Medtronic

FINAL

Q3 FY23
Earnings call commentary

Ryan Weispfenning

Good morning. I'm Ryan Weispfenning, Vice President and Head of Medtronic Investor Relations. Welcome to Minnesota, where signs of spring are in the air. I appreciate that you're joining us today for Medtronic's fiscal 2023 third quarter earnings video webcast.

Before we go inside to hear our prepared remarks, I'll share a few details about today's webcast:

- Joining me are Geoff Martha, Medtronic Chairman and Chief Executive Officer and Karen Parkhill, Medtronic Chief Financial Officer. Geoff and Karen will provide comments on the results of our third quarter, which ended on January 27, 2023, as well as our outlook for the remainder of the fiscal year. After our prepared remarks, the Executive VPs from each of our four segments will join us, and we'll take questions from the sellside analysts that cover the company. Today's program should last about an hour.
- Earlier this morning, we issued a press release containing our financial statements and divisional and geographic revenue summaries. We also posted an earnings presentation that provides additional details on our performance. The presentation can be accessed in our earnings press release or on our website at InvestorRelations.Medtronic.com.
- During today's program, many of the statements we make 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.

- Unless we say otherwise, all comparisons are on a year-over-year basis, and revenue comparisons are made on an organic basis, which excludes the impact of foreign currency and revenue from our Q1 acquisition of Intersect ENT.
- References to sequential revenue changes compare to the second quarter of fiscal '23 and are made on an "as reported" basis, and all references to share gains or losses refer to revenue share in the fourth calendar quarter of 2022 compared to fourth calendar quarter of 2021, unless otherwise stated.
- Reconciliations of all non-GAAP financial measures can be found in our earnings press release or on our website at InvestorRelations.Medtronic.com.
- And 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, let's head into the studio and hear about the quarter.

<OPENING VIDEO TRANSITION>

Geoff Martha

<Introduction and Key Messages>

Hello everyone and thank you for joining us today. We reported our Q3 results this morning, and we executed to deliver a top and a bottom line that were ahead of our guidance and Street expectations. We are urgently forging the path to durable growth, and there are many proof points of our progress in these results. Our Cardiovascular and our Neuroscience portfolios had strong, high-single digit organic growth as we launched new products and demonstrated continued strength in our established, market-leading Cardiac Rhythm Management and Spine franchises. And at the same time, some of the recent revenue headwinds that have held back our growth are subsiding, including product availability in businesses like Surgical Innovations, Cardiac Diagnostics, Aortic, and ENT.

The aggressive transformation at Medtronic is advancing. We're focused on reducing complexity, enhancing our culture, improving capital allocation and portfolio management, and upgrading our global manufacturing operations and supply chain capabilities. At the same time, we're progressing on our plans for significant cost reductions. These are aimed at partially mitigating the continued impacts from macro conditions such as inflation and FX on our profitability and cash flow. These cost reductions also create room on our P&L so that we can increase our growth investments. And I'm very encouraged by the rebound in our revenue growth, despite procedure volumes remaining a little softer in a few markets and volume-based procurement in China. We are confident in delivering durable revenue growth over the coming quarters as recent revenue headwinds continue to dissipate, and we execute across our businesses.

<Q3 Results – Established Market Leaders>
So let's take a closer look at our Q3 results. As I highlighted at an investor conference last month, we're thinking about our portfolio of businesses in three groups: highest growth, synergistic, and established market leaders. I'll start with our "Established Market Leaders", a group of our largest businesses that make up about half of our revenue. Both our Cardiac Rhythm and Spine businesses had really good quarters, growing 8% and 5%, respectively. In CRM, we continue to see strong market adoption of our Micra™ leadless pacemakers, which grew 14%, and our Defibrillation Solutions business grew 7%, as replacement headwinds are moderating. And just last week, we received CE Mark for our Aurora™ extravascular ICD.

In Cranial and Spinal Technologies, we delivered another strong quarter, with 6% growth in Core Spine, including 12% growth in the United States, and 8% growth in Neurosurgery. This is driven by our market-leading ecosystem of Aible™ enabling technology and the associated pull-through of our best-in-class spinal implants.

From our AI-enabled surgical planning platform, to our patient-specific and differentiated spine implants, to our imaging, our navigation, and robotic technologies, we're differentiating ourselves with spine surgeons around the world.

