Smith & Nephew 03/04/2014 **FAT-UK-531**

SN GBP £9.10 Core **LOW** **B**

Revenue growth starting to pickup

Last week's review of the Healthcare sector noted that it is underpinned by growing long-term demand. As such it is worth considering specific opportunities in healthcare equipment and services. Smith & Nephew is one of the largest global players within this space and has an attractive long-term growth profile.

With healthcare such a significant area last week's report only started to get under the hood of individual opportunities. It is therefore worth revisiting more closely what is on the "operating table" for investors.

As a brief reminder the healthcare sector looks to have the potential to outperform in the long-term. This is on rising demand due to ageing population and the rising middle class in emerging markets.

The industry is dominated by pharmaceutical and biotech stocks in terms of market value which adds significant drug development risk. However, the smaller healthcare equipment & services side isn't exposed to drug development.

We also noted that healthcare funds are dominated by pharmaceutical & biotech stocks. As such it is worth firstly considering the smaller **healthcare & equipment sector** as significant exposure here can only be garnered through stock picking.

Smith & Nephew (S&N) is the obvious place to start as it is worth more than all the other UK Health Care Equipment & Services groups combined. It has two divisions: Advanced Surgical Devices and Advanced Wound Management.

Looking at the charts, the technical set up is positive with the uptrend that resumed in late 2011 largely maintaining its pace and leading to a new all time high of 963.15p. The share price has drifted lower since, however the overall pattern remains bullish and we expect higher levels emerging in the near term.

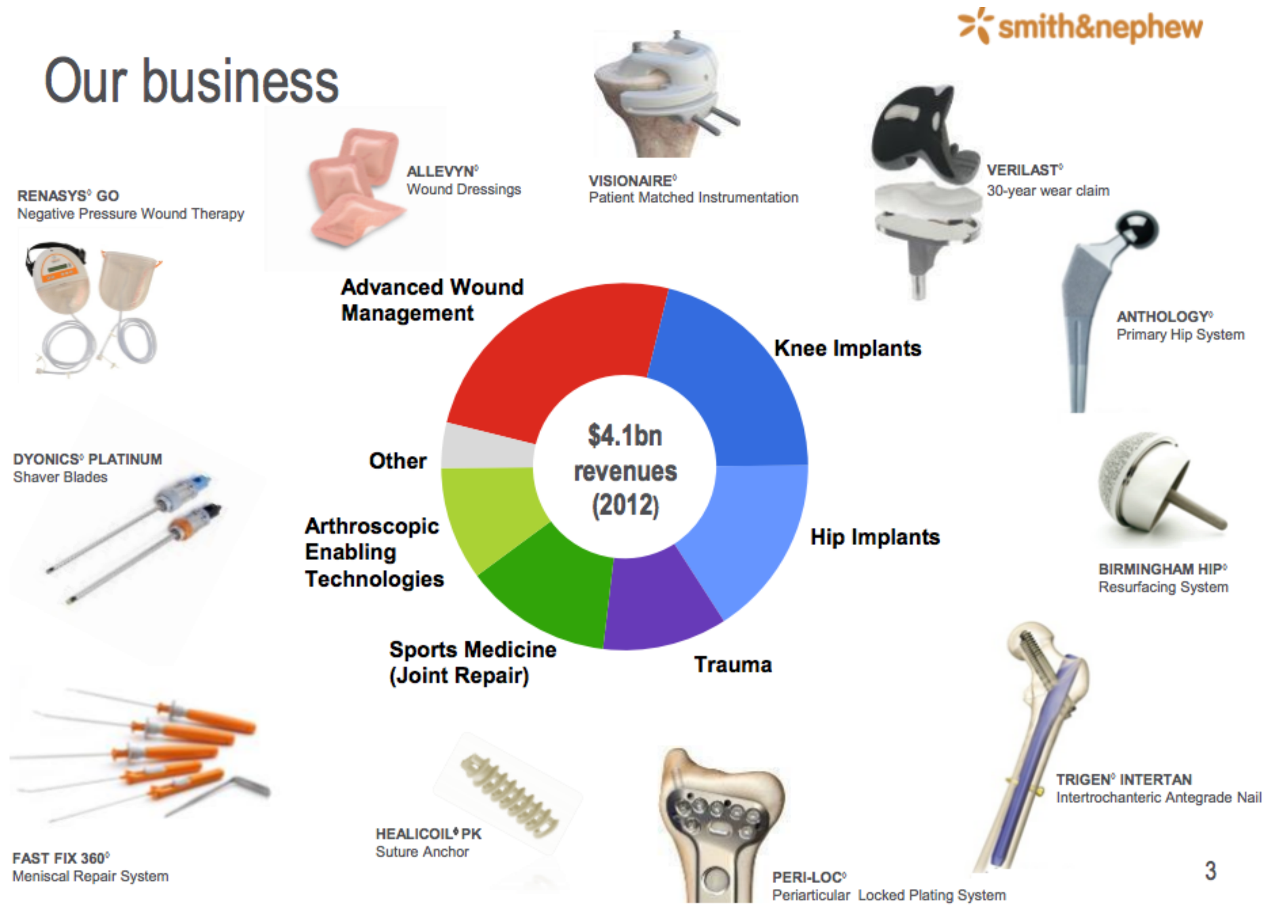
Looking briefly at the valuation side and Smith & Nephew fits the profile of a defensive healthcare group that steadily grows profits. For 2014 the forecast P/E is 18X earnings but this falls to 15X in 2016 and then 12X in 2018.

