

Medtronic, Inc.

United States of America/Equipment & Services

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UBS Research

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F3Q Preview: Significant Step-Up in Op Margin Leverage Expected

- We expect solid key business results, improved op margin leverage ex-FX
- Our 28.0% Op Margin implies ~300 bps of Y/Y improvement, adjusted for FX
- MDT could deliver mid- to upper teens CC EPS growth, adjusted for FX
- Valuation: \$87 price target, 12x EV/EBITDA on FY18E EBITDA of \$11.2 bil

We expect solid key business results, improved op margin leverage ex-FX

We expect sales of \$7.015 bil (+6.8% CC) vs. consensus of \$6.983 bil and EPS of \$1.06, in-line with consensus (see Figure 2 on page 4). We expect key questions for the call to include: 1) Synergies and leverage, adjusted for FX; 2) Update on key new products (e.g. TAVR, DCBs, leadless pacers and insertable monitors); and 3) An update on use of cash, potential strategic investments. Please see page 5 and beyond for additional details on our expectations for adjusted leverage and business segment estimates. We remain comfortable with our above-consensus revenue projections, driven by our detailed revenue build, summarized in Figure 4. We expect solid results, significant improvements in leverage net of FX, and business momentum to sustain growth in the upper half of management's guided range for the next several quarters.

Our 28.0% Op Margin implies ~300 bps of Y/Y improvement, adjusted for FX

We expect year-over-year op margin leverage to be an important topic on next week's call. Based on our analysis (summarized in Figure 1 on page 3), we expect FX-adjusted pro forma op margin leverage of as much as 300 bps, a significant step up from ~30 bps in F1H16. Consistent with the analysis we published last quarter, we estimate that every \$50 mil of upside on the top-line relative to our estimates adds another 30 bps of operating leverage.

MDT could deliver mid- to upper teens CC EPS growth, adjusted for FX

Our F3Q16 adjusted EPS estimate of \$1.06 reflects 7% growth, however, adjusting for an estimated 11-12c in FX headwinds for the quarter (similar to F2Q16), year-over-year constant currency EPS growth should be in the mid- to upper-teens compared to adjusted pro forma EPS of \$1.00 a year ago. This is consistent with management's guidance of an accelerating CC EPS growth in F2H16.

Valuation: \$87 price target, 12x EV/EBITDA on FY18E EBITDA of \$11.2 bil

Our 12x target multiple is roughly in line with the large cap medical supply comps. We see upside to this multiple if MDT's pipeline continues to beat expectations.

12-month rating	Buy
12-month price target	\$87.00
Price	\$77.66

Contributing authors: Yi Cheng

Trading data and key metrics

52-wk range	US\$78.83-64.52
Market cap.	US\$110bn
Shares o/s	1,419m (COM)
Free float	100%
Avg. daily volume ('000)	1,983
Avg. daily value (m)	US\$150.1
Common s/h equity (04/16E)	US\$55.8bn
P/BV (04/16E)	2.0x
Net debt / EBITDA (04/16E)	1.5x
RIC	MDT.N
BBG	MDT US

Sources: UBS, Bloomberg

EPS (UBS, diluted) (US\$)

	04/16E	
	UBS	Cons.
Q1	1.02	1.02
Q2	1.03	1.03
Q3E	1.06	1.06
Q4E	1.27	1.28
04/16E	4.38	4.38
04/17E	4.91	4.87
04/18E	5.47	5.40

Definitions of terms and abbreviations are available in the appendix section of this report, and more extensively on internet at www.ubs.com/glossary

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Medtronic, Inc.

Company Profile: Medtronic, Inc.

Medtronic is a global manufacturer and provider of medical devices and equipment across a wide range of specialties including cardiac rhythm management, vascular intervention, structural and valvular disease, spinal disorders, neuro-modulation, surgical equipment and diabetes.

Statement of Risk

Our \$87 price target is based on 12x EV/EBITDA on FY18E EBITDA of \$11.2 bil. Risks to our price target include lower than expected deal synergies, failure of key pipeline products, unexpected slowdown in key markets and regulatory delays of key products.

