent, driven by our successful debt issuance and tender transactions that we completed last spring and summer.

Our adjusted nominal tax rate was 13.6 percent, lower than we expected, due to increased deductions from the exercise of employee stock options, and benefits from finalizing taxes owed on certain returns.

As you know, generating strong free cash flow remains a priority across the company, and you are seeing this focus come through in our results. Third quarter free cash flow was 2.1 billion dollars, up 21% from last year. And year-to-date, free cash flow is 4.9 billion dollars, representing a conversion ratio of 90%, well above our full year target of 80% plus.

We remain committed to disciplined capital deployment, balancing investment in R&D and tuck-in acquisitions to drive future growth, while returning a minimum of 50% of our annual Free Cash Flow to our shareholders. And, year-to-date we have returned 2.8 billion dollars, or 57% of the cash we generated, resulting in a total shareholder payout of 51% on adjusted net earnings.

Now turning to guidance…

For the fourth quarter, we are comfortable with current Street consensus on organic revenue growth and EPS, prior to any impact from the Coronavirus.

We expect overall organic top line growth of approximately 4.5%. By group, we expect CVG to grow 4.25 to 4.5%, MITG 6.25 to 6.5%, RTG approximately 4% organic, and Diabetes to be flat to down low-single digits. And, based on recent rates, currency would have a negative impact of 80 to 140 basis points.

On 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 fourth quarter, we expect our operating margin to be up slightly including the impact of currency, or roughly flat on a constant currency basis, as we invest to support current and upcoming product launches.

Below the operating line, we expect our fourth quarter interest expense to be approximately 160 to 165 million dollars and our fourth quarter adjusted nominal tax rate to be around 16%, which would put our annual rate at approximately 15%, lower than we originally expected, and reflecting the benefits we have had so far this year.

We are raising our fiscal year 20 EPS guidance to a range of $5.63 to $5.65, up from $5.57 to $5.63, and reflecting our third quarter bottom line outperformance. For the fourth quarter, we expect $1.62 to $1.64.

As mentioned up front, all of the guidance I just gave excludes the impact of the Coronavirus. Because the situation is so fluid, it is difficult to truly quantify the impact just a few weeks into our quarter. And for that reason, we plan to provide an update for you later this quarter.

Finally, I would like to note that we plan to hold our biennial Institutional Investor and Analyst Day on Tuesday, June 2nd, in New York City.

Back to you, Omar.

Omar Ishrak
Thanks, Karen. I'd now like Geoff to make some remarks on the quarter and the outlook. Geoff?

Geoff Martha
Thank you, Omar.

There are a number of *positive* things from the quarter that I want to highlight, but first I would like to address our top line performance. Even though much of it was transient, we did not perform at the level we were expecting, and the drivers surfaced at the end of the quarter. We just can't have surprises like this… for us, nor for you. And we *are making* changes.

At our upcoming Investor Day in June, I'm going to walk you through what innovation-driven growth means for Medtronic, and the comprehensive set of initiatives to take full advantage of the pipeline. These initiatives are meant to ensure we see the acceleration of our revenue from the pipeline… *and* to improve our predictability.

On *that* note, I want to discuss an aspect of our plan to address the surprise we saw this quarter. *One* issue is the weighting of our revenue to the final month of the quarter, which leaves us susceptible to surprises late in the game, like what happened this quarter. Too often, our largest orders come in at the end of the month. This dynamic makes the business challenging to manage. It stresses our operations. *And* it really makes it difficult to mitigate headwinds that pop up within the quarter. So, to fix this, we will change our current operating mechanisms, certain internal metrics, and some incentives as well.

And I want to flag the opportunity coming up with our extra week in Q1. The impact of the changes that I just mentioned likely *won't* be contained to a quarter, so I'd like to use a good portion of the benefit that we would get from the extra week in Q1 to launch these initiatives. So when we guide to the first quarter, we will give you guidance on an underlying basis *excluding* the benefit of the extra week, *and* we'll give you an estimate of the benefit of the extra week net of these changes.

Like I said, we plan to discuss these and other changes during our Investor Day. But I want to assure you one thing that I'm on this, and we're taking the appropriate actions to improve consistency and avoid future surprises.

Now, before I close and we get to Q&A, I've got to highlight a number of *good* things that occurred this quarter – accomplishments that I believe can't get lost in this quarter's narrative.

First, we drove a better operating margin *despite* the light top-line, and free cash flow was *outstanding*. These are two things that we have been working on for a long time. Over the past couple of years, we've taken action on both of these areas, and we feel really good about the operating rigor and the culture we put in place to drive the bottom line and improve cash flow.

Also, emerging markets growth continues to be strong for us. They represented 17% of our revenue and, once again, grew strong double digits… 14% this quarter. We think of emerging markets actually as an independent growth vector for the company.

And we have to acknowledge the progress with our pipeline. We are starting to see approvals and launches come through for important and innovative products…and there's more to come. Yes, the slowed purchasing ahead of these launches hurt us in some businesses this quarter, but this is going to turn. Customers are really excited about our new offerings!

I'd like to end by saying that the underlying fundamentals of the business are strong, we have a full pipeline that will accelerate our revenue growth and take share, not just next quarter, but next year, and beyond. We're very excited about the future of the company, the new technology that we bringing to market, the impact this will have on patients and physicians, and the value that we're going to bring and generate for our shareholders.

Alright. Back to you, Omar.

Omar Ishrak

Thanks, Geoff. I couldn't agree more with the approach that we're taking, and I'm just as excited about our outlook going forward. Before we start Q&A, I'd like to briefly note that we currently anticipate holding our Q4 earnings call, which will be my last earnings call, on Thursday, May the 21st. Let's now move on to Q&A. In addition to Karen, Geoff, and me, our four group presidents – Mike Coyle, Bob White, Brett Wall, and Sean Salmon – are also here to answer your questions.

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.

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 earnings call. Thank you.