

# FINAL TRANSCRIPT

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## **SNN - Q1 2007 Smith & Nephew Earnings Conference Call**

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the Smith & Nephew first quarter results conference call. For your information this conference is being recorded. Before we begin would you like to read out the safe harbor statement?

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**Unidentified Company Representative**

This presentation contains certain forward-looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995. In particular, statements regarding planned growth in our business and in our operating margins discussed under outlook are forward-looking statements as are discussions of our products pipeline. These statements as well as well as the phrases aim, plan, intend, anticipate, well-placed, believe, estimate, expect, target, consider and similar expressions, are generally intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors, including, but not limited to, the outcome of litigation and regulatory approvals that could cause the actual results, performance or achievements of Smith & Nephew, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Please refer to the documents that Smith & Nephew has filed with the US Securities and Exchange Commission under the US Securities Exchange

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Act of 1934, as amended, including Smith & Nephew's most recent annual report on Form 20F for a discussion of certain of these factors.

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### Operator

I would now like to hand the call over to Sir Christopher O'Donnell, chief executive of Smith & Nephew.

Christopher O'Donnell. Well let's make a start. Well good morning everybody in the room here at the Institution of Mechanical Engineers where our annual general meeting or shareholder meeting is taking place later on this afternoon, and good morning to everybody on the conference call.

Thank you for joining us today for our first quarter presentation which also contains details of our earnings announcement and we have also announced today that I'm going to be handing over the post of chief executive here to Dave Illingworth at the half year and I'll touch on that a little bit more at the end.

What I'd like to do is just remind you of our strategy for continued value growth and how that's developing. We do have a clear focus on innovation to provide clinical benefits and to provide value for healthcare systems and we've moved this progressively towards a focus on the active informed patient segment. These are people who demand high quality healthcare outcomes and are well informed about technologies in the marketplace and we're specifically trying to inform them about Smith & Nephew's advanced technologies.

We are also announcing today our earnings improvement program. We continue to aim for above market growth in each of our market segments. We continue to invest in R&D and innovation on a go forward basis, but we expect additionally to enhance our margins through the earnings enhancement program that we'll detail later.

Our balance sheet, you all know that it's our intention to maintain flexibility for acquisitions, but to return capital to shareholders whilst maintaining investment grade rating and we indicated with the full year results that we would return up to \$1.5 billion of shares through a share buyback over the next two years and that remains our plan.

And clearly we're looking for value enhancing acquisitions. We're looking for either/or of unique and additive technologies and improved channels to markets.

We're very pleased with the acquisition that we announced in the first quarter, which we expect to complete in the mid-year, of Plus Orthopedics. We're engaging now with the company and they will give you some more details later but we're very pleased with the initial way this is going prior to the transaction being finally completed.

This does move us to number 4 in the global market for reconstruction. We've also made good progress with our DUROLANE license agreement and the integration of OBI announced last year and also in the first quarter we completed a world wide distribution agreement in Advanced Wound Management with the American company Covalon which revolves around collagen based wound management products.

With respect to Q1 we've made a really strong start to the year. Group revenue growth was 12%, excellent growth across all our businesses. All these numbers are in constant currency and to grow Orthopedic Reconstruction 15% against a 9% market growth

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is really a terrific performance, but that's actually not as good as the performance on our Orthopedic Trauma and Clinical Therapies business with a 19% growth rate. We were very pleased to see Endoscopy bounce back strongly into double digits at 12% and very encouraged also by the performance of Wound Management at 4% excluding the tissue engineering, the discontinuation, the final quarter I am delighted to say of discontinuation of DERMAGRAFT comparator.

As we said, the share buyback program has started and the Earnings Improvement Program is already underway.

So the batting order we're going to have today is that Adrian Hennah, our chief financial officer, will take you through the Q1 numbers; Dave Illingworth, chief operating officer will talk you through the businesses and where they stand and the highlights, and there are some real highlights of those; and then lead into what we're actually doing under the Earnings Improvement Program, and then Adrian will pull the numbers together, including EIP Program to hopefully enable you to understand how this sets the business up going forward.

So with that I'm going to ask Adrian to come across to the podium and talk about the Q1 numbers. Adrian.

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**Adrian Hennah - Smith & Nephew - CFO**

Thank you Chris and good morning ladies and gentlemen, if we could turn to the next slide which is slide 8 in your pack, the income statement. Revenue in the quarter was \$744 million representing a growth of 12% at constant exchange rate on the comparable period last year. (Technical difficulty) a further four percentage points increase in reported revenue at 16%.

Trading profit also was \$148 million; this represents a growth of 19% at actual rate and 14% at constant rate. A trading margin of 19.9% was 0.6 percentage points above the comparable period last year, we'll look further at this on a segmental basis in a moment.

We provided for costs of \$17 million in the quarter in respect of our earnings improvement program and we spent \$5 million on this program in cash. These were mainly in the wound business and we'll be describing the full cost we expect for the program in a moment.

Net interest income in the quarter was \$2 million. This item will clearly be impacted if we go forward by the timing of the completion of the Plus acquisition, any (technical difficulty) acquisitions and the share buyback program.

So if we could move to the next slide which is slide 9 in your pack. (Technical difficulty) income statement. The tax charge is 31% in the quarter, the charge we currently expect for the full year. As noted in previous quarters, new accounting rules, particularly in the USA, require a somewhat more formulaic approach to assessing the outcome of tax disputes. The tax rate is therefore likely to be somewhat more volatile and unpredictable within the past.

Adjusted earnings, or adjusted attributable profit for Q1 was \$106 million, a 19% growth on quarter one last year.

Turning then to the next slide and an analysis of revenue by business segment. You'll hear from Dave in a moment more detail behind the numbers for each business; I will therefore make only a couple of financial points in respect of this and the next two slides. On this [slide] you can see the growth rates in the quarter for each of our business segments adjusting for currency and small acquisition in Endoscopy.

If we turn to the next slide, slide 11 in your pack where we have an analysis of revenue growth rates by segment and by geography. The cost of the exchange growth rate in our reconstruction business was 15%, the same rate as in quarter four of last year. This was slightly higher than we expected at the time of our full year numbers, driven mainly by strong sales of our new products in the USA. Growth in the USA reached 20% driven entirely by volume and mix gains. Pricing in our Reconstruction business in the USA was essentially flat. Pricing outside the USA was slightly negative with particular reductions in Japan.

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The Trauma and Clinical Therapies business growth rate increased from quarter four, with stronger growth globally in Fixation up to 9% in quarter four '06 to 13%. In [the US] Fixation growth rate in quarter one increased faster than we had expected to 15% up from 5% in quarter four '06. There was a continuation of the high Clinical Therapies growth at 33%. The Clinical Therapies growth rate includes an 8% benefit from in license of DUROLANE in quarter three last year. Underlying growth was therefore about 25% in Clinical Therapies.

Endoscopy growth rate increased into double digits. Repair and Reception each account for just over one third of Endoscopy sales. The more mature Reception area grew at 4% in the quarter, the Repair area at 22%. Visualization and DOR sales which account for about 20% of the total (technical difficulty) and were particularly high in quarter one. We expect Visualization and DOR growth rate for the year will average significantly less than the 20% achieved in quarter one.

The reported growth rate in the Wound business was 2%, a small reduction from the reported Q4 '06 growth rate of 3%. As signaled with our full year numbers, quarter one was adversely impacted by about \$4 million in sales or 2% growth brought forward into Q4 '06 in order to handle the impact of a change in MRP systems in the UK.

