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# **Smith & Nephew Q2 and H1 2022 Results**

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## **Introduction**

Deepak Nath

*CEO, Smith & Nephew*

### **Summary**

I will just draw your attention to the Safe Harbour statement on the slide that is about to pop up in front of us. So it is a pleasure to be reporting the results of my first full quarter as CEO and also to be meeting many of you in person for the first time.

So as you can imagine, I have been spending these last few months getting into the detail of the business and building up a picture of how we can drive greater performance and value. So before we get in to the quarter's numbers, I would like to share my initial thoughts on Smith & Nephew's positioning, some of our early priorities and our expectations.

Smith & Nephew has many exciting opportunities with a number of factors that are lining up for us to go to the next level of growth. Innovation is a key driver of value in our industry, and this is a company with innovation at its core. I have seen leading technology in every aspect of the business, in established products, in recent launches and in the depth of pipeline across our franchises.

Secondly, the fundamental competitive positioning is strong. We have a clear right to win in all franchises. There are structural advantages that are distinct from our competitors and our proprietary platform technology with applications across multiple devices and procedures.

And importantly, the delivery is good in two out of our three franchises that account for about 60% of our revenue base. So there is no systemic barrier to execution. The challenges would not be surprising to you, strategic execution in Orthopaedics still needs to improve. And our manufacturing and supply chain are not yet where we need them to be. Both our growth and our margin recovery have been held back as a result.

So I have spent some time going after the root causes. Although there is already some work underway, we have now developed a new structured programme of execution with a deep level of oversight that I know is required to deliver this type of programme and at pace. This work has already started.

Turning to our results. I would say our first half performance was mixed. Wound & Sports Medicine continue to be on track, whereas Orthopaedics was held back by execution and supply chain challenges, and of course, the impact of China VBP.

We have adjusted our 2022 guidance reflecting these supply chain challenges and the difficult macro environment. Anne-Françoise will walk through the Q2 and H1 results, and then I will come back and talk in more detail about our comprehensive action plan for the future. Anne-Françoise?

### **Q2 2022 Revenue**

Anne-Françoise Nesmes

*CFO, Smith & Nephew*

**Q2 2022: Growth reflects VBP and COVID in China**

Thank you, Deepak. I agree with you. It is certainly really good to be in person for the first time in two years as far as I am concerned. So thank you for making the effort to come. But as Deepak said, I will start by going through the detail of the second quarter. So growth in the second quarter was 1.2% underlying.

The slower growth than the first quarter mainly reflected a number of known factors. These were:

- One fewer trading day than in 2021;
- The implementation of China VBP in hips and knees; and
- Lockdowns in some region of China, which particularly affected our sports franchise.

Looking at our growth by geography:

- The US was the fastest-growing region at 2% for the quarter as a whole;
- Emerging markets grew 0.8%, reflecting the headwinds in China, but offset by strong growth in India, the Middle East and Latin America; and
- Other established markets were flat, reflecting a slow quarter in Asia Pacific.

**Orthopaedics**

Going into the details of the franchises, overall. Orthopaedics revenue fell by 1.1%. As I mentioned earlier, VBP implementation was a significant headwind. If we exclude China, Orthopaedics grew by around 2%. In Reconstruction, knees grew 2.7% and hips declined 3.7%, as well as the VBP impact on our out of US revenue, the quarter reflects the need for improved execution and supply chain management that Deepak will talk about shortly.

We are also continuing to roll out our cementless knee in the US. And while it is too early to move growth significantly in the quarter, we do expect to become more visible in the second half.

Other reconstruction returned to double-digit growth and robotics growth was well ahead of the overall segment. Our offering is continuing to develop. The first CORI-assisted hip and cementless knee procedures were completed in the quarter. And in second half, we expect to become the first company to offer robotics-assisted new revisions.

Trauma & Extremities declined 6% and was slow across most regions. As you may be aware, we opted not to participate in the broader rollout of the provincial trauma tenders in China, which explain part of the decline in the sales.

**Sports Medicine & ENT**

Sports Medicine & ENT grew 1.9% with Joint Repair growing 2.1% and Arthroscopic Enabling Technologies declining by 0.5%. As I mentioned earlier, sports medicine was particularly impacted by the impact of COVID outbreaks in China. Without China, the franchise growth would have been around 5%, with 7% in joint repair and 2% in AET.

Otherwise, the drivers of the business were very similar to the first quarter. The recovering knee repair market continues to drive our growth in established markets as level of physical activities return to normal. Also, we have recent launches such as FAST-FIX FLEX and FASTSEAL, which continue to track ahead of our plan and are making an increasingly

important contribution to the growth. As we mentioned before that availability of electronics remains a challenge, and this is continuing to be a headwind in AET.

ENT growth of 11.2% reflects continued post-COVID volume recovery, also helped by successful price increases in the US.

### **Advanced Wound Management**

And finally, Advanced Wound Management grew by 3.8%. Within that, Advanced Wound Care grew 3.3% driven by good growth from our infection management portfolio and a strong quarter in Asia Pacific region. And in July, we launched a WOUND COMPASS Clinical Support App, which is a tool to help healthcare professionals assessments and choose the most appropriate treatments. It is a great example of our cross-franchise digital capability and also the value of our broad evidence-backed portfolio.

