



Conference Call Transcript

SNN - Smith & Nephew Investor visit to Smith & Nephew Endoscopy

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PRESENTATION

Mike Frazzette - Smith & Nephew - President - Endoscopy

Okay, well good morning everybody. Welcome back to land. If you enjoyed the harbor cruise last night, the food and the company, just make sure you take a moment to thank [Jo Metzger] and his team who put all that together. Those things usually require a little bit more work than is readily apparent when you're doing it. But it was good time and I hope you all enjoyed it.

As Dave mentioned last night, we've got a pretty good day planned for all of you. And it's my sense here at the outset that most if not all of you have a good idea, a good understanding of our orthopedic [recon] business because we know that it's all about BHR all the time. And I think that some of you have a pretty good understanding of our advance wound management business as Joe's taken that business to where it is heading today and you get a lot of good things going on there.

So today, we hope to get you informed about our Endoscopy business. And I think if you leave today half as enthusiastic and as passionate about this business as we are, then we will have accomplished our objective for the day.

So, let me start off by introducing Dave Illingworth, our Chief Executive Officer. And we're fortunate to have Dave here today. I think you all know Dave's background. He came to Smith & Nephew back in 2002, as the Orthopedic's President.

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Subsequently promoted to Chief Operating Officer and recently appointed as the Chief Executive Officer. What you might not know about David is that he is a very customer intense individual. And what we try to do here in endoscopy over the last year since I've been here is change the culture a little bit to be more customer focused, more customer intense.

You know, it's good to have somebody at the top of the house that understands that to get through the motion that the President's role, the Chief Executive's role is that of a salesperson. You have to be close to your customers and so he helps drives that throughout the organization, especially helps here in Endoscopy.

So a good example that was just last week, Dave was in New York meeting with some of the financial community and we happened to find out about it. We pulled him into HSS for an afternoon, which HSS for those of you who are familiar with it, was just ranked by U.S. News and World Report as the number one Orthopedics Hospital in the United States.

Dave has a great relationship with a lot of the orthopedic surgeons there, so we wanted to leverage that relationship and introduce him to a lot of the sports medicine guys. And they took to him instantly and it just helps us overall to have that connection with our customers to the top of the house. So, we're happy to have him here, we're happy to have him as Chief Executive most importantly. And with that, I'd like to introduce Dave to kick off the meeting.

Dave Illingworth - Smith & Nephew - CEO

Thanks Mike. Well, good morning. This is one of those balancing acts of trying to give you the right amount of information here this morning to kick off the day. But, not boring you silly because I've met with most of you, a lot of you one on one over the last few weeks. And I don't want to repeat myself. I feel like I've been repeating myself in my investor visits. We've had eight, nine, ten a day for the last week or so. We've had a couple of different road shows and it's gone extremely well.

But let me also welcome this group to the Endoscopy headquarters here in Andover. I think you're going to really enjoy the day today. I think you will be quite surprised, pleasantly surprised with the work that's going on. And I think you will be surprised and pleased with some of the excitement that you're going to see, not only in the folks who are going to be presenting to you, but also in the products and the pipeline of products that you're going to be getting your hands on today. So I encourage you to make the best of it.

Before we start, I expect everybody has read the forward looking statement. So please read it, there will be some forward looking statements that we will be making today and throughout the day and I would expect that all of you will understand that.

Let me start with a little bit of an overview about the group and the strategy. We have a very simple and elegant strategy within the group. We have a strategy that all of Presidents, all of the major Executives can recite, they understand, they buy-in to and it really has several different legs to it.

Number one is a market focus. We want to be a market focus company. We believe that focusing on the act of informed patients is going to give us a competitive edge as we move forward in these market places.

And also we have had a track record and a reputation for being an innovator and maybe the innovator, in the orthopedics space clearly over the last few years and we would like to be able to continue that performance. And in fact we are going to put some work into making sure that we have a very predictable and repeatable process for innovation.

The second leg of the stool which is in the area of earnings improvement. We are very confident in our ability to bring value back to our shareholders through earnings improvement. We call this earnings improvement versus cost take out because clearly we do not want to lose the edge that we have gained in being able to grow our businesses faster than the markets that we participate in.

And faster than competitors that we compete against. It's important to us. So it's more than just being more efficient and taking cost out, it's also being able to grow faster than the market place and being able to leverage that growth.

Third is to better manage our balance sheet. We do want to maintain some flexibility for acquisitions in the future and we have stated publicly that we will buyback up to \$1.5 billion worth of our own shares over a two year period. And that's going along quite well.

And then the last piece is value enhancing acquisitions. This is an area that I think a lot of people misfire on. We're very strong believers that you have to have some discipline on the acquisition side.

We're also very strong believers that acquisitions have to support your strategy. If a potential acquisition supports your strategy there are many ways to make the financials work. If it doesn't fit your strategy, no matter what you do, you don't have the passion within your business and within the folks in your business to make the financials work.

So first and foremost, we set a strategy for our businesses and we go out and look at the things that we might be able to combine with our Company. Whether it be with an acquisition of technology, an acquisition of a company or a combination of channels or whatever, that is really going to support our strategy. And we do have a lot of discipline. And we understand that these are difficult in order make work as a matter of course.

Let me touch for a minute on active informed patients because this is something that we talk a lot about and we're going to continue to talk a lot about. And I know that when I first started talking about it, I got a lot of looks that looked like their eyes were glazing over.

What is Smith & Nephew talking about in the active informed patient? We feel very strongly that this will be an area that will differentiate us in the future as a company. We believe that we have a strategy that is going to enable us to plant a stake in the ground and claim that we own the active informed patient. We think it's going to help us expand our market places. We think it's going to give us better economics as a result, focusing on these types of products and these types of patients.

Our goal is to be the brand preferred by the active informed hip and knee patients. Currently we're number one in hip resurfacing on a global basis. We do have the Oxinium technology and we're also building on the strength of our other businesses that are focused on active patients. We're number one in the world and global arthroscopy and we're number three in the world in joint fluid therapy. So from very early intervention, to complete implants, we have continuous product innovations that are driving market share gains for us.

If I could touch just for a minute, and this will just be a 30 second touch, we get asked a lot about what are the longer term development areas that this company is focused on. And it's in these three areas. We think that there will be a transformation within this business over the next decade. The areas that we're focused on longer term are number one Biomaterials. Number two, cell based therapies and number three, energy based repair.

And if you think about the competition, let's take orthopedics for a minute. If you think orthopedics, and think about all the companies in the space, what they really try to do is figure out how to take a disease state like osteoarthritis and figure out a way to put metal in somebody's body. I mean that's what orthopedics is all about. And 10 years from now we believe that that's not what orthopedics is going to be all about.

We believe that focusing on the disease state of osteoarthritis, it's more important to figure out how to repair that cartilage surface. There are technologies. There is science that is going to be available in the next decade that will lead to some transformation of these orthopedic companies. This is an area - and that's why I think we have a very distinct and unique advantage because if you take our top ten research scientists and line them up along this wall, everyone of them is a cellular biologist. If you take the traditional orthopedic companies and take their top scientists and line them up against the wall, every one of them is a metallurgist.

They're thinking about do I cast it, do I forge it, do I grind it, do I polish it and that's not the way that we think. We have a business that really is focused on tissue repair. It's one of the advantages of having the largest advanced wounds care company in the world in terms of wounds treated, because we constantly are thinking about and we care about the tissue healing process, and tissue repair. So it's one of the areas that we're going to try to exploit over the next decade.

So we've got some pretty exciting prospects, you're going to hear about them. We do have a long term upward demand curve for our products. We have a tailwind in terms of demographics. All of the orthopedic companies have that going for them. We have very innovated products with strong patient and medical professional, and payor benefits. We do look at it when we're developing new products. We don't just bring new exciting things on to the market without thinking about the clinical benefits and the quantifiable economic benefits associated with those products.

We have a great track record for a continuous flow of new products and technologies. We have strong and strengthening market positions. We will get some benefits from both the Blue Sky acquisition and also the Plus Orthopedics acquisition. We have clear upside in our trading margin from earnings improvement. We talked about that a lot. We've given the analysts and our investors some pretty significant detail about the work that we're doing in order to transform our company in to a more value enhancing company for our investors.

We are doing some work on our balance sheet. We're returning share to - capital to our investors with share buybacks. Our acquisitions are adding value and I believe without being too self serving, that after you listen to some of the presentations today and have a chance to meet with Mike Frazzette, we have an excellent and experienced management team that have a lot to offer to this industry.

Real quickly on the business structure, I won't take a lot of time on this. But this is our first half revenues. You can see that we have a pretty nice balance across our business. About a quarter of our businesses in Advance Wound Management, about a quarter in Endoscopy, and then the other half is really split up between the Orthopedic Trauma and the Orthopedic Reconstructive businesses.

So a couple of closing comments here. One of the things that we were talking about at the Board level not too long ago was, how many FTSE 100 companies are delivering double digit growth, double digit top-line growth, double digit earnings growth and double digit dividend growth? And I can tell you there aren't many. It's in the single digits out of the FTSE 100, and we're one of those companies. We have some very, very interesting things going on in the Endoscopy business.