This quarter was also, as Chris has said, the last of the material year-on-year effect from the sale of the Tissue Engineering business, also reducing growth by about 2 percentage points. Underlying growth in Wounds was therefore around 5 percentage points in line with recent quarters. Sales growth in Wound in the USA was 22% excluding Tissue Engineering, though this did include some small increase in wholesaler inventory levels.

Turning then to the next slide and an analysis of trading profits by business segment. Trading margin for the Group as a whole after the restatement was 19.9%, up from 19.3% in quarter one last year. In the Reconstruction business, margins were broadly flat. Some direct consumer costs in the USA and price reductions in Japan impacted on margins. Trauma margins were also broadly flat. Price reductions in Japan also impacted here. Endoscopy margins fell by 1%. Mix changes especially connected with the Visualization and DOR products were an important driver of this.

Wound margins improved by 3.3%. This follows a 2.4% improvement in quarter four of last year. The 3.3% does include some one-off benefits but is mainly a reflection of the early impact of the EIP program.

R&D spend across the businesses fell slightly as a percent of sales from 4.5% to 4.3%. As noted last quarter, we do not see this as a trend. Indeed as we'll discuss in a moment in the context of the EIP, we expect an increase in the R&D spend as a percent of sales over the coming years.

Turning then to the next slide and the free cash flow. We generated \$60 million of free cash flow in quarter one. The capital expenditure of \$38 million includes \$7 million in respect of intangibles. (Technical difficulty) \$31 million was slightly below the \$38 million in depreciation. This reduction (technical difficulty) of heavy investment on instrumentation to support the new products. We continue to expect this investment to reduce into 2007 from last year but to increase from the level in quarter one.

The outflow of \$32m in respect of working capital included \$30m spent on increasing inventory. We continue to expect a higher conversion of profit to cash in 2007 than in 2006 as the upfront investment in capital for the new products reduces relative to sales made.

Turning to the next slide and a quick update on our share buyback program. We said [in February that based] on an assumption that we use about \$2 billion on acquisitions over two years, we plan to buy back up to \$1.5 billion worth of our shares over the same period. This of course remains our plan. We expect to spend about \$900 million of course on completing the Plus acquisition. This acquisition has not changed our assumption about \$2 billion in total for acquisitions. We will though of course keep the number under review as our acquisitions program proceeds. Since starting the program in February we have bought back 6.4 million shares for an outlay of \$80 million.

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Turning then, lastly in this section, to slide 15 and the outlook. Our view of the Company's overall outlook from the position we set out in February. In the Recon area we see current global market growth of about 9% per annum. We expect a sustained, but of course not indefinite, sales growth benefit from our strong recent product launch program, in particular BHR in the USA, Journey, Legion and Deuce. Based on these launches we expect our revenue growth to continue to exceed market growth in 2007 and beyond.

Within Clinical Therapies, which accounts for about one third of sales within the Trauma and Clinical Therapies business, we see further good growth but not at the underlying rate achieved in the last two quarters. In Fixation we see current global market growth of about 11%. We expect to remain close to market growth for 2007 as a whole.

In the Endoscopy, the arthroscopy business accounts for about 80% of revenue and a large proportion of profit. Arthroscopy revenue was 11% in quarter one. We believe that this broadly paced market growth and expect to continue to do so through 2007. The Visualization and DOR business within Endoscopy is much more lumpy. As already mentioned we saw strong sales growth in quarter one but expect growth rates to be volatile quarter by quarter.

In the Wound area, we continue to see a current growth rate for our served market excluding the negative pressure market of about 5%. This compares (technical difficulty) quarter one, also we believe about 5%. There will be no material year-on-year impact from the DERMAGRAFT disposal after quarter one, and we continue to expect to grow broadly in line with our served markets for the full year.

With regard to margins, as you will see in more detail in a moment, we continue to expect that the benefits of our Earnings Improvement Program will be evident during 2007, but with an orientation towards the end of the year. We also expect to see some further exceptional restructuring costs in 2007 as this program is implemented.

As you know, we also expect the reported EPSA growth rate in 2007 for the full year will be reduced by the comparison for the lower tax charge in 2006. There was no impact in quarter one, as we reported the same tax charge in quarter one last year, this year. But with a full year tax charge of 31%, the 340 basis points increase from 27.6% tax rate last year, would reduce reported EPSA growth by about 5 percentage points in the full year. We continue to expect (technical difficulty) to be broadly neutral on EPSA in 2007.

And with that I'll hand over to Dave to talk about the business behind the numbers.

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**David Illingworth** - *Smith & Nephew - COO*

Thank you, Adrian and Chris. And to all of you sitting here, good morning or excuse me, good afternoon.

(Technical difficulty) take a look at our global market position and our business areas. In Reconstruction we are currently number (technical difficulty). We will move up to number [12] with a 20% share (technical difficulty) on completion of our acquisition of Plus Orthopedics. We hold number three in the Trauma Fixation market with a 11% share. And we are growing slightly ahead of the market rate. Clinical Therapies is growing ahead of the market and taking significant share.

Smith & Nephew are clear world leaders in our Arthroscopy market and we intend to maintain this position. In Advanced Wound Management, we are the global number two behind KCI but we are the clear world leader in terms of numbers of wounds treated. Overall, a strong market (technical difficulty) positions and we are going to build on them.

Moving on to review the (technical difficulty) business by business, if I turn to Reconstruction first.

In Reconstruction, we had another strong quarter of growth. I draw your attention to the chart on the right-hand side of the slide which shows that after a difficult start in the last year, we quickly returned to double-digit growth and that we continued

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to outpace the market. The market has continued its recovery in the US and in some European markets as well. The overwhelming story this quarter has been the success of BHR, which has exceeded our expectations resulting in 40% growth in hip revenues in the US this quarter.

And really just to digress for a minute, a hearty congratulation needs to go out to the team of people who have been working so hard to penetrate this market in the US, get it positioned properly. We are ahead of schedule on training physicians and surgeons to use the product. We're clearly ahead of our expectations in the budget that we have for this product. And we think we're positioned extremely well, and very hearty congratulations to the team, because they've been working very, very hard.

We're likely to have a competitor in this marketplace later this year, but we are understandably proud of this quarter's performance with BHR. As we said last (technical difficulty) benefits of our (technical difficulty) 2006 new product launches would be a strong driver in 2007, and this is proving to be the case, both in hips and in knees, with the latter maintaining a consistent 12% growth. The performance (technical difficulty) of new products for the (technical difficulty) 21%, a clear indication of the health of this business.

I would just like to (technical difficulty) bring you up-to-date on the Plus acquisition before I move on. Just to remind you of the (technical difficulty) from Plus, it takes us to the number four global position and doubles our European business. The complementary nature of the product range is excellent, and should give us the strongest hip line-up in the industry. We are paying just under \$900 million for this business, which has \$300 million in revenue in 2006. It has just rolled up its Q1 numbers, and is performing well and as expected. Integration can be a very difficult thing to get right, so we are putting a lot of effort into planning it, and we're planning it with the Plus management team, and it's going very well. The synergy targets are confirmed, and we have assigned these targets to work streams for implementation and execution. We expect to complete the acquisition in the summer.