As a maker of knee and hip joints Smith & Nephew is exposed to rising demand due to ageing populations and obesity. Emerging markets are a small part of revenue - 13% in 2013 - but contributed half of 2013's revenue growth and set to become more significant in future.

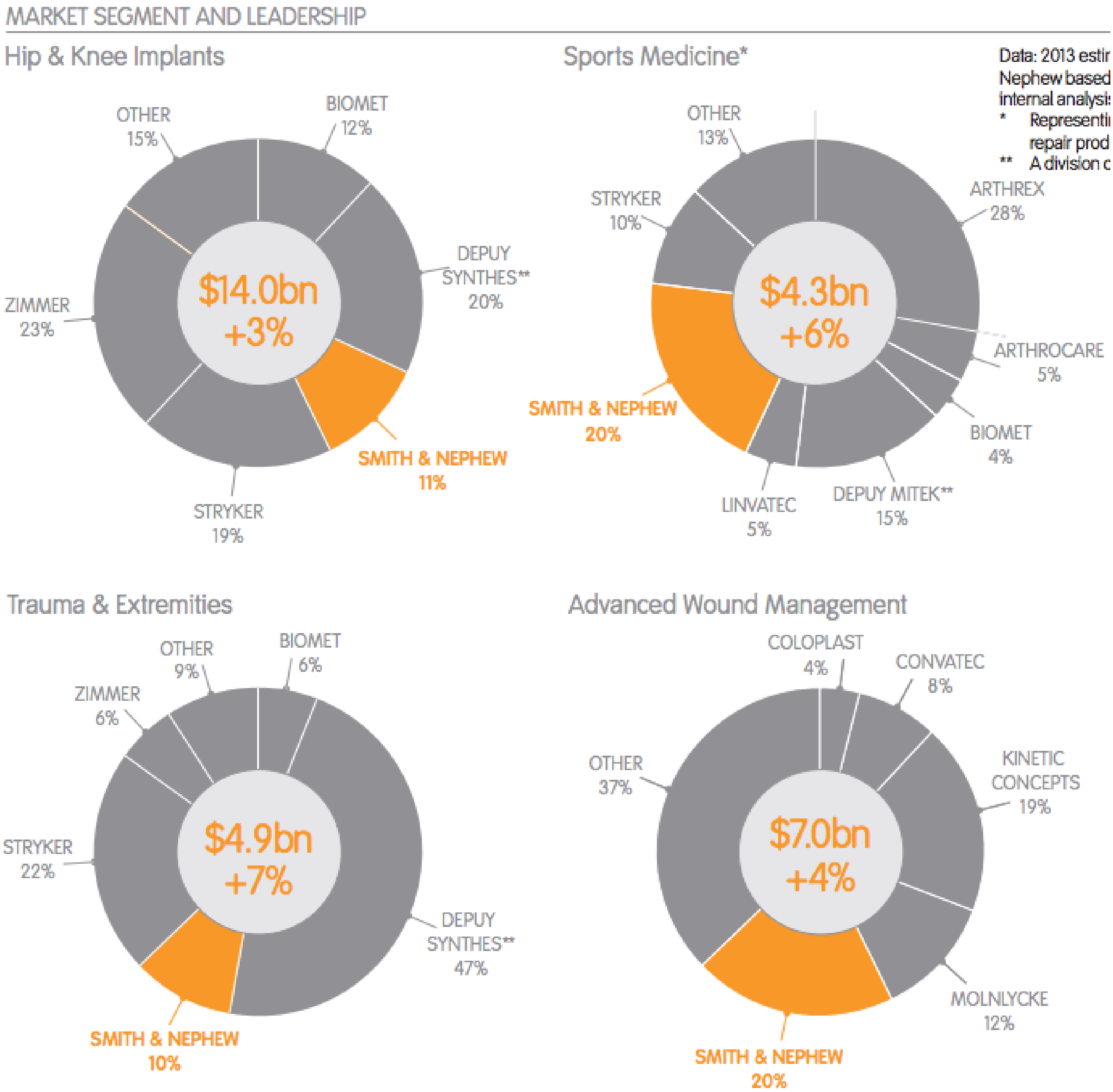
Smith & Nephew 101

The below graphic shows the breakdown in revenue in 2012 with the bulk of revenue from Advanced Surgical Devices. In Q4 2013 70% or revenue was from Advanced Surgical Devices and it made up 69% of trading profits.

Smith & Nephew: product examples



The group's market share in these areas is given in the graphic below which shows that Smith & Nephew is a leading global player. In Advanced Wound Management the has the leading market share globally.



In terms of the outlook for these areaa and the global population is set to rise from 6bn in 2000 to 10bn in 2050. The proportion of people who are over 65 is forecast to increase from 7% to 16% over this period.

