

# FINAL TRANSCRIPT

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## **SNN - Interim 2009 Smith & Nephew Earnings Conference Call**

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## PRESENTATION

### Operator

Ladies and gentlemen, a disclaimer will now played into the call. After that there should be some silence and background noise before the call starts.

This presentation contains certain "forward-looking statements" within the meaning of the US Private Securities Litigation Reform Act of 1995. In particular, statements regarding expected revenue growth and trading margins discussed under "Outlook" are forward looking statements as are discussions of our product pipeline. These statements, 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, claims and regulatory approvals, that could cause the actual results, performance or

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All forward-looking statements in this presentation are based on information available to Smith & Nephew as of the date hereof. All written or oral forward-looking statements attributable to Smith & Nephew or any person acting on behalf of Smith & Nephew are expressly qualified in their entirety by the foregoing.

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**David Illingworth** - *Smith & Nephew* - CEO

Well, good morning, everyone. Welcome to our 2009 second quarter results presentation, and as is the usual custom here we've set, I'll talk to you about the progress of our business and our achievements in the second quarter, and then I'll hand it over to Adrian Hennah, who will take you through the numbers.

Despite pretty challenging markets, we generated revenues of \$926m in the quarter, and a margin of 22.9%, an increase of 310 basis points in the quarter. We're very pleased with our profit performance, as you would expect, as we are seeing the positive benefits of our earnings improvement action taken over the last two years.

Our Orthopedics business had a solid quarter, although our emphasis on the younger, active patient segment means that we are experiencing a disproportionate deferral rate of procedures, in our opinion. Our Trauma business grew by 2% globally, and by 4% in the US, as our External Fixation business returned to growth, and we continued with our efforts to maintain a solid foundation of growth in this business.

In Endoscopy, our repair business achieved double digit growth as our product portfolio performed well, but as we've been saying for some time, the weaker capital markets are obviously counterbalancing this. Advanced Wound Management revenues were up by 4% as our continued investment in this business pays off, and we've had a number of significant successes with IP litigation for Negative Pressure Wound Therapy this quarter as well.

If you look at our adjusted earnings per share, they were up by 10%, and in line with our policy we increased our interim dividend by 10% to \$0.0546 per share, and \$0.0273 per ADS. All in all, we're very happy with our overall performance, and very happy with the profit and margin performance. Before we look at our businesses in detail, I'll comment -- make a couple of comments on the market conditions that we are experiencing as we see them.

Healthcare systems globally are really continuing to reflect the tougher economic conditions. That's already been seen in some other industries. It's clearly difficult for us to predict the outcome of the US healthcare reform, ultimately.

In orthopedic reconstruction, it is also hard to predict the shape of the recovery from the deferred procedures, but we are confident that the deferred procedures will come back in time as patients can only defer these procedures for so long. We're seeing some deterioration in mix benefits, but we've seen only modest pricing pressure, nothing remarkable at this point.

In the Endoscopy market, capital equipment sales continue to suffer from the economic conditions, and as we expected, there have been some deferral of elective procedures as well this quarter.



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In the Wound Care market, growth continued, although there are some more recent signs of a slowing in demand. Customers continue to demand quality products that represent clear clinical value in this segment. The negative pressure wound therapy economic arguments for healthcare providers are increasingly compelling, in our opinion, as tougher times demand strong value propositions, and this segment clearly has a strong value proposition.

Now, if we look at each of our businesses in turn, starting with Orthopedics, we estimate that the orthopedics reconstruction market grew by about 3% this quarter. Our performance was, as we expected, slightly behind the market. In the US our reconstruction business grew by that 3% number overall, impacted by lower volumes, some loss of mix from our high technology products and some modest price pressure.

We continue to gain benefit from new product introductions of late, like the R3 Acetabular cup and our VISIONAIRE, both new product introductions over the last quarter, which were very well received in the marketplace. Our data tells us that the younger, more active patient is a little slower, as this patient segment is more likely to defer procedures.

Now, we've put a lot of effort into having everyone identify us with the younger, more active patient segment, and we've put a lot of effort in defining ourselves as the company for this segment, and we have had substantial benefit from this segment in the past, and we do believe that we'll see substantial benefit in the future.

If you look at our traditional hip and knee businesses, they continue to perform well, and they have achieved market growth rates globally, and above market growth rates in the United States.

In Europe, our reconstruction business was impacted by slower markets. It was impacted by reduced mix benefits and the continued integration of our European businesses. Earlier this year we strengthened our management team in Europe. This team is making substantial progress and we expect to see benefits in the next few quarters. More specifically, Promos, our new shoulder that we received and inherited from Plus grew particularly well in Europe in the quarter for us.

We estimate that the trauma market grew by 7% (sic - see presentation) in the quarter. Several of our product ranges performed well, including our INTERTAN nail and our VLP plates, and we did see a return to growth for our external fixation products as well, which we haven't seen for a few quarters.

Orthopedics expanded its margin by 210 basis points, as the benefits of the European reorganization came together with other efficiency measures, including the reorganization of their logistics systems. We also continued our tight controls over discretionary expenses in the quarter in this business.

For the second half of the year, we see continued tough conditions ahead of us, and ahead of a return of consumer confidence of sorts, and a more favorable economic environment.

As the chart on this slide shows, it talks a little bit about our training, and we went through a pretty tough time during the DPA phase, where we had much reduced training, and this is really a key for our higher technology products, which are higher touch products, like the VHR and JOURNEY Knee, etc. We're now able to rebuild these training programs, and we're also increasing the number of instrument sets in the field as well.

In the second quarter, we opened our first training facility in China, in Shanghai, and have more planned for the future. We've started to train local surgeons in earnest, as the next step to building a substantial business in this very important country for us.

In Trauma, our continued focus is on strengthening our US sales force to fully exploit our product range, which we think is excellent. We have great products. We continue to invest in the portfolio, and we're very committed to driving this business forward.



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In Clinical Therapies, we have a sales channel that is unique in this industry. We plan to build on this sales channel success geographically, and we also plan on leveraging its ability to carry additional products to our customer base through this channel. We expect our increased momentum to come from surgeon training, additional deployment of instrument sets, our excellent product range and our commitment to customer service.

Now, if I turn to Endoscopy, we had double digit growth in our repair business, but it was overshadowed by the continued weakness of the capital equipment market, which has impacted our visualization and resection businesses. Our US revenues declined by 10% as procedural volumes continued at a lower level in the quarter, and visualization declined by nearly 40%. We continue to drive incremental improvements to our US business.

In Europe, Endoscopy grew by 4%, with double digit growth in the UK and Germany, offset by slower growth in Southern Europe. Our knee and shoulder repair products performed very well, led by the ENDOBUTTON fixation device, our FAST-FIX Meniscal Repair System in the knee, and the FOOTPRINT and BIORAPTOR suture anchors in the shoulder.

Our Hip business grew by over 50% in the quarter as procedures in this new segment are growing -- increasing very rapidly. Endoscopy grew its margins to 22.7%, benefiting from the outcome of factory reorganizations, operational effectiveness activities, and some favorable mix. Last year's comparator was impacted by some one-off costs, I will remind you.

In the second half of the year we expect a continuation of the tough market conditions seen in the first half. We are increasing our investment and refreshing the product portfolio for Endoscopy, with emphasis on our repair and resection segments. We plan to launch a new radio frequency generator and probes in the second half of this year.

We continue to reduce the cost base in this business -- excuse me, in the capital equipment side of this business, to manage the profitability of this product group and have substantially reorganized the manufacturing of these products.