Turning to our Surgical Innovations business… SI grew sequentially as we made solid progress recapturing the share that we lost due to supply challenges over the last few quarters. Year-over-year, SI declined as a result of expected stapling VBP tenders in China. But excluding China sales, SI grew 5% in Q3. Look, surgeons around the world prefer our Advanced Surgical products, and we expect the momentum we're seeing in SI to continue. In particular, in our leading Advanced Energy franchise, we're seeing strong adoption of our recently launched cordless Sonicision™ 7, and we're preparing to launch our recently approved LigaSure™ XP.

<Q3 Results – High Growth Markets>

So we're on the right path with our established market leader businesses. And at the same time, we're advancing our position in high, secular growth MedTech markets. These businesses are contributing about 20% of our revenue today and collectively growing above our company average. We're investing disproportionately in these businesses and expect them to become an even bigger part of our growth over time.

So starting with Structural Heart… while the TAVR market continued to be impacted by healthcare staffing challenges and COVID in Japan, we drove 11% growth in Q3, including 12% growth in the United States. We're seeing great physician reception for our Evolut™ FX system, which just completed its first full quarter of launch in the US. Evolut™ FX combines industry-leading durability with enhanced and predictable valve deployment. In addition, data was presented during the quarter at PCR London Valves showing Evolut™ FX's commissure alignment has improved significantly, which is important for coronary access and valve hemodynamics. Now looking ahead, we will continue to bring Evolut™ FX around the world, and we are currently seeking approval in the Japanese and European markets.

In Cardiac Ablation Solutions, we grew 3% globally, as provincial China VBP tenders weighed on our results. Outside of China, CAS grew in the high-single digits, including low-double digit growth in the United States on the continued strong adoption of our leading Arctic Front™ cryoablation technology. We're also advancing what we believe will become the leading Pulsed Field Ablation portfolio. In two weeks, highly anticipated data for our PULSED AF pivotal trial will be released in the late-breaker session at ACC. The trial is evaluating our PulseSelect™ PFA catheter in both paroxysmal and persistent patients, and this will be the first results from an IDE trial in the PFA space. And we're on track to be one of the first companies with a PFA catheter in the US market.

We also continue to make progress on bringing our Affera mapping and navigation platform and Sphere-9™ catheter to market, as we completed enrollment in our pivotal trial during the quarter. Sphere-9™ can perform high-density mapping and deliver either PFA or RF energy, all from the same catheter. And given Sphere-9™ is a focal point PFA catheter, it is highly complementary to our PulseSelect™ anatomical PFA catheter. Finally, our CAS business just launched the AcQCross™ transseptal access system, with its zero-exchange workflow, and the only system approved for both mechanical and RF crossings. So when you think about our Arctic Front™ cryo solution, our DiamondTemp™ RF catheter, our PFA catheters, our left-heart access solutions, and our Affera map/nav system… we're assembling a leading ecosystem of technologies to meaningfully increase our participation in the fast growth, $8 billion EP ablation space.

In Surgical Robotics, we're making good progress as the second major player in this exciting space. We continue to see positive sales momentum with the rollout of our differentiated Hugo™ robotic system in many international markets. And we started our US IDE trial for a urology indication during the quarter. Given less than 5% of surgical procedures globally are done robotically, we expect our Surgical Robotics business to become a meaningful growth driver for Medtronic.

In Neurovascular, we grew 9% and would have grown a couple points more if not for the China VBP. We continue to see very strong growth in several categories, including flow diversion, aspiration, and stent retrievers. Given stroke is the #2 cause of death globally and there is still very low therapy penetration, we see a long runway for high growth in this market that is approaching $4 billion.

And in Diabetes, we continue to see strong international growth offset by declines in the US where we lack our latest products. We remain focused on resolving our FDA warning letter and are ready for reinspection. We also remain in active review with the FDA on our submission of the MiniMed™ 780G system with the Guardian™ 4 sensor. Outside the US, our Diabetes business grew 18%, on continued strong sales momentum of 780G and Guardian™ 4. The 780G is now launched in over 90 countries, up from 60 last quarter. We're seeing strong CGM attachment rates, which drove CGM growth of 34% outside the US. We continue to invest heavily in assembling our ecosystem of durable pumps, smart pens, patch pumps, sensors, algorithms, and customer service, with multiple programs under development… all with the intent of restoring strong growth of our important Diabetes franchise over the coming years.

