Q4 FY19
EARNINGS CALL COMMENTARY
MAY 23, 2019

Medtronic

Ryan Weispfenning
Thank you. 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 2019, which ended on April 26, 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. In addition, the reconciliations of any non-GAAP financial measures are available on our website, InvestorRelations.Medtronic.com.

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 rates and ranges are given on a constant currency basis, which compares to the fourth quarter of fiscal year 2018 after adjusting for currency. Unless we say otherwise, annual rates and ranges are given on a comparable, constant currency basis, which compares to fiscal year 2018 after adjusting for currency and the FY18 divestiture of the Patient Care, DVT, and Nutritional Insufficiency business. All of these adjustment details can be found in the reconciliation tables included with our earnings press release. 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 Ishrak
Thank you, Ryan, and thank you to everyone for joining us.

This morning, we reported a solid finish to a strong fiscal year for Medtronic. We delivered revenue growth, operating margin, and EPS all ahead of Street expectations. Q4 revenue grew 3.6% organic, with outperformance in RTG and MITG offsetting challenges in CVG and difficult comparisons in Diabetes. In addition, Emerging Markets continued to be a big driver, growing 12%.

Our adjusted operating margin expanded 140 basis points, including currency, reflecting our entire organization's focus on Enterprise Excellence. On the bottom line, we grew adjusted diluted EPS 8.5%, or 9.2% at constant currency.

For the full fiscal year 2019, revenue, EPS, and free cash flow all came in above the guidance ranges we set at the beginning of the year, as we executed against our commitments. Revenue of $30.6 billion grew 5.5% organically. Adjusted diluted EPS grew 10% on a comparable, constant currency basis and 11.5% pro-forma. Free cash flow of $5.9 billion grew 62%, much faster than earnings, reflecting the focus of our entire organization on improving this important metric. Last June at our Investor Day, we set a target to improve our free cash flow conversion to 80% over the next 2-3 years, and we achieved it in just one year. FY19 free cash flow conversion was 83%, notably above our peer average. In FY19, we invested our capital into future growth platforms, with a focus on returns, while at the same time increasing our returns to shareholders through share repurchases and a rising dividend.

In Q4, we overcame significant challenges and relied upon the diversification of our business to deliver another quarter of solid top- and bottom-line results. Let's discuss some of the more important drivers of our performance, starting with our Restorative Therapies Group, which had another very strong quarter, growing 6.5%.

The launch of the Mazor X™ Stealth navigated robotic system is off to a strong start and building momentum. We sold 26 systems this quarter, increasing our spine robotic market share to more than 70%, with an installed base that is now more than three and a half times that of our closest competitor. While Mazor sales are driving Brain Therapies growth, we believe they are also a good leading indicator of future growth in our Spine division, as customers that are purchasing our Mazor system are also choosing to increase their share of Medtronic spine implants. In fact in Q4, over 80% of our Mazor systems were sold to customers who chose to enter into combined capital and implant contracts, and the percentage of Mazor robotic cases that use our Medtronic spine implants continued to climb, exceeding 60% in Q4, a double digit increase from Q3.

When you combine our Spine division sales with the sales of our capital equipment from our Brain Therapies division used in Spine surgery – our Spine division grew 5.6%, with the U.S. Core Spine business growing 11%. This is how our competitors report, and a strong indication that our enabling technologies – robotics, navigation, imaging, and powered surgical instruments – will help increase sales of spine implants.

In RTG, I'd also highlight Neurovascular and Pain Therapies. In Neurovascular, our market leading stroke portfolio continues to perform extremely well, with double-digit growth in stent retrievers, flow diverters, coils, and neuro access products. In Pain Therapies, we continue to gain market share despite the market's recent slowdown. Our Pain Stim business achieved a number one share position in Q4 for the first time in two and a half years, driven by our differentiated Intellis™ system, with its Evolve℠ workflow algorithm and Snapshot™ reporting.

In MITG, we grew 5.1%, driven by strength in Advanced Stapling and Advanced Energy. This is an impressive performance, as the Surgical Innovations business overcame challenges resulting from the shutdown of a major sterilization supplier's facility. I just cannot say enough about how our team stepped up and successfully managed this issue, quickly identifying alternative suppliers, and rerouting our supply chain to get inventory to the right place at the right time. We expect to be back to full sterilization capacity late in Q1.

In CVG, we grew 1.1%, as we faced challenges in drug-coated balloons and LVADs, as well as CRM replacement devices, given where we are in our replacement cycle. At the same time, multiple product lines showed exceptional strength in the quarter with high-teens growth from our Reveal LINQ™ insertable loop recorder, and mid-teens growth from both our Micra transcatheter pacing system and our Arctic Front™ AF ablation catheters. We also continued strong, double-digit growth in our TAVR franchise. Our TYRX™ anti-infection product grew in the high-twenties, and we saw a notable pick-up in its utilization following the WRAP-IT data presentation at the American College of Cardiology meeting in March.