New product launches continue to be critical to our success in this space that moves very quickly. We expect several new products, including BICEPTOR system, which is the first all arthroscopic procedure for biceps tendon repair, and the BIOSURE Interference Screw for ACL reconstruction among others, to drive our growth in the second half.

Now, moving on to Advanced Wound Management, revenues in this business grew 4% in the quarter, in line with the market, and reflecting also the impact of the UK distributor consolidation that we went through in the quarter. The majority of Europe delivered a good performance, and the launch of ALLEVYN AG in two formats this quarter was very well received. Our US business had flat revenues in the quarter.

In Negative Pressure Wound Therapy, although we had a strong competitor in this -- although we have a strong competitor in this segment, that continues to defend its position very vigorously, we are meeting our milestones in this business, and we're making very good progress. We've launched our RENASYS pump, our new pump, in 13 countries, including the US, and sales productivity progress continues.

We are increasingly confident about our Negative Pressure Wound Therapy business, and we continue to resource it properly, with healthy investments. We're steadily gaining ground in the marketplace, with customers who like our products, who like us, and who like our quality of service.

The margin for Advanced Wound Management grew by 500 basis points in the quarter, benefiting from the continued achievement of more effective processes. We've been talking for several quarters about the Chinese factory. Well, the Chinese factory is now officially opened, as scheduled, and making products, and we expect to be selling these products by the end of the year.

So if I may turn my attention to the second half of the year for Advanced Wound Management, in the second half we will continue our focus on increasing our US presence, and building momentum in that area. Our Negative Pressure Wound Therapy



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business has an expanding product range, and an increasingly strong intellectual property base, especially in the UK and Germany. We are in this market for the long-term. We've said it all along, and we're very pleased with the progress we're making.

As part of our EIP actions, we are going to be closing our Largo factory in the last quarter of this year, and we expect the margin benefits to flow from early in 2010. And with that, I will turn it over to Adrian.

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

Well, thank you, David, and good morning, ladies and gentlemen. If you can turn firstly to Slide 12 and the income -- Slide 14, actually, and the income statement. As David said, revenue in the quarter was \$926m. This represents unchanged, underlying revenue after adjusting for exchange rates on the comparable period last year, a reported decline of 7% given the strength of the dollar.

There was one fewer selling day in Quarter 2 2009, compared to Quarter 2 2008, 63 instead of 64. Adjusting for this, we estimate that sales grew at constant currency by about 1%. Trading profit in the quarter was \$212m, underlying growth of 17%. Trading margin was 310 basis points higher than Quarter 2 last year. Interest costs are down on last year, reflecting both lower borrowing and lower interest costs.

Moving to the next slide, Slide 15, and further down the income statement, the tax charge in Quarter 2 before exceptionals and amortization was 31.8%, the same as in Quarter 1, and the rate we expect for the full year. Adjusted attributable profit for Quarter 2 was \$136m. Adjusted earnings per share were \$0.154, which is 10% higher than Quarter 2 last year. EPSA growth is lower than the underlying 17% growth in trading profit, due to the strength of the dollar.

Turning to the next slide, Slide 16, and an analysis of revenue by business segment, you've heard from Dave on the progress of each business. On this schedule you can see the growth rates in the quarter to which Dave referred for each of our business segments. You can see that reported sales in the Wound business were particularly impacted by the strength of the dollar. Wound has a larger proportion of its sales in euro and sterling than the Group average.

Turning to the next slide, and an analysis of revenue growth segments by segment, and by geography, we have, as usual, shown in an appendix the growth rates for our main product types, and I'll refer to a couple of these numbers. At constant currency, sales in our Orthopedics business in the quarter were flat on Quarter 2 last year. Hips declined at 1%. Knees grew at 1%. Trauma fixation grew at 2% and Clinical Therapies declined 4%.

In the United States, Ortho growth was 2%. As Dave has mentioned, we, like other companies, saw somewhat softer volume demand, and this softening has had a particular impact on our higher technology products.

Growth in our US Knee business was at the market rate of 4%, despite the weakness in the higher technology products. Hip growth of 2% was also held back by a decline in BHR sales in the USA, which has been exacerbated by the macroeconomic pressures. BHR pricing in Quarter 2 did not change materially on the previous quarter. BHR accounts for about 25% of our US hip sales. Trauma fixation sales in the US were 4% higher than in Quarter 2 last year. Clinical Therapy sales in the USA fell by 3%.

In Europe, Ortho sales fell by 8%. We have seen some significant impact from softening market demand in these Europe numbers. We saw weakness across several, but not all European countries. The weakness was mainly in volume. As in the USA we have seen most softness in our higher specification products.

We have also been impacted, in line with guidance, by the tail-end of the business integration. And this has included a number of quite recent managerial changes, which inevitably take a while to bed down.



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For the rest of the world, Ortho sales grew at a solid 7%. We have seen some impact from the macroeconomic challenges in the more mature of these markets, especially in Japan and Australia, but positive underlying trends in the emerging markets continue, however, to outweigh these pressures. We've seen only modest weakening in like-for-like pricing in the Orthopedic area. We have seen a more significant weakening in mix improvements.

Endoscopy sales fell by 2%. We continue to see a significant fall in demand for capital equipment within this business. This fall is most substantial in the USA but evident in Europe and elsewhere too. Capital sales accounted last year for about 25% of total Endo sales. As with the Ortho business, we have also seen some modest further softening in procedure related demand.

Within Endo, arthroscopy sales, including both repair and resection, grew by 4%, and visualization related sales fell by 26%. Sales in the USA fell by 10%, grew in Europe at 4%, in the rest of the world at 7%.

Wound sales grew at 4% in the quarter. This included a contribution from NPWT sales for total growth of 2%. Total Wound sales were flat in the USA, grew by 3% in Europe and by 8% in the rest of the world. In the United States, NPWT sales began to benefit from the new pumps and dressings, as we signaled this will be a gradual process. Sales of other wound products in the USA were disappointing. We have lost some share over the last couple of quarters.

In Europe we saw solid progress. I signaled that there was some impact on sales from changes to our wholesalers in the UK on June 1, impacting the whole Wound division growth by a couple of percentage points. This was partially offset by an increase in wholesale inventory in Germany, an increase we will see reversing in Quarter 3.

NPWT sales in Europe progressed well in the quarter. We did also see a slight weakening in market demand in some parts of Europe. In Quarter 1 this was confined to Eastern Europe. We now see some softness in some other markets.

Turning to the next slide, Slide 19, this shows the usual analysis of revenue and trading profit by business segment. As you've already noted, the trading margin for the Group was up 310 basis points in the quarter on Quarter 2 last year. In Ortho, margin increased by 210 basis points in the quarter. We continue to benefit from a focus on a combination of tight budgetary discipline and investment in improving the efficiency and effectiveness of our main processes.

The Endoscopy margin increased by 340 basis points in the quarter. This too reflects the tight cost discipline, and also the closure of the manufacturing site and the weak comparative, as Dave mentioned. The margin in Quarter 2 last year was reduced by unusual legal costs and business development costs.

Margin in Wound was 500 basis points higher in the quarter. NPWT was, as expected, again loss making in Quarter 2. The year-on-year improvement in Wound margin was again not yet materially driven by any change in the level of investment in NPWT. As in our other businesses, improvement was due to a combination of EIP programs and budgetary discipline.

Turning to the cash flow statement, we generated \$11m of free cash flow in the quarter, and \$64m in the first half of the year. This was lower than last year due principally to the timing of tax payments. Capital expenditure in Quarter 2 was \$89m, with the largest part investment in instruments. Restructuring spends on the EIP program was in line with our expectations.