TOTAL SEGMENT VALUE

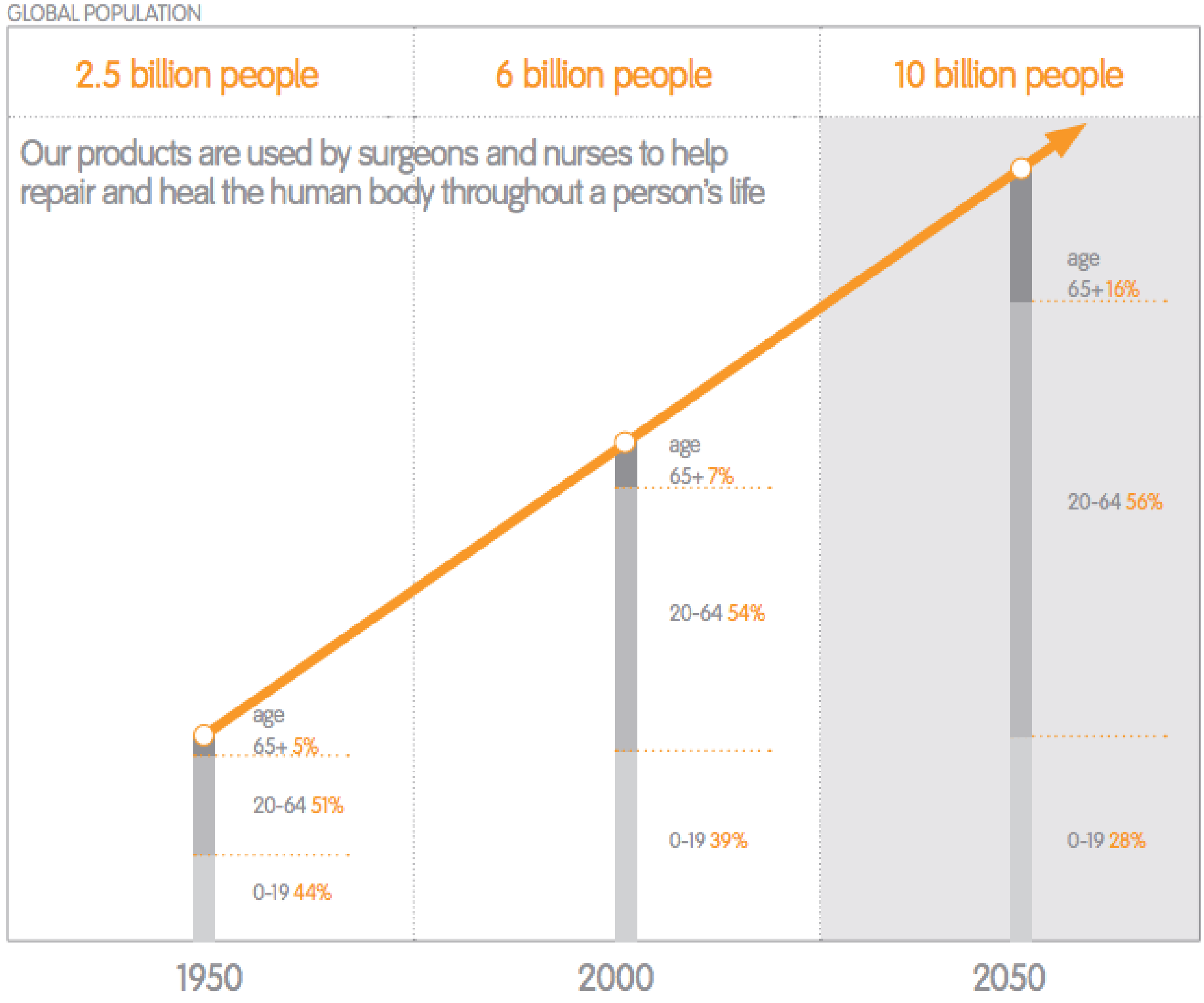
ADVANCED SURGICAL DEVICES

$23.2bn +4%

TOTAL SEGMENT VALUE

ADVANCED WOUND MANAGEMENT

