Full Year 2019 Results

Thursday, 20th February 2020
Presentation

Roland Diggelmann, Chief Executive Officer

Good morning. Good morning, everyone. Thank you for joining us today. Welcome to Smith+Nephew’s 2019 results. It’s an absolute pleasure to be here, really delighted to be here and to be able to report the results first time as a CEO. I’ve had the opportunity to serve on the Board. But of course since being appointed, I’ve really had the chance to be much more focused on the business and visiting our sites, our organisation. And truly, this has reinforced my view on the potential of Smith+Nephew and the potential of this great organisation and its people. We got great brand equity, we have fantastic trust from our customers. And we have great technology and solutions. And I think this will continue to serve very well to maximise our technologies.

I’ve also quickly come to see that we have the right strategy in place, that we operate with the right franchise, which is the franchise model, the three distinct franchises, the regional setup, and of course, a strategy that is very much focused on innovation and providing new, enhanced and better solutions to our customers and to patients. There are of course areas that I’d like to continue to emphasise on, such as customer focus, putting the customer at the centre of what we do, winning in the US, continue to expand in China, maximising growth opportunities in emerging markets. I’m sure we’ll talk more about COVID 19 of course, through the course of this presentation. Innovation, not just what we innovate and the product but also how we provide innovation to the marketplace. And then of course efficiency and how we are operate our business across the entire value chain.

For the rest of the presentation. I will focus first on the 2019 results, and then I’ll highlight 2019 Q4, excuse me, and then I’ll update you a little bit on our strategies and priorities and how we go forward into 2020. Graham will take you through the details of our financials and our guidance.

So first, the highlights on the full year numbers. We’ve had a really good full year 19. We’ve delivered on the growth and on the margin guidance; revenue for 2019 was $5.1 billion. With 4.4% underlining revenue growth 4.8% reported. Trading profit was $1.2 billion. Trading margin of 22.8% represents 40 basis points underlying expansion and after adjusting for 50 basis points one time legal gain in 2018. Earnings growth was also constrained by a one-time gain and the lower than usual tax rate in 2018. EPSA of $1.02 was still higher than previous year.

Moving to the sales breakdown, and what you can see here is a broad base strength across the group. All the franchises, Orthopaedics, Sports Medicine and ENT and Wound Care contributed to our growth; all three accelerated over 2018. Growth was also broad based geographically, two largest markets the US and China, provided three quarters of the total growth and a meaningful contribution also from the rest of the APAC region. And as you can see also from EMEA and Latin America. Emerging Markets growth is 16.1% and now represents 19% of the Group sales.

I now move to the details of the fourth quarter, with revenue of $1.4 billion on the quarter 5.6% growth in the quarter. This was held by an extra trading day as it compares to 2018. But it does it does represent a substantial acceleration over the 3.9% in the first nine months
of 2019. Acquisitions contributed 0.2% two underlining growth. As you can see, Orthopaedics grew at 5.1%; Sports Med and EMT at 10.1%, a double digit growth quarter, which is great to see; and Advanced Wound Management grew 1.9%.

Looking at the geographies the US grew 4.2% and very pleasingly other established markets return to growth at 2.4%. Improved performance in Europe here drove this acceleration. The UK and Ireland business returned to growth and in line with our plans. Emerging Markets grew 16.6% in the quarter growing double digit across all three franchises. China finished with approximately 30% growth for the full year.

I’ll now go to the details of the franchises, starting with Orthopaedics, which grew as you've seen at 5.1% for the quarter; Knees grew at 4.7%; JOURNEY II continues to drive our business and we've seen a higher growth in centres using a robotics application and NAVIO systems. Hips up 0.7% overall; strong quarter in the US with 3.9%, which was offset in the quarter by in large part a distributor change in Asia Pacific.

We continue to develop our joint replacement portfolio in the quarter: the US launches of JOURNEY II uni-knee as a real important milestone. And the OR3O dual mobility system, which we're currently in launch. Other reconstruction grew 31.6% this is enlarge driven by the sales of our robotics portfolio. And we continue to expand both the install base and the utilisation of NAVIO in the quarter. Trauma grows 7% and within that plates and screws were up double digit driven by the rollout of the EVOS system and then INTERTAN nail also remained or maintain double digit growth.

Moving to sports medicine and ENT which grew 10.1% overall, joint repair within sports med grew 14%; really continued strength of the portfolio across all the regions and across knee and shoulder repair.

Arthroscopic enabling technologies grew 5.1%, building on the return to growth in the third quarter, the video, the mechanical resection and radio frequency categories all accelerated following the product launches earlier in the year. And we've also seen strong capital sales in Europe that contributed to the growth as well. ENT grew 10.7%. This again, driven by the increase in adoption of Coblation.

Shifting to advanced wound management, growth of 1.9% overall, and within that wound care grew 0.7%. US pricing is an ongoing headwind here, and we wait to see the lap and the effect of contract renewals in the middle of the year 2020. So this continues to offset some improved performance that we've seen in Europe. In the quarter, bioactives declined by 2.2%. This also reflects a very strong quarter prior year comparable for the acquired Osiris Therapeutics business, and at the time the launch of Graphics PL prime.

Encouragingly Santyl and market demand remained stable in the quarter and the Advanced Directives franchise stabilised for the full year as a whole. Advanced wound devices grew 15.2% and our negative pressure products continue to perform well ahead of the market with PICO and RENASYS again growing double digit.

Allow me to now move on to strategy. We launched our five imperatives at the beginning of 2019. I fully endorsed those as a Board member: full support from my side. This strategy gives us the pathway to meet our mid-term aim of consistently outgrowing our markets with a focus on innovation, on people, and on efficiency. I'm very pleased with our progress so
far. The emphasis is now on maintaining the positive momentum that we’ve had in 2019. And then with added specific priorities in 2020.