The (technical difficulty) continues with Trauma and Clinical Therapies, with 19% revenue growth in the quarter. We now have five consecutive quarters of improved revenue growth. (Technical difficulty) that we've done around sales force deployment and then sales force management is now paying off. As I said earlier, our Trauma business is growing revenues slightly ahead of the market rate, and Clinical Therapies is growing well ahead of it. Our new internal Fixation products, TriGen, INTERTAN and Meta Nails, together with the full range of PERI-LOC since (technical difficulty) the upper extremity range last year, have all contributed to this performance.

In addition, an improved quarter for Fixation products and accelerated growth for Clinical Therapies, helped by the EXOGEN 4000+ revenues, has contributed to this strong performance.

So, let me move on to Endoscopy. Our Endoscopy business returned a double-digit growth this quarter at 12%, benefiting from strong growth outside the US, particularly from the UK, Japan, and Australia. Repair has (technical difficulty) consistent growth rates of over 20%, and for the first time this quarter equaled the revenues of Resection. We (technical difficulty) growing at around 4%, with revenues particularly strong outside the US. These performances (technical difficulty) were combined (technical difficulty) good quarter for Visualization and Digital Operating Room, where we had a strong top-line growth ahead of a new camera launch. The lumpiness of this part of the business is well illustrated by the graph on the right. We have a new management team at Endoscopy, and (technical difficulty) teams in turn know the challenges, and are rising to them. The proportion of revenue from new products is 27%, and a very healthy indicator for the future.

Before I talk about Advanced Wound Management's performance for the quarter, I'd like to spend a few minutes talking about (technical difficulty) strategy for their business. As I've said before, this business has excellent growth prospects, and excellent potential. (Technical difficulty) strategy is clear. We are reworking the portfolio, we're taking a serious look at acquisition opportunities, and we are reviewing our products and product ranges. We are also focusing hard on costs, and as a market leader, we must get better scale leverage within this business. Thirdly, we have now achieved a turnaround in our US business. We (technical difficulty) people, we have shifted priorities, and we have shifted resources, and it's paying off. We still have [a lot] to do, but we are making very good progress.

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Our Advanced Wound Management business in the US grew at 22% this quarter, but outside the US we are being adversely affected by continuing healthcare spending constraints, so overall revenue increased at 4%, if you exclude the effects of the discontinued tissue engineering business, 2% if you don't.

ALLEVYN foam dressings, one of the Group's largest brands, is maintaining a consistent growth rate of around 10%, and VERSAJET hydrosurgical wound debrider has had another good quarter with particularly strong growth in the US. Infection management remains a difficult area for us, with ACTICOAT. The (technical difficulty) affected by low-cost alternatives, and we are looking for solutions to that. The proportion of revenue (technical difficulty) new products is 12%.

So, that gives a quick review of our four businesses in the quarter, and now, Adrian, I'm going to split it up with Adrian, and we would (technical difficulty), excuse me, on the Earnings Improvement Program.

Well, first of all, we have very clear objectives for the Earnings Improvement Program. These are not just cost-cutting, but it's a balance between outperformance on the revenue line and leveraging our (technical difficulty) to significantly enhance our earnings. We intend to enhance the short and medium-term performance of the company, liberate resources for reinvestment, and establish a long-term culture of continuous improvement. This policy has come off the back of a company-wide in-depth review, and we have worked very hard to build successful game plans, and to get realistic goals and time commitments. We have prioritized the available opportunities. We have established well-thought-out work streams. And we're moving forward aggressively but realistically. The four global business units, by the way, have taken full ownership of these initiatives.

So, (technical difficulty)? We have a total of 19 work streams, and 12 of these are active and being worked. Another 7 (technical difficulty) starting to come on-line, and in the advanced planning stages. We have aggressively pursued several of these initiatives for some time now, and we have seen some benefits come through already, for example, in the Advanced Wound Management margins this quarter. It is not (technical difficulty) about operational efficiency. We are concerned with operational effectiveness as well. For instance, we are (technical difficulty) at some support functions across the business, by centralizing them, which (technical difficulty) gives us some economic leverage. But we additionally have an opportunity to deliver a better quality of service as well, if we approach the opportunity with an eye towards efficiency and an eye towards effectiveness.

As we move through this program, we will be utilizing proven change management techniques to establish a profitable growth culture going forward.

We do (technical difficulty) program which impacts all of our businesses, and it impacts all of our geographies as well, and as noted, is currently encompassed in 19 initiatives. This (technical difficulty) activity in manufacturing (technical difficulty) of our product portfolio, clearly SG&A, including how we leverage our structure, how we deploy and manage our growing sales channels, and a continuous drive to operating performance and improvement of that operating performance.

We are going to take a harder look, if I start with the manufacturing and cost of goods, we're going to take a much harder look at how our (technical difficulty) divisions are made, and how our manufacturing footprint is deployed with an eye for the future. By most measures, COGS is neither a distinct advantage nor disadvantage to us on a broad basis, as we benchmark.

However, at the same time, we see clear opportunities to improve. We are in very robust markets, and we intend to perform strongly within these spaces. This means we must be able to not only support this growth through supply, but we must be able to do so efficiently and effectively, and in a cost-effective manner. Our initiatives here center, but are not limited to, Asia, expanding our supplier base, as well as our own investments in this area, including the leverage of our Plus acquisition, and their presence in mainland China.

(Technical difficulty) is clearly an area of opportunity for Smith & Nephew, and there are many pockets of opportunity throughout the Group. This (technical difficulty) only a few areas, including the very real opportunity for us to leverage the whole of our company, as we look at how we manage information technology, how we employ procurement best practices, and several other areas, including leveraging our HR best practices across the entire Group.

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I also mentioned sales deployment which is a broad term but very real as all of you know we have invested quite heavily over the past few years in creating our specialized sales networks. We will continue to invest in growing our channels but I think you will find that the investment will be at a slower pace than in the past few years.

We have established a critical mass, particularly in the US from which we can grow but right now we are focused on optimally deploying these resources in the right accounts, in the right territories to give our customers the best service and also allowing our sales teams to have the greatest chance for success.

These activities are matched with creating the right administrative support structure that provides optimal effectiveness for supporting our sales teams and customers (technical difficulty) provide an increased leverage at that structure.

I trust that this gives you some sense for where our focus has and will be and the kind of results that we can deliver. For obvious reasons we are not going to play out each initiative in the public domain as that would provide just too much information for our competitors and potentially create an environment that is not conducive to proper planning and execution within the business.

We are in an enviable position right now; we have good markets, we have good performance, we have a good outlook and we have a great team of employees delivering on these results. We collectively believe that we can do better and our employees see this program as not only a way to improve our results but also a way to free up resources for further reinvestment in a great company. And that in the end is the real prize.

I'd like to turn it over to Adrian and he's going to explain the financial impact of the program.

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**Adrian Hennah** - *Smith & Nephew - CFO*

Thanks Dave and so we're on slide 31 now for those of you listening in at a distance -- and the slide 31 and the financials we expect from the earnings improvement program. We expect to be able, including the benefits of this program, to increase our trading profit margin by an average of at least 1% per annum each year until at least the end of 2010.

This target is net of the planned increase in R&D spend to which Chris has referred. This target does include margin gains from all other sources except Plus to which I'll refer in a minute. We do not expect gains from organic growth or any other source on top of these targets.

We are assuming in these targets a pricing environment which does not change significantly from the current position. Specifically we are assuming, looking across all our markets, no significant net increase or decrease in like-for-like pricing but continued scope for mix improvements. We do include the current year, 2007, in the period over which we expect an average of at least 100 basis points per annum margin improvement.

