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Smith & Nephew 22/11/2018 **FAT-UK-759**

SN GBP £13.94 Core **LOW** **SH**

Fat Prophets take some Profits

Smith & Nephew (LSE.SN) recently unveiled its 3Q18 trading update which highlights, in more concrete terms, its turnaround plans. We also saw that management is handling the transition period well and achieving guidance targets. However, with the turnaround likely taking a long time and with increased market volatility in the near term, we believe that it is worth taking some profits.

What's New?

A lot of things have changed since our last coverage in August (FAT-UK-745) where we looked at new CEO, **Namal Nawana's** first quarter with the company and its first half 2018 (1H18) performance. 1H numbers were decent and point towards achieving guidance numbers and Mr Nawana also discussed some initial measures to facilitate his turnaround strategy.

Following that and from September, the company's share prices took a nose dive following a string of downgrades from "The City" (London's Wall Street) amidst some concerns of 'a lack of a concrete strategy' for the turnaround as well as prevailing soft markets in advanced wound care to non-invasive surgical tools.

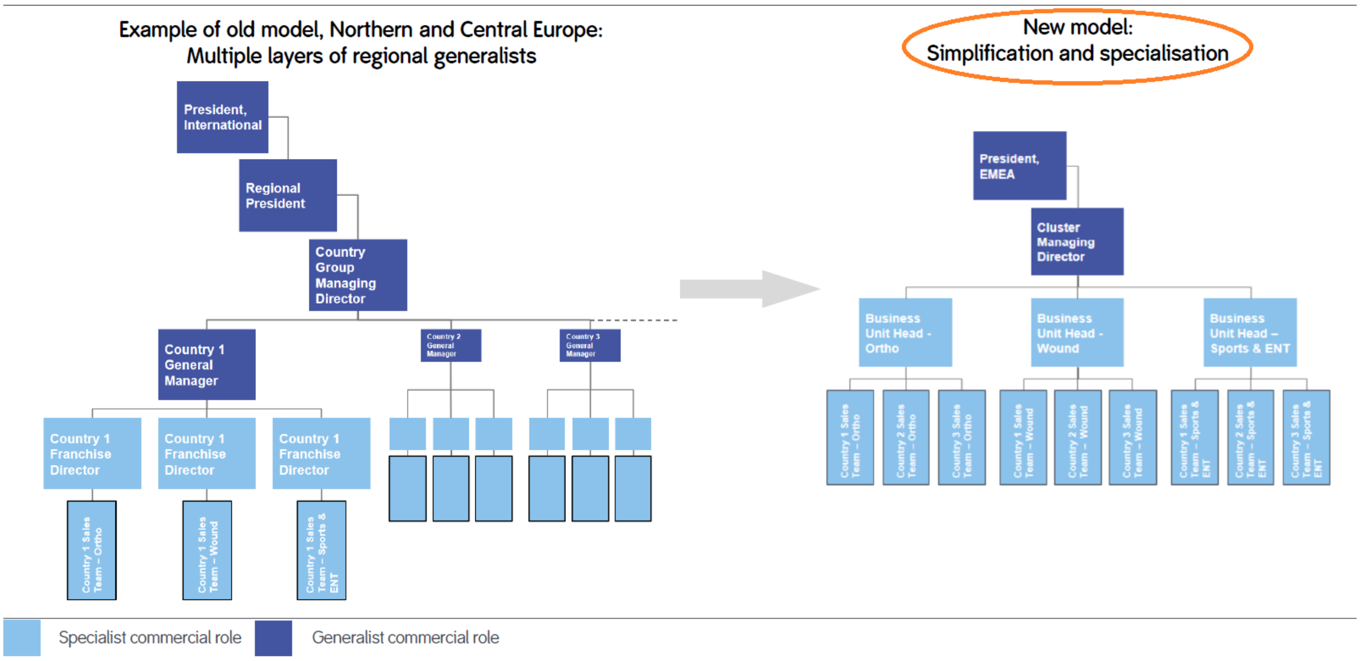
However, in early November, the company unveiled its 3Q18 trading update showcasing some better-than-expected demand for its hip products as well as more clarity on its turnaround strategy. Consequently, since its Octobers lows, the shares have rallied some 10.8% to reclaim lost ground.

In light of that, we believe it's an opportune time to cash in some profits and we issue a SELL HALF recommendation.

3Q18 Trading Update

Looking at the trading update and Mr Nawana unveiled his approach to shifting gears dubbed the "new commercial model" where he intends to streamline operations, reduce complexity, cut costs and accelerate top-line growth.