$7.0bn +4%

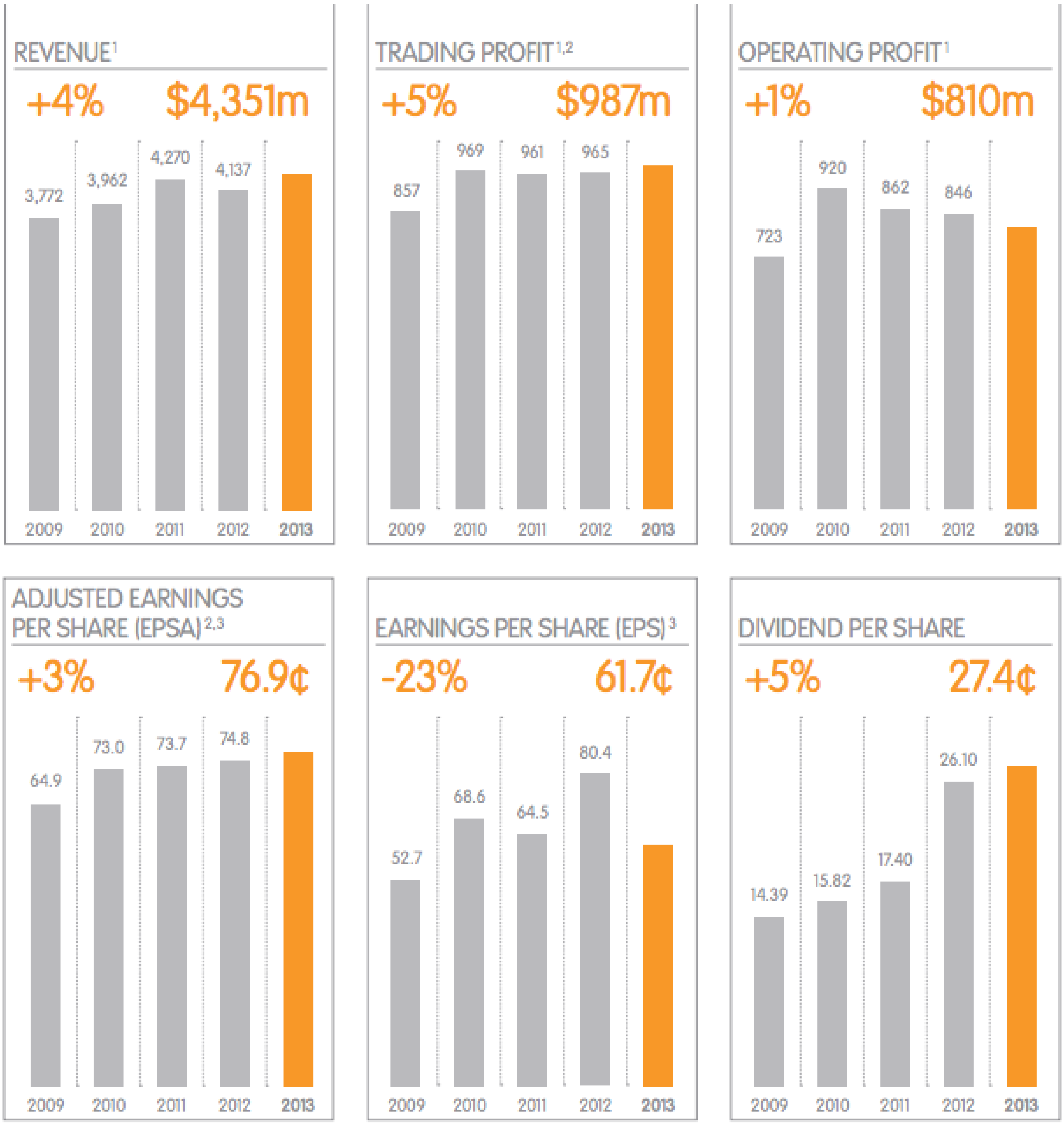


Source: United Nations – World Population Prospects, The 2012 Revision.