Bioactives grew 2.4% in the quarter, driven by our skin substitutes portfolio and advanced wound devices grew 7.9% with continued double-digit growth in PICO.

### **H1 2022 Financials**

I will now move to our first half financial results.

#### **H1 revenue by franchise**

I will start with revenue, which was \$2.6 billion in the first half, up 3.5% on an underlying basis compared to H1 2021. Reported revenue was flat, including a foreign exchange headwinds of 350 basis points given the strength of the US dollar against other major currencies. And as you can note here, the M&A effect was minimal.

As you see in the chart, Sports Medicine and Wound showed mid-single-digit underlying growth. And as with the second quarter, all of these growth rates reflect one fewer trading day than in 2021.

#### **H1 trading income statement**

Moving to the summary P&L. The gross margin in the first half was 70.9%, which is an increase of 30 basis points. A variety of factors are at play here and are important to note. Inflation is offset by some price increases and a tailwind in the first half from the timing benefit of our hedging strategy.

The trading margin, however, was lower at 16.9% compared to 17.6% in 2021. And that comes from higher SG&A costs, where we felt the inflationary pressure in freight and logistics that you see across the economy. And we have also increased commercial activity as patterns of engagement with customers return to normal.

And also I would like to highlight that in line with our strategic commitment to innovation, we have maintained our R&D ratio at 5.7%.

#### **H1 operating profit and EPSA**

And continuing down the P&L, adjusted earnings per share declined by 2% to \$0.381. You will notice, of course, that is ahead of the development in our trading profit due to a lower tax rate than in the first half of last year. And the interim dividend of \$0.144 per share is unchanged from 2021.

**H1 cash flow**

*Trading cash conversion 35%*

We generated trading cash flow of \$154 million in the period, with trading cash conversion at 35%, that is lower than in 2021, and the decrease was primarily driven by higher inventory, which you see in the working capital outflow of \$304 million. Part of that is that we have increased spot buying of raw materials and components to secure supply and mitigate the risk of shortages. There was also a further effect from the phasing of other working capital movements that we expect to unwind in the second half.

**Strong balance sheet**

And moving to the balance sheet. Net debt ended the half at \$2.4 billion, as shown on the slide. That is an increase of \$325 million in the first half with \$89 million coming from the acquisition of Engage Surgical in January and \$133 million coming from share buyback. The effect of all of that is that the leverage ratio finished the half at 1.9 times adjusted EBITDA, which is very similar to recent levels.

**2022 outlook**

And I will finish with the guidance for 2022. Firstly, we are continuing to target underlying revenue growth of 4% to 5% for the full year. The first six months, as you have seen, growth was 3.5% underlying even despite the COVID restrictions in China, and we continue to expect stronger growth for our business in the second half.

For the trading margin, we expect it to be around 17.5% for the full year. This reflects the prolonged and higher impact of the inflationary environment on our business, particularly in freight and also reflects continuing external supply challenges.

Clearly, we are continuing to manage input costs, but we are also maintaining critical growth investment in the future like R&D, and we do expect some of that to have an impact on our margin.

And with that, I will hand back to Deepak to cover our action plan.

**Looking ahead**

Deepak Nath

*CEO, Smith & Nephew*

**The right to win across all three franchises**

Great. Thank you, Anne-Françoise. So having covered our first half performance, I want to share with you my assessment of Smith & Nephew and how we are moving forward.

So I will start with the opportunities. I talked about our right to win, and that is critical because it gives us the confidence that we will be able to deliver our growth aspirations as we improve our execution.

In Orthopaedics, that right to win comes from our portfolio and our technology. On the portfolio, we now have a full product range across hips and knees that we can offer to our customers. There were major gaps in the past, but they have now been closed, and we are now starting to open a gap of our own against peers. For example, with the Engage

cementless uni knee. And in some ways, our product range is too wide, and I will talk about that later.

Our implant technology is unique and differentiated. We have the kinematic profile of the JOURNEY II Knee, with motion closer to the natural knee than competitive systems. We have a propriety materials technology in OXINIUM with applications across multiple devices and outstanding long-term outcomes. There's the OR30 hip cup that takes that material and applies it to dual mobility approach. And in trauma, we are completing our highly competitive EVOS Plating System with large plates, and that gives us a comprehensive and easy-to-use system that addresses all fragmented surgical needs.

And those are robotic-enabled technology platform, CORI, as well as the economic and portability advantages of CORI was designed from the beginning to be able to work on a range of other hardware and in a range of indications. We are just still at the start of the planned functionality. And you will start to see unique indications and assets added as early as later this year. And in fact, an update to Anne-Françoise what just mentioned, just overnight, we got approval for indication on the vision need that she had telegraphed. So really good development for us as we continue the journey with CORI.

In Sports Medicine, we also have a complete offering for our customers with Joint Repair, the Arthroscopic Tower and customer service. So most competitors either have gaps or are just selling equipment without the deep relationships in this segment. We have leadership positions in the various segments, including being the number one company in enabling technologies and biologics. And we have scalable synergies with other areas such as through CORI and cross-selling opportunities in the ambulatory surgical centres.

And in Wound, we have the broadest portfolio offering solutions across all key wound types, bringing together foams, devices, biologics, and as you just heard from Anne-Françoise, digital. We are a leading negative pressure platform with huge potential for market expansion. And we have a catalogue of strong evidence across our categories, showing proven clinical outcomes and economic value, and that sets us apart from the low-cost segment of the market.