This is a business that clearly has the momentum back. For several quarters in a row now we are delivering double digit growth in this business. It is about a quarter of our turnover for the entire group. They do have a leadership position in arthroscopy. And we are focusing on leveraging that arthroscopy strength. It is the core strength of this business and we're not going to lose that advantage. And if you talk to these folks, and once you see the products today, you're going to hear a lot about arthroscopy in sports medicine and as it relates to orthopedics.

We have a record of innovation and new products. We have some very interesting science and technologies that are common across our businesses that we can leverage. And it is an essential part of this active informed patient strategy.

And I guess last but not least, and new -- this will be demonstrated today is that we have new leadership with very fresh ideas and very strong and positive inputs into this business. So, with that I will turn it over and we'll get this day started. I'll turn it back over to Mike Frazzette.

Mike Frazzette - Smith & Nephew - President - Endoscopy

Okay, thanks Dave. Once again good morning everybody here, as well as those of you who are joining our webcast, it's my pleasure to welcome all of you to beautiful Andover, which happens to be the global headquarters for Smith & Nephew Endoscopy -- the worldwide leader as Dave said in minimally invasive arthroscopic surgery or surgery of the joint, otherwise known as arthroscopy.

My name is Mike Frazzette, I got to meet most of you last night and also got to present to all of you at the AAOS meeting earlier last year. And at that time I probably liked the fact that endoscopy is really a misnomer. We are very much an arthroscopy company and part of a larger orthopedic company, our orthopedic umbrella. And that orthopedic umbrella focused on joint implants, resurfacing, trauma products, clinical therapies and sports medicine.

Myself, I joined Smith & Nephew about 14 months ago. Prior to coming here I was the CEO of a medical device manufacturer, which ironically Smith & Nephew is one of our customers. Prior to that I spent 16 years with what is now called Covidien, it was Tyco Healthcare at the time we were in the healthcare segment of Tyco International in various sales marketing general management, and President of three different businesses there. So, I'm kind of the poster child of if you perform well and you're willing to drag your family all over the world, you can have a pretty good career with a big company.

I got to tell you that Smith & Nephew, the difference here and I hope you get this today, is there's a passion here in the employee base as well our customer base that we truly can make a difference in patients lives. And I think you'll see that. You'll get a flavor for it today. It's something that we believe here.

I know it gives me personal as well as professional gratification to be here in a company that I feel that way. But it's something our customers believe and our customers actually expect from us, they grew up by enlarge on Smith & Nephew. They look to us and for innovation, they work with us on a daily basis and it's just a great part of the overall formula.

Okay, I'm going to give you an overview of the business and then you'll hear from our two General Managers, Jerry Goodman and Joe Darling, who head up our capital business and repair business respectively. Following that we're going to take some questions, the three of us, as well as Dave and then we're going to get all of you familiar and have you touch some of our products. See how they work and feel and explain to you in an innovation field which will be right next door here.

We'll have some breaks. We'll have I think a pretty good pace for a decent cadence and give you guys some time to check your e-mails and make phone calls et cetera. And then time permitting at the end of the day we'll answer a few more questions if there's anything on your mind. We won't want to let you leave here, like I said at the outset the objective is to get you as excited and passionate about what we do here in endoscopy and how we contribute to the overall value of Smith & Nephew.

I'm going to spend the next few minutes talking broadly about our Endoscopy business. Like I said, I'm very proud of the customer intensity that we're starting to form here, the laser focus on our strategic business units, which we'll talk about more. But what you'll hear today is our plan to continue our top-line momentum that we started late last summer.

And I think you'll be impressed with respect to that versus where we've been in the past. The investments we're making in a fast growing repair market, the opportunities that exist outside the U.S., our commitment to innovation and a healthy vitality index. And of course, delivering above market performance and delivering shareholder value.

So, again on behalf of Dave and all the employees of Smith & Nephew thank you for taking out some time of your day and spending it with us to learn about Smith & Nephew Endoscopy.

From a market perspective this is a view of the arthroscopic market which includes access to the joint which is pumps, pumps [sites], resection products which include our shaver blade business, our RF technology which prepare the joint for repair. And then repair products which are implants and other medical devices used primarily to reattach soft tissue to the bone.

In this market place we're the clear market leader with 24% share. We believe that we will have and continue to maintain a strong competitive advantage in this attractive growth space, because really of three things -- good demographics in increasing affluence in emerging markets, excellent channels to market throughout the globe, and continued innovation that helps expand markets through product and procedural adoption such I meant just a little bit.

In addition to this, what you don't see on this slide is that we had a very strong brand loyalty index. We do customer surveys. We're very active measuring brand loyalty as well as net promoter score which is also referred to as the likelihood to recommend score. In both instances we're near the top of the scale. So we start from a position that I think most companies would die for.

We start from a position of strength. We're the market leader, we've got a very loyal customer following. Our customers, our surgeons grew up on Smith & Nephew on Dyonics brand, on Acufex brands and they want us to win, they expect us to win, and they engage with us on a daily basis to help us win.

So I'm confident that the combination of that along with the market conditions will continue to help us provide high sustainable earnings and shareholder value.

You will hear a lot about the attractive space and I think the question has to be asked, well, why within an attractive space? Well, of course it starts with demographics. People are living longer. They want to stay active later into their lives. They're better educated about their health and their healthcare options. And that includes everybody here in this room by the way.

There's a preference for minimally invasive procedures. You get shorter recovery times, lower morbidity rates and equal or better outcomes than open procedures. Overall, a strong economic case for patients, for surgeons and for payor alike.

Other drivers in the market include a focus on surgeon training. Not just at the product level, but on techniques as well. For instance we're seeing a real push in double [oral] fixation of the shoulder and you'll see that at the innovation fare, as well as anatomical repair of the ACL. We're leading the charge not only in new products that we're launching to drive these markets, but in technique in educating the surgeon on how to perform anatomical repair of the ACL.

And a good example of that is Japan. Japan leads the world in anatomical repair, or double bundle as its known, with nearly -- with over a quarter of all the ACLs repair end up being anatomical double bundle repair. What that means is more content in every procedure not just one EndoButton, two EndoButtons. Two interference screws, double instruments sets and these are the things that we develop in concert with the surgeons to provide better outcomes for their patients.

A very good driver in this market is ambulatory surgery centers, predominantly here in the United States, which by their very nature are day surgery centers. They drive sports medicine. And yearly reports to us indicates that reimbursement rates will be more favorable starting in January of 2008 in the AFC market.

We have a unique competitive advantage. I mentioned about the brand loyalty. We got a global brand loyalty that is unsurpassed. Our surgeon customers again, throughout the world grew up on Smith & Nephew and they want to see us win. And we also have a worldwide infrastructure that supports the ideation, product development as well as sales and marketing, or downstream marketing in all the key markets for us throughout the world.

These two advantages mean we can win. And when you combine the passion that we have for the business, and the attention to the operating results that we've had in this business, along with the fact that we can win in these spaces, we believe that we got a clear defined pathway to success.

Let's take a quick look now at our business units. First of all, when I arrived last July I found a company that had spent a great deal of time and resources building some non-core businesses. And in an honest attempt to grow the top-line, there was investment and in some non arthroscopy businesses like vascular and GYN and others. And for all intents and purposes it was out of focus. We were spending a lot of time, a lot of research and a lot of energy growing non-arthroscopy businesses.

One of the earliest changes that we executed was the development of the strategic business units within the overall endoscopy business. And that was really the focus us around two key parts of our business, the capital business and the repair business. And it's a pretty easy to find.

You basically aggregate those light businesses and you go about everything from ideation, new product development to downstream marketing in one cohesive unit. It gives you laser focus, it gets people accountable to that business and I've always been one that's believed that you'd need to focus to grow.

And it's refreshing to see our businesses - it's satisfying to see that since we did that last summer we've now seen over the past year, we are now a double digit growth company which for the three years leading up to last summer we were in the mid high single digits in terms of growth.

So we created two strategic businesses. You'll hear about that in a little bit more detail in just a minute as Joe and Jerry come up to talk about them.

I'm going to give you just a Reader's Digest version on them. The capital business unit is based around the historical core of our business which is the Dyonics brand. It's a mechanical shaver blade that without more 30 years ago. This technology will change the course of orthopedic medicine forever and if you ask orthopedic surgeons today what brand they most readily affiliate with sports medicine, Dyonics will be at the top of the list.

However, while we continue to leverage the brand, the strength of the Dyonics name and the reputation -- the fact is that the sale of capital equipment throughout the world has changed in 30 years. In fact it's changed in the last 10 years.

So today we have a dedicated business now around all the necessary attention of our customers need, from product development to low cost country manufacturing as well as supply and channel management. In addition to a world class effort around building the brand.