The first one, of course, remains commercial execution: really important that we need to continue to see the improvements, on the changes that we’ve made, all of the franchises are expected to build on this for the year. On top of that, we’re focused on some major cross franchise opportunities. One being the ASC the ambulatory surgical segment in the US, the other of course being the ongoing – ongoing growth potential in emerging markets.

Reimbursement changes within the ASC opportunity with a new coverage of total knee replacement from 2020 onwards will certainly help there. And we look to leverage our existing advantages, such as our position in sports medicine and CT-free robotics for this specific ASC segment.

Emerging markets are now 19% of our sales, as I mentioned, China being about a third of that. We see increasing health provisions that will continue to drive growth, access to health care, among other things, and of course, we’ll continue to deploy additional resources in the markets with the highest potential. I think there's still a big opportunity from accelerating other established markets in Europe, notably in Japan, Australia, New Zealand, Canada. The structure that we have now in place with country clusters, which also means that each target area has dedicated leadership as opposed to in the past. This allows us to much better address each set of opportunities and specific customer needs in a very, very focused way.

Second priority for 2020 is of course, the generation of enabling technologies. They remain a central part of our strategy. And you'll hear more from us on the course of the year in this specific area. What we'll do in 2020 is certainly launch the next generation of robotics platform. It builds on the handheld CT free design of NAVIO and it has a further reduction in footprint. It also allows for faster and more accurate burring. Over time this base system will become the centre of a multi-asset offering that will enable us to meet a range of surgical needs with one single platform.

Biologics is another enabling technology that will recently built up through acquisition, as you know, the acquisition of Osiris therapeutics. And then finally on the right what you can see is our connected arthroscopic sports medicine tower. The recent launch of the next generation lens 4k visualisation system is going very well and supports this integrated approach. And you'll hear more about our plans to expand our connected platforms, and also a cloud-based system by AAOS in March.

The third priority clearly is renewing our commitment to innovation and to bring the best technology to our customers. We’ve planned product launches in high growth areas this year, including in robotics, in ENT, and executing on those will be important for the organisation. For the medium term, we want to accelerate the cadence of launches and be at the forefront of developing areas such as digital health and also regenerative medicine.

We intend to invest more in R&D to achieve this, and you should also expect to see our R&D ratio to continue to rise; we will obviously manage that through the P&L in other areas of the line. M&A to access external innovation also remains an important part of our strategy. You've seen us close a number of deals and mid-size small and mid-sized acquisitions last year. And in this year in January was the acquisition or the announced acquisition of Tusker Medical in ENT. It really adds nicely to our ENT franchise, gives us access to a new and high
growth segment of office based tympanostomy. Our teams are actively continuing to search for further opportunities for interesting technologies that continue our bolt on, tuck in, and are enhancing our differentiation in the marketplace.

Fourth priority is of course, ongoing focus on our people and on the structure. We have, as I mentioned since 2018, implemented a new structure around the franchise model with dedicated responsibilities for franchises for Orthopaedics, for Sports Med and ENT, and for Wound. And we also have a regional commercial structure, which is very straightforward and brought new leadership into the executive team as well.

The leaders have been adding talent since and I think it can be seen through the results. And we'll be working on further deepening that talent through the course of 2020 and beyond. Also, on the right you'll recognise the new brand purpose; I think you can also see it when you look around a new brand, the visibility and our culture pillars. This is really important that we continue to embed the behaviours across the organisation and that will be another part of our sustaining performance.

Then finally, final priority is to drive excellence for our value chain. Smith+Nephew already has an APEX programme, and Graham will talk more about this. We're coming to the end of this. But we're also launching further initiatives that go significantly deeper and beyond that. Part of the work will be ensuring we operate on an optimised footprint, drive lean and sustainable manufacturing with broader automation. But this also is more than just cost and efficiency. It's about putting the customer at the centre of what we do in every aspect of delivering our product.

It's also about bringing new products to the market. And we've worked on streamlining surgical procedures, which is really important part of our customers’ daily work, simplifying the instrument sets and we're driving excellence in sales training. We ensure that our reps are fully equipped to bring innovation to our customers and deliver the innovation to the customer. And we're also investing further in professional and medical education.

The franchise structure helps us here, it makes us closer to our customers at every level. And the specialists leading the new model now have the procedural knowledge to interact efficiently with medical practitioners. We’re now also looking to move closer to this on the sales rep level. And that means greater share of direct distribution wherever possible.

I've been closely involved in these initiatives since becoming CEO. And after three months, I'm not ready to announce finalised targets, but we'll come back to that at half year. And with that, I’d like to hand over to Graham, our CFO, to take us through the financials and the guidance.

Financials
Graham Baker
Chief Financial Officer

Thanks Roland, and good morning, everyone. As you've seen full year revenue grew 4.8% on a reported basis and 4.4% on an underlying basis, excluding the impact of foreign exchange in acquisitions. Trading profit grew by 4% to $1.2 billion, and the trading profit margin was
22.8%. We realised around $80 million of additional savings under the APEX programme, partially offset by initial margin dilution from M&A and investments from mid-term growth opportunities. The R&D ratio, for example, stepped up to 5.2% of sales in 2019 from 4.8% in the prior year.

The net outcome was an underlying trading margin increase of 40 basis points over 2018 excluding the 50-basis point benefit in the prior year from the one-off legal settlement. That takes us to 80 basis points of aggregate expansion in the last two years and 100 basis points in the last three. Moving further down the P&L, adjusted earnings per share grew at 1%. Lower than growth and trading profits as we saw an expected rise in the tax rate on trading results to 19.1%. This was a normalisation following the 2018 tax rate of 16.1%, which benefited from a one-off tax provision release on settlement of audit, and was in line with 2019 guidance.