<Q3 Results – Synergistic Businesses>

And in our Synergistic businesses, we also had strong performances across several businesses. We grew double digits in Cardiac Diagnostics as we ramped up production of LINQ II™. In Neuromodulation, we grew 12% in Pain Stim, and the market continues to recover. And our GI business grew high-single digits on strong adoption of GI Genius™, which uses artificial intelligence to help physicians detect polyps during colonoscopies.

With that, I'll turn it over to Karen to discuss our third quarter financial performance and our guidance. Karen?

Karen Parkhill

Thank you, Geoff.

<Q3 Financial Recap>

Our third quarter organic revenue increased 4.1%, exceeding our guidance and representing a significant acceleration from our first half results as we begin to put the acute supply chain challenges behind us. Our non-GAAP EPS of $1.30 landed above our guidance by 3 cents on higher revenue growth and increased interest income, and 6 cents if we take into account a larger currency headwind than expected at the beginning of the quarter.

Looking at our revenue from a geographic perspective, US grew 2% and our Non-US Developed markets increased 6%, even with a 3% decline in Japan as COVID affected procedure volumes. Excluding Japan, Non-US Developed markets increased 8%. Emerging Markets grew 5%, impacted by an 8% decline in China from COVID and VBP provincial tenders in stapling, cardiac ablation, and neurovascular. Outside of China, Emerging Markets actually grew 17%. I would also note that China represented a 110 basis point headwind on our total company growth – which highlights the strength of recovery in our other markets. VBP has affected us more than many of our competitors, given the size and breadth of our business in China. However, we do expect that we are now through the majority of the impact.

Our adjusted gross margin declined in the quarter as we faced impacts from inflation and currency, with currency driving about a third of the change. These declines were expected and a result of inflationary pressures that occurred 2 to 3 quarters ago. Our incurred manufacturing variances have continued to be significant in the past few quarters. And as they roll off our balance sheet onto our P&L, we expect continued gross margin pressure in Q4 and next year.

The gross margin impact translated into a decline in our adjusted operating margin as well, although this was partially muted by expense control and the benefit of our currency hedging program.

Our balance sheet remains strong, and we continue to execute our enhanced capital allocation and portfolio management work, balancing future growth investments with returning a minimum of 50% of our free cash flow to shareholders, primarily in the form of our dividend. We see strong opportunities for organic growth investments internally, leading us to target R&D growth at or above revenue growth. And we continue to focus on supplementing our organic investments with tuck-in acquisitions.

We've also announced this fiscal year three businesses we intend to separate that account for about 8% of our revenue, and we're making progress toward completing those transactions. We expect to close our Renal Care Joint Venture with DaVita here in the fourth quarter and continue to progress with the separation of our Patient Monitoring and Respiratory Interventions businesses, which we expect to occur sometime in the second half of next fiscal year. We have also closed on acquisitions that will contribute to our growth in the years ahead, including Affera, which expands our presence in cardiac ablation, and Intersect ENT, which adds unique sinus implants to our ENT portfolio. We have driven these moves to not only focus and streamline our portfolio, but also to improve our weighted average market growth rate over time.

<FY23 and Q4 Guidance>

Now, turning to our guidance…

Given our top and bottom line beat in the third quarter, we are raising our full year revenue growth and EPS outlook. On the top line, we expect our fourth quarter organic revenue growth to be in the range of 4.5 to 5%, which is unchanged from what was implied by our second half guidance that I gave last quarter. I would note that our organic growth guidance excludes the impact of currency and revenue from our Intersect ENT acquisition, and it also now excludes revenue from our Renal Care Solutions business, as we expect the separation to occur during the fourth quarter. If recent exchange rates hold, foreign currency would have a negative impact on our fourth quarter revenue of $165 to $215 million. Taking into account currency, Intersect ENT revenue, and the partial quarter of Renal Care Solutions revenue, our guidance would imply reported revenue in the range of $8.2 to $8.3 billion.

We are also maintaining the fourth quarter revenue growth segment expectations that were implied by the back half guidance I gave last quarter. We continue to expect Cardiovascular to be up 5.5% to 6.0%, Medical Surgical to grow 2.5% to 3%, Neuroscience to increase 6.5% to 7%, and Diabetes to decline in the low-single digits, all on an organic basis.