On the repair side of the business now it's all about driving procedures. And that means proprietary technology in products and materials as well as techniques to make arthroscopy surgery easier for the average orthopedic surgeon. We need to continue to invest in surgeon education and we do that to drive adoption in those techniques.

Hip arthroscopy which I think some of you mentioned last night, was first mentioned a double OOS about four years ago. But it was such in infancy it had very little impact on the overall company.

Hip arthroscopy now is beginning to provide a significant impact to our company both in terms of revenue and profit growth. As a matter of fact, if you asked surgeons today and you asked some of our folks today if our hip arthroscopy courses, we probably see more excitement from our surgeons that we do in any of the other courses that we provide in.

In addition in our repair SBU now, we've provided or we've built a technology road map and we continue to invest in pipeline, whether its derivative, whether is platform, or whether its breakthrough products. And you'll see a little bit about that today.

Okay, in terms of the global opportunity, I think -- you know at these types of meetings it's always good as Dave says to showcase the experience and the talent of our management team. And unfortunately our most tenure and experienced managers, Ruben Rosales, who heads up our international business and not surprisingly he's travelling this week -- Ruben is in Europe and Asia going through some budget meetings. But Rueben has been in orthopedics.

He was in Smith & Nephew back when arthroscopy in sports medicine was in its infancy. He's been with Smith & Nephew now for 20 years. He's been in healthcare for over 30 years. And interestingly enough, if you had a conversation with Rueben he would tell you that they key to success is not much different today than it was 30 years ago.

It's about getting close to your customers, listening to your customers and engaging them in what they believe is important to help them be successful. Not a simple task, but I think it's something that we do very, very well throughout the world. We think we've got a distinct competitive advantage in that we function as a global company. And as a result our image is even further enhanced outside the U.S. than it is in the U.S., and in the U.S., we're the global brand leader.

We also take the handoff from the SBU to our international markets very seriously. For example we just held a significant international training course. We had more than 150 colleagues, sales people, marketing people, country managers, general managers and staff and educators as well as key surgeons assemble in Toronto.

And this type of activity will clearly give it the kick for the second half of the year. But more importantly it helps us build and engage sales and marketing organization to serve our loyal customer base throughout the world, for the long haul.

Even before that type of handoff, we developed specialized products that addressed geographic metric preferences. This helps reinforce our innovation strategy and our innovation brand equity with our customers. We talked at AAOS about our launch of the Supine hip distractor. Well that was primarily targeted for the U.S. market.

Yesterday some of you mentioned to me that you saw a press release about the lateral hip distractor. That's something that we developed entirely for the international market because international surgeons preferred to do hip arthroscopy with a patient lying on their side, versus their back. So there's a tremendous international input into the new product development as well as the downstream marketing function of the business.

Let me change gears here for just a second and talk about performance. Here again, this is Endoscopy only. First of all we had excellent growth in the first half of 2007. As they said, after three years of high single digit and looking for effective ways to grow the business by expanding a line, it's very comforting to see that focus does in fact mean growth. So collectively since last summer, we've been a double digit growth company. And mind you, our portfolio's broader than all of our arthroscopy competitors.

Our repair business is growing just shy at 20%, and with the exception of one hiccup that I will comment on in a minute, that's a very positive trend. New products such as EndoButton for repairing the ACL, BIORAPTOR for shoulder and stability repair have help deliver a healthy vitality index of 28%. And by the way we measure vitality index as new product sales as a percentage of total product sales and that's new products being three years post launch.

Sales of our more established base products such as FasT-Fix the gold standard from meniscal repair, as well as other based products are growing nicely and help bolster the line.

Now I mentioned the hiccup and we received reports of rare cases in which patients were developing pretibial soft tissue swelling. And this was anywhere from two to 36 weeks after insertion of the CALAXO screw. And so, even though the effects have been rare, in transit we've felt it was prudent to withdraw the product from the market.

So we've voluntarily withdrawn the product. And really for two reasons, the first one is we're committed to patient safety, first and foremost. We are in fact an ethical medical device company, so that's got to be fist priority.

The second thing is we're committed to delivering quality products to our surgeons and making sure that their practices are as seamless as possible. So for those two reasons, we voluntarily withdrew the product. We put together a team of specials to look into it, to examine the pathology to take a look at patient records et cetera. And we'll see what happens.

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We're convinced that it's a great technology, we have full confidence that we can get the thing fixed. But the fact is that this is not a traditional interference screw made of metal or some other inert material. This is a bio active product. It's not only bio [resourceable] but the clinical trials have suggested its osteo conductive. So we've got to get this right. So it's more prudent for us to be cautious then we will.

In the interim surgeons have options to use other interference screws. We've got a broad portfolio in the knee, which I think is a good testament to our overall repair portfolio.

Moving on, the launch of our HD camera system and the early results are very promising. Jerry will speak to that more in a minute. And then the rest just speaks more of the focus. Around our key arthroscopy drivers investing in conferences like AANA and ISAKOS our trade shows, as well as getting rid of some of our non-core businesses like IDET, which we transferred over to clinical therapies at the beginning of this year.

So, we got the business focused. We got a strong management team, some of whom you met last night, others you'll meet today. A good first half and 2007 and we believe we're well positioned to close this year's strong and deliver a significant above market performance and significant value to our shareholders.

So thank you for your attention. And now what I'd like to do is introduce Jerry Goodman, our General Manager of our Capital business.

Jerry Goodman - Smith & Nephew - SVP, General Manager - Endoscopy

Thanks Mike and good morning. Before I started, I wanted to give you a brief overview of my background in the industry. I started with U.S. Surgical 17 years ago as a sales representative. And in 11 years I was with U.S. Surgical I held various sales and sales management positions, truly given me a feeling for what it's like to be in the trenches.

And in 2001 I came to Smith & Nephew Endoscopy where I've held executive roles in sales, marketing and most recently as our Senior Vice President of our capital position. So, 17 years experience gets me up on the podium here, and hopefully I'll get some smiles out of you guys today as well.

But in talking to some of the folks last night, there's interest in to why a capital division? And Mike alluded to it briefly while we're focusing our efforts in this area. But really it's about the customer, and it's about our global customer. And meeting the needs of that customer in the way of how we bring a product to market, what products we bring to market and how we service those products we bring to market.

Our capital division is defined as basically components that are sold stand-alone. So, a shaver box, a pump, a camera, a camera control unit, and those components plug into a wall, a boom or a cart. And then we have our shave blades, our RF lines, our pump tubing. And all those single use devices that go along with the boxes that we sell. Really it's basically a razor and razorblade model.

Our capital division portfolio includes technology platforms that make arthroscopics surgery possible. Access that provides sterile pathway into and out of the joint, and enables the surgeon to expand the joint. So we're talking about our cannulas, our tubing and our pumps. And it really opens operating space for the surgeons to proceed.

Our visualization products like our cameras, our control units, our monitors, that allow the surgeons to better see the anatomy and clearly see inside the joint. And then are resection products enable the surgeons to resect and remove tissue in order to prepare the surgical site for repair, which Joe will talk to you later today as far as our repair business unit.

And our service organization ensures that the capital component of our portfolio is always in the best possible working condition when surgeons operate.

In some industries a box is box, but in our company with a Dyonics brand truly separates us from the competition. We're the pioneers in this market. And our brand equity faced our recent proprietary customer studies, shows us to be as strong today as we've ever been.

But optimizing our portfolio, delivering excellence in marketing and utilizing a highly trained and focused distribution channel, we're going to maximize the needs of our diverse customer base. And that's what it's all about because if we do that, we can achieve our operating objective in the areas the market reader shift, revenue growth, share growth, gross margin and operating profit growth.

We can't and we're not going to take a cookie-cutter approach to reaching these operating objectives. As a market leader we have to understand the customers need and how to fulfill those needs. It's about more than getting just feedback from our sales force. The survey I mentioned previously reflects the needs of our customers, and we use that information to drive our decisions.

Mike has shed some light on our key market drivers, but additionally new procedures in hip arthroscopy and shoulder arthroscopy are providing opportunities for growth in both the capital and repair business units. So long enough to sell more single use devices. And interestingly enough, medical technology more and more is marrying commercial innovation.

So when a surgeon is sitting in his home theatre room, and he's watching HD images projected on a 90 foot screen, he wants to see that same quality of image on the monitors in the operating room. And when he's using a wireless remote or central control to put his garage door up and down, or turn on the stereo in his house, that's the functionality that they're expecting in the operating room as well. And as the market leader we're prepared and able to deliver.

Our global market is really diverse. I was speaking with some of the folks at my table last night about the segmentation and how we look at this global market. You have teaching institutions. There's 5,000 ambulatory surgery centers, community hospitals, developing international markets and group purchasing organizations.

Each one of those customer segments has diverse needs from high performance to pure functionality, all the way to acceptable performance in value price. Our three tier portfolio in marketing approach is designed to match and shape our technology with the needs of each customer segment. Ultimately we just need to get in the door.

