Q1 FY18 EARNINGS CALL COMMENTARY
AUGUST 22, 2017

Medtronic

Ryan Weispfenning
Thank you, Darla. Good morning and welcome to Medtronic's first 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 first quarter, which ended on July 28, 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, as well as details related to our Patient Care, Nutritional Insufficiency, and DVT divestiture to Cardinal Health. During this earnings call, many of the statements made may be considered forward-looking statements, and 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 first quarter of fiscal year 2017, and rates and ranges are given on a constant currency basis. Finally, 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 first quarter revenue of $7.4 billion, representing growth of 4 percent. Non-GAAP diluted earnings per share were $1.12, growing 11 percent.

Our results this quarter reflect the strength of our underlying businesses and stable growth of our markets, as well as the diversification benefit of our groups and regions[1]. While a temporary sensor supply constraint and an IT disruption affected first quarter revenue growth, we continued to drive operating margin expansion[2]. This margin improvement, combined with a previously communicated tax benefit in the quarter, translated into strong earnings leverage. Looking ahead, we have now entered a period of clear acceleration in our innovation cycle, and we expect to see increasing revenue momentum from several important new product launches over the balance of the fiscal year[3].

Before discussing the details of the meaningful progress we are making on each of our growth strategies, let me briefly cover the two specific issues that affected our first quarter performance.

In our Diabetes Group, we are experiencing strong demand around the world for our new diabetes technology. This demand is a direct result of our differentiated strategy to move toward fully closed loop systems, which utilize our algorithms and CGM sensors to automate insulin dosing. We launched the MiniMed® 640G in international markets in 2015, and the world's first hybrid closed loop system, the MiniMed® 670G with the Guardian® Sensor3, in the US in June.

These advancements have increased our installed base and market share, resulting in a large increase in CGM demand, above our already high expectations. To put it in perspective, in just the past 10 quarters since launching the 640G, our overall sensor unit demand has more than doubled. The increased demand is largely for the new, highly accurate generation of sensors, the Enhanced Enlite® in international markets and the Guardian® Sensor3 in the US, and has temporarily outstripped our production capacity. We accelerated plans to increase sensor production capacity last year, but these lines are not expected to be ready for commercial production until our fourth quarter, at which time we expect to have the capacity needed to meet the rapidly growing sensor demand. Until then, we have to prioritize sensor fulfillment toward our installed base of customers; in the short-term, this leaves less available for higher revenue-generating new patient system sales.

It is also important to note that our Priority Access Program, necessitated by the early approval of the 670G – which allowed customers to purchase a 630G and then swap it for a 670G once available for a small fee – has been very successful, with close to 32,000 enrollees, exceeding our original expectations. However, because we only recognize a small portion of deferred revenue when exchanging the pumps, the program currently affects both revenue and margins. We expect to complete fulfillment to our Priority Access customers later this fall.

Toward the end of this fiscal year, we expect our Diabetes Group to be in a position to capitalize on its differentiated innovation in the marketplace, with stronger revenue and profit growth not only from increasing sales of our leading insulin pump technology, but also ongoing sensor annuity revenue.

Next, let me update you on the IT system disruption that occurred in June. As we communicated over the course of the quarter publicly, including in 8-K and 10-K filings, we experienced a global disruption to an IT system on June 19th that affected our ability to process, ship, and manufacture orders globally. During the days following, we mobilized resources as quickly as possible to not only identify the underlying issue, but also put in corrective measures to restore the system. As a result, our system was subsequently and fully operational later that week.

After the system had been fully restored, we engaged Ernst and Young to conduct an independent root cause analysis in partnership with our own technology experts and our vendor partners. The independent analysis concluded that the root cause was due to inadvertent human error, which caused a misconfiguration within certain data storage systems and resulted in our IT system becoming inoperable. Both our internal analysis and the independent analysis found no evidence of external actor involvement, data exposure, or compromise in this event.

Based on our internal findings and that of EY, we are taking appropriate actions to prevent this type of event from happening again, including but not limited to improvements aimed at IT network design, hardware and software systems enhancements, operating processes and execution, and governance.