In Diabetes, we grew 0.6%, an anomaly given difficult prior year comparisons that we described on our last earnings call. Despite the challenging comparisons, Diabetes delivered mid-teens growth in international markets and our fourth consecutive quarter of triple-digit growth in standalone CGM. Looking ahead, we expect Diabetes growth to reaccelerate in the first quarter and to be accretive to total company growth in FY20. At the ADA conference in June, we plan on hosting an investor meeting, where we will update you on the progress of our pipeline and an exciting series of product launches we have planned over the next 24 months.

Now, turning to Emerging Markets. Our performance continues to be strong, growing 12% this quarter, and representing 16% of Medtronic revenue. Our strength was diversified across all four groups and across multiple geographies, with China growing 13%, South Asia by 22%, and Southeast Asia by 20%. In addition, Middle East & Africa grew 13% and both Eastern Europe and Latin America grew 8%. Our strategies of public and private partnerships, optimizing the distribution channel, and in some markets, localization of R&D and manufacturing, are driving growth and differentiating Medtronic.

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Overall, it was another solid quarter despite the noted headwinds, and a really strong year for Medtronic. But as we look forward, we're even more excited about what lies ahead, as the investments we've been making in our pipeline begin to pay off with accelerating revenue growth, and ultimately, value creation for our shareholders. We expect our topline to accelerate over the course of FY20 and into FY21, driven by the anniversary of recent headwinds, combined with major products that are launching now or will launch over the next 12 months.

It's worth highlighting some of these near-term launches. I'll start with CVG. In our TAVR business, we are expecting low risk indication expansion in the US, as well as launches of our next-generation TAVR valve, the Evolut® Pro Plus. We intend to launch this valve across all sizes, including a large, 34 millimeter valve. In CRHF, two of the biggest launches we have in FY20 are (#1) our Reveal LINQ™ 2.0 insertable cardiac monitor and (#2) our Micra® AV transcatheter pacing system. LINQ 2 will feature Bluetooth connectivity, five-year battery longevity, enhanced sensing specificity, and the ability to monitor new physiological parameters. Micra® AV, which is one of the most disruptive products in our pipeline, is expected to launch around fiscal year end. It will enable us to access and disrupt over 55% of the eligible pacemaker market, up from 16% today.

In MITG, we continue to make great progress with our soft tissue robotics program, and we're now preparing for our initial launch in FY20, consistent with our commentary over the last several quarters. Our initial launch activities will occur outside the US and support our clinical and regulatory strategies in geographies around the globe.

I know everyone is anxious to see the robot, and for competitive reasons, we've obviously kept this program close to the vest. The good news is that we plan to host an analyst event this Fall to show the robot. We're in the process of working on dates, and as soon as we get everything confirmed, we'll be sure to send the analysts an invitation.

In RTG, as I mentioned earlier, the launch of the Mazor X Stealth™ is off to a great start, and we expect this will continue to drive growth in our Neurosurgery business, along with creating demand for our Core Spine implants. In Neurosurgery, we are preparing for the launch of the Midas Rex™ MR8™ drill platform in the first half of FY20, and we expect its differentiated features to drive share growth.

In Neurovascular, we just launched our next generation stent retriever, Solitaire™ X, and our React™ 071 aspiration catheter, advancing our leadership in the treatment of ischemic stroke. In Pain Therapies, we expect the full launch in FY20 of our Accurian™ nerve ablation platform.

In Diabetes, we expect to file for a non-adjunctive indication for our CGM sensor in early FY20, thereby allowing us access to the US Medicare market for the 670G. In addition, in FY20 we expect to launch the MiniMed™ 780G, our Advanced Hybrid Closed-Loop System with Bluetooth connectivity. The 780G will feature next-generation algorithms designed to improve time-in-range to over 80%. The system will reduce the burden of carb counting, enable remote monitoring as well as remote software downloads, and include several key enhancements to our CareLink™ system.

What all this means for the company as a whole is that we expect our growth rate to accelerate over the course of FY20, with the second half growing faster than the first, as we (1) anniversary recent headwinds, and (2) bring these innovative products to market over the next several quarters.

Moreover, we expect our topline momentum to build heading into FY21, as we get the increasing benefit of the FY20 product launches that I just mentioned, as well as the benefit of several products that we expect to launch early next fiscal year, such as:

- our Percept™ deep brain stimulation system, the very first deep brain stimulator with sensing capabilities;
- our DiamondTemp™ focal ablation catheter system, which will initially launch in Europe; and
- our Interstim Micro™ 3cc MRI-compatible sacral nerve stimulation system, which is fully rechargeable and 80% smaller than our current, market-leading device.

While there isn't enough time today to go through the longer-term pipeline, with all of these products launching, the takeaway that I want you to have is that each of our four groups has the potential to see accelerating growth in FY21.

Let me now ask Karen to take you through a discussion of our fourth quarter financials. Karen?

Karen Parkhill
Thank you.

As Omar mentioned, we delivered fourth quarter organic revenue growth of 3.6 percent and EPS growth of 8.5 percent.

For the full year, our adjusted operating margin expanded 120 basis points, including 50 basis points on a constant currency basis, and in line with the guidance we gave at the beginning of the year. We remain focused on our Enterprise Excellence program, better leveraging our size and scale and driving improved effectiveness and efficiency across the company. This past year in particular, the benefits of the program were most evident in SG&A, where we drove 40 basis points of improvement.