Once we get in a door, our customers will see the value of our product and the breadth of our offering -- our good, better, and best strategy lends itself to seamless product development. And as we improve upon our technology, one of our customer segments will get better technology and as each of our customer segments will get better technology in a timely fashion.

So let me give you an example, our shaver blades. We have standard shaver blades that we use as it relates probably into this Tier 2 revival performance competitive functionality, price competitive. But also as an innovator in the marketplace we have elite blades and elite [birds]. And those elite blades and elite birds spin a little bit faster and they have a little bit better torque. And so we are able to achieve higher ASPs in that area, and bring the customer up to better efficacy in the procedures on particular cases.

And then you move up to the Tier 1 high performance, superior functionality where we have proprietary electro blade technology. The only Company on the market place that can cut and coagulate at the same time. So we look at this segment that strategy, and we use it in everything we do.

Let's take a look at our first half performance. We grew our visualization and [DUR] business by 14%, and we grew our resection business by 5%. We've continued to feed the new product pipeline by launching multiple new products in the first half year, and none of them is more exciting than our HD system that you'll get to see later on today in the project demonstrations.

We've also audited our capabilities in marketing in R&D and we've been able to identify areas were doing good in some, and some areas were not doing so good. And we need to improve upon to better align our people with deliverables.

Additionally we've undertaken the segmentation of our marketing team. We've been focusing on upstream and downstream. This will truly change how we approach our customers and enable us to better provide support to both our customers and our sales force.

I'm going to add some questions here. Who has an HD television in their homes? What about the box to convert the signal to HD? Don't know. What about an HD DVD player?

Well really, I'm not going to try to burst your bubble but if you don't have the box and if you don't have the DVD player, you're not going to get a true HD signal. And you're not going to get the best picture. So really HD in a complete system is about the weakest link and it's only as good as its weakest link.

Our HD system is a complete system, meaning our camera head is HD, our control unit is HD, our control systems in our image management are HD as well as our monitors are HD. And in the case with our HD system, really I can't do it justice standing up here. A picture worth a thousand words, so once again when you go into our digital operating room later on today, you're really be able to see the quality and what that image can bring to the operating room.

We've discussed the drivers of the capital market in our increased focus in this area and through this increased focus, (inaudible) will be initiating a number of important initiatives to drive profitable growth. And that's profitable growth alluding back to what Dave has suggested earlier today.

And from our revenue side, we really look at par. And what par means it's the potential to, p, penetrate existing accounts, and a, acquire new business. And also, r, retain business in our existing accounts.

We're also delivering technology that exceeds the expectations of rapidly growing international market place. And downstream marketing campaigns, like a recently launched faces in Dyonic ads, which are in front of most of you today, will continue to reinforce and leverage our brand leadership position, customer intensity as we attract new surgeons through our products.

From a profit side, we continue to focus on earnings improvement initiatives, by scoring ways to increase the profit contribution of our capital portfolio including identifying low cost country manufacturing opportunities.

In closing, we will continue to add out-innovate and outpace the competition, not just from a technology perspective, but from the implementation of a multi-faceted approach to portfolio maximization, marketing, distribution channel superiority, and customer intensity.

This comprehensive approach through our market place will provide us with our sustainable competitive advantage and I'm truly excited to take the lead in charge and do just that. Thank you.

Joe Darling will come up and talk to us about his repair business unit, and I look forward to spending some time with you folks later today as we tour the facilities and the product demonstrations.

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

The slides are stuck I think.

Mike Frazzette - Smith & Nephew - President - Endoscopy

A little help on the slides back there.

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

Well, as he's doing that let me a first of all say good morning to all of you and welcome as well. My name is Joe Darling. I'm General Manager of the arthroscopic repair business. And just to keep in step with everybody else let me give you a little background on myself as well.

I've been in the healthcare industry for just about 23 years now. And I've served capacities in sales and marketing with [Abda] laboratories, Baxter International, and with Wyeth Pharmaceuticals.

I joined Smith & Nephew Endoscopy just about two years ago. It'll be two years in October of this year. And I came in as Vice President of marketing. And then recently I've just in the past year, I was appointed to the position of General Manager for the Arthroscopic repair business.

What I'd like to review with you today is what arthroscopic repair is actually all about. I'd like to share with you some of the dynamics that we're seeing in the market that is driving phenomenal growth for this overall segment.

I'd also like to share with you how we as a business plan on capitalizing on this tremendous growth opportunity, but first let me tell you a little bit about what the arthroscopic repair SBU actually is.

It's a very simple definition in my mind and it's about people. It's a team of people from marketing, from the surgeon development, from engineering and clinical education that are dedicated to providing high quality and effective products and techniques to customers to repair joints in the human body.

Let's talk a little bit about some of the things that are driving this very exciting market. First of all as Mike and Jerry both mention, you see an active aging population. People want to stay active longer. They want to get well quicker. But as patients have problems with joints as an example, they look for minimally invasive surgery that will allow them to return to work in a quicker fashion.

They want to regain the lifestyles more quickly. We're also seeing as Mike had mentioned, a very favorable U.S. reimbursement trend starting in January of 2008. That's actually going to be a phase in period over the next four years starting in January, particularly in the ambulatory surgery [centered] market.

In the international markets, we're seeing increased adoption of procedures and techniques. As we increased our educational programs, both domestically and outside the U.S., we're seeing an increased adoption overall of our products and techniques.

Let's talk a little bit about some of the market movers. As you look at each segment, in repair, it's very simple. It's about technologies and it's about techniques that make the arthroscopic process simpler to perform with better outcomes.

The knee market for example, we have had drive as Mike alluded to, a technique called anatomic reconstruction or double bundle. So it's not just about products, it's also about techniques as well.

In the shoulder market, the key here is moving more procedures from what we call open surgical procedures to close procedures such as arthroscopic procedures.

In hip, very exciting market opportunity. An extremely high interest level in the surgeon community in doing hip arthroscopy. And I'll talk a little bit more in depth about that later on in my presentation.

Small joint area, again about instruments and products to allow for better access. These are very small tiny joints that the surgeon is dealing with. New products come into the market that allow easier access into those joints, that's helping drive this market as well.

And Dave touched upon the biologics area. We segment this into two areas. Bone regeneration and cartilage repair and I think a lot of you know in fact, commented to me last night during dinner, cartilage repair is viewed as the holy grail, a huge opportunity in terms of market growth.

So the repair business my franchise is essentially broken in to five key areas. Knee franchise, shoulder, hip, small joint and biologics. Our flagship franchise is the knee franchise repair franchise. Here we have drive anatomic reconstruction into the market. And as Mike alluded to, more than a quarter of the surgery that are performed in the Japanese market are performed with anatomic reconstruction.

And our shoulder franchise, we're driving new products into the market particularly in the rotator cuff in instability market. In fact if you take a look overall at shoulder repair, the two key areas that we really want to focus in on, is rotator cuff and instability. Those are the two biggest components of the shoulder repair market.

Just about a year ago, next month, we launched one of our newer technologies called KINSA for instability. And that's where the shoulder dislocates and the joint pops out periodically.

You're going to be hearing a little bit more, especially as you go through some of the product demonstrations next door about another new technology that's going to complement that line called KINSA, the rotator cuff. Both [knot-less] technology that make it easier and simpler for the surgeon to convert from an open procedure to a closed procedure.

This is an interesting area because if you take a look, overall the number of arthroscopic shoulder procedures that occur are less than 50% of the total market. So there's a huge opportunity to convert open to the closed or arthroscopic procedures.

In the hip franchise, we are actually the pioneers in developing instrumentation, anchors, and patient positioning systems working in conjunction with the leading hip surgeons of the world. We spent a lot of time over the past few years developing a complimentary portfolio of products to allow surgeons to go in and perform hip arthroscopy in terms of over section or a repair of that joint. And we'll talk a little bit more in depth in just a few minutes.

Small joint, we've refocused on this area recognizing the huge opportunity that exists in pursuing this market. More and more surgeons in fact are wanting to do small joint procedures.

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On the biologics front, we continue here to expand on our bio materials in our scalpel technology platforms. We provide solutions to surgeons and patients, particularly in the small focal defect market.

Overall our strategic objective is very, very simple. We want to be number one in the repair segment and we're going to do this by having a very strong global sales force to sell our products. Secondly, we have a very strong breadth of product line. In fact if you take a look in our breadth of portfolio between capital and resection, we're probably the strongest in the market. We have a world class surgeon education program that I'll be talking about as well.

Last but not least is innovator technologies and techniques, to bring to the market to sustain that leadership position. We have done and will continue to be pioneers in providing the best solution for surgeons and patients.

We have a four point plan to achieve and sustain that late leadership position. First Mike spoke about customer intensity. Utilizing in ideal management process that we call voice of the customer, taking ideas from customers to address their needs. Putting it through a screening process by using an advisory board of some of the leading arthroscopic surgeons in the world. They help us prioritize those products and techniques that we're looking at through the ideal management process.

And once we prioritize them, we put them through what we call an accelerated development process. And essentially what we want to do is get faster speed to market. We want to be a first mover. And we're going to do that by gaining customer focus.