While the IT disruption did have some impact on our overall performance for the quarter, it was not material to our quarterly revenue or earnings per share. We continued to deliver mid-single digit revenue growth and double digit EPS growth, in line with our long-term expectations. This event could have had a more significant impact in the quarter if not for the outstanding work and commitment of our employees around the world and the understanding and partnership of our customers. Our team rose to the occasion to ensure product was available to customers and patients during the disruption and then worked tirelessly to fulfill backlogs that built up during the event. This resilience and around-the-clock commitment of our Medtronic team made all the difference – and ultimately allowed us to return to normal operations expeditiously and effectively.

There is no longer any outstanding backlog associated with this event, and our IT system is operating normally. We are pleased to put this event behind us.

Now, let's discuss each of our growth strategies: therapy innovation, globalization, and economic value. In therapy innovation, we are seeing strong adoption of our innovative new products across all of our business groups.

In our Cardiac & Vascular Group, which grew 6 percent, we are leveraging the breadth of our products and services, as well as our strong positions in important, rapidly expanding markets to drive sustainable growth. In the first quarter, transcatheter valves, AF ablation, LVADs, transcatheter pacing systems, insertable diagnostics, atherectomy, and drug-coated balloons all contributed to CVG's strong performance.

In TAVR, we delivered growth in the high-thirties in both the US and international markets. Looking ahead, we expect our recent US FDA approval for intermediate risk and global rollout of our Evolut® PRO valve to drive continued TAVR growth. In Coronary, we gained drug-eluting stent share with our recently approved Resolute Onyx™ in both the US and

Japan, and we expect this product to increasingly drive meaningful Coronary growth as we go through this fiscal year.

Next, our Minimally Invasive Therapies Group grew 3 percent, or 5 percent after adjusting for the divested businesses that will no longer be part of our reported results starting in the second quarter. We had mid-single digit growth in our Surgical Solutions division driven by new products in Advanced Energy and Advanced Stapling. In Advanced Energy, we continue to rollout new LigaSure™ instruments and our Valleylab™ FT10 energy platform. In Advanced Stapling, our endo stapling specialty reloads with Tri-Staple™ technology are driving growth. We also continue to rollout Signia™, our new, single-handed powered surgical stapling system that provides surgeons with real-time feedback during surgery. These innovations are providing momentum to the transition from open surgical procedures to minimally invasive surgery, or MIS, resulting in better patient outcomes and lower healthcare costs. At the end of this fiscal year, we intend to further our goal of moving procedures from open to MIS with the first-in-human use of our surgical robot platform. We look forward to bringing a more comprehensive value proposition to our customers across all key surgical areas: open surgery, traditional MIS, robotic surgery, and services.

Our Restorative Therapies Group grew 2 percent this quarter, and within RTG, our Spine division grew 1 percent. We estimate that both the US and global spine markets have slowed modestly. However, we continue to gain market share, which we attribute to the success of our "Speed-to-Scale" new product launch initiative. We also continue to gain market traction with our Surgical Synergy strategy, growing the number of customer contracts that combine our spine implants with capital equipment for imaging, navigation, and powered surgical instrumentation sold by our Neurosurgery business.

Our Brain Therapies division grew 7 percent, driven by high-teens growth in Neurovascular and high-single digit growth in Neurosurgery. Brain Therapies continues to see traction from our recently launched StealthStation® S8 surgical navigation system, and strong low-thirties growth of our Solitaire™ family of revascularization devices for acute ischemic stroke.

Turning to Diabetes, while revenue growth declined 1 percent given the reasons mentioned earlier, we gained global durable pump and consumables share, driven by significant clinician and consumer demand for our 6 series pumps. CGM revenue grew in the low-twenties, including growth of nearly 50 percent in international markets, driven by demand for our sensor-augmented pumps and improved sensors. The Guardian® Sensor3's coming off our production line consistently demonstrate a MARD, which is a measure of sensor accuracy, of 10.4 percent in a real-world setting, in line with the performance we saw in the pivotal studies but with a much larger sample size.