### **Two of three franchises already executing well**

So let me turn to these two franchises, Sports & Wound. We are demonstrating that as a company, we are more than capable of capitalising on the advantages we have. As a reminder, as I mentioned, 60% of our revenue comes from these two segments.

Sports has been outperforming the market for many years. And when I look at why I see commercial excellence built on a deep understanding of customers and a precise targeted approach for engaging with them. And there is also a steady stream of innovation across procedures and a successful integration of assets that we have acquired.

The Wound team has done many of the same things as that franchise has accelerated over the last few years. We have made good use of our structural advantages by focusing on portfolio strength, breadth and evidence-based selling. We have also executed well on high-growth acquisitions like Skin Substitutes and Leaf.

And importantly, we have successfully driven margin improvement at the same time. So both are well placed to continue in the same way. In Sports Medicine, we have refreshed the

capital equipment for the last two years and added a new innovation platform with biologics. And in Wound, there is still an opportunity to deepen the penetration of advanced treatments with wounds today, either not being adequately treated or not being treated at all.

And finally, as I mentioned, there is an exciting pipeline across these categories.

### **Orthopaedics held back by execution and supply chain**

Turning to Orthopaedics. That is clearly where our key challenges are. It has been a long-term outperformer but has trailed the market certainly since 2020. A key priority for me has been to understand why that happened and what we need to do to get back to winning. The aim in Orthopaedics is to be a procedure innovator with best-in-class implants, as I alluded to, and paradigm-changing enabling technology on the CORI platform.

As you know, we had a major product gap. Not having a cementless knee hurt us for a number of years. The fix for this is in place with the cementless LEGION that is rolling out now. It was not perceptible in first half results. But as Anne-Françoise has mentioned, we expect that to start to register in the second half and going forward.

There are more structural factors as well. However, and that is around execution and in supply chain. In terms of execution, we have become more complex and less agile than our larger peers, both in terms of our portfolio and the ways in which we work. For example, we are still supporting multiple hip stems and knee systems in parallel, when peers are increasingly focusing on just one family.

We also have not recognised that operations and commercial have become disconnected when they need to be working even more closely together for top class execution. The result is the supply is not always well aligned with commercial needs.

And finally, capital management has not been efficient. Instrument sets are not always optimally placed with full sets at centres that may not need them and not enough sets elsewhere. The financial effect is that asset turns are lower than they should be, and on an investment, that is about half of our CapEx.

So let me turn to supply challenges. In manufacturing and in supply chain like everyone else, we are feeling the effects of increases in raw materials and freight across our businesses. But it is also apparent that our current solutions to the Smith & Nephew specific issues, and that is in orthopaedics, not in Wound and Sports are not working fast enough. We are addressing the root causes efficiently. So we have made good progress in addressing the operational issues in Memphis that hurt us in 2021, for example, staffing shortages that we alluded to.

The fundamental efficiency and reliability of our supply chain is not where it needs to be. The effect is not just the outright shortages that we saw last year and continue into this year, but also that reps have spent far too much of their time managing existing customers rather than acquiring new business. For example, in the case of trauma, the majority of our reps are spending 40% or more of their time managing logistics and inventory.

### **New structured programme covering biggest opportunities**

These challenges were not always there. Some were made worse by COVID and for others, the disruption of the pandemic had problems as they developed. We know the importance of getting this fixed and the work is underway. Building on our previous work, the team has put

together a comprehensive 12-point programme of execution in the last two months that cover the biggest opportunities for our company.

These are at the highest level regaining momentum in Orthopaedics, really fixing orthopaedics across recon and robotics and trauma, improving productivity throughout the supply chain. And of course, further accelerating Sports and Wound.

The elements have been worked out in quite some detail and are backed by robust structures for accountability, and I am taking personal oversight. I will come back to that in a moment.

### **Programme of execution underway – Orthopaedics**

For now, I wanted to give you a bit more detail on Orthopaedics and some of the things we are working on are picked out on the slide.

First, we are rewiring the commercial delivery. There are a range of aspects to this, but examples are:

- A greater focus on differentiated products and procedural innovation;
- Aligned incentives and a more detailed customer segmentation.

Secondly, we are going to streamline our portfolio by reducing the number of implant systems we support in a category. For example, in hips, we go from 11 systems down to six. That will include renewing our sales efforts on the priority brands and will bring benefits from simplification and great focus throughout the organisation.

We also will improve our asset utilisation, particularly with instrument sets. We are establishing clear principles on where we prioritise placement, where we use consignment and where we use loaners and rolling out analytical tools to support management. This work has started already.

And where we are rebuilding the demand planning process, closer collaboration between operations and commercial will address short-term tactical supply chain decisions and longer-term signals to better align production with market needs. There is a lot more behind this, and I will keep you updated on progress and provide additional detail in the coming quarters.

### **Clear accountability to ensure sustained impact**

So turning back to the programme. Some of you know this, I have driven this type of program successfully before. In my experience, a big part of the success of this work will be having the right governance and accountability to ensure that the plans are followed through and the changes become a normal part of how we operate.

We already have refreshed leadership in commercial and operations with area-specific experience and track record. You already know Brad Cannon, our Head of Orthopaedics and Sports, and of course, the Orthopaedics leadership team that report into Brad.