The second component is innovation. Innovation on the technique and on the product front. Several new techniques have come to light over the past few years. As Mike had mentioned anatomic reconstruction of the knee, double roll fixation per rotator cuff in the shoulder. Those are just a couple of new techniques that have been developed over the past several years to address a growing need for better performance in the market at the patient level.

We're going to focus on key platforms and let me share with you exactly what I mean by a key platform. We have a product that's been used for a number of years in the knee market. It's called FasT-Fix. It's a meniscal repair product that is used to fix the meniscus in the knee. That uses a technology called a sliding suture knot technology. We saw that one of the challenges for surgeons in the shoulder market is the ability to tie knots orthoscopically. So we took the platform technology of FasT-Fix and we applied it to our shoulder franchise.

We now have two new products in the market that utilize this platform technology to make shoulder surgery easier to perform. And that is a key in this market. You go out and you survey surgeon the first thing they're going to tell you when you ask them, what are you looking for in a new product? They're going to tell you what I really want is something that's easy to use with a good outcome, at least comparable to what open surgeries are like.

So we utilize platform technologies to really drive some of our innovation in products and in techniques as well. We'll continue to focus on our biologics strategy and introduce new products in this area as well.

Key driver is having a world class surgeon education program. We have invested very, very heavily over the past year in surgeon education. And you'll see some of the results of those investments in just a few minutes.

What we want to do here is work with some of the professional society. The Arthroscopy Association of North America as an example, we are working in conjunction with to create what we call localized regional programs. Currently what happens with a lot of surgeons, if they have to take time out of their practice, travel long distances, spend time away from their practice and learn new techniques and learn about new products.

What we intend on doing is creating localized programs. Localized programs will allow them to keep up with the new technology and to have hands on training and [categoric] sessions that will allow them to learn the new procedure by utilizing the new products.

We also implemented a new position this past year called clinical marketing specialist. This is a team of individuals that are highly trained, highly skilled, and are focused on some of the key institutions both in the U.S. and in the international markets.

These clinical specialists carry the knowledge on the techniques and products to seed the market, especially when we're about to launch a new product. We're actually implementing this as part of our KINSA rotator cuff initiative when we launched the product this month. The key position for driving growth in the arthroscopic repair franchise.

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We're also having them focus on the fellowship programs. This is typically where a surgeon goes in, spends time in an institution, a highly specialized institution to learn about a specific segment of repair technology. And they focus on that and they're going in and they're actually teaching and training these fellows as they rotate to their fellowship program.

Last but not least it's all about sales forces excellence, having the best channel globally to go out and sell your products. And we're going to focus more heavily in the next year on education and execution of our strategy.

Mike had mentioned too, we just recently completed a global training initiative. During the month of August we trained the international teams. They were brought into one location. We put them in front of surgeons who came in and demonstrated utilization of the products, demonstrated some of the new techniques. We went out with a domestic roadshow, six different cities bringing the sales force in for heavy very intensive training, which is going to help fuel our growth as we move in the second half of this year.

I mentioned before our pioneering in hip arthroscopy. What I'd like to try to do for you right now is give you a very high level snapshot of what we foresee as the potential opportunity. Has to be somewhat of the busy slide, but I want to try to keep as simple as I can for you. This is a very difficult market overall to assess in terms of a market potential.

So what we've done is we've taken a look at what are the hip conditions that have been seen in 2006 in the global market and right now we've got that tagged at about 8.3 million patients that present with some type of hip disorder or hip pain -- or hip related pain, I should say.

In speaking with our expert surgeons, they're assuming that about 10% of this 8.3 million patients could be patients with -- potential patients with hip disorders that would be candidates potentially for hip arthroscopy. Okay? 830,000 patients in 2006 if you extrapolate the 10% off the 8.3 million.

Actual hip arthroscopies performed that we estimate in 2006, about 25,000 hip arthroscopies. That's less than 3% penetration of the overall hip potential market. So there's a huge gap between diagnosis of the underlying hip condition and actual treatment. So what are we going to do about it? What we're going to do is -- actually, before I go into that, I want to highlight a study that appeared in July last year in JDJS and this was a study that was done by [Dr. Qualisy] and associates.

And essentially this reinforced what we were suspecting in the hip arthroscopy market and that is that one study showed -- this study showed that 33% of the patients were actually misdiagnosed and that the average correct diagnosis took 3.3 different physician visits with a span of almost two years. So you can see it's somewhat of a difficult assessment to do and part of that is the education of the surgeon at the general practitioner level and also of the patient as well.

So in order to tap into this opportunity, what we plan on doing is investing heavier on the surgeon education front. In order to do hip arthroscopy you have to have the right instrumentation, the right positioning systems to distract the joint. And what we need to do is get more surgeons into training programs to show them specifically how to go in and diagnose that problem. So we're increasing our investments in surgeon education.

We're also utilizing the surgeons that have been through an intensive training program, either a fellowship or what we call a mini-fellowship, to actually go out and educate the general practitioner. And this is usually where the patient presents first. They are the gatekeepers, if you will, for these patient types. So we're educating the general practitioners. We piloted this program early this year and had some very good results with it.

We're also implementing patient education programs. So if they're suspecting some kind of an underlying hip disorder, we'll have web-based tools that they can go into and we're also utilizing at site -- at the site of the physician's office education materials to educate the patients on hip disorders.

Key here, too, is having a full complement of hip positioning systems and instrumentation. As Mike mentioned and as several of you had mentioned last night as well, you saw our recent press release on the launch of our lateral hip positioning system. It now fully rounds out our whole portfolio in hip positioning.

At AAOS in 2006 we launched our -- we launched our supine hip positioning system. That represents about 70% of the market, more domestic use. And with the lateral distractor now, that'll take care of the other 30% of the market, which, as Mike had mentioned, is more of an international preference. There are some surgeons in the U.S. who like to do it laterally, so this is the full complement that will allow us to do that.

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So at the end of the day in hip arthroscopy, we want to ensure that we're coming out with a continuous stream of innovative products and techniques that allows the surgeon to go in and perform this important procedure in a simpler manner.

So let's change gears here a little bit and talk about our first half performance. We had great performance in the first half, growing at 19% in the repair segment. And part of the reason for that is we invested in surgeon and sales force education. We did more training programs for both the sales force and our surgeon community in the first half of the year. We're starting to see the result of that.

But you complement that with the new products that we've brought to the market as well and we've launched several new products over the past year in both the knee, shoulder and hip market that have complemented and help bolstered our growth in the first half. And we see that as sustaining growth moving in the second half of this year and I'll talk about that in just a minute.

So on the shoulder front we launched our KINSA suture anchor. You'll see that next door. That was launched late October of 2006 for instability. We came out with a new Director Set and that's the instrumentation that's utilized to do anatomic double bundle reconstruction in the ACL.

We've also extended our fixation devices, which is the EndoButton with EndoButton Direct and EndoButton CL. And as I just mentioned in the previous slide, we came out with our new hip positioning system. We now have a full complement in that area. So that has helped fuel some of the growth in the first half of this year.

We fully expect that as we move into the second half of this year with the pipeline that we have coming to the market across the franchise that we will easily sustain that growth. And you'll see that in the knee franchise we're coming out with additional products. Same thing with the shoulder. In particular here one that I would highlight is our TWINFIX Anchor System. This will give us a more robust portfolio to compete effectively in the double row fixation market.

On the hip front, what's important here is that surgeons are continually looking for new techniques and new technologies to make it simpler for them to perform this procedure. We have several products that recently launched, and obviously the lateral hip positioning system, but we'll be complementing that with a new hip set and hip access system as well.

And then on the small joint front, since we have a renewed focus here, we are increasing our educational efforts and our sales force focus and pursuing this important market opportunity for us. And we fully expect to bring some new anchors to the market as well, which is a key element in that particular market.

So, in summary, just closing out here, we will continue to capitalize on the high growth markets, such as our shoulder and our hip markets, through increased investments in surgeon education, in sales force education, we will drive new products and techniques into the market as a result of having a robust product pipeline that will allow us to capitalize in that area.

We'll also continue to leverage our global presence, particularly in the international market. And most importantly, we will continue our focus on being customer centric by delivering products that address their needs.

Thank you. Mike?

Mike Frazzette - Smith & Nephew - President - Endoscopy

Thanks, Joe. Okay, well, that concludes our prepared comments. And what I'd like to do now is open it up to questions. We've got the group here prepared to answer any questions that you might have. And again, I just want to remind you that after questions we'll take a break, we'll do the Innovation Fair and then we'll come back at the end of the day. And so if we haven't had an opportunity to answer your question up until then, we'll still have some time, okay.

You, pass the microphones around, so we can hear all the questions.

QUESTION AND ANSWER

Mark Mullikin - Piper Jaffray - Analyst

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Mark Mullikin with Piper Jaffray. Just a couple of questions for Joe. You referenced biologics several times but did not mention a specific product. Are products in development or do you have products out there now in the biologics category in terms of penetrating that market?