Next, let's turn to our Globalization growth strategy. Emerging markets grew 12 percent, in line with our long-term double-digit growth expectations as we continue to expand access to our products and services around the world[4]. Our consistent emerging markets performance continues to benefit from geographic diversification, with strong results around the globe. Latin America grew 16 percent, with double-digit growth in Brazil, Mexico, Chile, and Argentina. We had continued strong results in China, growing above market with 12 percent growth, as we continue to consistently perform in a complex environment that we believe will become one of our largest markets. Southeast Asia delivered 12 percent growth, with Vietnam, Indonesia, and Thailand all delivering robust results. In the Middle East, we grew 12 percent, as we began to see recovery in the region. In particular, Saudi Arabia grew in the mid-thirties, our first quarter of growth in six quarters, as customer inventory levels appear to have normalized, and hospitals have begun to purchase again.

Let's turn now to our third growth strategy, Economic Value. We continue to see success in our Hospital Solutions business, which grew double digits, as we are now managing cath labs and operating rooms for nearly 140 customers around the world, including our first in Mexico. We are also seeing strong growth in our TYRX® value-based program for infection control in implantable devices, more than doubling the accounts under contract in the quarter to 325. Now, approximately 10 percent of our US CRHF implantables revenue is covered under a TYRX-related value-based healthcare risk sharing arrangement. In Diabetes, we were pleased to announce a new outcomes-based agreement with Aetna, where a component of our pump reimbursement will now be based on successfully meeting clinical improvement thresholds.

We are aggressively developing other unique, value-based healthcare solutions across each of our groups. While we are still early in this journey, we remain focused on leading the shift to healthcare payment systems that reward value and improved patient outcomes over volume. As always, we expect to do this in a way that benefits patients and healthcare systems – as well as our shareholders.

Before turning the call over to Karen, I would like to highlight that we closed our transaction with Cardinal Health at the beginning of the second fiscal quarter, divesting a portion of our Patient Monitoring & Recovery division. We expect this transaction to have a positive impact on our revenue growth rates and margins, with modest near-term earnings dilution. We remain committed to disciplined portfolio management and capital deployment that balances return to shareholders with reinvestment in internal and external opportunities that are aligned with our growth strategies and are expected to drive strong financial returns[5].

With that, let me ask Karen to now take you through a discussion of our first quarter financials and outlook for the remainder of the fiscal year. Karen?

Karen Parkhill
Thank you, Omar.

As Omar mentioned, our first quarter revenue of 7 billion, 390 million dollars represented an approximate 3 percent increase as reported, and approximately 4 percent on a constant currency basis. Foreign currency had a negative 33 million dollar impact on first quarter revenue. And tuck-in acquisitions completed almost a year ago contributed approximately 140 basis points to revenue growth, driven in part by the benefits gained from Medtronic ownership.

Our revenue fell just shy of 4 percent growth – by approximately 30 million on a total of 7.4 billion dollars. When we updated our guidance in July, we expected our revenue would be slightly higher, but the IT disruption caused a unique dynamic, affecting our visibility through quarter end as we worked to clear the order backlogs, including higher than expected sensor demand in Diabetes. And, as you know, given the buying patterns of our customers, we tend to have a larger amount of sales in the last few weeks of every quarter in some of our businesses. Importantly, as Omar mentioned, the IT system disruption is behind us, and we are seeing strong demand for our new technologies, giving us confidence in our revenue expectations for the remainder of the year.

In the quarter, we delivered continued operating margin expansion and strong EPS leverage. GAAP diluted earnings per share were 74 cents. Non-GAAP was $1.12. After adjusting for the 2 cent negative impact from foreign currency, non-GAAP diluted EPS grew 11 percent.

Our operating margin for the quarter was 26.9 percent on a constant currency basis, representing a year-over-year improvement of 50 basis points. With the impact of currency included, our first quarter non-GAAP operating margin also improved, increasing 10 basis points year-over-year. Taking into account currency and the acquisitions that we have done in the past year, our operating margin improvement on an organic basis was approximately 70 basis points in the quarter.

The operating margin improvement was driven by efficiencies as we continue to deliver on our Covidien synergies. This was partially offset by purposeful investments we are making in sales and marketing in the first half of the fiscal year to support new product launches.