You'll see from these margin targets and your own forecast of our revenue, that we therefore expect trading profits to be increased by at least \$100 million per annum in 2009 as a result of margin improvements and by at least \$150 million in 2010. We expect to incur cash restructuring costs of about \$125 million in order to deliver on these efficiency improvements. In addition to these costs, the program will also require some incremental CapEx which will increase our CapEx run rate slightly above the normal 8% of sales.

There will also be a number of non-cash write-offs principally at Plant and Equipment, which we will also identify separately. We expect these to be about \$75 million over the program.

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The target does not include the benefits of integrating the Plus acquisition; these will be in addition. To remind you, we expect cost savings from the integration of at least \$40 million per annum by the third full year 2010. We expect in the same year additional sales of around \$45 million per annum.

Plus as you know currently has lower trading margins, about 12% in 2006. Consolidating the Plus numbers will therefore initially be margin dilutive. Together with the integration benefits, we expect the Plus acquisition to be slightly margin accretive in the third full year. Continue of course to expect the Plus acquisition to be broadly earnings neutral in 2007 and accretive in 2008 and beyond.

Turning then to the slide 32, a little further information about the program; we expect the cash costs to be incurred fairly evenly by year over the three years to end of 2009. We do however expect that the charge to the income statement in respect to these costs will be more uneven, driven by when the level of certainty for provisioning set as an accounting standard is met. The provisioning is likely to be front end loaded and quite a high proportion could be charged in the current year.

We're not giving targets for individual businesses. We do however see around one half of our total margin opportunity in the two Ortho businesses, much of the remainder in the Wound business with a smaller but still significant opportunity in the Endoscopy business.

And with that I'll hand back to Chris.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Right, thank you Adrian. What I'd like to do is summarize, make a few remarks about succession and then turn over to questions. And obviously what we're announcing here are very good first quarter results and in fact, some of them are quite extraordinarily good. I've been involved with orthopedics for a long time but I can't remember anybody ever posting a 14% growth in US hips which is what we did in the quarter and a 23% growth on a global basis.

If you look at clinical therapies, we posted a 33% gain in the quarter which again is a terrific number and we've got similar numbers; over 20% in Repair, in Endoscopy, in Digital Operating Room. I tell you what was most pleasing, US Wound was up 22%, ignoring the demographic discontinuation but we've some remarkable growth going on in the company and it's something that we're very encouraged by.

It is principally driven by new products, new products across the businesses and their impact and our estimate is this is going to roll forward for some considerable numbers of quarters and indeed years.

We've also announced today the earnings improvement program and we believe this is an ambitious but realistic program that we can deliver in the timescale we've indicated that is essentially going to -- mean a significant cultural change within Smith & Nephew. We have been driving very hard on top-line; we haven't been putting so much resource into managing margin over the last several years. And this is something that Adrian and Dave will work together on to say no we're going to do this differently.

Yes we'll continue to drive the top line, we'll continue to out perform the sectors as an aim in each of the sectors we're in but we're going to improve our margins as well at the same time. And I think the program laid out is very, very solid.

Our outlook for the year is unchanged, we have -- the terrific first quarter has given us enhanced confidence in our expectations for the year but particularly because of the likelihood we'll have a BHR competitor coming in sometime during the second half. We're saying as far as the models are concerned that it's sensible to leave the outlook unchanged.

I'd like just to say a few words on succession. This is something we take pretty seriously and we identified, around 18 months ago, that we believe we had an exceptional talent in the company in Dave Illingworth and we promoted him to Chief Operating

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Officer around 15 months ago. That was a good move for the company except it was an incredibly tough time to be promoted to Chief Operating Officer as the bottom was perceived to fall out of the orthopedic marketplace at the same time.

I think you can see from these results and indeed the things we can see going on in the business, related EIP, new product momentum etc. that Dave has done an outstanding job as Chief Operating Officer and therefore, I recommended to our Chairman, John Buchanan, and to the Board that we should step up our planned succession program and announce my retirement today and Dave's stepping up to Chief Operating Officer from the middle of the year.

The business is in very good shape, the Earnings Improvement Plan which Dave and Adrian have put together, they have the authorship and ownership rights on. Yes I looked at it and debated it with them but something that Dave and Adrian have put together that's going to give additional momentum to the company and it's right that Dave should step up to leading the total company at this time.

As far as I'm concerned, I have had a terrific time with Smith & Nephew. It's had some wonderfully good moments, listing on the New York stock exchange, seeing some significant new products brought to the market that will influence long-term markets for a long time, like Oxinium, which we still haven't got to the full potential of, and probably won't for another five years or so. Some of the real skills that we're building in biologics for the future, I think will stand the company in very, very good stead. So I think we're in extremely good shape as we go forward.

It is a genuine retirement. It's not code for I'm off to do another job. I will have some other part-time activities, but I'm not going off to something else. The time is right to hand the reins over in the way that the Board had foreseen, to Dave, at this time, and I have great pleasure in so doing.

So, with that, I'm going to turn the meeting over to questions, and we're going to take questions, are two from in the room and two from on the call, and we'll start with two from in the room. Hans here down at the front and then we'll take one from Michael. Sorry, can we bring the microphone down here please?

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## QUESTIONS AND ANSWERS

**Hans Bostrom** - *Goldman Sachs - Analyst*

Hans Bostrom from Goldman Sachs. First of all, in order to establish the basis of the Earnings Improvement Program of about, oh just over 100 basis points per year, could you give us a sense of what improvements we should expect from this program in the course of 2007?

And if I may ask a second question, then it would be, you have had a very strong growth in your sales force and you point out the sales force deployment as I understand it, slowing somewhat in terms of the growth rate at least, in future years. What are the, shall we say, productivity enhancing measures you are expecting to implement in order to achieve above average growth rate in the businesses you operate, while still slowing the growth rate in your sales force deployment?

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**David Illingworth** - *Smith & Nephew - COO*

Yes, I'll take a shot at it. You know, you want to go first?

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**Adrian Hennah** - *Smith & Nephew - CFO*

I'll do the first one. The -- in terms of the base year, what we're saying was very clear, average of one percentage point per annum over four years. The average is deliberately there to give us a little bit of wiggle room, mainly -- but essentially we think it's fairly

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evenly spread. We don't think this is the back end of the fourth year, or anything like that. We essentially think it's fairly evenly spread. But clearly as we're starting part of the way through the first year, we don't want to be too specific around the first year. So we're just giving ourselves a little bit of wiggle room, but essentially you should see that four percentage points fairly evenly over the four years, including the first one.

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**Hans Bostrom** - *Goldman Sachs - Analyst*

(Inaudible question - microphone inaccessible).

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**Adrian Hennah** - *Smith & Nephew - CFO*

No, the base is 2006.

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**David Illingworth** - *Smith & Nephew - COO*

Now, let me try the second one, because I -- it's a great question Hans. The fact of the matter is that we have productivity gains waiting for us in our sales channels right now. We have, in order to divisionalize and get sales channel-specific sales forces, we have deployed very aggressively. So my feeling is, in the short term anyway, we can take a more measured approach, do a better job of balancing the territories, do a better job of working more effectively across those channels.