As shown in the graphic below, he is reorganising the business and taking out the layers of 'generalists' towards increased specialisation and a flatter, and more agile structure:



Source: 01 November 2018 Company Presentation

Part of this ‘specialisation’ shift is transitioning the business **from a regional focus towards a ‘global franchise structure’**.

In the previous structure, the businesses were organised on a country basis with departments for each franchise (product categories) which led to multiple layers of administration, thus higher costs and complexity.

The shift now focusses on franchises such as (i) Orthopaedics, (ii) Wound Care, and (iii) Sports Medicine and leadership now responsible for the product categories instead of the entire portfolio in any single country. This makes leadership responsible for a larger ‘P&L’ (Profit & Loss).

Though we find this shift pleasing, we are well aware that a global reorganisation takes time. Even Mr Nawal acquiesced that “moving from a regional selling model to a global franchise model, doesn't happen overnight.”

He did note that the transition is progressing well and hasn’t impeded with results stating that he is “… very, very pleased that we've been able to keep the trains running while we're making this turn. And we're most of the way through hiring our leaders, which is great, but that's a lot of organizational change”

However, as part of the transition, we believe that acquisitions are also likely take a backseat in the interim. Evidence of this when Mr Nawal commented that “…in these early days, the kind of work we're taking on is really improving our business, changing our organizational net design and our work methods…” We believe that to be a prudent move, as focus will accelerate the turnaround time.

With that discussed, the 3Q18 period was a standout for the year so far, as numerous categories reported organic growth. According to management, strong demand in both the US and Emerging Markets were the primary drivers reporting year-on-year revenue growth of 6% and 10% respectively.

The graphic below illustrates the different growth rates across categories:

Franchise revenue analysis

	2017					2018			
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	
	Growth %	Growth %	Growth %	Growth %	Growth %	Growth %	Growth %	Revenue $m	Growth %
Sports Medicine, Trauma & OSB	**4**	**3**	**2**	**2**	**3**	**1**	**2**	**476**	**4**
Sports Medicine Joint Repair	7	5	8	6	6	6	8	166	8
Arthroscopic Enabling Technologies	(1)	(4)	(3)	(3)	(3)	(5)	(1)	138	(2)
Trauma & Extremities	5	7	(2)	5	4	(2)	(5)	122	3
Other Surgical Businesses	7	11	6	4	7	9	8	50	12
Reconstruction	**3**	**2**	**4**	**4**	**3**	**0**	**3**	**374**	**4**
Knee Implants	5	4	6	6	5	2	3	232	4
Hip Implants	0	(1)	1	1	0	(2)	1	142	4
Advanced Wound Management	**1**	**3**	**2**	**0**	**2**	**(2)**	**1**	**319**	**1**
Advanced Wound Care	1	2	(1)	(3)	0	0	2	184	1
Advanced Wound Bioactives	(8)	0	7	0	0	(12)	(6)	81	(7)
Advanced Wound Devices	16	14	8	14	13	2	9	54	11
Group	**3**	**3**	**3**	**2**	**3**	**0**	**2**	**1,169**	**3**

Source: 01 November 2018 Company Presentation

Summing up the progress to date Mr Nawana commented that “these results were achieved while successfully redesigning how we will run the company. **There is still more to do**, and I am pleased with the pace of progress and engagement across the organisation.”

We are pleased to see the company managing the transition well and we like that the company is reaping the benefits of its years of investment in its portfolio. On that note, management is looking to sustain the R&D pipeline by ramping up investments in the unit while also looking at potential bolt-on acquisitions once the reorganisation is completed.

Given that topline performance was better-than-expected, we expect annual profit margins to be higher than management’s guidance of “at or above 2017 levels” of 21.1%. However, given that there is little time left, management has kept guidance unchanged.

Looking forward to FY19, CFO Graham Timothy Baker noted that they’re “reviewing the overall targets as a result of our commercial restructuring and some other opportunities we've identified in recent months” and added that they will provide an updated outlook at year’s end. We’re keen to see how management expects the reorganisation to impact business.