Net Other Expense, which is included in our operating margin, was 66 million dollars compared to 39 million in the prior year, and negatively affected our operating margin improvement by 30 basis points. The increase in Net Other Expense was due in part to foreign exchange remeasurement and our hedging programs, which combined were a 5 million dollar loss in the quarter versus a 4 million dollar gain in the prior year. Looking ahead, we expect Net Other Expense to be approximately 110 million dollars per quarter, and slightly higher than that in the second quarter. This includes approximately 30 to 40 million dollars per quarter of hedging expense based on recent exchange rates.

Below the operating profit line, Net Interest Expense was 194 million dollars, slightly less than our original expectations as income earned on our cash investments helped to offset debt expense. Looking ahead, we expect Net Interest Expense to be approximately 180 to 200 million a quarter.

Our non-GAAP nominal tax rate was 13 percent and benefitted from 47 million dollars in operational tax adjustments that became evident and were communicated late in the quarter. Excluding these adjustments, our non-GAAP nominal tax rate would have been 15.7 percent, in line with our expectation between 15.5 and 16.5 percent for the remainder of the year.

First quarter average daily shares outstanding, on a diluted basis, were 1 billion, 376 million shares. We repurchased a net 1.1 billion dollars of our ordinary shares in the first quarter, executing the annual return commitment to shareholders, concluding our incremental 5 billion dollar commitment announced in January 2016, and pulling forward some of our incremental 1 billion dollar repurchase commitment from our divestiture to Cardinal Health given our lower stock price. We expect shares to continue to come down in Q2, and then stay roughly flat for the remainder of the year, given our tendency to purchase shares earlier in the fiscal year.

In June, we increased our cash dividend by 7 percent, making this our 40th consecutive year delivering a dividend increase. Combining our share repurchase activity with the 625 million dollars we paid in dividends in the first quarter, our total payout ratio was 111 percent on non-GAAP net income and 169 percent on GAAP net income. Keep in mind, our payout ratio is elevated as we tend to execute the majority of our annually planned share repurchases early in the fiscal year.

Before turning the call back to Omar, I would like to reiterate our annual guidance and update it with the completion of our divestiture to Cardinal Health, which occurred at the start of our second quarter.

For fiscal year 2018, we continue to expect comparable, constant currency revenue growth to be in the range of 4 to 5 percent, which removes the divested revenue from the second, third, and fourth quarters of fiscal year 2017, as well as the impact of currency. On a comparable basis, the divestiture is expected to result in more than a 30 basis point improvement, given the partial year impact, to our fiscal 2018 revenue growth. This translates into a full year, annualized recurring growth rate benefit of approximately 50 basis points as highlighted previously. While we recognize the divestiture has a positive impact to our guidance range, the current supply constraint in Diabetes will continue to impact growth in that business until later this fiscal year.

Looking at revenue growth by our business groups:

- For CVG, quarterly growth rates have typically been between 4 and 7 percent in recent years. Given the strength of its near-term pipeline and easing prior year comparisons, we now expect CVG to grow in the upper half of its historical range for the full fiscal year. We expect CVG's growth to be strong in the second and third quarters, before facing a difficult comparison in the fourth quarter.
- MITG has typically reported growth rates between 3 and 4 percent, excluding the impact of acquisitions, and the divestiture is expected to increase growth by about

a point. In fiscal 18, given the partial year impact of the divestiture and lower growth in the first quarter, we now expect MITG to grow in the range of 3.5 to 4.5 percent.

- For RTG, quarterly growth has typically been in the 3 to 5 percent range in recent years. Balancing strong growth in Brain Therapies against competitive challenges in Pain Therapies and a strengthening share position in a relatively flat Spine market, we now expect full fiscal year growth for RTG to be at the low end of this historical range.
- Finally, in our Diabetes Group, historical growth before the recent market disruptions was typically in the high-single digits to low-double digits. With the impact of the temporary supply constraint, we now expect Diabetes to grow in the range of 1 to 4 percent this fiscal year, with improvement in the second half, as we fulfill the new 670G to non-Priority Access customers in the third quarter and increase our sensor supply in the fourth quarter. While the growth acceleration has been delayed by a few quarters, we expect to enter fiscal year 19 with ultimate strong, double digit growth in Diabetes.