Smith & Nephew recent growth and outlook

Set against this backdrop and Smith & Nephew's recent growth has been modest with revenue and trading profits both up 15% from 2009 to 2013. Adjusted earnings per share increased by 18.5% over the same period to $0.769 in 2013.

Moderate growth over five years



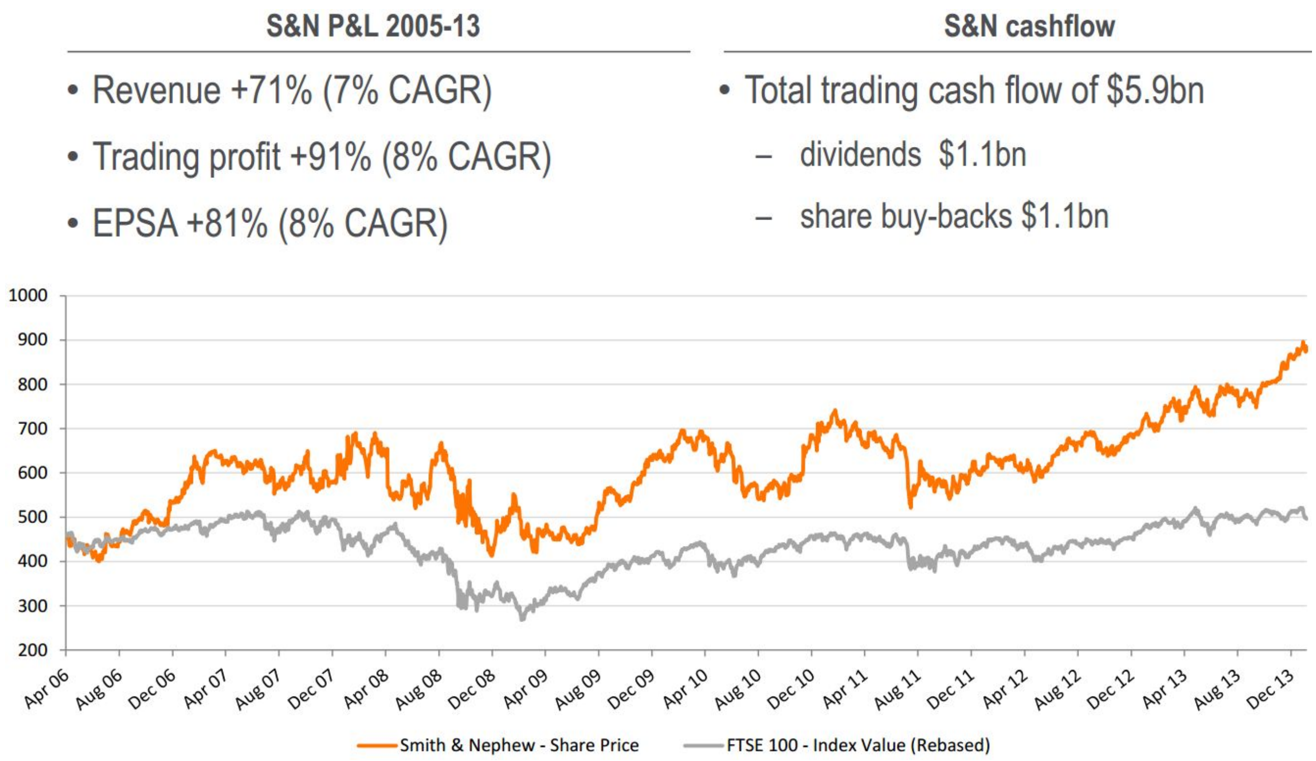
However, things appear to be looking up with 4% underlying revenue growth in 2013. This was as the first half saw only 2% growth but Q3 came in at 5% and Q4 at 6%.

In the company's outlook statement it stated that "market conditions in the second half of 2013 are expected to continue in 2014." The trading margin is also expected to improve due to the efficiency programme and investments.

Accordingly, the period of weak revenue growth for Smith & Nephew looks set to come to an end. This is as developed markets start to recover from weak economic conditions and emerging markets contribute a greater proportion of revenue growth.

The long-term profile of Smith & Nephew is of a relatively low risk group that outperforms in the long-run. Excess cashflow has also allowed for share buy-backs helping earnings to grow faster than revenue.