Basic earnings per share declined by 10%, principally reflecting the impact of amortisation, deal and integration costs on acquisitions completed during the year, together with continued restructuring and metal on metal charges, which also grew marginally in 2019. We propose to increase our fully a dividend by 4% in line with our progressive dividend policy. We generate your trading cash flow of $970 million, a 2% increase over 2018. Trading cash conversion decreased slightly from the prior year, largely due to expected growth in capital expenditure to around 8% of sales, as we progress changes to our manufacturing site base, but remained robust at 83% despite these investments.

Working capital outflows at $145 million improved by $50 million from the prior year. Driving this we saw improvement in our debtors collection more than offsetting an increase in inventory levels in 2019. Drivers of the inventory increase included product launches, our M&A activity and building Brexit-related safety stocks in both the UK and continental Europe. As a final note on trading cash following implementation of IFRS 16, you'll see we now disclose lease liability repayments separately. There is through no material difference between 2018 and 19 in either trading profit or cash conversion as a result of the change.

Free cash flow of $714 million was $130 million higher than 2018 principally due to metal on metal insurance receipts, which we will record in the 'restructuring, acquisition, legal and other' line. We've also taken a further $121 million P&L charge to ensure the metal on metal provision remains fully up to date with our latest actuarial assessments.

On the balance sheet, net debt increased by around $500 million to $1.6 billion. Strong free cash flow comfortably covered CAPEX and dividend needs as well as nearly half of the $869 million cash acquisition costs in the year. We now also include $170 million of lease liabilities and our measure of leverage and finish the year with a leverage ratio of 1.2 times adjusted EBITDA.

Moving on to the APEX programme, where we've updated the financial targets. We're delivering the programme faster than we first anticipated. So it's beginning to scale down as we move into 2020 and will close in full by the end of the year. We also see more savings in the course of the work now expecting to reach annualised savings of $190 million by the end of the programme, $30 million more than initially planned. Total restructuring costs on APEX should be around $290 million, $50 million above initial guidance, and therefore broadly maintaining the ratio of costs to benefits that we targeted at the outset. Between closing
APEX and initiating the new programme Roland mentioned earlier, we expect total restructuring costs in 2020 to be in the range of $130 to $140 million.

Now, let me finish with guidance. The ongoing COVID 19 outbreak obviously creates short term uncertainty. We’ve seen a considerable impact on our China business in February, with almost no elective surgeries taking place, while the healthcare system prioritises containing the outbreak and protecting patients. On the positive side at commercial and manufacturing employees have been returning to work, we are supplying products to urgent cases and we’re ready to step up activity as and when the situation normalises.

The 2020 guidance assumes that this normalisation happens early in Q2. Clearly the outcome and financial consequences could be materially different from this assumption. With that said, our full-year guidance is for underlying revenue growth to be in the range of 3.5-4.5%. For the phasing of your models, the effects of the 2019 price cuts in the US wound care business – sorry, yes, the 2019 price cuts in the US wound care business and one less trading day will be headwinds for the first half in 2020. We also currently assume the COVID 19 impact to be an H1 effect. And a combination of these factors may see very little or no quarterly growth in the first quarter, with constant – consequent pressure – sorry – on first half margins.

Based on rates prevailing at 14th February, foreign exchange will reduce our reported growth rate by around 80 basis points for the full year, and acquisitions will add around 130 basis points. We therefore expect reported sales growth to be between 4% and 5%. For the trading margin, we expect improvements in efficiency, including from restructuring, to be offset by a foreign exchange headwind of around 50 basis points, dilution of around 20 to 30 basis points related to our recent acquisitions, and planned ongoing investments in the mid-term growth including R&D. As a result, our expectation is for the 2020 full year trading margin to be at or slightly above the 2019 level.

We expect our tax rates to be between 18.5% and 19.5% for 2020. This is lower than the range we forecast for 2019 mainly because of increased clarity of interpretation of certain US tax reform rules, and continuing improvement in geographic mix. We’ve also adjusted our medium-term guidance to a range of 18% to 20% barring any further one-time tax impacts or changes in tax rates. And with that, I’ll hand back to Roland.

Summary

Roland Diggelmann, Chief Executive Officer

Thank you, Graham. I just wanted to summarise, I think 2019 has been a very successful and good year for Smith & Nephew. I believe we achieve broad based growth acceleration across the entire businesses and the company. We’ve delivered on the margin guidance and we’ve made good progress against our strategic imperatives. The aim, of course is to sustain this positive momentum. As Graham mentioned, we see a disruption from COVID 19 in China. We also see this as an isolated one-year effect, we remain very committed to the growth opportunities in China. And of course, the serving – the patient – patients in China, going forward.
Globally, we will continue to enhance the medium term growth profile with commercial execution on one side with innovation, new products, and business development, with external innovation as well. And you will, of course hear more from us on the value chain excellence initiatives by mid-year. And as you've seen – just heard and seen from Graham, our medium-term guidance for growth and margin expectations is unchanged.

And with that I thank you for your attention and look forward to your questions.

Q&A

Dave Adlington (JP Morgan): Morning, Dave Adlington JP Morgan. So a couple questions really. So on – just strategically that was obviously a big, big change in the last 18 months or so. Just wanted to get your thoughts on those and any additional changes you may or may not be making, I think they're likely to be pretty limited, but just to get your thoughts on that. And then secondly, on R&D, increasing the amount you'd like to spend there just going to give you an idea of areas that you'd like to focus that spending on and the sort of time frame you might be thinking about in terms of return on that spend.

Thanks.

Roland Diggelmann: Thank you, I think on the strategy, it is founded on the changes we made to the organisation, first of all, the franchise model that's been introduced and a clear responsibility for technology and innovation in the franchises. The new regional set-up which is much clearer, with the opportunity to also go more direct and serve customers in a more direct fashion. Innovation is very much the core of the strategy. Everything we do should be focused around innovating products and solutions.