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

Great question. We do have products in the market. The way we define biologics is biomaterials in the scaffold technology. Some of the complements on the biomaterials front, we have our bio RCI anchors as an example. We have our TWINFIX absorbables.

As Mike mentioned as well, we have the CALAXO platform, the PLC platform of products and we have scaffold technology that's being used in the international markets for a cartilage repair product.

Mark Mullikin - Piper Jaffray - Analyst

Okay. And then on the anatomic ACL market, the penetration in Japan is greater than 25%. What's the penetration outside of Japan?

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

We don't -- I don't have those figures. It's very difficult to break them out in some of the other markets. I can tell you it's a very growing trend in the U.S. market, predominantly as a result of the education initiatives that we put forth.

They actually originated in the Japanese market in terms of the anatomic reconstruction. That's why you see high growth rates along with the products that we're able to deliver over there to allow them to do that procedure.

Mark Mullikin - Piper Jaffray - Analyst

Okay. And then just one broader question for Mike. I guess when we look at the arthroscopic repair and capital SBUs, is it a different call point? I mean what's the difference that makes you segment it into the two different SBUs?

Mike Frazzette - Smith & Nephew - President - Endoscopy

Great question. It's -- well, first of all, it's a different focus. As Jerry pointed out, the repair -- the capital business from our vantage point is capital purchases, like video and digital OR, as well as our razor/razorblade business. So from a customer standpoint, there are some different call points there. The repair business is procedure driven. That's the sales rep that's in the OR that's driving -- that's training the surgeon on procedures, on technique, and then driving implants during the procedure.

The capital business is a longer term sell. It involves administration; it involves the CFOs, the CEOs of the hospitals. The surgeon doesn't make a digital OR purchase, for instance. But the surgeon determines what kind of shoulder anchor they're going to use or what kind of knee fixation they're going to use. So there are some differences in call points and differences in sales time and sales patterns.

Jason Wittes - Leerink Swann - Analyst

Hi. Jason Wittes from Leerink Swann. A lot of us are focused on the margin improvement plan that you have in place. And I think of the 400 basis points over four years that's been cited quite often by David, about a quarter of that is going to come from the endoscopy division.

Is that -- could you kind of highlight where exactly that's going to come within that division? Is that within the sales force, is that moving up the value chain or is there some duplication in the back office we should be aware of?

Mike Frazzette - Smith & Nephew - President - Endoscopy

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Good question. The earnings improvement program is across the entire company of Smith & Nephew. And when I got here a lot of the employees reminded me that endoscopy kind of started earnings improvement, even well before the program was announced, with the closing of our [gasket] and rotor facility and consolidation of our manufacturing.

So one of the things that we've got here in endoscopy is a culture built around the business that we have. We don't have quite the gross margins as our orthopedic reconstructive business, so I think people are more accustomed to making choices. So it's part of the culture.

Having said that, there are a lot of cross GBU, what we call cross GBU initiatives, so across each of the global business units, that are taking place. For instance, the restructuring of our European commercial organization is under way. I am very involved in the restructuring of our Japan organization. So in those two marketplaces, for instance, we're looking at everything from back office efficiencies to commercialization practices.

Dave Illingworth - Smith & Nephew - CEO

Just to be absolutely clear on the numbers that you're throwing out, Jason, we've never said that a quarter of it was going to come from endoscopy. What we've said is that we expect that about half of the savings will come from our wound care business and the other half will come from the combined orthopedic businesses. So I think it's dangerous to think that a quarter of it will come from endoscopy.

Jason Wittes - Leerink Swann - Analyst

-- to put words in your mouth.

Dave Illingworth - Smith & Nephew - CEO

Thanks, I appreciate that. The other thing is -- well, actually, I'm just trying to make sure that everybody's clear on because one of the things about endoscopy that we believe that this business has -- needs more investment. There are some real growth opportunities here.

We don't have clear line of sight of what the profitability of all the competitors are in this space because several of them are private. Some of the larger ones we don't have a good view of what their profitability actually is.

But we do believe that we are close to the head of the class on the profitability of this business. And we believe that we need to leverage that position and it may actually take a little bit more investment because there are some real growth markets here.

Jason Wittes - Leerink Swann - Analyst

I guess related, what percentage of your business is disposable?

Dave Illingworth - Smith & Nephew - CEO

I don't believe we provide that data, do we, Joe?

Jason Wittes - Leerink Swann - Analyst

I just was curious about the percentage of your business which was disposables versus non-disposables.

Unidentified Company Representative

(inaudible - microphone inaccessible)

Jason Wittes - Leerink Swann - Analyst

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Okay, fair enough. I guess if you go -- if you flash back a few years back, you guys saw a lot of competition or reuse issues with your razors and shavers. I'm guessing that's completely [anniversary] at this point and it sounds like that's less of an emphasis for this business.

You're looking to sort of -- that's not something at least that you showcased here. You're looking to move into sort of higher margin businesses. Is that the right way to think about how you can progress forward.

Mike Frazzette - Smith & Nephew - President - Endoscopy

Let me be very clear because reuse is, was and still is an issue and we continue to battle it at the local level, at the regulatory level, at the government level. Having said that, we think that it's relatively stable and the 5% growth in this section I think would point to that fact. But it's not something that we can ignore.

We just believe you've got to battle it at each of those levels. You've got to give patients the choice and a lot of hospitals today are providing choices to patients. When you go in, you sign a document that approves the use of reusable products.

And I think if you are a patient, you would think about that and I think most people would choose not to have a reusable product used on them or implanted in them if given the choice. And so that's what we're doing. We're going to battle it because we believe it. We believe it's the best way to practice medicine. And by and large, when given an audience, we're finding that it's agreed upon.

Mike Matson - Wachovia - Analyst

Hi. Mike Matson from Wachovia. Question for Mike or Jerry. Just wondering in your capital equipment business, have you seen any disruption out there from the hospitals given the turmoil in the debt markets? Have they pulled back at all from any of their capital expenditures?

Jerry Goodman - Smith & Nephew - SVP, General Manager - Endoscopy

Not at all. We haven't seen any pullback from the capital expenditures. And usually they're budgeted for and they either come in a traditional cycle or when innovation drives the market, like our HD systems.

So if you look at our HD camera system that we've launched in Q2, if that's any indication, we're exceeding our expectations in that area. So obviously there's money out there to drive innovation in the operating room. So I haven't seen that much of an impact at all.

Mike Matson - Wachovia - Analyst

Thanks. And then you seem to be pretty arthroscopy or orthopedics focused and I know some of your competitors, like Stryker, they're a little more diversified in their endoscopy business. Is that a direction that you would consider going in, moving into general surgery and things like that?

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

Well, as I said at AAOS, we're always going to evaluate adjacent businesses, but first and foremost we've got to build on our core. I really believe that you do the sweet score analysis to determine what drives your economic engine, you understand what you're passionate about, and you also understand what you can win at.

And we know that when you think of those three things, it's arthroscopy for us. So yes, we're going to look for opportunities that are adjacent to build out our resection portfolio, to build on our repair portfolio, but don't expect us to get too far from that core.

Mike Matson - Wachovia - Analyst

All right. Thanks.

Joe Darling - Smith & Nephew - General Manager - Arthroscopic Repair

We like to see our competitors get kind of crazy, by the way -- out of focus

Matt Miksic - Morgan Stanley - Analyst

Hi. Matt Miksic from Morgan Stanley. Question on sort of the potential synergies across your orthopedic businesses with repair and capital. You talk about the importance of education and identifying, for example, patients for hip arthroscopy.

You haven't talked about it today, but I think that's true also for the [deuce] and identifying the right patients for that. Are you seeing synergies across your businesses now going both ways? I mean is Birmingham helping drive your brand and synergies in these businesses and vice versa? And then I have one follow-up.

Mike Frazzette - Smith & Nephew - President - Endoscopy

That's a very good question, I would say. And I'll defer to Dave here to add on. Just from my vantage point, I think it starts with putting the people in the businesses that have that type of mentality. And prior to Dave becoming Chief Executive, I don't think that existed. We were very decentralized. But we're heading in that direction from a back office standpoint. Obviously we're looking for synergies.

But from a commercial standpoint, which is I think your question, are we doing anything to leverage our brand or our strength in one business than the other, and the answer to that is yes. But we've got a long ways to go. We're doing some things from a commercial standpoint this year. We're pulling our sales and marketing groups together from a global standpoint to meet.

We're getting our education people together to talk. We've set up councils now, sales and marketing councils on a regular basis. They're meeting and they're looking for opportunities. A lot of activity but we haven't seen any results yet. So it's a great question. We've got a long ways to go, but at least we're thinking about doing that now.

Dave Illingworth - Smith & Nephew - CEO

I'd like to make a couple of comments on that because I think this is an area that we've done a very poor job of in the past. We can do a heck of a lot better here. In the past, Smith & Nephew orthopedics, if you split it up into three businesses, sports medicine, trauma and reconstructive orthopedics, we went out of our way to basically build separate identities.