Net debt rose slightly to \$1.2b in the quarter, as a result of the lower free cash flow generation, currency movements and the payment of the final dividend for 2008.

Turning to the next slide, Slide 21, and the outlook for 2009, Dave has commented on our views on overall market growth. In the Orthopedic reconstructive area, we believe that underlying global market growth declined to around 3% in Quarter 2. We expect our recon growth to be slightly beneath the market rate in 2009, due principally to the pressures at present on our higher specification products.



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Within Orthopedic Trauma, we believe that the underlying market growth declined to about 7% in Quarter 2. We continue to expect to move towards a sustainable market growth rate over time. We do not expect to achieve the market growth rate this year.

Within Orthopedic Clinical Therapies, we do not see a major change in current trends in the near term. Within Endo, we continue to expect sales to be materially impacted by market weakness in the capital equipment area until the economy improves, and within Wound we continue to expect to grow ahead of the market.

In the face of the tougher economic climate, we remain very focused on improving our operational efficiency, through tight cost discipline and our EIP projects. As we've always said, the extent to which we can improve our margin depends in particular on changes in like-for-like pricing, and substantial changes in volume growth trends. We continue to see very material scope for margin improvement, and are committed to achieving it.

We expect an interest rate on net debt of 3% to 4% for the full year, as in Quarter 2. And finally a comment on phasing. We've again included in the appendices a schedule showing the number of business days in each quarter. There is the same number of business days in Quarter 3 this year as last year, and one extra day in Quarter 4, and a total of one fewer in the full year. And with that outlook on 2009, I'll hand back to Dave.

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**David Illingworth** - *Smith & Nephew - CEO*

Thank you, Adrian. Let me find my notes here. Okay, thanks a lot. There are a few specific messages that I'm going to be brief on before we open it up to Q&A.

Clearly the conditions in the market are tough all over for everyone. Our focus on the higher technology products and the younger, active patient is creating some challenges for us in the near term, but in the long term this is the segment we want to be in, as it is a broader and faster growing market, and really does drive our innovation, which ultimately benefits our customers.

Endoscopy is performing very well in its Repair business, and that should be understood and noted, and has some very good product launches to drive growth, while dealing with some of the challenges from the capital side of that business itself.

In Advanced Wound Management, we've seen continued growth, and we're going to be continuing to focus on our US business and the big opportunity that Negative Pressure Wound Therapy offers us. We really have overhauled this business. We told you we were doing it several years ago, and we've put a lot of effort into it. We think there's a lot of value that can be created from this wound care business, and it's starting to pay off for us.

As a company, we have a strong emphasis on customer service. We work with our customers to help them -- we try to work with our customers to help them improve clinical outcomes and find cost efficiencies through our innovation.

The substantial progress that we've made in the earnings improvement program really gives us the ability to ride out these tougher times, and quite frankly, we're very fortunate that we started our earnings improvement program before this economic wave hit us, because it would have been tougher to do what we're doing today if we had started when the economic recession and the economic tough times started.

But the fact that we started about a year earlier is serving us very well, and we've stayed the course. We continue to invest in our businesses while we're doing that, and we're performing very well, and delivering profits and driving substantial margin improvements.

We're very strongly focused on executing our plans and generating continued, sustainable, profitable growth. And with that, we'll conclude the formal part of this session, and we'll go to Q&A.



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## QUESTIONS AND ANSWERS

**David Illingworth** - *Smith & Nephew - CEO*

How are we going to do this? We'll start with you, David.

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**David Adlington** - *Cazenove - Analyst*

Thanks, morning. David Adlington from Cazenove. A couple of questions, firstly on the revenue side and your outlook. It sounds like you've taken a different view, I think probably with your growth in respect of the market rather than a different view on the markets. I wonder if you can confirm that, and really what's driven that change in view since the last quarter?

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**David Illingworth** - *Smith & Nephew - CEO*

I'm happy to take that if you want.

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

Sure.

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**David Illingworth** - *Smith & Nephew - CEO*

Yes, I think the nuance there is that we are seeing some deferral of procedures. We think we are disproportionately affected because of our strong focus on the younger, more active patients, and I think if you look at some of these markets, we are seeing now data that suggests that we are seeing a mix shift, and the only way that we can explain that mix shift is by the -- assuming that we're getting a deferral of some of these procedures, and we think we are.

It makes sense. We don't think these procedures are going to go away long term. Just because there's an economic recession doesn't make your hip pain go away, or your knee pain go away, but it might make you think about whether or not you want to take six months off work if you're in a private insurance program, or if you're worried about losing your job.

And I think we're seeing that, and I think that we had it really, really good on the front end when we were expanding that marketplace, and really taking some significant share. I think we've proved over the years. I -- there's very few quarters that I've sat in front of you and said that we did anything but grew faster than any other company in the marketplace.

And I think right now we're seeing the effects of that. But if you look at our -- if you take just a couple of products out of our mix, and look at what we would call our standard hips and knee products for instance, we're performing at or above market growth rates, so we think we're still taking share with those products.

So we do think it is a short term thing, and we're still very, very committed to it and we're saying that this probably isn't going to change for a few quarters, and it's something we're prepared to deal with.

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**David Adlington** - *Cazenove - Analyst*

Thanks. And then just on the margins, it might be a difficult question to answer, but how much of the cost savings that we're seeing drop through to the bottom line, how much of that is structural, i.e. due to the EIP program and how much is it a short term reaction to the slowdown in revenues?

**David Illingworth** - *Smith & Nephew - CEO*

Well, it does have -- it does have both of those components as part of it, and it's hard to figure out exactly what's coming from where because we don't -- we don't talk about EIP any more as a specific program internally. Because it was getting too hard to try to discriminate what was a formal EIP program and what was normal productivity that's going on in the business, and everything just started becoming blurred.

We were spending more time trying to discriminate EIP so that we could answer your questions than we were about really trying to get after the margins. And when it's all said and done, it's about margin expansion. So for us it's all about margin expansion. I think the important thing to note is that we're -- we don't think we're anywhere close to the bone here, in our ability to save and get efficiencies in our system.

We've still got a long way to go. And so we're still pushing on it very, very hard. If I was going to guess, I'd probably say it's probably 50/50 but that would be a guess.

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

I think the important point is there are no unusual one-off items in this quarter. There is nothing that isn't sustainable in that sense at all. It was a slightly weak comparative which was slightly flat on the year-on-year, but there is nothing -- no unusual --

**David Illingworth** - *Smith & Nephew - CEO*

And the other -- yes, I think the other thing that's important to note is, we're seeing a little bit of a saw tooth of performance here, and I think that's very natural for us, and maybe slightly disconcerting for folks on the outside when they look at us on a quarter-by-quarter basis.

We've always said that we are not going to make bad short term decisions -- bad long term decisions for short term needs. If we were worried only about how our margin progression looked, we wouldn't have done the things that we did in the first half of '08 with our Negative Pressure program for instance, where we really put the accelerator down to the floor and said, wow, this thing really does work, let's really go get a product, let's redesign it, let's deploy hundreds of people and have big giant launches, and let's go, go, go, go, go.

And if we'd been worried about the short term margin impact of that, we wouldn't have done that. But we don't -- we honestly don't think that way, and we're asking for a little bit of slack in the sense that it's not going to be a smooth curve. But whatever margin we get to at an exit rate in 2010, and the target is 24.5%, but whatever it is, it's going to be substantially better than what we started with, and it's going to be sustainable, and it's going to help this business be more successful in the future, and that's how we're approaching it.

**David Adlington** - *Cazenove - Analyst*

Can I just pick you up on that? Are you standing by the 24.5% currently for the (multiple speakers)?