Where I'd like to put more emphasis on is not just on what type of products we develop, but how do we actually deliver those across to the markets. It's not just about what we do. It's about how we do that, how we launch, how we manage end to end processes. A great example here, for instance, is Sports Med and the integrated approach that we're able to deliver. And I think we're able to deliver that better than anybody else. Really looking at entire procedural approaches, for instance, shoulder repair, knee repair, and what is everything a customer may need to do that very successfully.

So these are the refinements. I believe strongly that we can get better operationally, again, thinking end to end across the value chain, those improvements there. That's also why and how we're going to go into this excellence programme that you'll hear more about and – and also putting the customer really at the centre of what we do, providing education to our people, that they can really maximise our technologies, enhancing our medical education.

We have fantastic sites where we provide medical education, but we can do more of that. And we can get closer to the customer even in some regions in doing that. On R&D, indeed, I think it's the cornerstone, being a leading innovator in the market requires the right resources at the right places, enhancing R&D over time. And having a very clear focus from a market perspective, thinking about what the market needs, and bringing that back. And having a really end-to-end thinking in R&D, as well. Making sure that we deliver the innovation that the market wants, anticipating the changes in the markets and that is not just productivity. I think that is of course also procedures specific. But it is also how we deliver ultimately the
R&D across the organisation. And as you know very well, markets differ in their delivery models, we will see ASCs coming up in the US was indeed so the reimbursement specific in the ASC environment. We have a very different situation in in emerging markets with very different care delivery model. So we want to be very close to the market and I think we can be.

**Dave Adlington:** Maybe just as a follow up, structurally, those of us who have been covering this company for some time, we’ve seen growth the last ten years kind of stuck at the three to four level; we’ve dipped down to a couple of% in a couple of years. Do you see with the structure you’ve got currently getting to an escape velocity at 5% or more, do you need to change the structure of the group to do that?

**Roland Diggelmann:** I’m not sure I quite understood acoustically. Would you mind repeating?

**Dave Adlington:** Yeah, so you’ve been stuck at kind of 3-4% for a considerable time. Do you do you see with the current Group structure – so with the current structure of the business, can you get to 5% or more? Or do you need to change something?

**Roland Diggelmann:** No, I believe we can. And I think we’re only about 18 months in new into this franchise model was a very dedicated approach, again to the delivery, the innovation and the R&D as well. So I think it is absolutely possible. We've seen great progress. For instance, if you take the numbers in sports medicine was a very dedicated approach. Also a very integrated approach of delivering everything a customer needs and having an approach where we can be the solution provider instead of being the individual product provider. So I think this is absolutely doable in the structure. But we have to do more and making sure that the interfaces work very well. Thank you.

**Michael Jungling (Morgan Stanley):** Good morning good sir. It's Michael Jungling, Morgan Stanley. I have three questions. Firstly, when it comes to your China comment, and you – I think you mentioned there was a considerable weakness in February. Other companies have given more specific numbers, sort of down 50%, 60%, 70%. Could you perhaps be more clear on what you’ve observed so far in Q1 year-to-date with respect to China group growth?

And then secondly, when it comes to your organic sales growth guidance of 3.5% to 4.5%, does this include the coronavirus or not? Because it seems to me that any sort of weakness in Q1 – are we hoping for a recovery in elective procedures in the next three quarters or would that be something that is not included in the guidance?

And then question number three is a bit more clarity about the organic sales growth guidance with respect to regions. So the 3.5% to 4.5%, can you comment what your expectations are for the US and in Europe? And if you also can, I guess, in – well, US, other established markets and then the emerging markets? Thank you.

**Roland Diggelmann:** Thank you. Let me start with China. Of course, this is a very fluid situation, as I’m sure everyone knows by now. We keep observing the market and the developments very closely. We’re in touch with the authorities. First and foremost, the focus was, of course, around the safety of our employees. What we, of course, also have seen is the business that we’re in is elective surgery for the most part. Elective surgery is right now not the focus of the Chinese authorities. They are very focused, and rightfully so, on
containing the outbreak of the virus. So what we’re seeing is very slow sales in February. First, anticipated because of Chinese New Year. So there is that effect. But then, of course, there was no – no surgeries were performed.

So I hesitate to give you a number, but you would assume that it has been very, very little sales and the surgeries performed in the elective sector. There is some on emergency, and there is some in – on the wound side of the business.

Now the guidance, it does include the impact of COVID19 in China with the assumption that we will get to a normalised situation early in Q2. This is the information that we’re operating on at this stage. I think you’ve heard Graham again say that this could change. We will have to be just very vigilant and see what the information comes through the market. Our teams, obviously, are ready to take up the actual activities, go back to the hospitals and take up their normal functions.

Today, what they’re doing is a lot of areas – they do a lot of things around marketing, online programmes, education, etc., but they’re not having access to the hospitals at this stage. Now what we do expect in the system is a recovery. The recovery in the health care system that then allows these elective surgeries to be performed going forward. And the reason is fairly simple, this is pent-up demand. If you have – just to take an example, if someone needs an artificial hip, that demand will still there in a couple of months’ time.

The question, of course, is how quickly will the situation recover and what is the capacity in the system to then actually make up for this pent-up demand? And this is something that what – we don’t know. But we expect and we anticipate resilience in the system to actually provide a recovery. So this is to the extent that we can guide at this stage. Again, the situation is fluid, and we’ll have to observe it carefully.

On the guidance – on the growth guidance for the regions, we don’t guide individually on the regions. But what I would say is that we’ve seen really good growth in the US We expect that growth to continue. We hope to sustain that growth. Similarly, in EMEA and in APAC, much will depend, of course, on the situation in China because it is a big part of the APAC sales.

But in the long – medium to long term, I think it’s pretty straightforward. It’s – emerging markets will post the highest growth, we should definitely expect to see double-digit there on a sustainable basis going forward, followed by the US, followed by the more established markets and Europe.