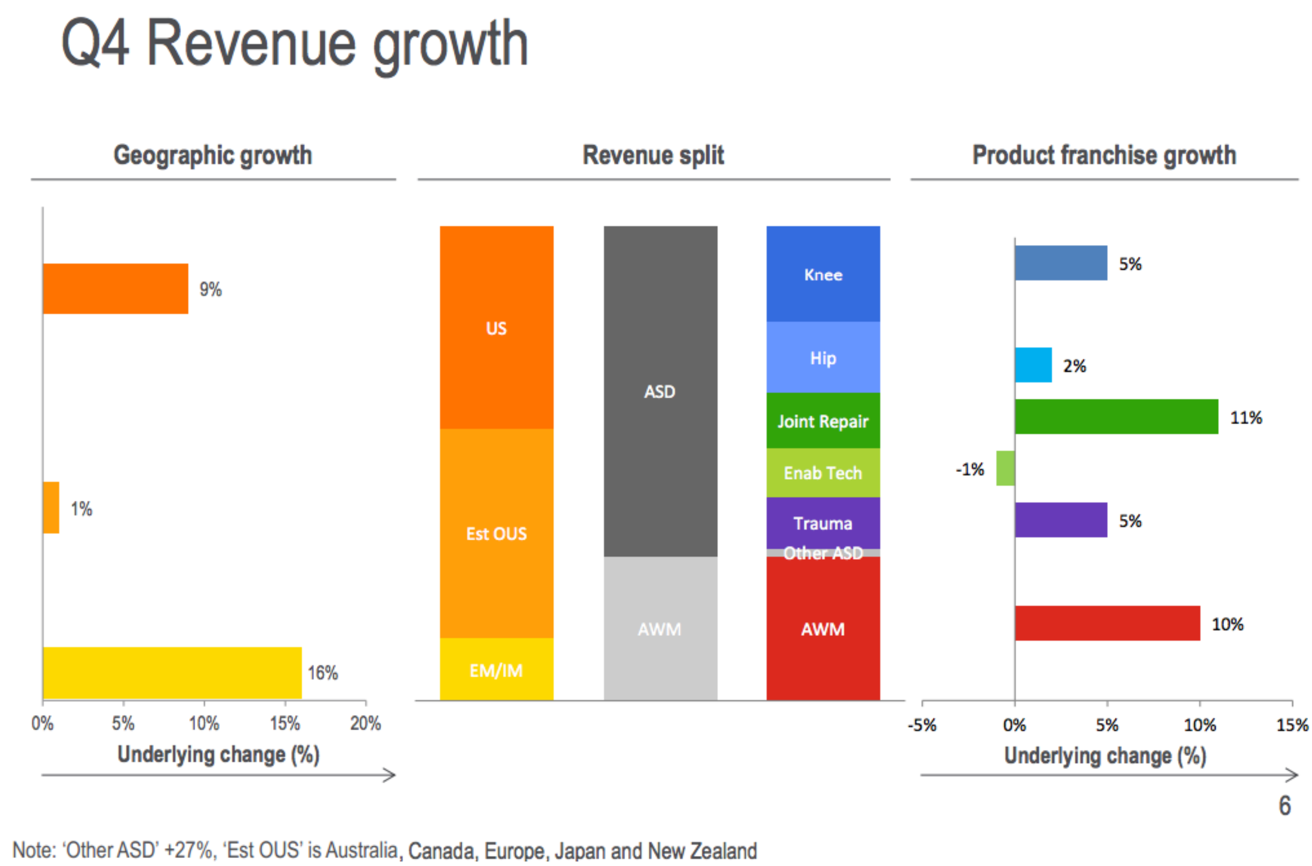
Smith & Nephew outperforms since 2006



Fourth quarter results

The below graphic gives Q4 2013 revenue and shows that knee, hip and joint repair is around half of the total. These areas saw 5%, 2% and 11% underlying revenue growth respectively on a year ago.