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**David Illingworth** - *Smith & Nephew - CEO*

Yes, it's still our target. It's still our target, and everybody wants -- everybody, I guess, it's some -- it's some kind of important thing for me to put a stake in the ground and say yes, absolutely, we're going to make it. It's our target, and it's really important. If we -- we can make it. We have the ability to make it. We have a view to programs where we think we can make it.

So it's really important for us to not come off that target, because what message would that send internally to our organization? Our organization is struggling just like everybody else's in terms of softer top-line, and the first thing everybody would want to do is make excuses about why you can't do something. But it's not about what you can't do, it's about what we can do.

We have the ability to improve our margins. Our target is the same. The risk is higher. The risk really is higher, because we did not know we were going to be in this environment when we started this thing. But we've worked our -- we've worked very hard.

But it's not easy doing what we're doing, and we've worked very hard to try to make up the ground so that we didn't get behind the curve, and there were times when we sat around and honestly, there were times when we sat around and went, oh man, are we really going to make it?

But we have a view to things that are out there, that we've already invested in, that we believe is going to pay off for us. But we will be a substantially better company when we finish this program.

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**David Adlington** - *Cazenove - Analyst*

Thanks.

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**David Illingworth** - *Smith & Nephew - CEO*

Michael? I'll just -- the mike's over here. We'll get it over there.

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**Unidentified Audience Member**

Yes, I have three questions. The first question is are you concerned that you are losing market share at the expense of your EIP program? If you look at your constant currency growth rates in Hips and Knees and also in Trauma and perhaps some of the other divisions, is it just coincidental that the market share losses are in line with the timing of an EIP program?

Historically you've mentioned that you will not use EIP at the expense of top-line growth. I'm just curious whether you feel that is now a risk, given the trends that we're seeing.

Secondly on the margin expansion in Q2 of 3.1 points, could you please give us a sense of how many points came from selling, and from general and from admin?

And then the third question I have, (technical difficulty) market, we've now seen a couple of companies talk about a softer European market, and to me conceptually that's difficult to understand given that we've got about 95% of procedures being paid by governments. So some help there would be very much appreciated.

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**David Illingworth** - *Smith & Nephew - CEO*

Yes. Well, let me take the first one first, and then Adrian, you can jump on the second one if you don't mind.

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

Sure.

**David Illingworth** - *Smith & Nephew - CEO*

The -- if you -- I can understand where you could draw the parallel and the question about the connection between EIP and softness in the top-line, I really do. But I'm telling you that if you draw that conclusion then in my opinion, you would affect not only my -- I think you'd be wrong, because I don't think we're anywhere close to it.

We have -- we've been working really hard to get our presidents of our businesses, who are really customer people, customer nuts -- they are commercial people. They're sales and marketing people. We've been working really hard to shore up their skill and their support system with operational folks, so that we can get at these EIP things, and we've brought in a world class person who we centralized operations under, so that we could take some of that burden off of them.

And I guarantee you, the first person -- the first time that we get close to compromising top-line because of our EIP program, our presidents are going to scream, and there hasn't been a whisper out there. We get together and talk about this all the time. And I just don't think -- I just -- I think the conclusion's wrong, it's just wrong.

And we're -- we talk about the fact that if we get to the point where folks are saying if we -- we incur -- we have money to spend. We're generating a lot of cash. We can make investments. We made the investments in the Negative Pressure Wound Therapy business. We didn't have to make those investments. If we were only worried about the EIP and the margins we wouldn't have done that. We'd have slow-rolled that.

So no, we're not doing that, and that's about as clear as I can make that, and I think if you draw the conclusion that you are, I think you're wrong, or not you, personally, but you the general group, and I think it just would be a wrong conclusion.

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

And I'm not sure, was your question between SG&A and cost of sales or within SG&A?

**Unidentified Audience Member**

Well, effectively I can't see the details in the accounts because you've put SG&A together plus with some [charters] in there so abnormal. But if you look at the 3.1 point improvement in the EBITA margin in Q2, did a point come from S? Did a point come from A? Some guidance there would be very useful.

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

Well, it certainly spread between cost of sales on the one hand and SG&A, and you get a rough measure of that by looking at the accounts, although there is a bit of exceptionals in there. Within SG&A, as David has said, I think the best thing to say, it is not, absolutely not front-line sales. We're not talking about commission levels of reps or things like that.

But as soon as you step away from front-line sales, there's a whole load of stuff that support sales, but is very much in a category of stuff we can make operationally more effective, but from the moment you step back, there are savings across the piece in most places, but they're efficiency things. They're not things that are customer service impacting, but to break it out (multiple speakers).

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**David Illingworth** - *Smith & Nephew - CEO*

I think there were some things that were deferred. For instance, we noted the training programs, Michael. As we were coming out of the DPA, for instance, and the actions with the Department of Justice, like everyone was, we were not able to do the type of training that we really would have liked to have done, and it's taken us a little bit of time to get that back up.

So obviously that has a small impact. But it's not a conscious impact on our -- decision on our part to rob Peter to pay Paul. It is just something that we're living with. If you look at our R&D spend, for instance, it's about where it was --

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**Unidentified Audience Member**

Quarter 2 last year?

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**David Illingworth** - *Smith & Nephew - CEO*

A year ago. So I think that we're feeling that we haven't reached bone, and I think that our presidents of our businesses will scream and holler if we get close.

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**Unidentified Audience Member**

And the European question, the European slowdown?

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

Yes, I think we'd agree with you. Conceptually it surprised us too. Certainly we, like others, talked, speculating as you were going into this new environment, where were you likely to see the most volume deferrals, and we thought it would be the US. We have been quite surprised by the softness in Europe, to be honest, and it's not been everywhere, not been every country, but it's been several. So yes, conceptually, we are as surprised I think as you are, Michael.

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**David Illingworth** - *Smith & Nephew - CEO*

I think there's -- just to maybe add a little bit of color to that, we still had the tail of the integration of those businesses to deal with. We said that we'd be reaching about \$80m, I think was the number we put out in lost sales, and we were up to about \$60m, 60-ish at the beginning of last quarter. So we're -- I think we're probably up to about the run-rate that we thought we were going to be at, so I think that had an impact. That factors into it.

The other thing is that we did not get at integrating these businesses as quickly as we would have liked, because we were dealing with the issues with the vendors, the principal owners that sold us the company that we had the issues with the sales practices. And we had a very thorough investigation that was, we felt, had to be extremely thorough because there was an informal investigation going on, as you know, by the FTC.

And we just took a lot of time and effort to do that right, and we really couldn't integrate those businesses while we were doing that, because how do you take -- you get two leaders of a country running a business, how do you pick one or the other when there's uncertainty about what's really going on in the organization?

So we got started late with the integration, so that, I think we still have a little bit of disruption there, and I think Europe, it has some general softness associated with it. Hans?

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**Hans Bostrom** - Goldman Sachs - Analyst

Hans Bostrom, Goldman Sachs. I had three questions. First of all on Endoscopy, you have previously stated that you didn't see very much margin improvement potential in Endoscopy, as far as I can remember. Now you have achieved 200 basis points in the first half of the year, despite the fact that sales are declining.

Maybe you could elaborate whether you are actually taking a more positive stance on the improvement potential in this business and what the impact of this factory closure could be in the second half of the year?

And secondly, in Wound Management, again, could you quantify or remind us what the actual cost reduction will be from the Largo factory closure by the end of this year and whether indeed you are running at double costs in this current phase with the Chinese factory?

And last, if you could give us a sense of what your sales force numbers and how they've changed year-on-year in the first half of the year, that would be helpful. Thank you.

