Q4 FY17 EARNINGS CALL COMMENTARY

MAY 25, 2017

Medtronic

Ryan Weispfenning
Thank you, Crystal. 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 2017, which ended on April 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. You should note that many of the statements made during this call may be considered forward-looking statements, and that actual results might differ materially from those projected in any forward-looking statement. Additional information concerning factors that could cause actual results to differ is contained in our periodic reports and other filings that we make with the SEC, and we do not undertake to update any forward-looking statement. In addition, the reconciliations of any non-GAAP financial measures are available on our website, InvestorRelations.Medtronic.com. Unless we say otherwise, references to quarterly results increasing or decreasing are in comparison to the fourth quarter of fiscal year 2016, and rates and ranges are given on a constant currency basis. References to annual results increasing or decreasing are in comparison to fiscal year 2016, and rates and ranges are given on a constant currency and constant week basis, which adjusts for the negative effect of foreign currency translation and the extra week that was in the first quarter of fiscal year 2016. 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 fourth quarter revenue of $7.9 billion, representing growth of 5 percent. Non-GAAP diluted earnings per share were $1.33, growing at 6 percent.

Before providing more detail on our quarterly performance, I would like to recap fiscal 2017, a solid year for Medtronic. We delivered record revenue of $29.7 billion, growing approximately 5 percent, in the mid-single digits for the fifth consecutive year[1]. We made progress in each of our growth strategies. In Therapy Innovation, we executed a steady cadence of meaningful product launches, as well as introducing some groundbreaking new technologies. In Globalization, we expanded access to our therapies in emerging markets around the world, resulting in double-digit growth. And in Economic Value, we continued to extend our industry leadership in developing value-based healthcare solutions. The integration of Covidien progressed as planned. We have now realized over $600 million in synergy savings and remain on track to deliver our goal of $850 million of total cost savings by the end of the next fiscal year[2]. This operational productivity, coupled with our revenue growth, were key contributors to delivering double digit EPS growth and generating over 5 and a half billion dollars of free cash flow. We strategically deployed our capital in line with our stated priorities, balancing the return of cash to our shareholders together with disciplined reinvestment in our businesses. We met our commitment of returning greater than 50 percent of our free cash flow to our shareholders in the form of dividends and net share repurchases. In addition, we invested approximately $1.5 billion in several strategic investments and 5 tuck-in acquisitions, and we expect these acquisitions to further enhance our revenue growth and improve returns over time. Finally, late in the fiscal year, we announced the sale of a portion of our PMR division to Cardinal Health for $6.1 billion as part of our disciplined portfolio management strategy.

But most importantly in fiscal year 17, together with our physician partners, we served 70 million patients – more patients, in more places around the world, than in any year in our history. It is incredible that two patients around the world are benefitting from Medtronic therapies and services every second[3]. I am very proud of our more than 88,000 dedicated employees, for all they accomplished in fiscal year 17, and all that we can accomplish going forward, as we continue to fulfill the Medtronic Mission.

Moving now to our fourth quarter performance, we had a strong finish to fiscal year 17, delivering over 5 percent revenue growth. CVG, MITG, RTG, and Diabetes all grew in the mid-single digits[4]. Geographically, we also demonstrated solid, balanced performance, with mid-single digit growth in the US and non-US developed markets, and double-digit growth in emerging markets. Complementing our solid revenue growth, our operating margin and cash flow continued to improve as expected.

Our performance continues to be fueled by our three growth strategies:
therapy innovation, globalization, and economic value. We are creating distinct competitive advantages and capitalizing on the long-term trends in healthcare: namely, the desire to improve clinical outcomes; the growing demand for expanded access to care; and the optimization of cost and efficiency within healthcare systems. These trends, along with an aging population in most countries, produce secular growth tailwinds that we believe represent sustainable, long-term opportunities for Medtronic.

Now, let's discuss our fourth quarter performance against each of our growth strategies. In Therapy Innovation, we continue to see strong adoption of our innovative products across all our groups.

In our Cardiac & Vascular Group, which grew 5 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. Combined, our TAVR, insertable diagnostics, AF ablation, LVADs, and drug-coated balloons are now annualizing at nearly $3 billion and growing at over 20 percent. In our cardiac rhythm implantables businesses, we recently received CMS approval for reimbursement coverage in the US for Micra®, the world's smallest pacemaker. Also, as announced last week, we now have US approval for the first MRI safe quadripolar CRT pacing system.

In TAVR, we delivered mid-thirties growth and increased our market share sequentially in both the US and Europe on the continued launch of our Evolut® R 34mm valve. In Coronary, we just received FDA approval of the Resolute Onyx™ drug-eluting stent at the start of this fiscal year. Looking ahead, we expect continued strong growth in TAVR, driven by the Evolut® PRO valve and intermediate risk indication expansion, and in Coronary, we expect the recent approval of the

Resolute Onyx™ will turn the mid-twenties US DES sales declines that we experienced in fiscal year 17 into meaningful growth this fiscal year.