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Highlights (US\$m)	04/13	04/14	04/15	04/16E	04/17E	04/18E	04/19E	04/20E
Revenues	16,589	17,006	20,261	28,815	30,737	32,775	34,777	36,744
EBIT (UBS)	4,770	4,828	5,269	6,290	6,996	7,757	8,432	9,107
Net earnings (UBS)	3,855	3,925	4,658	6,268	7,021	7,824	8,517	9,251
EPS (UBS, diluted) (US\$)	3.75	3.87	4.20	4.38	4.91	5.47	5.95	6.47
DPS (US\$)	1.04	1.12	1.24	1.43	1.59	1.71	1.79	1.88
Net (debt) / cash	479	2,313	(16,706)	(13,588)	(9,247)	(4,325)	1,135	7,347
Profitability/valuation	04/13	04/14	04/15	04/16E	04/17E	04/18E	04/19E	04/20E
EBIT margin %	28.8	28.4	26.0	21.8	22.8	23.7	24.2	24.8
ROIC (EBIT) %	27.4	28.7	12.3	9.1	10.4	11.9	13.5	15.3
EV/EBITDA (core) x	8.2	9.4	12.6	13.7	12.1	10.6	9.4	8.3
P/E (UBS, diluted) x	11.2	14.4	16.4	17.7	15.8	14.2	13.0	12.0
Equity FCF (UBS) yield %	10.4	8.2	5.7	4.7	7.1	8.2	8.8	9.7
Net dividend yield %	2.5	2.0	1.8	1.8	2.0	2.2	2.3	2.4

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied.

Valuations: based on an average share price that year, (E): based on a share price of US\$77.66 on 25 Feb 2016 19:43 EST

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Appendix

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	47%	33%
Neutral	Hold/Neutral	42%	34%
Sell	Sell	11%	23%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 March 2014.

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.

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Global Equity 12-Month Rating Definitions

Buy: FSR is > 6% above the MRA. **Neutral:** FSR is between -6% and 6% of the MRA. **Sell:** FSR is > 6% below the MRA.

Key Definitions

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

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Core Banding Exceptions (CBE): Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified the Companies Mentioned or Company Disclosure table in the relevant research piece.

Company Disclosures

Medtronic	MDT US	Buy	US\$77.66	25 Feb 2016
Company Name	Reuters	12-mo rating	Price	Price date

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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6. A U.S.-based global equity strategist, a member of his team, or one of their household members has a long common stock position in Medtronic PLC.

Medtronic, Inc.

Global rating history -- Medtronic, Inc., MDT US



Source: UBS CIO as of 26 February 2016

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1H, 2H, etc. or 1H11, 2H11, etc.	First half, second half, etc. or first half 2011, second half 2011, etc.	1Q, 2Q, etc. or 1Q11, 2Q11, etc.	First quarter, second quarter, etc. or first quarter 2011, second quarter 2011, etc.
2011E, 2012E, etc.	2011 estimate, 2012 estimate, etc.	A	actual i.e. 2010A
ADR	American depository receipt	ARPU	Average Revenue Per User
AUM	Assets under management = total value of own and third-party assets managed	Avg.	average
bn	Billion	bp or bps	Basis point or basis points (100 bps = 1 percentage point)
BVPS	Book value per share = shareholders' equity divided by the number of shares	CAGR	Compound annual growth rate
Cant Inc/Capita	Cantonal income per capita (Switzerland only)	Capex	Capital expenditures
CF	Cash flow	CFO	1) Cash flow from operations, 2) Chief financial officer
COGS	Cost of goods sold	COM	Common shares
Cons.	Consensus	Core Tier 1 Ratio	Tier 1 capital minus tier 1 hybrid securities
Cost/Inc Ratio (%)	Costs as a percentage of income	CPI	Consumer price index
CR	Combined ratio = ratio of claims and expenses as a percentage of premiums (for insurance companies)	CY	Calendar year
DCF	Discounted cash flow	DDM	Dividend discount model
Dividend Yield (%)	Dividend per share divided by price per share	DPS	Dividend per share
E	expected i.e. 2011E	EBIT	Earnings before interest and taxes
EBIT Margin (%)	EBIT divided by revenues	EBITDA	Earnings before interest, taxes, depreciation and amortization
EBITDA Margin (%)	EBITDA divided by revenues	EBITDA/Net Interest	EBITDA divided by net interest expense
EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental expense	EFVR	Estimated fair value range
EmV	Embedded value = net asset value + present value of forecasted future profits (for life insurers)	EPS	Earnings per share
Equity Ratio (%)	Shareholders' equity divided by total assets	EV	Enterprise value = market value of equity, preferred equity, outstanding net debt and minorities
FCF	Free cash flow = cash a company generates above outlays required to maintain/expand its asset base	FCF Yield (%)	Free cash flow divided by market capitalization
FFO	Funds from operations	FY	Fiscal year / financial year
GDP	Gross domestic product	Gross Margin (%)	Gross profit divided by revenues
H	half year	h/h	Half-year over half-year; half on half
hist av.	Historical average	Interbank Ratio	Interbank deposits due from banks divided by interbank deposits due to banks
Interest Coverage	Ratio that expresses the number of times interest expenses are covered by earnings	Interest exp	Interest expense
ISIN	International securities identification number	K	One thousand
LLP/Net Int Inc (%)	Loan loss provisions divided by net interest income	LLR/Gross Loans (%)	Loan loss reserves divided by gross loans