Looking at the second quarter, we would expect to be in the lower half of our annual revenue growth range on a comparable, constant currency basis, with accelerating growth in CVG offset by a decline in Diabetes in the high-single digits. Diabetes revenue is expected to temporarily decline sequentially before improving in the back half of the year for two reasons. First, we expect less deferred revenue recognition in the second quarter from our Priority Access program, as more pump shipments associated with this program occurred in the first quarter. Second, while we will be able to fulfill new 670G customers after we fulfill the Priority Access customers, we anticipate that new sales will be muted until we can ultimately fulfill sensors with the pumps. Only a limited amount of patients are likely to be willing to purchase a pump and wait for the sensors.

With regard to operating margin, we expect solid improvement in the fiscal year, with greater strength in the back half. We expect our gross margin on a comparable, constant currency basis to be flat for the year, with modest pricing pressure offset by operating improvement. SG&A, as a percent of revenue, is expected to improve, particularly in the back half of the year as we continue to execute on margin expansion opportunities in enabling functions, transition to centers of excellence, and optimize our distribution channels.

With respect to earnings, we continue to expect fiscal 18 non-GAAP diluted earnings per share to grow in the range of 9 to 10 percent on a comparable, constant currency basis.

For the second quarter, we would expect temporary year-over-year declines in our gross and operating margins, leading to EPS growth flat to slightly up, all on a comparable, constant currency basis, given the continued investments we are making to support product launches, the impact of temporary revenue declines in Diabetes, and the operational tax benefits we received in the prior year that are not expected to repeat. However, we continue to expect EPS growth and operating margin expansion to accelerate in the back half of the fiscal year.

While the impact from currency is fluid – and therefore not something we forecast – if recent exchange rates, which include a $1.18 Euro and 109 Yen, remain stable for the fiscal year, our full year revenue would be positively affected by approximately 380 to 480 million dollars, including an approximate 25 to 75 million dollar tailwind in the second quarter. Full year EPS would be affected by approximately negative 3 cents to a positive 1 cent, including a positive impact of approximately 0 to 2 cents in the second quarter.

Finally, regarding free cash flow, we continue to expect it to grow in the high-single digits, compounded annually, from fiscal year 16 to 18, albeit now on a comparable basis given the divestiture. To compare, you should adjust for items that are considered part of the divestiture net proceeds, like tax and transaction costs, that affect free cash flow. These are expected to be approximately 400 million dollars this fiscal year and 200 million dollars next year. In addition, you should adjust for the loss of free cash flow generated by the divested businesses, which was approximately 100 million dollars per quarter. Without these adjustments, free cash flow is expected to grow in the low-single digits, compounded annually, from fiscal year 16 to 18.

Now I will return the call back to Omar.

Omar Ishrak
Thanks, Karen.

Looking ahead to the remainder of our fiscal year, we have confidence in our guidance and visibility into the acceleration in our innovation cycle, as we see momentum coming from several new product launches this fiscal year, and let me remind you of a few of them:

- In CVG, we now have intermediate risk approval in TAVR and are launching our new Evolut® PRO valve. We also are in the early stages of market launch for our new Resolute Onyx™ drug-eluting stent, our Micra® Transcatheter Pacing System, and our MR-conditional quadripolar CRT pacemakers in our largest global markets. As we enter the back half of the fiscal year, we expect to launch HVAD Destination Therapy and our next generation Azure™ wireless pacemaker family in the US, as well as the IN.PACT® Admiral® drug-coated balloon in Japan.
- In MITG, as I mentioned earlier, we are launching our Signia™ powered surgical stapling system and gearing up to release our surgical robot platform later this year.
- In RTG, our product refresh in Spine continues, and we are preparing to launch our Solera® Voyager® 5.5/6.0 Fixation System. We are also seeing great traction with our StealthStation® S8 navigation system, and our continued partnership with Mazor and their Mazor X system.
- And in our Diabetes Group, in addition to ramping the 670G hybrid closed loop system launch, we are also preparing to launch our standalone CGM system, Guardian® Connect, in the US later this year, which will be combined with our Sugar.IQ™ app that utilizes IBM Watson cognitive computing.

Let's 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 second quarter earnings call, which we now anticipate holding on November 28th, which is a week later than normal given the closing time needed as a result of the divestiture to Cardinal Health. Thank you, and have a good day.