**Graham Baker:** If I may, I’ll just add one more thought for modelling purposes. I think, as Roland rightly outlined, we’re getting to the end of the third week post the scheduled Chinese New Year holiday, so there is a significant amount of uncertainty.

But to take Michael’s question, I mean, we’re 80%, 90% of our business below in those three weeks. That we’ve seen. And our assumption is that we continue to see a significant impact through Q1, but that it normalises early in Q2.

In terms of the comments Roland made around recovery, I think, again, he made all exactly the right points. If you think about it specifically in terms of modelling, how much comes back in 2019, again, we don’t have a perfect crystal ball on that. But I think if there’s – if you were to say that all those procedures were to get rescheduled at some point, we’re not assuming a full recovery within the calendar year in 2019. So probably more sensible to think
about a partial recovery back-end-weighted and stabilisation after a weak Q1 in the first half. I’ve got nothing to add in terms of regional mix.

Kyle Rose (Canaccord): Great. Kyle Rose from Canaccord. Wondered if you could talk just a little bit about the US total joint market. We see the number one market share player coming back, both with new products as well as improved supply. So maybe touch on your confidence in maintaining current growth rates in US hips and knees?

And then if we can talk about the portfolio. Just remind us what the timing is of a press-fit knee design in the US market as well as the launch timing for NAVIO.

And then just last question is, when you look at the portfolio, the one material gap is probably a total shoulder, given your franchise in sports repair, but also in the lower extremity total joints. I guess, how do you view that strategy? We saw a major competitor make a big acquisition or a planned acquisition in the second half of 2019. And do you view that as a build-versus-buy type of investment there? And how should we think about how you view the total shoulder replacement market broadly?

Roland Diggelmann: Great. Thank you for the question, Kyle. Indeed, the US is a very important market for us, almost 50% of our sales in the US. We’ve seen good growth momentum. We expect that we can sustain that momentum on the basis of the investments that we’re making, that’s investments in the portfolio, investments in the sales force, investments in the instruments that we’re deploying and also beyond that two specific areas.

One is going more direct in some areas where we have the opportunity. And the other is, of course, the advent of the ASCs, where, in most parts, we’re already supplying to the ASCs through our Sports Med franchise. So we see a good opportunity there to leverage our presence.

In terms of portfolio, I’m very positive about the ongoing progress with JOURNEY II. I think this is a knee that really meets the needs of the market very, very well. I can’t speculate much about the competition. Obviously, we’ve seen the numbers. We’d like to focus on our own delivery and our own strength. And I think we can sustain that growth rate.

On the cementless knee, I think that you asked about. Just for competitive reasons, I wouldn’t want to give you a date here but needless to say, that we’re working on it and that it is a very recognised part of the portfolio that we need to fill.

And equally so, we’re interested in total shoulder. Of course, it’s a nice and growing segment within Orthopaedics. Extremities is part of how we look at this entire remit. So indeed, that’s something that we keep looking at.

Graham Baker: Should we take a question from the line?

Roland Diggelmann: Sure. Sure, absolutely. I think there is questions from the phone lines.

Operator: Thank you. Ladies and gentlemen, we’ll take the questions over the phone. As a reminder if you wish to ask a question, please press star and one on your telephone keypad. The first question comes from the line of Veronika Dubajova from Goldman Sachs. Please ask your question.
Veronika Dubajova: Hi, good morning. It’s Veronika here. Thank you for taking my questions. I have two, please. The first one is just on the growth sustainability in China. And I guess two parts to the question. Obviously, you’ve delivered some pretty impressive growth in the past year and meaningfully ahead of your peers. I’d love to hear, Roland, what you think you are doing better and how sustainable you think that momentum is?

And as a follow-on to that, I know there was some discussion of value-based purchasing in China in the Ministry of Orthopaedics. Is this something you’re anticipating will take place? And to what extent is that contemplated in the guidance? And I’ll leave it at that. And I have a follow-up after that, if that’s okay.

Roland Diggelmann: Thank you for the question. On China, indeed, we’ve seen very good growth over the last years. I think this is sustainable growth on the basis of several elements, I think, having the right products for the market, having the right structure in the market having a really good outreach in collaboration with the KOLs and really doing the right things in the market from a very local perspective.

And I feel very comfortable and very positive about our team there. I visited very early when I took on this role as CEO. I’ve had a lot of experience in China in previous roles. I feel very comfortable with this ability to sustain the growth on the basis of what we have invested, and we will continue to invest in the market. Orthopaedics, of course, is the largest opportunity, but also Sports Med as a growing franchise has a lot of potential and so has Wound Care.

You also touched on – and maybe just to add what – the obvious, of course, that we see COVID-19 this year as an interruption of that, but that we don’t see a change in the mid and long-term potential in China and neither on our growth opportunities in the marketplace.

You asked about the value-based sales, which is a principle that was applied from a more pharma-driven business model. It is being piloted in several regions right now, several provinces in China. We are experimenting with this model. It is, I would say, slightly different than the pharma world where everything depends on an approval and then with a lowering price, you get much more and an accelerated penetration to the market.

This is a different model here. It works differently. So we’ll probably see tweaks to that value-based approach, but we’re absolutely ready to work with the authorities in these areas. As I said, we’re piloting the fact that we’re a big supplier in the market helps us because we can get out there early and experiment with that model.

What we like to see, of course, is indeed, that the agreements that we make have a real impact on the volumes and that we see that acceleration then. We’re well positioned to provide that acceleration and with the reach that we have in the market.

And so I’m very positive about this, albeit there might be a disruption in the system but this is the volatile system that we’re operating in China. We just need to do the right things in a very local – from a very local perspective.