In our Minimally Invasive Therapies Group, which grew 6 percent, we had high-single digit growth in Surgical Solutions driven by new products in Advanced Energy and Advanced Stapling. In Advanced Energy, we continue to rollout three new LigaSure™ instruments with a nanocoating that helps reduce instrument cleaning, which improves surgical procedure efficiency. And, we continue to see strength in the Valleylab™ FT10 energy platform. In Advanced Stapling, results were driven by the sustained adoption of our endo stapling specialty reloads. We also launched Signia™, our new, single-handed powered surgical stapler that provides surgeons with real-time feedback during surgery. These new products continue to facilitate the move of open surgical procedures to minimally invasive, resulting in better patient outcomes and lower healthcare costs.

In Patient Monitoring & Recovery, our above market growth was driven by strength in our PB980 ventilator, our Capnostream™ 20 bedside capnography monitor, capnography disposables, as well as our Nellcor™ pulse oximetry products.

Our Restorative Therapies Group grew 5 percent this quarter, with strong contributions from our Spine, Brain, and Specialty Therapies divisions. Our Spine division grew 3 percent and again gained market share. Core Spine grew in the low-single digits, continuing to benefit from our "Speed to Scale" initiative as we continued to launch a series of new products, including the Solera® Voyager® and Elevate™ expandable cage. In addition, Infuse® sales were strong, growing in the double digits.

Our Brain Therapies division grew 9 percent, driven by double-digit growth in Neurovascular and Neurosurgery. In Neurosurgery, our StealthStation® S8 surgical navigation system received strong surgeon enthusiasm at the American Academy of Neurological Surgeons annual conference last month. While we launched it late in the fourth quarter, we expect it to result in accelerating sales growth next fiscal year.

Turning to our Diabetes Group, the growth rate at 4 percent decelerated sequentially as we predicted, ahead of the full launch of the MiniMed® 670G hybrid closed loop system. Despite this, we gained insulin pump share in both the US and international markets, driven by strong clinician and consumer demand for our 6 series pumps. In the US, direct pump shipments to consumers grew over twenty percent. In CGM, we grew in the low-twenties and are seeing strong growth globally as more patients transition to our sensor-augmented pumps.

Regarding the US launch of the MiniMed® 670G, we have approximately 750 people currently taking part in our Customer Training Phase. The feedback has been extremely positive – with a continued increase in patient satisfaction levels. We are preparing for a broader launch in June to the more than twenty thousand pump users that are enrolled in our Priority Access Program. As stated before, we do not expect revenue growth to ramp substantially until after we have fulfilled the Priority Access orders, given the low revenue associated with the upgrade program.

Our product pipeline remains robust across all our groups, with a number of important near-term growth catalysts. We remain confident that our New Therapies can drive sustainable growth next fiscal year and beyond.

Next, let's turn to Globalization. Emerging markets grew 10 percent, as we continue to expand access to our products and services around the world[5]. In addition to ongoing traditional market development, we are executing on differentiated strategies, namely structuring partnerships with both governments and the private sector, as well as optimizing our distribution channels. We believe that these initiatives will not only position us for long-term leadership in emerging markets, but also will accelerate growth and lead to sustained market outperformance.

In the Middle East, we continued to face challenges in the macroeconomic environment, causing our revenue to decline in the mid-single digits. However, in Saudi Arabia, our largest market in the region, we are encouraged by the relatively stable sequential revenue we have delivered for the past two quarters, albeit at a lower base given the large year-over-year declines experienced earlier this fiscal year.

In other regions around the world, we delivered strong, double digit growth in China, Latin America, and Southeast Asia, and high-single digit growth in Eastern Europe. In China, we grew in the low-teens, with double digit growth across CVG, MITG, and RTG, largely driven by strong growth in pacemakers, advanced stapling, and neurovascular. In addition, we continue to see success from our expansion into Chinese tier two cities and private hospitals. In Latin America, we had high-teens growth led by strong results in RTG, Surgical Solutions, and Coronary & Structural Heart. Brazil, Mexico, Chile, and Argentina all grew double digits. In Southeast Asia, which grew in the low-twenties, we executed a number of channel optimization initiatives, including moving to direct distribution models in certain businesses in Indonesia and the Philippines.