Smith & Nephew drivers in Q4 2013



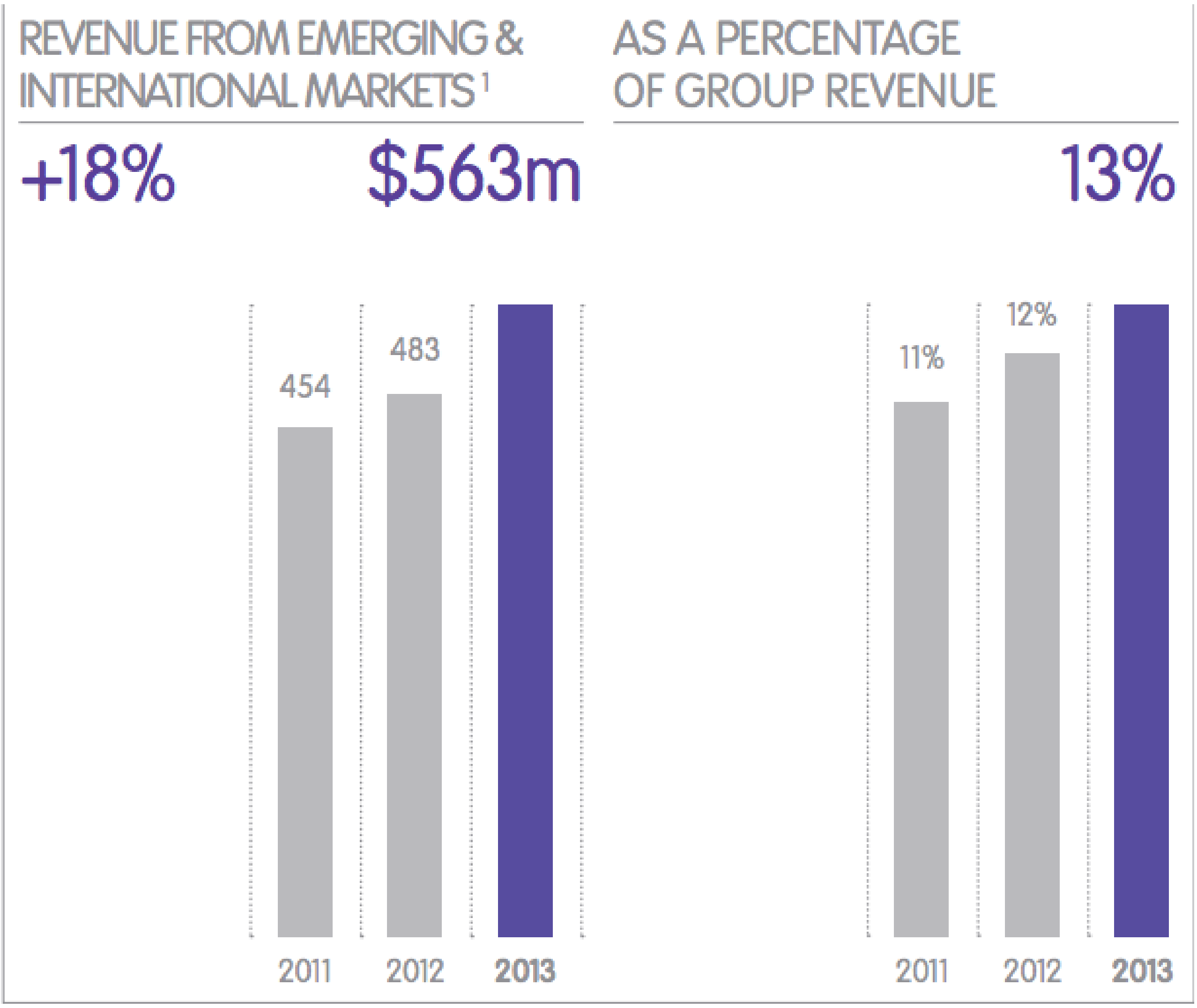
Trauma products saw a 5% revenue growth and enabling technology saw a slight 1% revenue fall. **Advanced would management saw 10% revenue growth in Q4 which was a solid performance.**

Looking on a geographic basis and the US saw 9% revenue growth while established markets outside the US (Est OUS) only saw 1% growth. Emerging markets & International markets saw 16% revenue growth which bodes well for the long-term potential of Smith & Nephew.

Strategy and drivers

Emerging markets are a relatively small part of the group's business at 13% of 2013 revenue which provides plenty of scope for long-term growth. In 2013 emerging markets contributed half of the group's overall revenue growth and so are a meaningful driver.

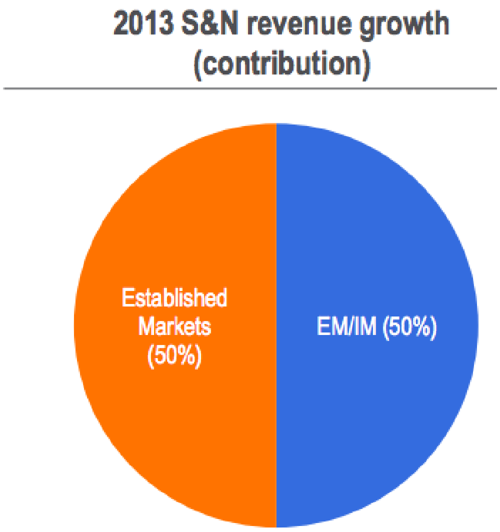
Plenty of scope to grow in emerging markets



Accelerating development in Emerging Markets

- 2013 highlights
  - China successful model
  - organic and inorganic investment
  - mid-tier strategy in place

- 2014 developments
  - build on 2013 acquisitions
  - implement mid-tier commercial model
  - further organic and inorganic investment



A key area of focus is to undertake acquisitions in emerging markets with 2013 acquisitions in Turkey, India and Brazil. However, the latest acquisition is for a US group Arthocare for US$1.7bn which was announced in February 2014.