Veronika Dubajova: That’s very helpful. Thank you for the colour. And if I can, slightly bigger-picture question, just curious, with a quarter plus now under your belt, thinking about the sort of strategic direction of the organisation, I know, obviously, you’ve been very involved in the strategy so far from the Board seat.
But if you can give us a little bit of flavour maybe for what surprised you now that you are in the CEO chair versus on the board chair, either to the upside or the downside at quarter-end, that would be helpful to get your perspective on.

**Roland Diggelmann:** Thank you. I think when I look at the entirety of the business, this is a business with great potential, with a very strong brand equity. And as I mentioned initially, the trust from the customers which in this business and industry is absolutely paramount.

I think we can do even more with our technologies. I would just maybe outline the leading Register leading survival rates in hips with the POLARSTEM, probably one of the best surfaces there we have in the industry, with Oxinium, excuse me, great technologies that we are looking to leverage even better.

And I think the way to do this is certainly to continue to invest in innovation, continue to provide innovation to the market, but also making sure that we actually can leverage these technologies across the entire organisation that we operate.

And that is end-to-end thinking, that’s excellence in launches, excellence in the commercial entity, being closer to the market when we can, getting – investing also more in the clinical side and the data side of the business. Because as was the previous question, we’re talking a lot about value-based pricing and value-based models, of course. Going forward, we’ll continue to have to demonstrate not just the viability of our products, but of course, the long-term clinical results and all the way to the economic impact our products have.

So many areas to touch. End-to-end thinking is really important. And then this focus on the structural changes that we made with the franchise models, which give very clear responsibility to innovation, portfolio management and then, of course, also the regional responsibilities. And we really want to stick to those and operate those in the best way.

Finally, being the best owners of our technologies means also being the best owners of the external innovation that we acquire. And again, here, finding the right gems, finding the right technology that we can leverage through our system, both commercially and strategically, and leveraging these opportunities.

**Veronika Dubajova:** That’s great. Thank you.

**Operator:** Thank you. The next question comes from the line of Tom Jones from Berenberg. Please ask your question.

**Tom Jones (Berenberg):** Good afternoon, good morning. I had two questions. One maybe for Graham and one for Roland. The first one, maybe for Graham. I was just – your guidance implies kind of an underlying improvement of about 70 to 80 basis points in 2020 on the margin. I was just wondering if you could split that into what’s coming from cost savings already achieved in 2019, cost savings you expect to achieve in 2020 and what is coming from inherent operating leverage or other in-built drivers. I guess what I’m trying to get to is kind of what’s the sort of natural expansion, how much of it is kind of a one-time step-up relating to cost savings.

And then the second question, a bit of a boring one, I know, but one I think we need to ask for Roland on the M&A front. Yes, just wondering how you’re feeling about the balance between large and small acquisitions. A year ago, your predecessor teed us up for a significant sized acquisition and a significant increase in leverage and then precisely nothing
happened. And we continued along the path of doing small, very successful onesie-twosie type deals. I’m just wondering kind of conceptually how you’re thinking about the relative attractiveness of a larger number of smaller deals versus a larger strategic deal?

Roland Diggelmann: Do you want to go first, Graham?

Graham Baker: Sure. Yes. Thanks, Tom. Look, I think I’m probably going to frustrate you with a deliberately flexible answer because the reality is exactly how much comes from which source, we’ll only be able to tell you by the end of the year. We run the business on an active basis. And therefore respond to different situations. And particularly, in an environment where we’re thinking about a wide range of scenarios from COVID, it’s hard to be very precise about what the balance is going to be.

As you’ll have seen from our reporting of APEX benefits, we did $60 million of incremental benefits in 2018. We did $80 million last year. And I’ve highlighted that we are looking to increase the total of benefits, so there’s about another $50 million to go. The incidence of those will come through in both 2020 and potentially 2021, even though the programme shuts down this year. So I’m trying to give you some sort of dimensionality of what to expect in this year. But as I also highlighted that there are new restructuring activities also starting up in the year.

So there’s a complex series of pluses and minuses in there around leverage, around the contribution of benefits, around the decisions that we make to reinvest those benefits, including into R&D, but also into sales and marketing and also some factors from the external environment. So I’m not going to go beyond – I’m acknowledging that in doing the calculations, you’ve roughly highlighted that there is underlying progress in the business, which is being invested in R&D, dilution from M&A and handed back in FX.

The key message that we’re conveying at this point is that we’re continuing to focus on delivering on our commitments, as we’ve done in 2019. So I’m not going to say very much more, I’m afraid.

Roland Diggelmann: On the M&A, I think you should expect more of the same in terms of small, mid-sized deals. What we’re looking there at is technologies that help us differentiate, technologies that we can leverage through our commercial organisation, these being within the segments that we operate or in close adjacencies. ENT being one, just with the Tusker Medical acquisition, which is really exciting and doing exactly that.

On larger deals, I would say we have flexibility on the balance sheet. We’re certainly exploring opportunities, but this is not a focus. We want to make sure that if we were to go in that direction, first of all, we need to be opportunistic here. This is something, of course, that you can’t plan.

But very clearly, this is something that needs to make strategic sense for us and then also financial sense. And we want to make sure we put the emphasis on both of these dimensions when we think about M&A.

Tom Jones: Okay. That’s very clear. Thanks for that.

Roland Diggelmann: Thank you.

Graham Baker: Thank you, Tom,
Operator: Thank you. The next question comes from the line of Kit Lee from Jefferies. Please ask your question.

Kit Lee (Jefferies): Thank you. I have two, please. Firstly, just a clarification question. I guess on one of your 2020 priorities, namely the operations transformation, is this on top of the APEX programme that you will be delivering this year? And if so, if you can give us any colour on how material would the cost efficiency amount be in addition to your APEX target? That would be great.