We had booths next door to each other, across aisle ways of AAOS, and you didn't even know they were the same company. We even went to the extent of trying to make the booths look different. To me that's nuts. It's absolutely crazy.

We have an orthopedic community out there that we can leverage a brand across the entire orthopedic space and we don't take advantage of it. You will see more of that kind of behavior, not the kind that I just described, but the opposite kind of behavior, which is figuring out how we can walk in front of that customer and you put our three orthopedic businesses together and they look and see that we're one of the largest orthopedic companies in the world with market leaderships in the segments that we participate in. That's the story we want to tell. We don't want to tell a story of being independent for the sake of being independent. We want to have that independent focus where it makes sense.

If there is a customer segment that we need to be very focused on and nimble and pay attention to, then we'll have the sales force and the marketing teams and the development teams focused on those segments. But we are going to act like an integrated orthopedic company that is world-class the way that we are.

So you're going to see a lot of that type of behavior moving forward. We're going to be bringing ourselves closer together without losing the identity of our sales channels and our marketing teams and that customer intimacy. Something I feel very, very strongly about.

Mike Frazzette - Smith & Nephew - President - Endoscopy

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The other thing, just to add a little more color to that, in the U.S. the orthopedic surgeons are much more specialized than they are in the rest of the world. For instance, in Japan, [Dr. Matsumoto] at [Kea University] is a knee guy. So he does everything from ACL repairs to meniscal repairs to knee arthroplasty. So he does it all. And we've got to get better at leveraging our continuum of care in those types of situations.

Dave Illingworth - Smith & Nephew - CEO

There was a very -- I think very -- personally I think very compelling point that wasn't talked about this morning as of yet, which I think gives us great advantage in this marketplace.

If you think about our continuum of care for osteoarthritis, let's start at the very beginning with sports medicine and our arthroscopic repair. And then you go on to early intervention like joint fluid therapy and using cell-based, mechanical-base tissue repair with our bone stimulation and the effects that it could have on cartilage that we're studying.

You look at the early intervention like deuce and the [uni's] and then Birmingham hip, which is earlier than the traditional implants of these Medicare/older population ages, we are the only company in this space that does the whole broad spectrum.

And I really believe that we can leverage this whole idea of looking at the disease state of osteoarthritis and bringing a suite of solutions to our customer base and I think that's the idea that we're going to continue to capitalize on as we bring these businesses together.

Matt Miksic - Morgan Stanley - Analyst

I just had one kind of nuts and bolts question. You talked about this anatomic ACL repair and double row fixation in the shoulder. Just wondering if you could give us some idea of how much better those procedures are for you in terms of revenue per procedure of ASP or are we talking about a multiple? If you can give us some color and maybe what you've seen so far in Japan as a result of that?

Mike Frazzette - Smith & Nephew - President - Endoscopy

I don't know that I can give you too much detail on it other than to reinforce the fact that it's not all about the product; it's also about the technique and training these surgeons. And you get -- you get some loyalty built when you're teaching surgeons how to do -- how to produce better outcomes for their patients in a simpler way. So you just engender that type of loyalty.

Having said that, when they use our techniques that we develop together, they typically use our implants, so we get better content. It may not be twice as much or three times as much, but we capture a greater degree of the content of that procedure.

Peter Cartwright - Evolution Securities - Analyst

Peter Cartwright, Evolution Securities. A couple of questions and a follow-up if there's time. First, I'd like to challenge a couple of things that you've said, Joe, and that Mike repeated about the loyalty. Sometimes when you listen to the surgeons talk and refer to the products by name and say on an ACL I use the Endobutton for one end and I use someone else's interference screw on the other end. I've been getting the sense that they have the same sort of loyalty, which you seem to feel.

Mike Frazzette - Smith & Nephew - President - Endoscopy

We do a couple of things on a continual basis and maybe during the course of the day you can talk to Joe and he can provide you a little bit more detail about it, but it's -- we measure brand loyalty index, which is a fairly well known exercise.

We also look at net promoter score, which is the -- for those of you who get your car serviced, you get that follow-up phone call, the question about would you recommend us to your neighbor, your friend, your mother, your daughter, whatever.

And in both instances, in brand loyalty index, we get just about as high as you can possibly get from a brand loyalty index, which means that our surgeons associate the top brand to Dyonics, okay, which is our brand. They've got a strong affiliation.

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In terms of net promoter score, we get a very strong net promoter score, which means that of the customers who use our products, most of them or very many of them are willing to recommend to use our products to their peers. And I can't debate the statistics, that's just what they are.

Peter Cartwright - Evolution Securities - Analyst

Maybe they remember to use your product at one end of the joint and someone else's at the bottom. The second question was for Jerry on the HD system. It could be because you said moving to HD, I sense that it's a modern generation in some respects; people are going the other way. They're watching football matches on mobile phones. So is this a product of the market really once or are you sort of -- is it something you are foisting on them? Is there any real advantage?

Jerry Goodman - Smith & Nephew - SVP, General Manager - Endoscopy

There's definitely an advantage to the HD product. Like never before, our surgeons can see anatomy inside the joint or inside the abdomen and that allows them to provide better patient care. Obviously, if you can see vascularity and your surgical anatomies very vividly versus possibly a granular picture, what have you, enables them to operate better.

So yes. And I think that the innovation isn't necessarily driving the utilization. It's what makes the procedures more efficient and how the surgeons are looking for better outcomes. And that's what ultimately decides if our products are purchased or not.

Peter Cartwright - Evolution Securities - Analyst

Right, and as a quick follow-up. You mentioned innovation out of Japan, which is perhaps unusual in itself. Can you just remind us, is Japan a drag on your business at the moment or a positive factor?

Dave Illingworth - Smith & Nephew - CEO

Japan is a very positive factor in our business.

Yi-Dan Wang - Deutsche Bank - Analyst

It's Yi-Dan Wang from Deutsche Bank. This is a question for Mike. You've identified markets outside the U.S. as a big opportunity for you. Wondering if you could put that into some context, how penetrated the markets outside the U.S. is versus the U.S.?

What are the key structural reasons, if any, that have caused that difference? And going forward, I suppose over the next three to five years, what percentage of endoscopy growth do you expect to come from the developed markets outside the U.S.?

Mike Frazzette - Smith & Nephew - President - Endoscopy

Today our international business, the way we look at it is U.S. and international. International business is growing at close to three times the rate of our U.S. business overall. Our business is about equally split between the U.S. and worldwide.

And I think what I mentioned was we believe we've got an inherent competitive advantage based on our infrastructure in our organization worldwide, everything from new product development and even the ideation.

So we've got ideas from key opinion leaders worldwide. It's not just a U.S. centric business. Double ACL is a great example. [Dr. Shino] in Japan, [Dr. Criston] in France, these are the guys that originated it and came up with the idea. They came to us. And I don't see that stopping.

I see us continuing to do that and then using our sales and marketing strength worldwide to drive adoption of those techniques. So I see no reason why our international business won't continue to grow, at least at the pace it's growing at.

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The emergent -- I mean we're no different than the rest of the industry. The emergence of healthy middle class that's going to want improvements in healthcare is going to drive sports medicine. It's going to drive minimally invasive surgery. We're pretty bullish on our ability to leverage our existing organization, our existing capability into the international market.

Yi-Dan Wang - Deutsche Bank - Analyst

Okay. And the follow-up to that, can you comment on whether there are any structural reasons why the international market is more underpenetrated compared to the U.S. market?

Mike Frazzette - Smith & Nephew - President - Endoscopy

I don't know that it is underpenetrated. I think that's -- are you suggesting that it's underpenetrated?

Yi-Dan Wang - Deutsche Bank - Analyst

No, my understanding is that the U.S. market for arthroscopy products is more developed and the markets outside the U.S. is less developed.

Mike Frazzette - Smith & Nephew - President - Endoscopy

I think the U.S. healthcare market, by and large, is a much more competitive environment. There are more dollars spent per capita here than there are in some of the -- clearly in the emerging markets. And so if you were going to start a healthcare company or a device company and look to the U.S. I think as your -- it's still our biggest and most important direct market.

Yi-Dan Wang - Deutsche Bank - Analyst

Okay, I'll follow up with you afterwards. Thank you.

Mike Frazzette - Smith & Nephew - President - Endoscopy

Okay. I'm sure you will.

Steve Wilson - Lapidus Asset Management - Analyst

Steve Wilson with Lapidus Asset Management. I'm curious. You talked about that this was a unit that deserves more investment. Could you just outline between R&D and sales and marketing and the key regions where those dollars need to be stepped up, where that commitment needs to be built?

And then secondly, could you just talk about the reimbursement market, and I'm thinking in sort of key international markets, whether there is resistance for sort of incremental technology above and beyond sort of a basic procedure or whether they're supportive of and financially rewarding constant innovation above and beyond sort of a standard of care?