**David Illingworth** - Smith & Nephew - CEO

Okay, well, let me take a shot, and you fill in the blanks, because there may be a few blanks along the way here. Endoscopy, you're exactly right. That's exactly what we said, that there was less opportunity for margin improvement in that business because there was. We think it was run more efficiently.

It had been, in our opinion, we had not invested to the extent that we'd felt like we could, or maybe should, and that's a judgment call, in the past. And we decided we were going to invest in that business, because you really need product introductions kicking out of that business to really stay at the forefront, and being the market leader, we felt like we needed to lead that.

And I think what you're seeing is, we have a very good manager there. Michael Frazzette, who's the president of that business, is doing a great job on controlling costs, number one, and number two is there's this strange effect that when the sales go down in capital, our margin goes up, because we have a positive mix benefit there.

So we're benefiting from that somewhat as well. So it is a little bit -- it may not make a lot of sense when you think about it on the front-end but when you start thinking -- when you get into it, it makes perfect sense. We have very good management and we're getting some positive mix benefit, and they're doing a really good job of controlling their costs. So that's what I would say about Endoscopy.

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

That plus a weak comparator that we have to recognize for Quarter 2 last year.

**David Illingworth** - Smith & Nephew - CEO

And we had a weak comparator, exactly. On Wound, on the factories, we will see -- yes, you're right again, Hans. We are running double costs. I don't know if it's double, but we are -- we certainly have two parallel factories running.

We're not going to close down the Largo factory until the end of the year, and we're still in the phase of getting products validated and qualified, and the quality and everything right, and registrations and ready to ship to customers. So there will be a phase where there is going to be overlapping cost. I don't really know exactly -- well, I don't think we've done a lot of work to try to figure it out.



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

It's not huge but it's -- it exists, but it's not huge.

**David Illingworth** - *Smith & Nephew - CEO*

Yes, it exists but it's not a huge area. So that is correct, and we should start seeing the benefits flow from really the beginning of the year. First, mid -- probably mid first quarter of next year.

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

Yes, and as to the [size], Hans, it's not -- we're not going to a level of detail of closing the site, but if you just want to think about it, initially around half of ALLEVYN will come out of the factory, and ALLEVYN is about \$250m a year, so initially around half of that, and if you think of the cost of sales on the Group average, you wouldn't be a million miles out, and then you'd need to think about what proportion of that is going to have savings and how much do you think, and you'll get to the right ballpark.

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

Very good.

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

But we're not going to give you the -- we're not going to talk about exact numbers there. But in future, more than the ALLEVYN will come out of the factory. So you're looking puzzled.

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

Can you run through those numbers again?

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

Yes, initially half of -- roughly half of ALLEVYN will come out of the Chinese factory. Total ALLEVYN sales are about \$250m. We give you those numbers in the --

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

What is the headcount in Largo, if you could answer that (multiple speakers).

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

No, I don't know the exact number.

**David Illingworth** - *Smith & Nephew - CEO*

I don't know the exact number. Do we have anything?

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

I don't know the exact figure.

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

Is that hundred or?

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

Yes, maybe a little more than that, actually.

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

And on the Endoscopy, so you're essentially saying that once the capital sales are starting to rise again, say 2010, you are not actually taking a more positive stance on the structural margin in Endoscopy because you will get an adverse product mix development there?

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

Not long term. Not long term. Right, we said at the start of the EIP, you're quite right, Hans, we believe that -- we believe that our Endoscopy business had pretty healthy margins. And so, no, we're not taking a different structural view of our Endoscopy, no.

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

And with regards to your market share losses in the traditional Wound business in the US, could you -- is this because of the focus on NPWT or are there other factors, new competition? How are you addressing that, and what is the timescale for addressing it?

**David Illingworth** - *Smith & Nephew - CEO*

It's a very good question, and I'm probably not going to do as good a job with the answer as you did with the question, because there's not -- it's not very simple. You asked a very simple question. Here's a very un-simple answer. We have a -- one of my strategic visions, and the strategic -- one of the real strategic comparatives of the Wound Care business is to increase their critical mass in the US.

The majority of the profit in Wound Care comes from the US marketplace, and we have always underperformed there. Why have we underperformed? Well, one of the reasons is because we're a UK company. We're a UK based company, and we just don't understand the market in the US as well as we do the UK and European markets, which we do extremely well in. When we bring out new marketing literature and brochures, and new products and everything else everything is geared towards the European customer. It's the same -- it's the converse of what's true in our Orthopedics business, for instance, when we were predominantly based in Memphis, where we were a US based company and we just didn't understand Europe very well.

You just -- I don't -- I know some of you folks who have lived in different parts of the world understand that when you get to another part of the world, you don't really understand it until you get there, and then once you're there, you realize that there are real differences, and that you have to be very local in the way that you address these -- your customers.

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And it's one of the reasons why we went to increasing our critical mass in Europe in Orthopedics so that we could build that nexus, so we could build that critical mass, so that we could be known as a European -- an orthopedic company in Europe that was the leader. And we want to do the same thing in Asia.

But going back to the question about Wound Care, I think that's one dynamic. It's hard to quantify what that really means to you, but I think that's a real dynamic, is that we are trying to change the critical mass over to the US.

Part of the plan was to do it through Negative Pressure Wound Therapy. We've been growing slower than we had originally thought in that business, but clearly, we've been growing at a rate that satisfies our desires and our ability to keep making progress in that segment.

We've had very, very strong competitive reactions and I think it's just a matter of getting the balance right, getting the right talent, getting the right sales people, getting the right critical mass, and then I think we'll start making sustainable progress in that marketplace. And I think that's basically where it is.

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

I had a final question, the one regarding sales force headcount. You didn't answer. Could you elaborate, please?

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

Yes, I'm afraid we don't have those numbers here with us, but there will have been a small increase in the quarter if you look across the whole business across the world.

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**David Illingworth** - *Smith & Nephew - CEO*

Okay, we're going to take some questions from -- we have to get to the phone lines here, because if not, they're going to come up here and strangle me I think.

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**Operator**

The first question from the phones comes from Ed Ridley-Day from Barclays Capital. Please go ahead.

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**Ed Ridley-Day** - *Barclays Capital - Analyst*

Good morning, thank you. First of all, just to follow-up on Endoscopy, the margins. Adrian, if you could give us a little bit more granularity in terms of the split between, just remind me about the last year's effect on Endoscopy margin, but also the benefit from the closure of the plant in Warsaw.

Second question would be just, Dave, you mentioned in terms of the centralized control of some of the sales costs. Could you talk a little bit more to that, just given the overall improvement margins across all your, and the impressive improvement in margins across all your businesses. Can you give us some detail about what you've done centrally which may have benefited all the businesses to improve the margin there?

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

Yes. On the first one, frankly we're not going to go down to the level of quantifying the benefits from individual factory closures. I'm sorry, we can't give you a number for the closure of the, well, actually over time it will be two factories in Endo and we can't do that.

In terms of the comparity, no I don't have the exact number of last year, I don't think we gave out the exact numbers of the two items but they related to a set of legal costs and related items that were a few million dollars. I can't remember the exact numbers in Q2 last year. So it's a smallish part of the chain but it does contribute to the growth year-on-year. Not a very satisfactory answer I'm afraid but that's all I've got here.

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**David Illingworth** - *Smith & Nephew - CEO*

All right. Let me take the other piece which is some of the centralized activities that we've done. We've done a lot. We have not, I think you said sales, we did not centralize the sales part of our business, we're actually keeping the customer facing part of our businesses very unique and very distinct, but we're trying to leverage as much as we can everything that's non-customer facing.