Medtronic, Inc.

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
LPR	Least Preferred: The stock is expected to both underperform the relevant benchmark and depreciate in absolute terms.	Market cap	Number of all shares of a company (at the end of the quarter) times closing price
m/m	Month-over-month; month on month	mn or m	Million
M and A	Merger and Acquisition	MP	Marketperform: The stocks expected performance is in line with the sector benchmark
MPR	Most Preferred: The stock is expected to both outperform the relevant benchmark and appreciate in absolute terms.	n.a.	Not available or not applicable
NAV	Net asset value	Net Debt	Short- and long-term interest-bearing debt minus cash and cash equivalents
Net DPS	Net dividends per share	NIM or Net Int Margin (%)	Net interest income divided by average interest-bearing assets
Net Margin (%)	Net income dividend by revenues	NV	Neutral View: The stock is expected to neither outperform nor underperform the relevant benchmark nor significantly appreciate or depreciate in absolute terms.
n.m. or NM	Not meaningful	NPL	Non-performing loans
OP	Outperform: The stocks is expected to outperform the sector benchmark	Op Margin (%)	Operating income divided by revenues
p.a.	Per annum (per year)	P/BV	Price to book value
P/E or PE	Price to earnings / Price Earnings Ratio	P/E Relative	P/E relative to the market
P/EmV	Price to embedded value	PEG Ratio	P/E ratio divided by earnings growth
PPI	Producer price index	Prim Bal/Cur Rev (%)	Primary balance divided by current revenue (total revenue minus capital revenue)
Profit Margin (%)	Net income divided by revenues	q/q or QQQ	Quarter-over-quarter; quarter on quarter
R and D	Research and development	ROA (%)	Return on assets
ROAE (%)	Return on average equity	ROCE (%)	Return on capital employed = EBIT divided by difference between total assets & current liabilities
ROE (%)	Return on equity	ROIC (%) or ROI	Return on invested capital
Shares o/s	Shares outstanding	Solvency Ratio (%)	Ratio of shareholders' equity to net premiums written (for insurance companies)
sotp or SOTP	Sum of the parts	Tax Burden Index	Swiss tax index; 100 = average tax burden of all cantons
tgt	Target	Tier 1 Ratio (%)	Tier 1 capital divided by risk-weighted assets; describes a bank's capital adequacy
tn	Trillion	UP	Underperform: The stock is expected to underperform the sector benchmark
Valor	Swiss company identifier	WACC	Weighted average cost of capital
CIO	UBS WM Chief Investment Office	x	multiple / multiplier
y/y or YOY	Year-over-year; year on year	yr	Year
YTD	Year-to-date		

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