On the operations side, we have Paul Connolly, who is our Head of Operations. And last summer, we brought in a new Head of Orthopaedics, Operations, and rebuilding other important areas. Our new Head of Orthopaedic Operations has driven similar turnaround, Ops turnarounds elsewhere. And a new Head of Supply Chain, previously ran an optimisation process in another orthopaedics business. And our new site leader in Memphis also has deep orthopaedics expertise.

On the actual delivery, in terms of these programmes, this program that I talked about, there is a responsible named owner for each area, and we have established a high cadence of interactions with responsible teams. That is fortnightly meetings under my direct oversight. Each area also has specific action plans with meaningful forward-indicating KPIs to track progress and again ensure accountability and transparency with reporting going all the way up to our Board.

Getting the full benefit of this work will take some time. We will start to see operational benefits from some elements quickly, such as asset optimisation and further benefits will continue to accumulate over the next two years.

### **Summary**

As you have heard me say, there are more opportunities than challenges with Smith & Nephew. This is a great company with a great outlook, and I believe we are not far away from showing this externally in all aspects of our business. There are challenges we need to address, but things are starting to line up even in orthopaedics, where we are poised for an inflection.

We have an outstanding portfolio already, and we are bringing the next wave of innovative implants to market like the cementless knee, the Engage UNI knee, EVOS large and the next-generation shoulder. We have enabling technology and leadership already with CORI and the unique platform extensions to come. I talked about one of them just now. We have a revitalised management team and we are getting on with rewiring, literally rewiring our commercial delivery with energy and at pace.

I see these initiatives as part of our transformation journey as an innovation-led portfolio medical device company. And they are aligned with the strategic framework that we previously communicated to strengthen, accelerate and transform. As these foundations are fixed in orthopaedics, it will free up our people and capital to take much better advantage of our clear right to win.

We will keep investing in innovation and continue with M&A across our portfolio. Sports Medicine and ENT and advanced wound management are already showing what we can achieve when we combine leading technology and getting the execution right. And I see significant opportunities to invest further in these well-performing franchises.

I am truly excited by what is ahead. And now we will take questions.

### **Q&A**

**Patrick Wood (Bank of America):** Just three quick ones, I guess. Short-term, the supply chain Q2 situation. It sounds like Memphis got better. So maybe a little bit of details in terms of the other hiccups, I guess, outside of Memphis. That is the first one.

Second one, I appreciate it might be a difficult topic, but mid-term margins. Any commentary there, given a tougher jumping off point, given the environment? And then last one, you touched on it in terms of the orthopaedics work that you are looking to do. Am I taking the right sense here that you feel like you have got the right people in place, whether it is below

the leadership team, like further down. And it is more about intensity and culture? Or do you feel that further down the structure, there might need to be some new people coming in. It is how you want to characterise the two there?

**Deepak Nath:** Thanks, Patrick, for the questions. So first, let me talk about the Memphis part of it. So as I noted, in terms of product availability in Orthopaedics. We indeed have made improvements in Memphis.

The biggest issue we faced last year was around staffing. And we are largely on the other side of it, knock on wood, right? You never see any on the other side of staffing anywhere ever in this environment, but we have lapped that. The issues as I find in terms of product availability in Orthopaedics is supply is a piece of it, but the rest of it is in our hands. The connectivity between commercial and operations is not where it needs to be, which has led to product availability challenges and one of the highest levels of inventory in this business.

So we have got stuff. To put it simplistically, it is in the wrong places. And we did not just get there overnight. It got there over a period of time because our wiring was not working as intended. So we understand that problem now. So we have got to continue to improve our Memphis operations, but we have got to fix this wiring. And that is the work that is underway so that we can better connect demand at an account level to a production plan.

And in the near term, when I talk about how we improve asset utilisation, we are going to embark on a structured programme to move inventory and sets from low consumption accounts into higher consumption accounts. So we have been doing this sporadically in certain places. But what we are doing is taking a step back, undergoing a structured programme and looking at this globally versus kind of optimising locally. And we believe over the next two quarters, that will have a benefit by effectively putting steps where they can be consumed. And that will free up some time from our reps.

Related to that, what I believe we have underestimated and we view this at one point, but somehow, we have lost our way on the importance of logistics, particularly last mile logistics in orthopaedics. So we are embedding logistics experts in our commercial teams at the right level of aggregation, let us call it natural areas. That is the change to how we have operated in the recent past. So that will help offload all of the logistical burden that is now falling on reps on to people who are trained in this area and were able to bring the right level of focus. So that is the first answer to your question.

So regarding indeed the difficult topic of second half of this year. What we see? We had obviously plan for a certain level of inflation and inflationary effects at the time we set our budgets and our guidance. What we are seeing is significantly higher than our worst-case scenarios that we have modelled. And when we put that into context with other factors, and where we have seen the inflationary pressures, it is we have called out freight and distribution, but there are other impacts of that elsewhere as well.

So when we look at the add up and we see the macro factors lining up, we believe the responsible thing for us to do is to call out how we see the business evolving with the risks. So that is why we have taken the approach that we have taken.

Now in terms of the leadership team, what I want to emphasise, of course, some of you have met Brad. We have given an expanded responsibilities. He was previously responsible for

just for sports, but now he is also responsible for orthopaedics. But these are distinct organizations underneath that.