And then the second question is on your next-generation robotics platform. I’m just wondering how different would this be compared to the current version and whether you need to retrain surgeons or take a pause on the sort of marketing and training before you launch the new product. Thank you.

Roland Diggelmann: Thank you for the question. Let me just take a – I’ll give a first set of answers, and then I’ll hand over to Graham to give some more colour on efficiencies. I think the first answer is, yes, this will come on top. This is separate programmes that are intended to go deeper to go across the value chain. You’ve heard us talk about lean manufacturing by other areas, but also about the ability to get closer to our customers.

So we’re taking a broader and deeper look here. We intend to come back by half year with a more precise set of numbers. But indeed, this is the intention to continue to work in the efficiencies across the entire value chain. Graham, do you want to give more colour?

Graham Baker: Yeah. Again, I think you’ve said the main things, Roland. Yes, it is on top of APEX. We’re not going to be giving precise details until the half year, but we are clearly guiding that this year’s restructuring costs in total will be in the range of $130 million to $140 million.

And that, again, if you do the arithmetic on what’s already been spent on APEX and think about what’s left to spend, therefore against the total, a little under half that is APEX spend, a little over half of that is the new programme.

I think, beyond that, the only sort of other – sort of broad directional guidance we could think about is the new programme is not a million miles away in overall scale from APEX over the coming years. I think that’s fair to say.

Roland Diggelmann: Thank you, Graham. On robotics, indeed, we’re looking at the next-generation robotics platform, which we’ll build on NAVIO. We’ll continue to emphasise a handheld system, which is CT-free, which I believe has huge advantages if you think of the ASC setting.

Further reduction on footprint. Having a modular system is going to be important, and then a very distinct technology around the burring that we offer, so faster, more accurate burring.

Over time, this platform should become the base for a multi-asset offering. That’s where we want to take it. Again, focusing on the ambulatory surgical centre, where, one, we have a foot in the door already through sports medicine; and b, we feel that our solution will be well-received because of the small footprint and the modularity of the system.

The next update is planned for the academy. So for AAOS in March in Orlando. So if you have the time, please come and see us. It should be exciting.
Kit Lee: Yes. And just coming back on NAVIO, I guess my question was, before you launch the new product, do you have to sort of take a pause on training the surgeons or on your marketing activities? But it sounds like, because it's a modular approach, you probably do need to do that. Is that fair?

Roland Diggelmann: Yeah, absolutely, that’s fair. This is building on NAVIO. It will have much of the same look and feel. Training and education is a very important part of NAVIO today, will continue to be. Obviously, this is a very different approach for a physician who hasn’t worked on robotics in the past.

And even if he has worked on robotics, maybe another solution, this one has a very distinct look and feel, and it does require training, and we’re taking this very serious. It is very, very important that they go through that training. And we’re also putting the resources behind that.

We also believe that it will be very well received because of the differences it offers. Again, handheld, small footprint, modular, fast in operation and then, over time, this multi-asset platform and offering.

So indeed, it’s building on NAVIO. We’re excited about it, and we like the fact that it is different from what’s out there.

Kit Lee: Okay, great. Thank you.

Roland Diggelmann: Thank you.

Operator: Thank you. The next question comes from line of Ed Ridley from Redburn. Please ask your question.

Ed Ridley (Redburn): Hi, guys. Thanks very much. A couple of follow-up questions. First of all, Roland, on M&A and the questions regarding larger deals. We know, obviously, from Wright medical disclosures that Smith+Nephew was one of the counterparties in those negotiations. And as you’ve highlighted, that area is obviously the interesting area to be in.

Can you speak a little bit more about – I mean you talked about your scale and how you look at it, but don’t you feel that is – those kind of deals are – should still be on the table for Smith & Nephew if you want to go into faster-growing areas? That will be my first question.

And a quick follow-up on capital sales and for NAVIO. When might we see disclosure on the installation numbers and the utilisation numbers for NAVIO as competitors such as Stryker, Intuitive Surgical get? Thank you.

Roland Diggelmann: Thank you. I’m just trying to reconcile the question here, sorry. So on the first one, obviously, I can’t comment on any speculation or any data that was put out on previous deals. Of course, we remain interested in the general area. As I mentioned earlier, I think we believe extremities are part of the broader offering in orthopaedics. That’s an area that we continue to look at. We’re focusing on, again, technology and innovation here.

The second question around the capital deployment relative to competitors, if I understood the correction – the question correctly, we’re not just...

Ed Ridley: I only asked in terms of the capital inflation numbers is if we might soon be given installed base or utilisation numbers on the NAVIO.
Roland Diggelmann: No, we don’t intend to give numbers on the NAVIO and its utilisation. We’ve also seen that others who have given out numbers in the past and not going there anymore. So we’re looking at this really as a technology platform to enhance our business. And I think it’s a very exciting technology, very exciting means to enhance our sales in the core business of Orthopaedics.

Ed Ridley: Okay. Thanks very much.

Roland Diggelmann: Thank you.

Operator: Thank you. The next question comes from line of Virendra Chauhan. Please ask your question.

Virendra Chauhan: Hello?

Roland Diggelmann: Yes. We can hear you.

Virendra Chauhan: Yes. So I have a couple of questions. Firstly, on the hip slowdown that you also mentioned. It was due to a – I think, a vendor or supplier side issue. So I just wanted to understand if we should be thinking of that as a one quarter blip or should we be thinking of it as a persistent one for the next few quarters and then you kind of lap that up? So should we be thinking that – what exactly would be the nature of this?

Roland Diggelmann: Thank you. I think it’s around the hip and the slowdown in the fourth quarter. I believe this is indeed a phasing and an event that will return to growth. I think we have a very good hip franchise. This was also – or is a consequence of some distributor change with consequent impact in Asia Pacific. So I look at this as more of an anomaly, and I’m confident that we’ll get back to good growth on the hip business globally.