What have we done? We've centralized operations, we've brought in a gentlemen by the name of Jeff Adams from Danaher who's a world class operations guys, and basically took the operations from all of our different businesses and matrixed it into Jeff. He's implemented lean manufacturing in all the factories, [combined] systems and put centralized procurement in place and gone to e-auctions and all, everything you would normally do in a world class business. And in terms of cost of goods sold, it's had a dramatic impact for us, a very dramatic impact and we're very, very happy with the work that he's done.

We also went to a centralized logistics. We built several new world class logistic centers, one in Europe, one in the US, we invested heavily in that. We brought in an individual from FedEx. Who better knows about logistics than FedEx? We brought in an individual by the name of Mike Peters who's doing a great job for us in leading that effort.

So those are the types of things that we're doing in centralizing some of the back office things.

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**Ed Ridley-Day** - *Barclays Capital - Analyst*

Great, thanks, Dave. And in terms of just that centralized procurement which is obviously very effective, how many countries, geographies, have you rolled that out across already?

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**David Illingworth** - *Smith & Nephew - CEO*

Good question. Do you know the answer to that?

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

Well, it's not an easy question to answer because --

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**David Illingworth** - *Smith & Nephew - CEO*

Definitely in the US.

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

Yes, sure, and of course some things you purchase centrally so be definition you do them for multiple countries, so for multiple factories so --

**David Illingworth** - *Smith & Nephew - CEO*

It's really global but I'm not sure exactly. Ed, the answer is it's global but it has various degrees of depth in different parts of the world. Like, for instance, we put a procurement office in China, an international procurement office in China as part of the effort. So it reaches even, it's not just the US it reaches all the way to the Far East. But it's very well established in the US, very sophisticated, probably has a lack of sophistication in some of the other areas thus far, so we still have a way to go.

**Ed Ridley-Day** - *Barclays Capital - Analyst*

Okay. Thanks very much.

**David Illingworth** - *Smith & Nephew - CEO*

Thank you.

**Operator**

Thank you. Your next question comes from the line of Matt Miksic from Piper Jaffray. Please go ahead.

**Matt Miksic** - *Piper Jaffray - Analyst*

Good morning.

**David Illingworth** - *Smith & Nephew - CEO*

Hi, Matt.

**Matt Miksic** - *Piper Jaffray - Analyst*

A quick question on the Ortho business and then a follow-up on Trauma. So looking at your US numbers, you mentioned some of your products outside of BHR are actually doing, like your core US hip products are actually doing fairly well. I'm looking at those numbers and am I hearing you right, that they're sort of above market growth rates, sort of like mid single digit hip growth numbers if you take out the deferrals and BHR and so on?

**David Illingworth** - *Smith & Nephew - CEO*

Yes, you're hearing that right. We believe that if you take BHR out of our hip portfolio that we're taking market share in those products.

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**Matt Miksic** - Piper Jaffray - Analyst

And then on the knee side, I guess, it's a market growth rate is what you're seeing there. I guess you're seeing a fair amount of deferral in BHR, how would you look at your hip and knee business? Do you see more deferrals on one side or the other? Maybe any color you can provide.

**David Illingworth** - Smith & Nephew - CEO

Good question. I'm not sure in fact -- well, I am sure that I haven't seen those numbers. We haven't got to that level of, in terms of discussing it for this meeting here. I know we have that data.

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

Well, what we can see, it's the growth rates of individual products which we can see and they are both on the hip and knee side. What we can't do is go behind that and say well how much is deferral and how much is not? In terms of our higher specification products we're seeing softness on both the hip and the knee side in the US, no question.

**Matt Miksic** - Piper Jaffray - Analyst

Okay, and higher specification products is where you're focused, so I think I understand that.

And then on Trauma, you've been working on some steps towards reorganization and changes to your sales force for, I think, a number of quarters. Could you tell us where you are, what kind of benefits you're starting to see or when we might hit the inflection point to get you back at or above market growth?

**David Illingworth** - Smith & Nephew - CEO

Well, I -- it's a good questions, it's a tough question. Trauma is an interesting area for us, we've had some very, very good years in Trauma and we've had some years that we've struggled a little bit. The fact of the matter is we've got a very big competitor out there that has a very large percentage of the marketplace. What I can tell you is that we think that we're doing the right things in this area, we've got a great product lineup, not just a good product lineup, but we have a great product lineup in Trauma so we can't use our products as an excuse for how we're doing. And I think we're just going to -- our plan is just to continue to battle it out in the marketplace.

Our feeling is that over time the fact that we have the breadth of products all the way from the clinical application in the doctor's office to the traumatologist, to the arthroscopist, to the joint reconstruction surgeon and many of those times they overlap, or at least they overlap within a practice of surgeons. We think that as long as we have that wide breadth of products with market leading position in those areas, in Trauma we're number three, as you know, that it's going to serve us very well. So we're going to continue to battle it out in the marketplace and it's tough going when you're up against a big strong company that has over 50% market share.

**Matt Miksic** - Piper Jaffray - Analyst

And do you feel like it's still a matter of retooling and adding to your distribution or are there some product weaknesses that you feel like you have to address?

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**David Illingworth** - *Smith & Nephew - CEO*

I don't think it's product weaknesses at all, Matt. I'll restate that, I really think we have a great product line up. I do think when you're up against a competitor like we're up against, it's a little bit like stocking the shelves in a supermarket when -- they have the ability to exert their will in some areas.

We're trying to come up with a strategy that works. We're going to continue to battle it out in the marketplace. We have good service, good people, good products. We win some, we lose some. We've got the business back to a point where we're now, we think we're at a base where we can grow that business again. It wasn't long ago that we were growing this business 17%, 20% and for multiple quarters in a row. And it was when we were deploying and developing our own independent sales channel. And I think we hit a little bit of -- we hit some speed bumps along the way here, but I think we're in a place where we feel pretty good that we can really substantially build this business going forward and we're going to continue to slug it out.

**Matt Miksic** - *Piper Jaffray - Analyst*

Great. Thanks for taking the questions.

**David Illingworth** - *Smith & Nephew - CEO*

Yes, you bet, Matt.

**Operator**

Thank you. Your next question is from the line of Lisa Bedell from Sanford Bernstein. Please go ahead.

**Lisa Bedell** - *Sanford Bernstein - Analyst*

Good morning, I have a few questions. Firstly, on the European slowdown you mentioned that it was only in certain countries. Would you be able to go into some detail in terms of the countries where you've seen the slowdown?

Second question is on the Endoscopy Division. Could you give us a rough idea of the proportion of sales that are capital equipment versus arthroscopy? Maybe what the levels were in 2008 under more normalized market conditions. And some guidance on the differential in margins would be really helpful.

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

Sure, let me take the second.

**David Illingworth** - *Smith & Nephew - CEO*

You can take them all if you want.

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

Well, the second one's easy, I was going to throw you the first one. On the second one, capital was around 25% last year and we do make money out of capital but not a lot basically. So the margins are materially different between capital and repair and that's the next point that Dave was making to Hans and others earlier.



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Yes, Europe, no, we don't want to give specific countries but there is a material variation when we look at our numbers. We, I guess you could say, maybe we'll call up Italy as being a particularly weak one for us, but beyond that it's probably best not to talk about particular countries.

We also, as Dave mentioned, have in our numbers the end of the business integration issues which do mean that country-by-country we have a skew that isn't necessarily the market weakness. But we would say it was in several but not all.

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**Lisa Bedell** - Sanford Bernstein - Analyst

And then one last question. You mentioned surgeon training in the US is pretty much back on track. Could you discuss product development and how that's changed, so pre-Deferred Prosecution Agreement and post. Are you collaborating with fewer surgeons? Has the structure of collaboration changed?