Mike Frazzette - Smith & Nephew - President - Endoscopy

Well, let me just speak to the regulatory environment and I think the first part of your question might have been directed to Dave. But the regulatory environment we do find challenging in some markets. As the markets develop, as these countries develop, they're putting into place regulatory structure that didn't exist in prior years. So it's taking a little bit longer in markets such as Japan, for instance, and clearly in the emerging markets of Eastern Europe and Asia.

That being said, again, I think we're in a good position to capitalize on that. We've got a -- we've got regulatory infrastructure throughout the world in each of our direct markets and we've got a regulatory origination here that supports them. And I think by and large we do a very good job. I'm very confident that we can continue to gain regulatory approval and do the things we need to do to get products on the market.

Reimbursement levels I think follow that. The mix, some markets they're very favorable. Other markets not so much. But look, I mean everybody's looking for better outcomes, so if you can develop products and demonstrate improved outcomes, you can improve -- you can demonstrate value, you're going to have a winner, no matter whether it's here in the U.S. or whether it's in Eastern Europe or in Asia.

The first part of your question was in terms of investment and why this business deserves more investment. Let me just take one step back and say -- take one step back and suggest to you that a big part of creating the strategic business units in arthroscopy was to do just that, to suggest to the organization that we've got an economic sweet spot here where -- that drives our financial engine, that drives our operating results, that we're passionate about in markets that we can win in. And that's where we're going to focus our investment from a new product development standpoint to a commercialization standpoint. That's where we're going to focus our energy.

And so we've done a lot of that. We've throttled back on investment in the non-core areas, like GYN, like vascular. We transferred the IDET spine business over to clinical therapies that has the core competency to drive office-based procedures and reimbursement. So we're doing that. We essentially cleaned up our house.

Now, going forward I think I would yield to Dave if there are things that -- I mean we recognize we have to compete for investment dollars with our friends in Memphis, just like any large business does. But I can tell you that our R&D spend, for instance, as a percentage of our revenue is in line perfectly with our corporate objectives.

Dave Illingworth - Smith & Nephew - CEO

I'll make a couple of comments just to make sure that I didn't send the wrong message earlier. Clearly, we've been spending money and investing in this business.

And I think it's really more a matter of focus and reassigning those resources to the areas that we can grow the fastest and can be the greatest impact for this business longer term. And I think Mike has done a very good job of focusing efforts back on the core arthroscopy business, on the sports medicine area. That really is our core strength.

We have throttled back the investments on gynecology and vascular. We've taken the spine business, which was going to take a tremendous amount of resource investment to do it at the endoscopy business, moved it over to the trauma and clinical therapies business where we have 350 people selling to the orthopedic surgeons in their office.

And so we didn't have to put that additional investment into the infrastructure in the endoscopy business. So I think it's more a nature of -- that's more the nature of it. It's making sure that we're spending our money in the right places and that we're leveraging ourselves across the different businesses.

We haven't starved this business in the past but I don't think we've focused properly. I think we've lost a little -- I've got to be careful in saying this because everybody'll write this down, but I just think we've lost a little momentum over the last five or six years in the area of arthroscopy and sports medicine when we didn't need to and we can get that back very quickly. We are the market leader and I think this team is very, very focused on that area now. They're going to be a force to be reckoned with given the focus that they have.

Mike Frazzette - Smith & Nephew - President - Endoscopy

And as far as rationalizing, making decisions, the team here is very accustomed to making choices. As I said, we're not -- we're not at the same level in terms of gross margin as our reconstructive business, for instance.

So we make choices and we do a pretty good job in terms of identifying what our key drivers are and making sure that we're investing in those key drivers, at least to the extent that we believe our competitors are, if not to a greater extent. And if you don't do that you can't win.

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So we see commercialization as a key driver, we see new product development ideation. We have something called InVentures, which is our surgeon program where they're -- like yesterday we had two surgeons, two pretty distinctive key opinion leaders in-house working on new ideas with us. So we do that. We invest in those types of programs.

And those are at the expense of the things that don't drive the business. (inaudible) with same number of ads in bone and joint that you see from some of our competitors because that doesn't drive our business. Surgeon education drives our business, sales and marketing drives our business and operating efficiencies.

Steve Wilson - Lapidus Asset Management - Analyst

Does more of the investment build need to be at the front end on the development side or the backend in terms of the sales and marketing and the education and training side?

Mike Frazzette - Smith & Nephew - President - Endoscopy

We like our pipeline. We've got a healthy portfolio, healthy pipeline, as I pointed out, derivative products, breakthrough products, platform products. We're very comfortable with our pipeline.

So we're going to continue to plug along at the pace that we're investing in today, which is consistent with what you guys know we invest from a corporate standpoint. But from a tactical standpoint, it's more about on the backend, on the commercial side, on the surgeon education sales and marketing.

We've got time for two more and then we're going to need to take a break.

Michael Jungling - Merrill Lynch - Analyst

Hi. It's Michael Jungling from Merrill Lynch. I have three questions for the team. Firstly, how are you progressing with low cost manufacturing? Secondly, when you look at the opportunity in emerging markets, do you feel there is a need to create a second low cost brand to make it affordable for countries in China and India? And thirdly, if you look at your margin expansion program in endoscopy, is R&D cost relative to sales your biggest headwind?

Mike Frazzette - Smith & Nephew - President - Endoscopy

Okay, from a low cost country standpoint, we're progressing quite well from a low cost country standpoint. For our business, that has more to do with sourcing than it does with actual bricks and mortar. And I think Dave can probably speak to what we're doing in some of the other businesses. But we've initiated a sourcing project quite a while ago and have made quite a bit of progress in that regard.

Emerging markets, I'll let Joe and Jerry speak to that, but we do have an active 2G program that we refer to. It's the second generation program where we sell products to emerging markets, recognizing that in some of those markets they're just not going to afford some of the highest technology products. And then I'll let these guys add some color.

And then the last question was?

Michael Jungling - Merrill Lynch - Analyst

(inaudible - microphone inaccessible)

Mike Frazzette - Smith & Nephew - President - Endoscopy

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Well, like I said, we're comfortable with our portfolio. I don't believe that we've got a lot of headwind there. We've got a great pipeline, a combination of derivative products based on existing platforms, new platforms and breakthrough technology. So I don't see that as a limiting factor at all.

Michael Jungling - Merrill Lynch - Analyst

(inaudible question - microphone inaccessible) on the R&D side. As you move into the biologics, does the cost of doing business get more expensive? So is R&D increasing [or do the] sales as you move into more expensive technologies requiring greater clinical trials?

Dave Illingworth - Smith & Nephew - CEO

I think that's something we're going to need to deal with, Michael. I think all the orthopedic companies are going to have to deal with it. We are going to find ourselves, like it or not, competing with some of the large pharma companies in terms of products in the future. And I think it's very important for us not to get into a mode where we're chasing the pharma companies with our research dollars.

I believe that we can come up with a unique model for biologics and you will learn more about that as we develop it because we are actively putting management time into debating and deciding what will be our unique business model in terms of biologics.

And over the next six months probably there'll be a lot more to discuss about that as we start developing and become more public with what our plans are in that area. I think it's -- I think it's absolutely an area that we have to address and we will -- we will have some announcements to make in terms of how are we going to address this research model in terms of biologics going forward.

Mike Frazzette - Smith & Nephew - President - Endoscopy

And just to add a little bit more color on endoscopy specifically because I didn't get your question at first, but I think as long as we stay very focused on two things, and that's bone regeneration and cartilage repair, that we're not going to run into headwind. We've got a pretty good solid basis of technology there and we can build a pretty healthy portfolio with what we've got in-house right now.

Dave Illingworth - Smith & Nephew - CEO

You did have one additional question, which was the issue of the low end products in these developing countries and that's another area that we have some pretty active debate. I'll give you my opinion, which is not universally held and agreed upon within the folks that work with me, which is actually a good situation because healthy debate is wonderful.

But I've got a lot of experience in some of these emerging markets and I can tell you it's hard to be a Motel 6 company and a Ritz Carlton company all in the same -- in the same skin. And I believe that we're going to be developing lower cost products that have Western quality. Let's take China for instance. I don't believe we're going to ultimately compete in that low end segment of the Chinese market, which could be the largest piece of that market.

Right now what we're focused on is first having a manufacturing strategy that gets us an entry into a very large market and then also looking at products that have the quality level that we can live with as a company, that we're going to feel good about bringing to our customers, that are manufactured in the country that have a lower price point, with Western quality associated with them. And that's our current strategy.

And there's a lot of discussion around whether or not that's going far enough in some of these markets. So I think that remains to be seen. But I just am a very strong believer that it's hard to be at two very, very opposite ends of the spectrum as a company.

Mike Frazzette - Smith & Nephew - President - Endoscopy

We're going to take a 30-minute break now folks, so 10 o'clock now.

Dave Illingworth - Smith & Nephew - CEO

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We'll answer any questions later on.

Mike Frazzette - Smith & Nephew - President - Endoscopy

Yes, we will. I'd just ask that you be back at ten-thirty and we'll take you through the Innovation Fair. Thanks.

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