In APAC, of course, it will depend short term on the further impact or not of COVID-19 in China. But generally, for the rest of the world, in particular, for the US, I expect good growth.

And then as we continue to launch the Dual Mobility Cup, in particular, in the US, we should see better growth rates even in the future. That will take a couple of quarters until we actually see the impact of the launch, but very positive about our hip franchise.

Graham Baker: Yeah. I think just to add on – sorry, just to add, from my perspective, yes, clearly, the distributor change was a one quarter blip. But clearly, the overall impression that I’m giving around the potential for our overall sales growth to drop to potentially zero in the first quarter that will be felt through our franchises. And as Roland outlined, actually, it’s the elective procedures that are the ones that are being impacted the most. And therefore, you will see that slowdown come through in the orthopaedic and the sports franchises, in particular, when you see the global numbers for Q1, I anticipate.

Virendra Chauhan: Okay. And just another follow-up – not a follow-up, I have another question. So if you look at the performance for the last few quarters, singling out or picking out wound as an area or – from three franchises, if I might put it that way, wound seems to be one area of the clear underperformance, and if you also look at the non-device business, especially.
So Roland, any specific comments on – since you have comments on what could be the potential pain points and how you try and fix them because I think that looks like a low-hanging fruit, probable venture You want to – we want to fix at the earliest.

Roland Diggelmann: Thank you for the question. I’m just...

Graham Baker: Yes, we’re sorry the audio in the room isn’t terribly good. So we’re relying a little bit – I think both Roland and I are feeling our age maybe here, but we’re relying a little bit on the typing of the question. But I think it’s about the potential for Wound and your views on that, Roland?

Roland Diggelmann: Thank you. Thanks for interpreting, Graham. Sorry about that.

Graham Baker: It’s just the audio of the room.

Roland Diggelmann: So on the wound side, obviously, this is the franchise which posted the lowest growth. Now when you go deeper into the wound, you have to differentiate really by segments.

I think Wound Care is certainly an area where we will continue to see some price pressure. We’re also waiting to see the one-year lapping of the renegotiated prices in the US So I would say I’m moderately confident there that we’ll get there. Then we have the bioactives, where we’ve made a major investment with the acquisition of Osiris. I strongly believe that regenerative medicine is the future. Bioactive substance is there.

We’re up against a very tough comparable from previous year and the launches, but there is no reason to not to believe that we can go back to really strong growth rates on bioactives. And then finally devices is where we really posted fantastic growth, and we’ll continue to do so because we have really great products with PICO and RENASYS and then the next-generation of PICO coming. So negative wound pressure is a business that we continue to do well, and we’ll continue to lead the growth for Wound Care overall. Does that answer your question?

Virendra Chauhan: Yes, I think – Yes, yes. That was pretty much. Thank you.

Roland Diggelmann: Thank you very much. I think we’ll move to one last and final question, if there are any in the room or on the phone?

Operator: So we have a question over the phone. And the last question comes from line of Chris Gretler from Credit Suisse. Please ask your question.

Chris Gretler (Credit Suisse): Thank you, operator. Hi, Roland. Hi, Graham, I have actually a question on capital allocation, and I think we already discussed M&A, but could you elaborate maybe on R&D? And it seems you flagged a kind of increased investment appetite. Where do we actually see the highest return potential opportunity here? As you have now relatively widespread empire here? And how do you think about kind of in-house versus acquired R&D?

And the second question is on CAPEX. It looks like it’s running a bit high. I guess some of it is tied to the APEX programme. Could you maybe comment on the medium-term outlook? How much you think you will need to invest in property, plant and equipment, especially given your comments on instruments? Thank you.
Roland Diggelmann: Thank you. Capital allocation. Of course, both internal and external, I think we are – we have a very good balance sheet. We'd like to continue to keep investor grade – investment grade there, but we have opportunities, and that's good. We have the flexibility to act.

Again, I like small and medium-term deals where we can bring in exciting, differentiating technology in-house and leverage that with our own structure with our commercial presence. If it is other elements of M&A, what we would have to focus on very much is that we actually bring in the entire value chain so that we can – we don't have to build presence in markets as we do acquisitions. Hence, what you've seen small, medium sized tuck-in really differentiating on the technology and bringing innovation to the organisation.

CAPEX, I think, in short, we've obviously invested for growth. We'll continue to invest to support growth. But as a part of the PP&E, we should manage that also cautiously. We should make sure that we invest in the right places. I think we have some room there.

And we can also – maybe also as a side comment, of course, manage inventories and reduce inventories across the organisation without impacting commercial excellence. Graham, I don't know if you wanted to add on both of these points?

Graham Baker: Thanks, Roland. I'll start on the CAPEX point. Yes, I think you're right that the main driver of the pickup in our CAPEX has been around the manufacturing change programme within APEX. We have just announced the start of our new facility in Malaysia, and that has driven part of the cost in 2019, and that will continue to come through in 2020. Beyond that, I think, at the half year, along with the further operations excellence programme scoping, I think we'll give some idea of the forward view on CAPEX.

In terms of returns on R&D between in-house and external opportunities, I think, if you pick the right projects, they are both very good business. It's making sure that you pick the right ones and that you allocate the right things to meet the customer needs that are going to be value enhancing to patients and customers in the marketplace, as Roland highlighted.

Our franchise structure brings us closer to those customers and has enhanced our ability to make those decisions with confidence. And certainly, the pipeline that we have ahead of us we have confidence in, and the transactions that we've done already are good ones that, again, we have confidence in. So beyond that, I think I'd just probably be repeating what Roland's already said. So I think I'll leave it at that.

Chris Gretler: Thank you.

Roland Diggelmann: Well, thank you very much. This concludes our event. Thank you for your interest in Smith & Nephew, and I look forward to interacting with you going forward. Thank you.

[END OF TRANSCRIPT]