For instance, just because we have a dedicated Trauma sales force doesn't mean that we, all of a sudden, stop working with our Reconstructive sales channel, or that we don't cooperate and work with our Clinical Therapies channel. There are productivity opportunities in working together and across those channels. We've worked very aggressively over the last couple of years, to get these channels established, and I think we've over-shot it in some cases quite frankly. And I think we've take -- I think we have sat there and done some analysis and understood how we could more aggressively manage the productivity of these sales channels and these territories and we're in the process of doing that. And I think you'll see -- you'll see that sort of equilibrate over time and there may be a time in the future where we may have to ramp up the sales -- you know, acquiring new sales territories again in the future.

There has always been in my vision, for these sales channels to be cross-selling. There is no reason why we can't leverage the fact that we have four very strong sales channels in a marketplace and sometimes only one customer. There's no reason at all. The only reason is our own bureaucratic inabilities to get across those [silos], so we -- I've always had that vision, that we want to leverage it to the extent that we can possibly leverage it. But that doesn't mean taking away the independence of those sales channels. We put those sales channels in place for a reason, because we have different types of customers.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

I'll take a question from here please.

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**Michael Jungling** - *Merrill Lynch - Analyst*

Hi, it's Michael Jungling from Merrill Lynch. I have two questions. Firstly, after you've done your (inaudible) of the various divisions, I'm just curious, what do you think the underlying margin difference is of your divisions, compared to best practice?

And secondly, if I look at your margin enhancement program of at least one percentage point, that to me is not much difference to what I would expect naturally in terms of operating leverage from a well run company. So is your margin enhancement program actually a margin enhancement program or is it more a little bit more operating leverage that you've done in the past?

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**David Illingworth** - *Smith & Nephew - COO*

Good question.

**Adrian Hennah** - *Smith & Nephew - CFO*

Yes. We have benchmarked a lot as you can imagine. To answer your first about, what do you think the underlying differences are? We've done a lot of benchmarking, and used that benchmarking to help focus initiatives. What we've also learned though, is it can be jolly misleading to hang on one benchmark because we find all sorts of structural differences and all sorts of geographical differences, so we are reluctant to put down a specific number, because we feel it can be as misleading as it can be enlightening. But it's significant, so we've used those differences to help inform where to look for programs. So -- and that's how we've ended up with the 1 percentage point per annum and where it's allocated, so we do see differences, gaps in all our businesses and this is going to close significant part of it. Exactly how much you can debate till the cows come home frankly.

As regards the -- is the 1% ambitious enough, which I think is another way of putting your second question. Yes, we think so, and I think the words ambitious and realistic are very much in here. I mean it would have been easy to come up with some ridiculously high number and not have had a way of getting to it. That's not our approach at all. We are being very disciplined in making sure we have got programs in place, we can see where the numbers are going to come from and you know, we give ourselves -- you know, a realistic shot of getting at it. So that's what we've done, and we believe we've come up with a balanced number and the right number to shoot for.

**Michael Jungling** - *Merrill Lynch - Analyst*

This program will close the margin gap but if you look intensive numbers for some of your competitors that we also expect the margin to go up, so in four or five years time, the underlying margin gap that exists today will be exactly the same in four or five years time. So I can't really understand what the margin improvement program is.

**Adrian Hennah** - *Smith & Nephew - CFO*

Well possibly. We'll have to just wait and see what happens with other people's margins frankly at the time. And if it does that will help us more with benchmarking so that's more opportunity, but it's hard enough to shoot against the static target, let alone you know, potentially a moving one.

**David Illingworth** - *Smith & Nephew - COO*

Just to -- I think Adrian's points are right on, but we have to make this real and believable for the people in the organization. They have to own it. They have to have a commitment to continuous improvement, to looking for earnings improvement opportunities. And if the market and our competitors substantially change over the next couple of years then we're going to have to take a fresh look at this. This is not a static program, this is a program that we believe will be steeped in market realities. We believe it's a real ambitious and realistic set of targets to go after at this point in time.

**Christopher O'Donnell** - *Smith & Nephew - CEO*

I would like to add something on this one. I mean, the issue is, what is the investment proposition that Smith & Nephew represents? But we're saying two things here which are connected. We are calling this an earnings improvement program. We are not calling it margin improvement program. Now, we're going to measure it in terms of margins, but it's a combination of hitting our aims of driving above market growth for each segment, and improving our margins by this amount. In order to do

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that we will be investing more than most of our competitors, and we are delivering on that. We're growing at 15% in Recon. The other guys, some of them have better margins and some of them don't, aren't growing at anything like that rate. We see that sort of double-digit rate at Smith & Nephew rolling forward for a considerable amount of time. Similarly in the Trauma sector, which is a faster growing sector, we're driving the growth in that sector. We're investing in physical therapies, a unique formula. We're getting great results. So it's the combination and the investment thesis we're going to grow faster than these other guys and deliver margin leverage, which is an earnings improvement program.

If we wanted to, could we improve the margins more? Sure, but we would be compromising some of the growth, and as Adrian said, as part of this we're actually going to step up our percentage investment in R&D, and particularly we have the likely step-up over the balance of the decade in the need to invest in more sophisticated biologic-based products which were going to come for sale in the next decade.

But this is a very balanced approach. It's not entirely focused on margin. It's focused on earnings growth. So that's why we believe this is a very strong investment thesis and one which is distinctive (inaudible).

Okay. I will take a call from the air waves if we can please.

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**Operator**

We have our first question from Milton Hsu from Bear Stearns. Please go ahead.

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**Milton Hsu - Bear Stearns - Analyst**

Hi, thanks for taking the call. First of all congratulations to Dave, and to Chris best wishes in your retirement. Two questions here. Just first with the Earnings Improvement Program in place and the Plus integration underway. Does this necessarily mean that the size of the acquisition Smith & Nephew's going to be looking at will be smaller?

And specifically that, can you just give us a sense of any interest in the negative pressure market?

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**David Illingworth - Smith & Nephew - COO**

I'd be glad to. We are going to continue on with our current strategy in terms of acquisitions. I think we have -- Milton, we have demonstrated in the past that we have a wide range of appetites in either trying to bolt on companies or gobble up companies. And I don't see that changing. I think it will depend on what's available, whether it makes good sense for us in terms of our strategy, whether it makes good sense for us in terms of building shareholder value in the long term in this company. So I see our acquisition strategies remain the same. We're going to be aggressive. We're going to be looking to do the right thing and make good acquisitions that our shareholders are going to approve of. So, I don't see the Plus and the Earnings Improvement Program really impacting all that much.

The other question was, oh in T&P. Look I think T&P is a market that we should be in. It would have been nice to be in that market. KCI has built a strong market in the United States and we have been looking at that market through internal development I know. And when it makes sense and it's possible for us to make the right type of entry we may give it serious consideration. But that's really all I would want to say about it at this point in time.

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**Milton Hsu** - *Bear Stearns - Analyst*

Okay, thanks. And then just a second question. I know your revenue mix is a bit different than the pure Ortho comps here, but when you look across the board and you look at SG&A as a percentage of sales at about 38%, over a longer term is that a bogey or a target that you think you could get to with your structure where it's going? Thank you.

**David Illingworth** - *Smith & Nephew - COO*

Well I think we can impact SG&A, maybe not the -- exactly the question you asked or the answer you want. But I think we can definitely impact SG&A. And we have programs in place to actually make an impact in that area.

As far as what bogey we ultimately are going to go after in that area, a lot of it depends on the level of investment that we want to make and how important is it for us to outperform our competitors relative to the market.