Our fourth quarter adjusted operating margin was 31.5 percent, an improvement of 140 basis points, or 50 basis points on a constant currency basis. In addition to driving expansion by executing on our Enterprise Excellence programs, we also absorbed the unplanned expense of China tariffs as well as a negative 20 basis point impact on our operating margin from the sterilization issue, with purposeful cost control throughout the company.

In the fourth quarter, we successfully executed a 7 billion Euro debt offering and used the proceeds to reduce US dollar denominated debt. The new Euro issuance carries a weighted average coupon rate of 7 / 8ths percent, lowering the effective interest rate on our long-term debt portfolio and providing savings for the company for years to come.

Our adjusted nominal tax rate was 14.1 percent for the quarter and 13.6 percent for the year, in-line with the expectations we set on the third quarter call. Excluding the non-recurring tax benefits we received in fiscal year 19, our adjusted nominal tax rate would have been approximately 14.75 percent.

Perhaps most exciting is our annual Free Cash Flow at 5.9 billion dollars, a significant improvement over the 3.6 billion we generated last year and well above our guidance and expectations. All of our colleagues have made improving Free Cash Flow a priority, and this focus is yielding strong results, enabling us to achieve our conversion goal well ahead of the schedule I gave you at our Investor Day in June.

Going forward, you can expect our Free Cash Flow to grow largely in line with earnings as we continue to target an 80% conversion rate – above our peer average – over our long-range plan.

Before I move to guidance, I want to reiterate our commitment to balanced capital deployment. We continued to invest in future growth through disciplined investment in R&D, along with tuck-in acquisitions like Mazor and Epix, among others. And, we remain committed to returning a minimum of 50 percent of our annual Free Cash Flow to our shareholders. In fact in fiscal 19, we returned 4.6 billion dollars – 78 percent of the free cash we generated – to our shareholders through both dividends and net share repurchase. Our total shareholder payout for the year was 65 percent on adjusted net earnings.

Now, turning to our guidance for fiscal year 20…

As a starting point, we expect organic revenue growth to be 4 percent, plus or minus. While the impact of currency is fluid, if recent exchange rates hold, foreign currency would have a negative impact on full year revenue of approximately 1 to 1.5 percent.

By business group, we expect MITG to grow 4.5 to 5 percent, RTG to grow 4 to 4.5 percent, Diabetes to grow 6 to 8 percent, and CVG to grow 2 percent, plus or minus, all on an organic basis.

We expect our first quarter growth rate to be lower than normal on the heels of a better-than-expected fourth quarter, transitory headwinds from the sterilization shutdown in MITG, and a slowdown in our Peripheral business from paclitaxel-coated balloons. Given these, we expect organic revenue growth in the first quarter to be in the range of 2 to 2.5 percent, with currency having a negative impact of 2.1 to 2.6 percent at recent rates. By business group, MITG and RTG are expected to grow 3 to 3.5 percent, CVG looks flat, and Diabetes is expected to grow 5 percent, plus or minus, all on an organic basis.

From there, we expect our revenue growth to accelerate over the course of the year, with constant currency growth closer to 4 percent in the second quarter, and north of 4 percent in the second half.

We expect to continue to drive margin expansion of approximately 40 basis points on a constant currency basis, driven by our Enterprise Excellence initiatives. For modeling purposes, we would assume a modest improvement in the first half of the year, given lower revenue growth and a slight FX headwind, with increasing improvement in the second half.

We expect our tax rate to increase from 13.6 percent last year to 16 to 16.5 percent in fiscal year 20, given the changes associated with U.S. tax reform that we discussed previously. Of course, we remain focused on optimizing our underlying operating tax rate over time under these new regulations.

With respect to earnings, we expect non-GAAP diluted EPS in the range of 5 dollars and 44 cents to 5 dollars and 50 cents, which includes a negative 10 cent impact of currency at recent rates. For the first quarter, we expect a dollar 17 to a dollar 19, including a 4 cent currency headwind at recent rates.

After delivering on each of our commitments in fiscal year 19, I couldn't be more excited about fiscal year 20 and beyond. As Omar outlined, we expect our revenue growth to accelerate over the course of the year as we anniversary recent headwinds and launch a series of major products. And, we expect this momentum to build into fiscal year 21, with each of our four groups having the potential to see accelerating growth next fiscal year.

Now I will return the call back to Omar.

Omar Ishrak

Thanks, Karen. Before we go to Q&A, I'd like to acknowledge our 90,000 Medtronic employees who work tirelessly and are dedicated to fulfilling the Medtronic Mission – alleviating pain, restoring health, and extending life for so many around the world. In fiscal 19, our employees together with our physician partners, served over 75 million patients – or more than 2 patients every second.

Let's now move to Q&A. In addition to Karen, our four group presidents, Mike Coyle, Bob White, Geoff Martha, and Hooman Hakami, are also here to answer your questions. 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 Q1 earnings call, which we currently anticipate holding on Tuesday, August 20th. Thank you.