What I have called out is significant changes, thoughtful changes we have made in commercial, in franchise management and in operations, not only at the one level that reports into Brad, but a level or two below that.

Many of these folks have or have just now become effective in their roles. I mean the average tenure for the new folks are between six months, nine months, something like this, right? So they have just now come into place, get acclimatised and starting to really impact business in the way that we have hoped for them to be.

So in my assessment, we have got a good team in place that is experienced. They have drawn from the industry. They know what good looks like and they are bringing those best practices into it. And these are people who have joined us understanding the challenges that we have, right? They want to come into this building because they believe in the product portfolio.

And I can tell you personally have come into this, I was struck by the strength of our portfolio. This is not what I expected to find coming into it as an outsider into orthopaedics. And some of the folks who have come and joined us from leading companies are drawn to that and to our culture. So I feel very good about the team, several levels underneath in terms of the capability, the temperament, the culture that we want to change orthopaedics.

I also wanted to, at this point, to call attention to the fact that we have got a chance in Orthopaedics, but Sports, we are working well. Wound, we are working well. We have got the right culture. We have got the right execution, the right folks, as I mentioned, combined with the innovation.

**Anne-Françoise Nesmes:** [Inaudible] the midterm guidance, which was also some.

**Deepak Nath:** Yeah, mid-term, I focused on this first half. Yeah, the jump-off point, of course, is more challenging. And we are in an uncertain environment with unprecedented macro factors. We are focused on doing the things that we need to do to secure that three-year plan that we previously outlined. So has it gotten harder? Absolutely. The jump-off point is different.

But having said that, the things that I have outlined in Orthopaedics, the things that we are doing around productivity and margin expansion and around accelerating Wound and Sports. I believe are the right things to be doing, and then we will see how that plays out.

**Jack Reynolds-Clark (RBC):** So just on the sports med in China, is that more on the demand side or the manufacturing side? And this feels like a situation that probably would not improve without a change in approach to COVID from the Chinese leadership. So is there any opportunity here to get ahead of the game?

And then just another quick question coming back to the guidance. So what level of inflation is already baked into the revised guidance for New Year? And what specifically has worsened, particularly in the last quarter?

**Deepak Nath:** So I will take the first one. I will tee off the second one, and I will hand over to Anne-Françoise, is that good? I will give you all the hard questions, Anne-Françoise.

So on the first point regarding Sports Medicine, the impact indeed is from the lockdown. It is not a manufacturing-related topic. In terms of specific impact to China, it is a demand topic, right? In Orthopaedics, it is VBP. So just wanted to contrast the impact of China across those businesses.

There are supply chain challenges in wound and in sports as well. They are related to electromechanical components and chips. Those are supply chain, but they are not specific to China. They are just with large across the enterprise. So that is the thing that addresses your China question.

In terms of the inflationary pressures that we see, as I mentioned, where we are seeing a higher level than forecast impact is on freight and distribution. And that is not just us. I mean it is the nature of our network, right? We feel as we do, but it is an industry-wide topic, and we will see how things evolve. But do you want to comment more on that.

**Anne-Françoise Nesmes:** Just to give a little bit more colour. I mean, clearly, I had spoken and we had spoken about having done a range of scenarios. But things have gone tougher. And since we have spoken, there has been various geopolitical tensions, as we know. Freight is a key element, freight and warehouses.

And just to give you a feel, our costs have gone up by 40% year-on-year. So that is one of the key element. The other, of course, is people. We have done our salaries in the beginning of the year. But there is a cost linked to cost of living. There is a cost as you retain people as you recruit, and that is flowing through, although it is a smaller component.

And the smaller one, we are tracking that. Actually, we signposted quite well, is raw materials. That is a smaller element. But again, you were talking about the microchips just now. Electronics have gone up by 38%. I mean those are significant shifts that many industries are facing, and that is what we have to adjust as well. And we are working hard to offset as much as we can. And some of it will flow to the bottom line.

**Hassan Al-Wakeel (Barclays):** Firstly, Deepak, thanks for your update. I wonder what you put the historic underperformance of the business down to. How do you think execution will change going forward? And should we expect a meaningful resumption in M&A activity?

Secondly, where is cost inflation running at for the business? Where was it for the first half? And what is your expectation for the second half? And could you break out the margin bridge for the year and if it is just the 125 basis points that is changing, or if indeed, it could be anything else, perhaps VBP getting worse?

And then finally, just following up on the mid-term targets. Could you walk us through the margin bridge to 2024, where you see the key opportunities and the key risks in light of what you have talked about today?

**Deepak Nath:** Sure. I will call on Anne-Françoise for the second part of your question, but let me take the first here, Hassan. So as I indicated in my presentation, the execution-related issues have been in orthopaedics. In sports and wound, we have been executing well. We have got a great portfolio, and we have got the results to demonstrate that.

In orthopaedics, as I look back on it, fundamentally, we have had in the past portfolio gaps that had the set us and have impacted our commercial performance. As I mentioned now, we

have closed those gaps. We have got a full range in hips and knees across families, but we have got a full range.

And in CORI, we have got a platform that is still in the early stages in terms of functionality and indications that we are adding to it, including most recently, overnight. So that is a change from the past where we now have a portfolio and we have got enabling technologies to drive growth.