Right now we have put a strong premium on outperforming our competitors on the top-line revenue line, that cost more in sales deployment in order to achieve that, and so it's a trade off. And but we will have our eyes very focused on SG&A? Absolutely. And are there opportunities across the entire company to impact SG&A? Absolutely. Will you see results and will we report on them over the next three or four years as we make progress? Absolutely. And I would imagine you'll hold us accountable to that.

**Christopher O'Donnell** - *Smith & Nephew - CEO*

Thank you, Milton. Can we have another question please?

**Operator**

Yes, our next question is from Michael Matson from Wachovia. Please go ahead.

**Michael Matson** - *Wachovia - Analyst*

Hi thanks for taking my question. I was wondering if you could give us a dollar sales amount for the BHR, forgive me if you've already said that, but I might have missed it.

**Christopher O'Donnell** - *Smith & Nephew - CEO*

No. The answer is you didn't miss it, we didn't give it. And I think we don't tend to give individual product sales numbers and so we're not going to do it on this occasion. It is the product.

**David Illingworth** - *Smith & Nephew - COO*

(Inaudible) we would love to (inaudible).

**Christopher O'Donnell** - *Smith & Nephew - CEO*

But if you took it that it represents the majority of our US, not surprisingly US sales growth, then you'd be making the right assumption.

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**Michael Matson** - *Wachovia - Analyst*

So in other words the underlying growth there without the [conserved plus] would be in line with the market, that would be a reasonable assumption to make?

**Christopher O'Donnell** - *Smith & Nephew - CEO*

You just mentioned a competitive product which I absolutely don't recognize. But if you were talking about BHR then your assumption is right.

**Michael Matson** - *Wachovia - Analyst*

Okay, sorry about that. Freudian slip there. So let's see, in terms of your acquisition strategy, is the Spine area something that you might look at?

**David Illingworth** - *Smith & Nephew - COO*

Well I think Spine is in the same category as the comments I made earlier on topical negative pressure. I mean it's an exciting segment to be in, has good growth prospects and this question has actually been asked several times in the past to me at meetings like this and the answer is always the same. I would like to be in that segment. I think we would like to be in that segment. And it's a matter of is there the right entree into that segment. Is there something that makes sense for us to get some critical mass and participate? We don't want to get in there and not win. As you can see from our results and our strategies, our strategies are to win in the segments that we participate in.

So we continue to look. We think that our focus on biologics in the future will give us a broader and clearer view for Spine opportunities in the future and we're continuing to look at that.

**Christopher O'Donnell** - *Smith & Nephew - CEO*

Thank you. We'll take some questions from here (inaudible).

**Unidentified Audience Member**

A question on BHR. Are you able to say the number of surgeons you've changed as at the end of Q1? And whether you're 500 target for the full year will change? And also, can you say what the underlying hip growth is without BHR?

And then the second question is for the EIP program. Are you able to give us any ideas as to how that margin enhancement would split by function? So how much of that would come from manufacturing versus SG&A? And, thank you.

**David Illingworth** - *Smith & Nephew - COO*

We really don't want to answer the question on the numbers trained but I think it's important for you to know that we will have no issue at all hitting our targets for training surgeons. And we are well ahead of the pace and we will not be lowering our targets for trained surgeons at all. So that's what I can tell you.

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We really don't want to give a lot of granularity on this issue because we will have a competitor coming in the marketplace and we really don't want to give them any help whatsoever, because we've put a lot of effort into developing this market and training these folks in a very professional way. And we want to make it really hard for them to find them.

So that's where we are on it. But we will not be lowering our targets for that at all. And the underlying, I think Chris' pointer earlier is that if you roughly take out the --

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

The majority of the growth in the US is BHR.

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**Unidentified Audience Member**

Your underlying hip business growing in line with the hip market or faster than that? I mean are you getting any benefits from selling BHR on your existing business?

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**David Illingworth** - *Smith & Nephew - COO*

Well we have 40% growth.

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**Unidentified Audience Member**

Now that's fantastic, fantastic. But for the underlying hip business are you growing faster or in line with market?

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**David Illingworth** - *Smith & Nephew - COO*

Well I think it's very difficult to say. I'm not trying to avoid the question although it may seem like I am, because there are substitutions, there is expansion of the market, there's a lot of factors with BHR that makes it very difficult to try to understand what's happening in your -- what you would call, quote unquote, underlying business. I think we're roughly in that area.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

I think perhaps it might just be useful just to say here that's what's happening is, we have a clear window with BHR. We think that the window where we we're the sole player is going to change into a two player game. And in the short to medium term we don't think that's a big deal because we actually think that's likely to expand the market further. But what we've decided to do is to put a massive amount of effort behind BHR in particularly the US sector. Which means actually we are to some extent short-changing this huge potential of JOURNEY and of LEGION and our other products. We're saying guys go get this segment and build this as fast as possible.

So that's one of the reasons why we're kind of reluctant to say that look well this number or that number because actually we're targeting that as a growth segment. And we're not spending time on the other products. So actually, if we didn't have BHR, you would see better growth in other hits, you would certainly see better growth in these. Because we're just not spending the time on it.

Now we've got to balance that going forward. And, but this is a window and we're really capitalizing on this. Very focused. Dave and his team are really punching this home as you can see. So we're driving this very, very fast. We're getting excellent response

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at every level, surgeons, patients, PR, publications, magazines etc. And we're going to really capitalize on it. So I think that's the best way of thinking about it. But it's kind of -- it doesn't match up to sort of arithmetical pocket. So hopefully that's helpful.

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**Unidentified Speaker**

[Inaudible].

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**Adrian Hennah** - *Smith & Nephew - CFO*

Over the life of the program as a whole we see a broadly even split between cost of sales and non cost of sales. But that doesn't mean every year it's going to be split. Because although we've got an early increase in wind in cost of sales, much of the cost of sales is going to take a bit longer because that's the sort of lead times that are involved in dealing with big cost of sales improvement.

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**Charles Weston** - *Nomura Code Securities - Analyst*

Charles Weston from Nomura Code. I just wanted to clarify my understanding of the \$150 million that you mentioned for 2010 cost savings. If I forecast out the revenue growth for the four divisions until 2010 and apply 2006 margins evenly up to that point, can I then take another \$150 million off the cost from the already improved margin just through the changing business mix? Or does the improved margin, is that part of the \$150 million?

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**Adrian Hennah** - *Smith & Nephew - CFO*

I'm not sure that I follow the math in your question precisely, but let me just say [that -- what we have we got to] the calculations. And that was simply to take 4% times what you guys broadly in aggregate are forecasting for the revenue in the fourth year and multiply that by 4%. And that comes out to something over \$150 million. So we said at least \$150 million. That's how we got the number.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Now we'll take another question from the conference call.

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**Operator**

We now have Ed Ridley-Day from Lehman Brothers. Please go ahead.

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**Ed Ridley-Day** - *Lehman Brothers - Analyst*

Thank you. Good afternoon. Firstly on the EIP. I'm interested obviously with the Plus acquisition and the opportunity it gives you in China. And I was wondering if you could give a little bit more detail about what percentage potentially of manufacturing you think you might be able to switch over to China.

And switching to the Wound business, Dave, you mentioned on ACTICOAT some solutions you were looking at. Could you give a little bit more detail on that. And also on how you might rework the Wound portfolio.