While this is recommended by the board and supported by a 17% shareholder of Arthocare it is not certain to be successful. Arthocare's key areas are Sports Medicine along and products focused on the ear, nose and throat.

The deal is expected to boost S&N's earnings per share in the first full year of ownership and exceed S&N's cost of capital in the third full year. With only a modest premium to Arthocare's recent share price the deal looks like good value.

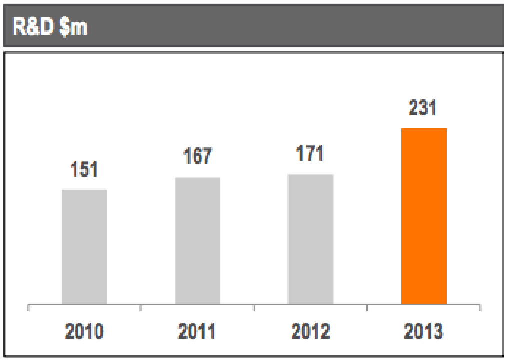
Assuming the Arthocare acquisition goes ahead the group expects that net debt to EBITDA will below 1.5X at the end of 2014. While this is a conservative level a share buy-back programme has been suspended to help bolster the balance sheet.

Smith & Nephew has also been lifting R&D expenditure at the same time as undertaking a cost cutting programme. This should serve to underpin its market position and growth from new products.

Turning on the R&D Tap in 2013

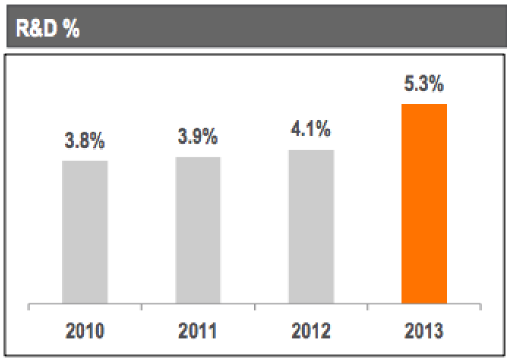
2013 highlights

- 23 new AWM products
- successful launch of JOURNEY◊ II BCS
- mid-tier portfolio
- new medical education websites



2014 developments

- R&D investment now evident in near-term pipeline
- greater focus on invention and access
- HP802 trials on-going



Smith & Nephew valuation and summary

The forecast P/E ratio for 2014 is 18.1X with a dividend yield of 2% that is 2.8X covered by earnings. For 2015 the P/E ratio falls to 16.5X earnings and then comes down to 15.1X the year after that.

US group Stryker is a close peer to S&N and is on 17X forecast earnings for 2014 which falls to 15.5X the following year. Thus S&N is appears to be at a slight premium but should also be boosted by the Arthocare takeover.

The stock clearly offers defensive characteristics as well as steady long-term growth which makes it compelling. Investors may have cottoned onto this given the 18.1X P/E for 2014 but this is by no means a deal breaker in our view.

With revenue growth and profits momentum set to improve the shares saw a jump on full year results. They have since come back marginally and so look to be attractive around current levels.

Long-term growth rates have the potential to increase over time as a greater proportion of sales comes from fast growing emerging markets. The increased investment in research and development is also supportive for medium term sales and profits.

Accordingly, we recommend Smith & Nephew as a low-risk and long-term conviction buy. Given the gain in the share price over the past year we recommend buying over time.

Snapshot SN

Smith & Nephew

Latest Closing Price: £9.10

Smith & Nephew plc is a global medical devices business operating in the markets for orthopaedic reconstruction and trauma, endoscopy (which includes arthroscopic procedures referred to as sports medicine) and advanced wound management. It operates in three segments: Orthopaedics, Endoscopy and Advanced Wound Management. It operates on a worldwide basis and has distribution channels in over 90 countries. Orthopaedic reconstruction implants include hip, knee and shoulder joints.

Market Capitalisation:£8bn

	FY1	FY2
Price to Earnings	18	16.3
Dividend Yield (%)	2.0	2.2
Price to Book	3.1	2.9
Return on Equity (%)	17	16.6