The other piece of this is the connectivity between commercial and operations that account for the product availability challenges that we see that really has hampered us. It is hampered our growth as our reps focus on inventory and logistics challenges and serving existing customers rather than going out and acquiring new business. That is one example of the impact of that.

The second is the fact that we have got high levels of inventory. We have got product in the wrong places, if you will, right? We have not been good. We have not had the process of ensuring that we are matching our supply and availability to customer needs. That is a process topic. It is an end-to-end topic that connects customer demand to a production plan and we have not gotten that right.

I do not believe we were ever particularly good at it, but we were okay for the scale of business we had. COVID really impacted that. And that has had a significant impact on us over the last couple of years.

So the good news for that is we know what the issue is. We have begun to work on addressing the issues. It is a process thing. There is not some big IT spend we have got to do. There is not some big structural barrier to us improving that. We know what we need to do on a good path to getting there, right? So that is the second piece of it that we are working on, Hassan. So I think I addressed first part of your question.

On inflation, I think he is looking for a breakdown in terms of the levels. I will turn it to Anne-Françoise to comment, some of which we covered in the last question, but perhaps you were not on for that part of it. So Anne-Françoise, if you wanted to.

**Anne-Françoise Nesmes:** So there were two parts to your question, Hassan. The first around the inflation in H1 and H2. As you can see, just looking at our trading margin, there is an impact on the trading margin is down year-on-year. And when you look at the elements of the P&L, the inflation in the cost of goods line is not as apparent as you would think because actually on the face of it, our gross margin is improving.

There is inflation starting to flow through as we are selling materials that has been built on a higher cost base. That is flowing through, but that is offset by the timing benefit of our hedging strategy from a foreign exchange perspective. But you can see the cost increase in SG&A, which I have referred to earlier, which is significant, and that is where we see the freight and warehousing costs we have talked about.

So that has an impact on H1, and we expect that to continue to increase in H2, particularly through the COGS line. So when we pull all of that together, and to your question, what does that mean for the full year, we had talked about three levers. Clearly, when we gave the initial guidance, we talked about the inflation being a headwind, and you referred to the 125 basis points we talked about.

And we talked about rightly as you said, VBP, which we mentioned at 60 basis points. VBP is about our current estimate, is in about the same position, probably slightly better, because of the delay in the first few months of the year. So that is not a material change in the full year.

What has changed is really our assumptions around inflation, which is probably 100 basis points higher than what we have assumed. And that is really where we are and the reason for the change to our guidance.

Now offsetting that, we are and we have taken price increases, so price is the lever we can push. But as we have always said, we cannot offset all of the price increases. And we are also continuing on the savings and the productive improvements we have planned. So the real change is that the macroeconomic environment and the inflationary pressure. And therefore, that leads back to the midterm guidance and the opportunities as you see [inaudible]

**Deepak Nath:** That is right. And just to repeat, Hassan, what I indicated earlier. Jump-off point is, of course, different now than maybe forecast. But in terms of the steps that we need to take to achieve midterm guidance of 21% margin and 4-6% underlying organic growth.

The steps we need to take in terms of fixing orthopaedics and enhancing our productivity and accelerating sports and wound are the things that we are working on, are the levers that we have to pull in order to get there. And what we now have is a programme under which these steps will be executed in order to get there. So we are focused on doing that.

You asked about M&A. Previously we had communicated in our strategic framework of strength and accelerate and transform that M&A would be a component of that. And I do see M&A being a component of it. As I mentioned, in some ways, we are a tale of two cities to invoke an analogy. We have to fix orthopaedics. We know what the issues are. We are working at pace to fix them. But then we have 60% of our revenue base two out of our three franchises. They are actually working very well, where all of the elements are combining and working as they should. And so we see opportunities to further invest behind that.

**Hassan Al-Wakeel:** That is very helpful. I guess what I was trying to understand is the margin bridge between the 17.5% and the 21% by 2024. Are you able to unpack the key components of that, please?

**Deepak Nath:** Sure. I mean, I will give you a top line answer and maybe follow up with you. So the big contribution there is the impact of growth. As I mentioned, from Orthopaedics coming back to levels that we have targeted. We expect a step-up in the second half of the year. Some of that is seasonality of our business, right?

But in general, on the back of not only seasonality, but product launches, we expect to see a step-up in growth. So that is one part of it. And we see that continuing as we see the full impact of things like our cementless knee, getting traction in the market, CORI placements driving further utilisation and pull-through of implants as we bring that forward.

Engage, our unicompartmental knee getting traction in the market. So when I talk about factors lining up, it is not any one factor that is particularly huge. It is the combination of these factors and the add-up of these factors that I believe is going to drive the inflection point in Orthopaedics. So the big component as we walk across from 17.5% into 21% is the impact of growth.

And then, of course, in terms of margin, we need to see in productivity, we are continuing the work to drive efficiency into our factories. The big opportunity is in Memphis. As I mentioned, there is good progress along the way. But I did not mean to signal that all the work is done. It is definitely continued impact of the initiatives we have in place around productivity that we expect to see.

And then, of course, when I talked about the opportunities in Orthopaedics, we see really good opportunities in wound and in sports medicine. On the wound side, as I coming into the company, I am struck by the opportunity to expand the market to drive penetration of some of our products, for example, negative pressure, broader adoption than is currently the case in procedures. So we are very well positioned to do that.