On the bottom line, we continue to drive significant expense reductions to partially offset the impact of inflation and foreign currency. Given our third quarter 3 cent beat, we raised the lower end of our fiscal '23 non-GAAP diluted EPS guidance by 3 cents to the new range of $5.28 to $5.30, including an unfavorable currency impact of approximately 21 cents at recent rates. For the fourth quarter, we expect non-GAAP diluted EPS to be in the range of $1.55 to $1.57. At recent rates, FX is about a 9 cent headwind to fourth quarter EPS.

While we won't give guidance for next fiscal year until our fourth quarter call in May, I did give some color on last quarter's call and will remind you of it today. We're encouraged by our recent progress on revenue growth. At the same time, current macro factors and our imperative to protect R&D investment are expected to create significant EPS headwinds next fiscal year. At recent rates, FX is a few hundred million dollar tailwind to fiscal '24 revenue, and an approximate 27 cent headwind to EPS, which translates to a 5% headwind to EPS growth. While inflationary pressures are starting to moderate, we still see significant mid-single digit inflationary impacts on our Cost of Goods Sold, as wage and raw material price increases continue to roll off our balance sheet and into our P&L. We are working to partially mitigate these headwinds through significant cost reductions, but both inflation and currency, and to a lesser extent interest and tax, are all looking to be headwinds that reduce our earnings power in fiscal ‘24.

<Karen Closing Remarks>

I would summarize by saying that - as we navigate this period of increased macro headwinds, we will be driving disciplined cost reduction. And we are committed to investing in our future growth drivers and our turnaround, as we firmly believe these important investments are necessary to drive durable revenue growth and long-term value creation.

Before I hand it back to Geoff, I want to take a moment to thank the thousands of employees across Medtronic who delivered this quarter. You are executing with excellence and accountability, leveraging our scale with differentiating capabilities, and managing our resources to accelerate innovation. It is because of your efforts that we will create a durable growth company, powered by our people, as we continue our mission-driven work of alleviating pain, restoring health, and extending life.

Back to you, Geoff.

Geoff Martha

Thank you, Karen.

<Geoff Closing Remarks>

Now before we open the lines for questions, I’ll make a few closing remarks. Last quarter, I noted that our aggressive agenda to transform this company would take time, and that’s still true. But I hope you will take away that we are operating with a high sense of urgency, which you can see reflected in our results this quarter. We’re reducing our complexity, enhancing our capabilities, and augmenting our management team with new leaders that bring an outside, diverse perspective. We're also exercising decisive capital allocation and portfolio management, devoting more capital to high growth opportunities and divesting non-core assets. There is an intense focus from me, our board, our management, and our employees to create a company with sustainable growth that you can count on. We're in attractive markets, with growing populations globally that can benefit from our therapies. And we fully expect to deliver durable revenue growth and turn our scale into a long-term competitive advantage. And through this process, create tremendous value for our shareholders.

<PAUSE>

Now let's move to Q&A. We're going to try to get as many analysts as possible, so we ask you to limit yourself to just one question, and only if needed, a related follow-up. If you have additional questions, you can reach out to Ryan and the Investor Relations team after the call.

With that, Brad, can you please give the instructions for asking a question?

<**PLAY Q&A OPENING VIDEO & INSTRUCTIONS>**

Brad Welnick

For the sellside analysts that would like to ask a question, please select the "Participants" button and click "Raise Hand." If you're using the mobile app, press the "More" button and select "Raise Hand." Your lines are currently on mute. When called upon, you will receive a request to unmute your line, which you must respond to before asking your question. Lastly, please be advised that this Q&A session is being recorded.

For today's session, Geoff, Karen, and Ryan are joined by:

- Sean Salmon, EVP and President of the Cardiovascular Portfolio;

- Bob White, EVP and President of the Medical Surgical Portfolio;
- Brett Wall, EVP and President of the Neuroscience Portfolio; and
- Que Dallara, EVP and President of the Diabetes Operating Unit.

We'll pause for a few seconds to assemble the queue…

Geoff Martha

OK. Thanks for the questions. We appreciate your support and continued interest in Medtronic. We hope you'll join us for our Q4 earnings broadcast – which we anticipate holding on Thursday, May 25th – where we'll update you on our progress and how we finished the fiscal year… and look ahead to fiscal '24. So, with that, thanks for spending time with us today, please stay healthy and safe, and have a great rest of your day.