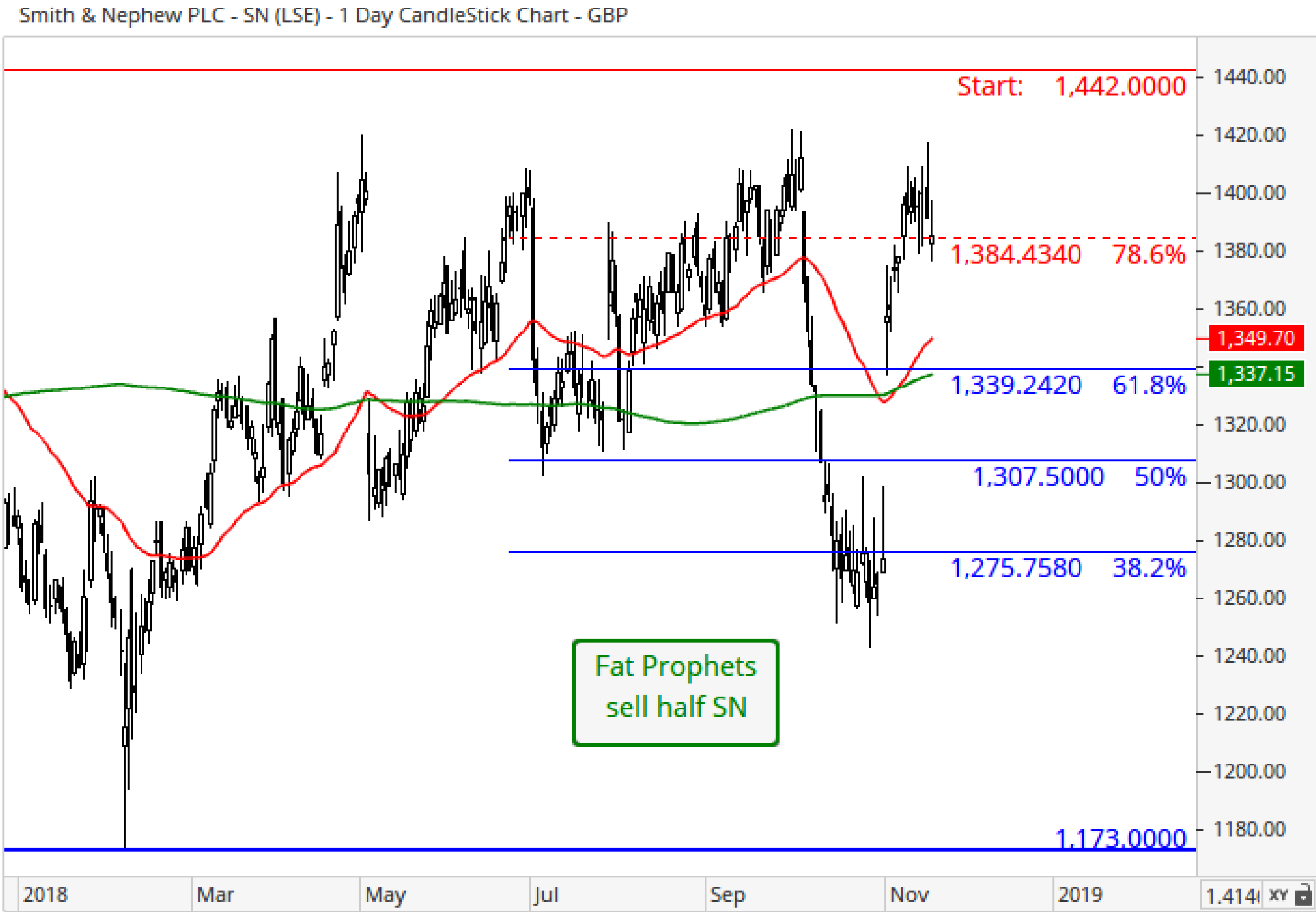
Smith & Nephew PLC - SN (LSE) - 1 Month CandleStick Chart - GBP

Summary

Smith & Nephew (LSE.SN) recently unveiled its 3Q18 trading update which highlights, in more concrete terms, its turnaround plans. We also saw that management is handling the transition period well and achieving guidance targets.

On the valuation front, the company's shares are currently trading at a forecast P/E ratio of 19.1 times for 2018, set to decline to 18.9 times the following year. While on the dividend front, yield expectations are at 2.0% in 2018 and fall to 1.9% by the following year as the cost-out programme picks up. In the long run though, dividends are expected to edge up.

Despite the positive results, we are well aware that turnarounds of this scale (global) take a long time to complete and as such believe it an appropriate take some profits off the table.



Accordingly, we issue a SELL HALF rating for Smith & Nephew (LSE.SN).

Snapshot SN

Smith & Nephew

Latest Closing Price: £13.94

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:£12.19b

	FY1	FY2
Price to Earnings	19.1	18.9
Dividend Yield (%)	2.0	1.9
Price to Book	3.3	3.2
Return on Equity (%)	18.6	16.3
EV/EBITDA	11.3	12.5