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

Turning now to our third 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 more than 130 customers around the world. Also, we continue to execute our value-based healthcare signature programs. One of these is TYRX®, our anti-infection envelope for implantable devices, which is an example of where a technology change directly results in clear and measurable value to the healthcare system, without any dependence on other variables. Since launching our value-based program for TYRX® earlier this calendar year, we have outcome-based contracts in place at over 140 accounts, helping drive over 20 percent revenue growth in TYRX® in the fourth quarter. Infection control for implantable devices is a large growth opportunity, as in the US alone, over 6,000 patients are affected annually.

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[6]. As always, we expect to do this in a way that benefits patients, healthcare systems, as well as our shareholders.

Before turning the call over to Karen, I would like to highlight the agreement that we reached in the fourth quarter to divest a portion of our Patient Monitoring & Recovery division to Cardinal Health. We were pleased to receive clearance from the US Federal Trade Commission last week and continue to expect this transaction to close in our second quarter of fiscal year 2018. This is a positive transaction for all involved, including our shareholders and employees, who, we believe, will thrive under this change in ownership. We are committed to disciplined portfolio management, and we reached the conclusion that these businesses, while truly meaningful to patients in need, are best suited under ownership that can provide the investment and focus that these businesses require. Upon closing, this transaction will have an immediate positive impact on our revenue growth rates and margins, with modest near-term earnings dilution. We intend to continue investing over the long-term in internal and external opportunities that are more directly aligned with our growth strategies and focus on strong financial returns.

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

Karen Parkhill
Thank you, Omar.

Our fourth quarter revenue of 7 billion, 916 million dollars increased 5 percent, both as reported and on a constant currency basis. Foreign currency had a negative 37 million dollar impact on fourth quarter revenue, and acquisitions contributed approximately 110 basis points to revenue growth.

GAAP diluted earnings per share were 84 cents. Non-GAAP was $1.33. After adjusting for the 2 cent negative impact from foreign currency, non-GAAP diluted EPS grew 6 percent.

Our operating margin for the quarter was 30.7 percent on a constant currency basis, representing a year-over-year improvement of 40 basis points. With the impact of currency included, our fourth quarter non-GAAP operating margin also improved, increasing 10 basis points year-over-year. We continued to cover the earnings dilution from our recent acquisitions, which means we maintained earnings expectations while realizing incremental acquisition revenue. 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 in part by efficiencies as we continue to deliver on our Covidien synergies. This was partially offset by purposeful investments we made in sales and marketing ahead of upcoming product launches.

Net Other Expense was 48 million dollars compared to income of 21 million dollars in the prior year, due in large part to lower net gains from our foreign exchange hedging programs.

Our full year operating margin improved 140 basis points on an organic basis, which takes into account the impact of foreign currency, acquisitions we have done within the past year, and the impact of the extra week in fiscal 16. This solid operating margin improvement was within our expected range for the year.

Below the operating profit line, Net Interest Expense was 196 million dollars, a sequential increase driven in part by our debt issuance in March. At the end of the fourth quarter, we had 33.4 billion dollars in debt and 13.7 billion dollars in cash and investments, of which approximately 6 billion dollars was “trapped.”

Our non-GAAP nominal tax rate on a cash basis was 17 percent, in line with our expectations. Fourth quarter average daily shares outstanding, on a diluted basis, were 1 billion, 381 million shares.

Turning to shareholder payout, in fiscal 17, we paid 2.4 billion dollars in dividends and repurchased a net 3.1 billion dollars of our ordinary shares. This represented a total payout ratio of 86 percent on non-GAAP net income and 136 percent on GAAP net income. Keep in mind, our payout ratio is elevated as we have been continuing to not only return 50 percent of our annual free cash flow to shareholders, but also execute the 5 billion dollar incremental share repurchase commitment we made through fiscal year 18.

Before moving to our income statement guidance, I want to reinforce our commitment to strong free cash flow generation, which we recognize is an important driver of long term shareholder value. In fiscal year 17, our free cash flow was 5.6 billion dollars, in line with our guidance, and representing very strong year-over-year growth of 35 percent. This growth was well above our long-term expectation to grow free cash flow in the high-single digit range – roughly in line with earnings – and is primarily due to the timing of litigation and tax items that affected our income statement in fiscal 17 but won't impact cash flow until fiscal 18. As you know, cash flow is subject to large swings in discrete items and, as we have demonstrated this year, can also be affected by timing. Going forward, we will talk about cash flow growth against a longer, multi-year view, and as such would expect our free cash flow to grow in the high-single digits, compounded annually, from fiscal year 16 to fiscal year 18.

Now, looking at the picture ahead…

To avoid confusion, our guidance for this next fiscal year does not take into account the impact of the planned divestiture. We intend to update our guidance upon close of the transaction.