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**David Illingworth** - *Smith & Nephew - COO*

Well in terms of the Plus presence in mainland China, they do have a factory. They do have an expatriate staff along with a mainland Chinese staff. The exact number of employees I don't recall, but it's not huge. It's in the 50, 60 range I think. Probably not that important at this point.

We see the presence of Plus in China as an important springboard for us. We have been looking at developing our procurement and our sourcing from the Far East. We in fact have already established a procurement office in Shanghai, and we have already staffed it with folks who are looking at how we can reduce our supply cost. And we see that the Plus acquisition actually gives us a great springboard. It gives us the ability to I think, take about 18 months to 24 months off our planning in actually moving into manufacturing in mainland China. And we think we can significantly reduce the costs.

As far as what percentage will be in the Far East at any point in time, I don't think we have those numbers firmed up as of yet. We also have a relationship in Malaysia for instance. So we have been working on this for some time, the Malaysian operation. And currently we source products from that operation for our Trauma business. And it's been a great relationship for us and it's helped us move that agenda forward. So that's a little bit of color around the Plus and the Chinese presence there.

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**Ed Ridley-Day** - *Lehman Brothers - Analyst*

Thank you. And --

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**David Illingworth** - *Smith & Nephew - COO*

As far as ACTICOAT goes, we have competitors in the marketplace who have convinced some customers, because of the cost pressures, that cost is more important than the efficacy of the product. I think we need to do a better job in the marketplace in explaining the differences between our product, which we believe is a very efficacious product, clinically efficacious.

Additionally, we also are looking for ways to reduce the cost of that product. We're looking at alternative design, we're looking at alternative suppliers, we're looking at alternative technologies. It's not anything that we would be comfortable in giving great detail around. So it is a high priority program within that business.

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**Ed Ridley-Day** - *Lehman Brothers - Analyst*

Okay.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

A question from the conference. Do we have another question?

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**Operator**

Yes. Our next question comes from Ilan Chaitowitz from Redburn Equity Research. Please go ahead.

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**Ilan Chaitowitz** - *Redburn Partners LLP - Analyst*

Good afternoon. This is Ilan Chaitowitz from Redburn Partners in London. Hi. I've got three questions. Firstly, I was wondering if you could confirm or otherwise a commentary from one of your competitors that there's been renewed vigor in both the German and the UK Recon markets?

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Secondly, at the Q1 statement you guided that growth in the first quarter would be lower than in Q4 but was expected to strengthen thereafter. I was just wondering if you were stepping back from that guidance or whether we should still expect to see accelerated growth over the course of 2007 from the first quarter?

And the final question pertains to two other questions that have been worded differently but basically get to the same thing, which I don't believe you've really quite answered yet, which relates to the difference between the inherent operational gearing in your business, whether it's from better sales and better mix, versus the impact of your restructuring program. And what I'm trying to get a feel for, which hasn't been possible even with the questions so far, is how much of the costs and the earnings improvements program is incremental to the structural improvements in your business and how much of it is a substitute for that.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

You want to deal with Germany Recon and --

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**David Illingworth** - *Smith & Nephew - COO*

I'll just quickly comment on your question about validating some comments from some of our competitors about renewed vigor in the UK and Germany. I think we're cautiously optimistic about those markets. We're seeing a -- I think what would be termed a cautiously slight uptick in the UK and Germany. And we're optimistic that there is some pent-up demand, especially in the German market. So I would say that that's probably a pretty good comment.

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**Adrian Hennah** - *Smith & Nephew - CFO*

And with respect to your second or third question, yes you're absolutely right. Quarter one growth of revenue did exceed the expectations we had when we put out our full year numbers slightly, as we've said. We've also said we're maintaining our view of the full year, which by implication means we're no longer seeing the acceleration which we did when we saw a lower quarter one. I think that follows fairly directly.

In terms of your pushing again at the question of the difference between improvements from -- structural improvements from cost removal as against improvements from mixes in the portfolio or other things, mechanically the guidance we've given relates to all margin improvements except Plus. So the mechanical guidance clearly includes everything.

In terms of how we've actually got to it, we, as I think Dave and Chris have made clear, we have a set of programs, 19 of them, which we have been working the cost benefits out of, the cost of achieving and the cost benefits out of, they are the principal drivers of the numbers we're giving you. So we are giving you total guidance [for all sorts of] margin improvement, but the principal drivers of those numbers are the cost improvements we see coming out of those 19 programs.

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**Ilan Chaitowitz** - *Redburn Partners LLP - Analyst*

Thank you very much.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Right I think we'll come back to the floor here. Peter.

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**Unidentified Audience Member**

[Inaudible] Securities. Given your comments on BHR in the US, do you have any sense that what you thought might be that the market share that this sort of product can take is going up, or are you content with 10% to 15%?

**David Illingworth - Smith & Nephew - COO**

I don't think we ever said 10% to 15% market share would be acceptable to us.

**Unidentified Audience Member**

[inaudible]

**David Illingworth - Smith & Nephew - COO**

Oh you mean as far the penetration of BHR in the market in general? Well it's hard to tell, Peter, because this is a brand new technology for the US market. So I'm not sure we totally understand the forces and the dynamics that are going on here.

We do know that there's a pent-up demand, that people want it, it's expanding the market in our opinion and I don't really see any reason why we should change our thinking around what it potentially could be because we have some historical markets. We have some markets that historically we can look back and say it's about 10% to 15%. And I think that's as good as an indicator as anything at this point.

**Christopher O'Donnell - Smith & Nephew - CEO**

Another question here? Michael?

**Michael Jungling - Merrill Lynch - Analyst**

Yes, it's Mike Jungling again, two further questions. If I look at your reconstructive margin in this quarter compared to last year at 5.2% despite a very positive product mix and also a better geographic mix from the United States which typically is a better margin market, can you explain why Orthopedics margins haven't improved in the first quarter of this year to last year?

And then secondly, what is the revenue growth in constant currency for Plus Orthopedics in the first quarter of 2007?

**Adrian Hennah - Smith & Nephew - CFO**

Yes Michael sure, you're right. It's essentially flat, the Recon margin in quarter one '07 compared to quarter one '06 and there are, as inevitably, a number of factors playing in that.

The biggest factors playing negatively on the margin were we did some investment in direct consumer in the US which was a sort of quasi experiment we're doing just to see the results. And that was a non-trivial cost. We're not disclosing the exact amount of it because obviously we're working on it. And secondly Japan. You're well aware from all our competitors that there's been significant price cuts brought forward by [three months] in Japan. They've impacted us as everyone else, Japan's a non-trivial market for us so that's impacted.

Those were the two main negative drivers. Yes and training costs on VHR. I mean VHR is obviously something we're pushing very hard as Dave and Chris has mentioned.

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In terms of the revenue growth of Plus we're not going to give you an exact number. We haven't closed this deal yet. However what we can say is that they have rolled out their quarter one numbers although as a private company they do it a little slower than public companies. But they have rolled out their quarter one numbers and we are very pleased with them. We're fine with them, they're on track.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Right, we'll go to another question from the conference.

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**Operator**

Yes, our next question comes from Mr. Max Herrmann from ING. Please go ahead.

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**Max Herrmann** - *ING Barings - Analyst*

Thanks for taking my call and Chris, obviously congratulations on having led the company to such a strong position as it is today. I just have two questions if I may.

Firstly, just on the share buy-back program just to understand a little bit about the phasing of it. It's slightly perhaps less in the quarter than I'd expected but do you expect to be able to be half way through the program by the end of this year?