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**David Illingworth** - Smith & Nephew - CEO

Well, I would say that during the time that we were under the DPA and we were spending most of our time trying to put systems in place to satisfy the Department of Justice that we had a high level of assurance that we could be compliant, during that phase we were not -- it was definitely lower levels of training, definitely lower levels of development exercises with consultant surgeons. We were working through all new contracts with them, it was very, very difficult to get through the individual contracts with the Federal Monitor. So there was a very, very slow period that I think, it just kind of works its way through the digestive track here over time. I think we're moving out of that and getting back to the point where we're getting back to a steady state of --

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

That's a double metaphor there all right, yes.

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**David Illingworth** - Smith & Nephew - CEO

Yes, it probably wasn't a very good way to say it. But anyway that's the point, or maybe it's a pig in a python, okay? But it's moving along this time phase and we're getting back to normal. We're getting back to normal where we're -- we have a very efficient research model in this industry that we're fighting real hard to keep. And that is we have a very close relationship with the surgeons and we get very direct feedback and it's one of the reasons why we can be as innovative as we are with some pretty reasonable R&D numbers in this industry. And I think that's good for healthcare and I think it's good for healthcare economics to keep that efficiency. And we're just trying to get back to normal so there's a period of time, you can pick the time, whether it's six months or 12 months or 18 months but that time had to work through.

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**Lisa Bedell** - Sanford Bernstein - Analyst

Okay and if I could ask one more question just back on Europe. How confident are you about the European market picking up any time soon, I mean this a region where there's minimal out-of-pocket contribution, a lot of government payments, the governments may be revisiting budgets over the next few years trying to balance books. Do you think that Europe could potentially remain sluggish for a few years even?

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**David Illingworth** - Smith & Nephew - CEO

Well, if you're asking if the agencies that are bailing out the economy who also fund the healthcare systems are going to have to find creative ways to balance their budget, I think the answer is yes, and I think it's going to take some time.

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What we're trying to do, I can tell you what we're trying to do as a company, we're trying to be part of the solution here. We're talking actively now as leaders of our business to our development engineers, when we get the face time with them about what are you doing to develop products that are taking costs out of the healthcare system. That's how we can do our part because we can help reduce costs and also improve clinical outcomes at the same time if we put our efforts behind it. And that's one of the things that we're trying to do, I think we have to be able to do that in the future.

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**Lisa Bedell** - *Sanford Bernstein - Analyst*

Great. Thanks very much.

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**David Illingworth** - *Smith & Nephew - CEO*

Charles and then Martin.

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

Hi, Charles Weston from Nomura Code. Two questions first on increasing of costs. We've talked a lot about cutting costs but going back to your comments on R&D. A while ago you talked about R&D moving up to 5% of sales, it's been around the 4% mark for some time. You actually said you increased it in Endoscopy over the last year or two, which means one assumes it's decreased somewhat elsewhere. So could you talk about the trends in R&D between the Divisions and also how and when that will move up to 5%?

Then also the increasing investment in the rest of the business, specifically where do you think you need to spend more money to continue to grow the business? You talked, again, about one of them being in the clinical therapies, you need more products down the clinical therapies distribution and you need to expand that geographically. So where else do you expect to focus your attentions on spending?

And then I just have one other question and that is on cross-selling efforts. Again, a few quarters ago you talked about how you'd, well, if we look over the last few years you've divisionalized the sales force and then sort of divisionalized them even more and then you said, "Well actually maybe we've over divisionalized." So perhaps you could talk a bit about your efforts in that regard.

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**David Illingworth** - *Smith & Nephew - CEO*

Okay. We never said we over divisionalized, Charles, but I can understand where you may have drawn that conclusion. What we did do there was we developed unique sales channels so that we could service unique customer groups. We had, when I started with the company seven years ago, we had only one type of sales person, it was called a full line sales person. That person spent 100% of his time in scrubs trying to get joint sales and in their spare time or by email or whatever they did it, or they would hire helpers to cover Trauma for instance, Trauma calls, because these things happened at all hours of the night. They never called on the doctor's office to sell our SUPARTZ and our EXOGEN products. We were nowhere in market share.

And we looked at it and we said, "This isn't right. We have to have appropriate sales channels for the market segments that we're participating in." So what we did is, we took the clinical products first away from our full line sales people and we created a clinical sales channel and we hired reps, excuse me, employees, sales people who were employees of the company to work for us and sell only those products into the doctor's office. Today we have a unique sales channel to anybody in the industry and we've gone from nowhere on Joint Fluid Therapy and really nowhere in Bone Stimulation to world leadership positions because of our sales channel and the decisions we made there.

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You go now to the Trauma side. We did the same exact thing. We took Trauma away from all of the full line sales people and we created a Trauma sales force. And it was an employee sales force and we had tremendous growth in Trauma.

The issue with Trauma is we went too far, we didn't need to take all of it away from all of the full line sales people because there are some places, if you're in New York City or London then you can have those very distinct channels with no overlap and it works perfectly because everybody is ultra specialized. But if you're in Sioux City, Iowa or Savannah, Georgia or wherever you are in a small town, or a small town in the UK, you know you're doing trauma calls twice a week, you're doing joints twice a week, you're doing scoping once a week and we needed to have some amount of overlap in certain places where it made sense. So we just tried to correct that and that's what we did, we didn't over divisionalize. We feel very, very confident that we took the right course of action there, but I can understand where that impression might come from.

In terms of R&D, what we said was that we were going to be around the 4%, you know, industry average here is around 4% on the R&D, if you correct and make it apples to apples, because not everybody categorizes these expenses the same way as each other. But if you really do apples to apples the way that we do it it's somewhere around 4%, 4% to 4.5%. What we signaled was that over time we were going to be moving up to around the 5% mark, you're absolutely right, that's what we said, and we still intend to do that.

And the reason we gave was that we believe that we need to fund extra activities in the biologic space. And what we did was we took all of our biologics activities out of all of our businesses and created a new biologics business in Raleigh/Durham, and we have a building, we have people, we have business development folks. And last week we had a whole day session with them reviewing all of their potential opportunities for investments and growing biologic opportunities over time. And it's just a matter of -- we haven't told them to run out and spend it.

The biologics activities and the potential are big bets, they're big important bets. And we're being very thoughtful about it, we're really trying to understand that space, we're building our competence, we're building our skill sets. The reason why we've put a greenfield in place in Raleigh/Durham was that it wouldn't be constrained by the thinking in a traditionally orthopedics business or a traditional endoscopy business so that people could act like a biotech company and that we would have a fighting chance to be able to really do well in this business in the future.

So it will come and when it comes we'll signal it and you'll probably see it with some technology acquisitions and some activities that we're doing. But we're still planning on it. It will cover over time.

And the clinical therapies and where are we going to invest? Clinical therapies is an area that we do want to invest in, we have two products that go through that channel. We have the Joint Fluid Therapy products and the EXOGEN products and we have a real competitive advantage in the market place where no other orthopedic company has this channel -- no other traditional orthopedic company, I mean none of the reconstructive companies for instance, the broader ones. I mean there are the Orthofixes and some of the other companies that are mainly in spine.

But we have a unique sales channel and we want to capitalize on it. We're sitting here saying, "Well, you know what, we could probably put some more products into the basket of the sales people and do very, very well because we've established ourselves." So that's what my suggestion was there and we clearly are willing to invest in that area.

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

Thanks. Just a quickie, what's the OUS hip and knee growth rates at constant currency?

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

OUS hip and knee rates at constant currency --

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

And that's it for me, thanks.