For fiscal year 2018, we expect constant currency revenue growth to be in the range of 4 to 5 percent, on both an organic basis and after taking into account the year-over-year benefit from the acquisitions we completed early last fiscal year. By business group, we expect CVG to grow in the range of 5 to 6 percent, MITG to grow in the range of 3 to 4 percent, RTG to grow approximately 4 percent, and Diabetes to grow in the 10 to 12 percent range, increasing from the first half to the second as we fully launch 670G beyond our Priority Access Program. Looking at the first quarter, we would expect total Medtronic revenue growth to be similar to the annual range. But, keep in mind that in the first quarter, we will be fulfilling the 670G Priority Access Program, so we would expect Diabetes growth to be similar to the past quarter and ramp throughout the year.

We expect solid operating margin improvement in fiscal year 18, with greater strength in the back half of the fiscal year. We expect our gross margin on a constant currency basis to be flat to slightly improve throughout the fiscal year, with modest pricing pressure offset by operating improvement. Given historical and current foreign exchange rates, we expect currency to negatively affect the gross margin in the first half of the year, with a greater impact in the first quarter than the second.

SG&A, as a percent of revenue, is expected to improve next fiscal year, particularly in the back half as we continue to realize additional Covidien synergies in our enabling functions and transition to centers of excellence. However, in the first half of the fiscal year, we expect SG&A as a percent of revenue to remain relatively flat from the first quarter to the second, as we invest in sales and marketing for important new indications and product launches, including TAVR intermediate risk, Resolute Onyx™ and the 670G.

Given our recent debt issuance and the purposeful liquidation of some of our investments, we expect net interest expense to moderately increase over the level just reported in the fourth quarter. And, while difficult to predict given a dependency on our stock price movement, we expect a slight tax benefit from the accounting change for excess benefits on stock options we will implement in fiscal year 18.

With respect to earnings, we expect fiscal year 2018 non-GAAP diluted earnings per share to grow in the range of 9 to 10 percent on a constant currency basis, with higher growth in the back half of the year as we fully launch important new products and realize additional savings in SG&A as mentioned. In addition to these items, given the tax benefits we had in the first half of fiscal 17 that are not expected to repeat, we would expect first quarter EPS growth to be at the upper end of the high-single digit range, with the second quarter in the mid-single digit range, both on a constant currency basis.

While the impact from currency is fluid – and therefore not something we forecast – if recent exchange rates, which include a $1.12 Euro and 111 Yen, remain stable for the fiscal year, our full year revenue would be positively affected by approximately 75 to 175 million dollars. Given historical and current rates, the impact from foreign currency would be a headwind in the first half of the fiscal year – including approximately 10 to 60 million dollar negative impact to revenue in the first quarter – and shift to a tailwind with the comparison against a stronger dollar in the second half. Full year EPS would be negatively affected by approximately 5 to 10 cents, including a negative impact of approximately 3 to 5 cents in the first quarter.

As Omar mentioned earlier, we expect the divestiture of a portion of our Patient Monitoring and Recovery division to Cardinal Health to close in our second fiscal quarter. As stated upon announcement, the transaction is expected to result in modest net dilution to our fiscal 2018 non-GAAP earnings per share in the range of approximately 12 to 18 cents, with the exact amount primarily dependent on the closing date of the transaction. The transaction is expected to improve our comparable, constant currency revenue growth rate and non-GAAP comparable, constant currency operating margin by approximately 50 basis points each. As previously stated, we intend to allocate 1 billion dollars of the after-tax proceeds to an incremental share repurchase in fiscal 2018, with the balance used to reduce debt.

Now I will return the call back to Omar.

Omar Ishrak
Thanks, Karen. To conclude:

- Q4 was a strong finish to the fiscal year, with balanced, diversified growth across our groups and regions.
- Along with the mid-single digit revenue growth, our organization delivered meaningful operating margin improvement and double-digit EPS growth, as well as growth in free cash flow in fiscal 17.

Looking ahead, I want to reiterate our longer-term commitment to drive not only mid-single digit constant currency revenue growth and double digit constant currency EPS growth, but also our focus on long-term value creation through strong free cash flow and strategic capital allocation, balancing return of cash to our shareholders with disciplined reinvestment to fuel future growth.

We will now open the phone lines for Q&A. In addition to Karen, I've asked Mike Coyle, President of CVG, Bryan Hanson, President of MITG, Geoff Martha, President of RTG, and Hooman Hakami, President of our Diabetes Group, to join us. We want to try to get to as many people as possible, so please help us by limiting yourself to only one question, and if necessary, a related follow-up. If you have additional questions, please contact Ryan and our Investor Relations team after the call. Operator, first question please.

Following Q&A:

Omar Ishrak
OK. Thanks for your questions. On behalf of our entire management team, I would like to thank you again for your continued support and interest in Medtronic. We look forward to updating you on our progress on our Q1 call, which we currently anticipate holding on Tuesday, August 22nd. Thank you.