And then, secondly. I know everybody is pushing you on cost savings and why can't you do better than 1%, but from a historical perspective you've had 1% targets before and actually have tended to deliver slightly below those targets. So I just wanted to know, you're obviously confident in that, but are there also downside risks on the cost savings programs as well?

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Okay, Adrian?

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**Adrian Hennah** - *Smith & Nephew - CFO*

Yes, in terms of the share buy-back. Yes, we started this thing in February and we have had two closed periods since then. One ahead of the Plus acquisition and one the closed period we've just been through, through neither of which were we buying. So that has somewhat restricted the number of buying days that we've had available to us. But we've been quite purposeful in those buying days and soon we'll be going at a rate that's completely consistent with \$1.5 billion over two years. And that remains absolutely our intention. To do this broadly evenly over the two years since the middle of February when we started this program. There's absolutely no change in that. That's what we're pursuing.

In terms of the cost savings, do you want to do that one Dave, or do you want me to do it?

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**David Illingworth** - *Smith & Nephew - COO*

Well I think it comes down to our focus on this area of the business. We have in the past had a stronger focus on driving the top line revenue line and I think that's what it comes down to.

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I think both Adrian and I have been associated with companies and cultures that know how to deliver on these earnings improvements. We have taken a very thorough approach to this. This is not the project of the week, or the project of the month or the project of the year.

This is a fundamental shift in how we are going to go about running our businesses. We are going to look at how do we change the culture. We are going to get people's hearts and minds involved in this. We have clear ownership of the GBU levels. And we are trying to strike a balance between continuing to outperform the markets that we compete in and also delivering on the earnings improvement.

So I think what was behind your question is will we deliver? And I personally believe that these are ambitious targets but imminently deliverable and we're making a commitment right here that we believe we can deliver on these. So that's kind of where we are and we're actually excited to get going on it. We're excited that this day is here that we can talk about it and we can actually get on with it.

And in fact, if truth be known, which it is now, looking at some of the margins, we've been working on this for the last several months. We just weren't ready to give a lot of details about it because we had to get ahead of the curve a little bit in the planning. So we feel very confident.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Okay we'll take one more question from the conference and one more from the floor then we must close this down, I think. Do we have another question from the conference?

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**Operator**

Yes. Our next question comes from Jack Scannell from Sanford Bernstein. Please go ahead.

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**Jack Scannell** - *Sanford Bernstein - Analyst*

Okay. A couple of questions. Market first and then Smith & Nephew specific.

On the market, Dave said that there's been a recovery in the US in 2006; Adrian said that you're expecting flat price in any mix. So I guess the question is what's recovered?

Secondly, if you're seeing 9-ish % market growth in Ortho Reconstruction in the US would it be right to think that's roughly 4-ish % volume and 5% mix?

And then finally, do you think there's any difference in the maturity or tenure of your sales force given your growth in the US recently? And may that be one possible cause of the margin differential?

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**Adrian Hennah** - *Smith & Nephew - CFO*

Yes. Well the first question was market recovery in the US, was there an inconsistency between what Dave said and what I said? Well certainly there isn't an inconsistency. We've certainly seen an uptick in the total market growth. You can see that as well as we can from all the reported numbers.

When I was talking about pricing and access to mix, that was spelling out to you an important assumption around margins improvement going forward, i.e. that the world of pricing isn't going to change dramatically in the course of the four years we're

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talking about margins. That's not the same thing as saying what's happened in the last year. So to be quite clear when we were talking about flat pricing and ongoing mix that was an assumption for the next four years which underpin the margin improvement. But over the last year we have seen an uptick in the market and essentially it's come from volume and mix and not pricing, that's essentially true in the US.

As regards the 9%. It's a 9% in Recon and not a 9% in Ortho that we are looking at. The market in the Trauma part of the business is growing more than that. We're seeing a market at about 9% growth in Recon. And as for the split of that, I can't speak for the industry as a whole and we're not talking specifically about our own split either. So the 9% we're seeing the market as a whole in aggregate.

As regards the maturity tenure of the sales force, I think that's one for you Dave.

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**David Illingworth** - *Smith & Nephew - COO*

I'm not sure I understood (inaudible) behind the question so --

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**Jack Scannell** - *Sanford Bernstein - Analyst*

Yes. Sales reps get more productive as they've been around for a few years and I wonder whether there's any systematic difference in the average tenure of your reps versus some of your competitors?

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**David Illingworth** - *Smith & Nephew - COO*

I would doubt it. I think that if you look at the sales forces that we have deployed recently in terms of direct sales forces in Trauma and direct sales forces in Clinical Therapy the tenure may very well be less, because we have tended to train these people on our own, put them in territories and get them up a productivity curve over a period of time. So my guess is that -- I'm just guessing I don't think we've really done this analysis, but my guess is; I think it'd be a pretty good guess, that in our Trauma sales force and our Clinical Therapy sales force they may be a little less tenured. But I think in the Recon I would see no reason why there would really be much difference between us and the competition.

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

(Inaudible) Recon and I think if anything our Endo sales force probably have a lot (inaudible) so it's a balance really.

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**Jack Scannell** - *Sanford Bernstein - Analyst*

Okay and if I may just come back to the first question. I guess is the short answer that volume picked up in 2007 versus 2006 when you say the US market improved?

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**Christopher O'Donnell** - *Smith & Nephew - CEO*

Well I don't think we can really speak for the market but my view would be 4% volume is too low because I don't think this 5% mix of the market level -- I think there's some mix but I don't think it's 5%. But that -- we can't verify that because we just don't have enough data. Okay?

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**Jack Scannell** - Sanford Bernstein - Analyst

Okay, thanks very much.

**Christopher O'Donnell** - Smith & Nephew - CEO

Well, anybody else have a question left in the room here? Okay, go ahead.

**Charles Weston** - Nomura Code Securities - Analyst

Charles Weston from Nomura Code again. I just wanted to see if you could give us an update on some investigations and law suits. The --.

**Christopher O'Donnell** - Smith & Nephew - CEO

Yes, but the (inaudible).

**Charles Weston** - Nomura Code Securities - Analyst

The answer will probably be short I know, but there's Department of Justice investigations and OIG investigations ongoing in the US, we haven't heard anything about that for a while. Are you still being requested for documents or are they in analysis mode? Any update at all you can give us there would be helpful.

And also the law suit with Synthes over the TFN was initially completed some months ago and I believe appeals are ongoing. But if you could give us an update there and any other law suits that you think may be material, such as associated with PERI-LOC or other competitors to your nailing system.

**Christopher O'Donnell** - Smith & Nephew - CEO

Okay, well there's not very -- there's nothing to say. The situation hasn't changed with regard to either DOJ investigation, either the antitrust one or the surgeons' contracts one. They're presumably doing their analysis and investigation but we don't know.

With regard to Synthes, we're having a fairly substantive dispute with them. We have got a very positive verdict including an injunction on the use of their nail (inaudible) as TFN nail and action is ongoing to make sure that is being implemented.

We've got some law suits coming back the other way related to PERI-LOC which we don't believe have particular merit but then again it's not a very big surprise and so we'll therefore also be engaged in this for some while. But in our view we have some very strong intellectual property and we intend to enforce so it may take a little while but that's what we're doing. There's nothing else of particular significance that I can really comment on.

Right, well thank you very much. Thank you all for attending. Thank you everybody on the conference call. We'll break off now and will be moving into our annual shareholder meeting. Thanks very much.

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