And the portfolio breadth we have when we look at films, and you look at dressings and we look at the biologics, the skin substitutes, those are all great products, great outcomes, great clinical data that underpin them. So we see true opportunities to accelerate. And I mean, I have called out negative pressure previously. So that is the other aspect of this. And the add up of all of these, I believe, if we execute this right, which we are well on the way to we will get to the 21%.

**Julien Dormois (Exane BNP Paribas):** I have three, if I may. So first of all, you reiterated your comments that you would expect growth in the second half to be much stronger than in H1. So I would be interested if you could walk us through what are the main areas in terms of orthopaedics, sports medicine and wound management that would explain the step up, that would be helpful, please.

Second question relates to the recent announcement by one of your main competitors in wound managements, 3M, that they are thinking about spinning off their healthcare business. That is typically the situation, where such a company starts to be more aggressive on pricing to make the drive look more beautiful, if you see what I mean. So are you worried that something like this could happen in the next two quarters and an impact the recovery in your wound management business?

And the third question is a housekeeping one. Just curious what was the FX impact on your margin in the first half? And what we should factor in for the full year, please?

**Deepak Nath:** Great, Julien. Hi. So the growth in the second half, maybe I will have Anne-Françoise walk you through a bit of the detail that we see. But just to frame the answer for H2. The levers I mentioned just previously on the orthopaedic side, what we see is continued placement of CORI. Of course, we are tracking not just placements and robotics is really a means to an end; it's ultimately to enable procedures and to drive implant.

So it is thoughtful placement of CORI. And the impact not only of Engage uni, the LEGION CONCELOC on their own, but also the impact of pull-through of the rest of the portfolio on these. So these are in orthopaedics, three of the drivers.

EVOS Large launched recently. And so that completes or brings our EVOS family to a place where we can sell the portfolio. Of course, the impact of that will be felt over time. We will start to see it in H2, but really the bigger impact will be into 2023.

So that is the orthopaedics picture at large. And in sports, and just let me comment on sports things. I have said a lot about wound. REGENETEN, we have highly differentiated

offering within sports. We see that as a continued driver of growth in that business. We also have great products, a great portfolio.

As I mentioned, we are the leaders in enabling technologies there and in the tower. So we continue to execute on all elements of portfolio in sports, but I did want to call our REGENETEN. So those are the factors, if you want to colour that Anne-Françoise a bit?

**Anne-Françoise Nesmes:** No.

**Deepak Nath:** You Good? Okay. So the impact of 3M. The announcement, of course, it is still relatively hot off the presses. So our top line is, we are going to be monitoring the impact commercially, obviously, carefully. In the near term, we expect to go about our business and go about executing as we have.

In terms of price pressure, I would want to speculate how that is going to unfold. But I strongly believe in the differentiation of our portfolio. Our strength comes from the breadth we have across all the categories that I mentioned, but actually within the category, each of these categories and the differentiation that we have in some of our, not only the lead products, but the second, third tier products – not tier that does a value judgment.

The secondary and tertiary products within each category are also themselves differentiated. So I am confident in our portfolio. I am confident in our differentiation, and I am confident in our team's ability to execute where we have been doing quite well in that regard. But obviously, we will be monitoring the posture and how things evolve there in the field.

And in terms of FX impact, you have made a comment already, but I will let you cover that a bit, Anne-Françoise.

**Anne-Françoise Nesmes:** So in the first half, there was a positive tailwind in the gross margin, in particular, as we see the timing benefit of the fact we hedge. To remind everyone, 50% of our revenues are in US dollar or actually 75% of our cost base is in US dollars. And we hedge 12 months in advance for some of those costs.

So clearly, as the dollar strengthened that quickly, we do see the impact flow through the revenue much faster than on the cost as the hedging protects us for a period of time. But of course, that starts unwinding at some point. So when we look at the FX for the full year would probably expect a neutral or slightly positive impact. But I hate doing forecast on FX.

I am not a trader in FX and God knows where the economy is going. So at this point in time with current FX, we think it is slightly neutral, shall we say. And as you look into 2023, we estimate a headwind of about 40 basis points to 50 basis points on the trading margin in 2023. So sorry, I expanded the question slightly.

**Deepak Nath:** Thank you, Anne-Françoise. I hope that answers your questions, Julien.

**Chris Gretler (Credit Suisse):** I have two questions. First, I am a bit surprised by the magnitude of a fix this orthopaedic business requires. Could you maybe elaborate on how that is going to impact your mid-term growth ambition? They are still 4-6%, particularly in light that you intend to streamline your recon portfolio. And did I hear that right that you are aiming to reduce the number of families in the hip from 12% to 6%. I think probably has not quite a meaningful impact on the gross outlook, and I guess, knee will be similar. Could you

maybe elaborate on that specifically in orthopaedics, and maybe in general, how that affects your overall top line growth ambition?

**Deepak Nath:** Sure. So our growth ambition remains unchanged. What I am describing is the how we intend to get there.

In terms of the Orthopaedics side, you mentioned the reduction in family on the hip side. And in knees, we do not have quite that many systems, right? So the magnitude of the change is going to be different. There is going to be work required to complete our family. So this is not a lever for the next two quarters or three quarters is more over the medium term that we have talked about.

But in terms of our growth aspiration in orthopaedics, I strongly believe with the actions that we have outlined, we are going to get there. And even in this quarter, despite the impact of China, we were on the low end of that corridor that we indicated.

So what I want to highlight is or we expect to be at the low end of that quarter. So the actions we have described are the means by which we are going to achieve the growth aspirations that we have laid out.

**Anne-Françoise Nesmes:** I guess the equation as well.

**Deepak Nath:** Yeah. Thank you, Anne-Françoise. So I mean just to accentuate again, the points that I have made in terms of the factors lining up. We see great potential in CORI as a platform that is a different paradigm. We are very pleased with the reaction, the feedback from surgeons who have used it. Of course, you get a spectrum of opinion. But we really are quite encouraged by the early results.

And I just want to remind everyone that we are at the start of that journey. So we have added indications to it. It is also about adding functionality, not only in the knee but also in the hip, where we are really at the very, very beginning of adding functionality on CORI for the hip. So the hip remodeler that we launched last quarter is the first step along that journey.

So that innovation and it is important that we have maintained the level of investment that we have called out in innovation is the lifeblood of our industry. Its core to what we do at Smith & Nephew. We have got a great differentiated products across our franchises on the back of innovation that we have done over the course of time. And so, we plan to continue that investment that will be a driver for growth. So I talked about CORI. And of course, on the implant side, it is the Engage Uni knee, it is LEGION CONCELOC, and of course, JOURNEY II, that continues to lead the way.

OXINIUM is a highly differentiated technology. The data that we have, the five and 10-year data on OXINIUM in independent registries, whether they come from the UK or Australia, are excellent. I mean, in the med tech business in my 20 years in this business, you can count on one hand the number of opportunities you have to talk about data that are that differentiated with OXINIUM. And of course, different fields have different role of data in terms of utilisation.

But having said that, we see really differentiated elements of our portfolio to drive continued growth in the orthopaedic side. So I hope that answers your question, Chris.

**David Adlington (JP Morgan):** Just with respect to that 2024 target of 21% and then coming back to Hassan's note in terms of the margin bridge, 17.5% this year. It sounds like you have got 40 basis points, 50 basis points headwind from currency next year to the margin. You obviously got probably some underlying inflationary pressures next year as well, but put some offsets with respect to cost savings and probably less dilution from some of the acquisitions.

So I suppose the big question is, if you get to 18.5% next year, if we are lucky that leaves you with 300 basis points jump into 21, open to this 20-odd years, I cannot think of a company that is done that margin improvement in one year in a mature company. So any comfort you can give us around that and where that has come from?

And secondly, again, bigger picture one for you, Deepak. You came into the role beginning of this year, and I think there was some messaging given that you have bought into those targets. I just wondered if you thought that they have become a bit of a millstone around your neck?

**Deepak Nath:** Well, David, look, there is no question that there is a bigger jump off point, whether you look at it from 2022 into 2023 or 2023 into 2024. As equally, we are facing I would say, relative to when the plans were put in place, the scale of headwinds, macro headwinds that we are getting into are significantly higher, inflationary pressures being one of them continued pressures on supply chains from all macro factors significantly higher than anyone could have forecasted in 2020. So back when the plan was put in place.

So there is no question that we are going. This plan now is being executed on in a different macro environment that was envisioned. Having said this, I indicated when I first got here that I have embraced the strategy and embraced the set of targets as my own. And I met what I said. What I have done over the last 100 days or 90-some-odd since the last time I was before you, is really dig into the business and understand how we are going to get there, right?

The path that we have thought about in December needed to be refined, needed to be rethought in order to go by achieving a target. That has been the focus of my work. I acknowledge the delta and the steps that you have taken, but much of what we are doing are not incremental changes. In Orthopaedics, it is a fix, right? It was a conscious choice of words because it is not working as an orthopaedics because they should.

So it is not a linear path from here to 2024. The fixes that we are putting in place, I expect to pay off in non-linear ways. Once we get the wiring right, get the commercial and operation teams working, as they should, and put the processes in place that any orthopaedics business should have, and we have got the people who know what goods looks like, who are executing on these things, I expect to have nonlinear jumps in terms of our performance in Orthopaedics to drive this.

The portfolio piece of it is key. Again, we did not have a full portfolio. We now have a full portfolio. We need to execute now with that full portfolio and the process that is in place. So I expect the benefits from that to accrue in a non-linear fashion.

In Sports and in Wound, it is a different story. It is, of course, building off of an already strong base. So there is perhaps a bit more, I do not want to say forecastable, but perhaps

you can draw more of a straight line from where we are to where we expect to be. So there, it is about really changing the trajectory, but we already have a hand the things that work.

So is it going to be easy? No. Am I going to be sleeping well at night every night between now and 2024? I can honestly say that I am going to be sweating those stuff every day. But do I feel that the actions we have outlined are the ones that can get us there? Absolutely. So I had the opportunity to come here and talk about a different picture, right? And I am not doing that today. I am talking about this year's and not about everything else. And it means that have got the conviction that we can get there with the actions that we have outlined.

I think we will call it a day there. Thank you very much.

**Anne-Françoise Nesmes:** Thank you.

**Deepak Nath:** Thank you. Thank you very much.

[END OF TRANSCRIPT]