**David Illingworth** - *Smith & Nephew - CEO*

Thank you, Charles.

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

OUS hips we declined at 4% against the market we think was zero, I'll get the right numbers here. Yes, OUS knees minus 1% against the market we think.

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

Thanks.

**Martin Wales** - *UBS - Analyst*

Martin Wales, UBS. I'll start with a couple of questions on Negative Pressure Wound Therapy. I guess we're over a year since you really pushed hard on this product. You seem to be running somewhere between \$4m and \$5m a quarter. I can understand why you don't want to commit to a precise timeframe of when this business will turn profitable, but should be thinking I guess 2010 or 2011 now? Also, if you haven't succeeded in that timeframe, could you ever succeed in that product area?

A corollary to that would be, I think you've indicted that the KCI are muddying the waters in terms of the US marketplace, I believe there was a preliminary injunction hearing due this month, maybe give us an update on that?

**David Illingworth** - *Smith & Nephew - CEO*

Yes, there is. Let me try to take them in order. First of all, I think your projections are a little low, for a change, that's nice. We're not going to give you the exact number but they're probably a little bit low. They're definitely low.

We are quite pleased with the progress we're making. We never said this was going to be easy. We said it's a huge opportunity and we have a right to win and we believe we're going to win. I had dinner with the CEO of our logistics partner, our distribution partner here in the US just a couple of weeks ago and he was as bullish as you could possibly be. The reports he's getting from customers, the reports I'm getting from customers are all extremely positive. But we have a -- we were probably a little overambitious and not really understood exactly what it would take to penetrate some of these accounts.

You have the world leader, which is KCI, they have, everything that was developed for the negative pressure market was developed by them in a sense and they have a wide range of applications. We come in with just, our first pass at a product and if we have any product gaps at all it is just real fertile ground to essentially throw up objections about what our product is and where it is.

We're making very good progress. We have all new pumps, we have all new products, we have new dressings. We're winning IP battles. Our customers like the product, it works really well, it has economic justification associated with it. So our feeling is very simple. It's not an issue of if at all in our minds, none, it's only when. And it's a matter of us staying the course, resourcing



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this business properly, not overreacting to anything and we're going to reach a tipping point at some point in the future where we're going to build a substantial business out of this and we're very, very confident of that.

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**Martin Wales** - UBS - Analyst

In 2010 or 2011?

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**David Illingworth** - Smith & Nephew - CEO

I don't mean to chuckle, I apologize for that but we don't think that way. I mean this is a product and we have an entrenched competitor and we have a right to win and we are making progress, and this is going to be a big business in five years. Whether or not this thing is profitable or whatever measure you want to give it in this quarter, next quarter, middle of 2010, end of 2011, really we don't think that way because we're in an investment phase in this business. We really are investing in this. We're almost like a start-up company here.

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**Martin Wales** - UBS - Analyst

Okay and an update on litigation? And also, Adrian, I think you said my \$4m to \$5m a quarter is too low yet you're talking about contributing 2%, \$208m. Maybe you could give me a little more color on that.

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

Your number is definitely too low, we've increased growth by 2% in the quarter, increased the growth rate by 2%. We can talk about your exact numbers outside but your number was too low.

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**Martin Wales** - UBS - Analyst

(multiple speakers)

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

On the patent stuff, yes, you're quite right, I mean clearly we are engaged on a set of patent disputes with KCI, they're coming hard at us. Yes, there is an injunction hearing in the US coming up. It's the same area as the UK and the German courts have ruled on recently and we won both of those. Clearly there's uncertainty, the substantive hearing is in February 2010 so I think there's several possible outcomes from the injunction. We might find an injunction against foam as we did have in the UK before it was overturned, as we currently do have in Australia pending the hearing. There might be no decision on the injunction until the substantive hearing in February, who knows? There's a whole series of possible outcomes. And that's part of a backdrop that makes this we're going to absolutely face it. As Dave said, there's no doubt in our mind this is going to be a hugely profitable product ultimately but it's another of those reasons why calling the quarter it will become profitable isn't particularly helpful.

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**Martin Wales** - UBS - Analyst

I was only asking for the year.

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

Oh right. I tell you what we'll give the decade.

**Martin Wales** - *UBS - Analyst*

Okay. Thanks very much.

**David Illingworth** - *Smith & Nephew - CEO*

All right, thank you.

**Tom Jones** - *JP Morgan - Analyst*

Hi, it's Tom Jones from JP Morgan. A question for Adrian just on currency. Taking your constant currency numbers it looks like you had about a 30 basis point currency headwind in the quarter on your margins, which struck me as somewhat of a surprise given that the collapse in sterling where you have quite a bit of your cost, particularly in the Wound business. So I wonder if you could just walk us through the currency impact of your various divisions line by line, very helpful.

Then secondly just on the mix that we were talking about earlier. How confident can you be that the mix decline that you've seen is purely related to patient traffic coming through the door and you're not actually seeing any shift down or down-branding from the surgeons? The reason I ask is that this does resemble a little bit the situation we saw in the early 90s where the first thing that went was the volumes, the industry dug its heels in on price, so the hospitals went down the route of down-branding and lowering the mix benefit. Then eventually a year or two later prices followed. It sort of seems to be following the same pattern. So I wondered if you could just make some comments there as well please.

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

Sure. On the currency I'm not sure exactly where you get your number from, Tom, but --

**Tom Jones** - *JP Morgan - Analyst*

Well, I just took your constant currency growth rate for the trading profit, which is, if you take \$198m and times it by 1.17 you get to about \$234m. Divide that by \$1b which is the flat number from last year and you get to 23.2-ish.

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

Okay ,I'm still not sure quite where you got that from --

**Tom Jones** - *JP Morgan - Analyst*

In the presentation.

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

Okay, all right, well, fine. But nonetheless, what you're saying is directionally correct, there is a slight negative transactional currency impact in the quarter. And that comes, yes, there's a gain in sterling for Wound and there is a loss in the dollars from both -- well the Orthopedic business and the Endoscopy business.

And just slightly more broadly, I mean we have a pretty good hedge in the round, in the sense that most SG&A spend is matched between the currency of the spend and the currency of the revenue and that, of course, is the greater part of the cost structure. Within cost of sales we do have a sterling heavy cost for Wound, which of course just at the moment is a good thing, at least year-on-year. And it's something like 40%-ish, 45% maybe of the cost in Wound is in sterling, and something like 15% of the revenue is in sterling in Wound. Conversely, in the Orthopedic and Endoscopy businesses taken together we are dollar heavy and it's something like 50% of the revenue in those currencies, and something like 70%-plus-ish of the cost of sales. So those two are what drive the slight transaction exposure.

It does impact with a delay because of course there's the inventory cycle in there which, in the case of Orthopedics in particular is quite substantial, and we do buy systematically a certain amount of full cover. So you can think of a delay of nine months to a year before you actually see that impact coming through. So whatever the calculation was for the quarter, you know, you've got to go back a little way to track it to its genesis.

In terms of the patient traffic, do you want to do that?

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**David Illingworth** - *Smith & Nephew - CEO*

Yes, well, I -- it's a great question, number one.

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

It's a very good question, yes.

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**David Illingworth** - *Smith & Nephew - CEO*

It's a very good question and it's not something that we can give you an unequivocal answer on. Our opinions on this are really driven by some anecdotal information that we have. I wouldn't say that it's 100% deferrals, I don't think it is. I think there are situations in different parts of our business where there probably is a movement to equilibrate a little bit on different specification products.

For instance, in the UK in BHR, I mean, BHR in the UK was 15% of the total hip market. We always thought that was a bit high in terms of what the steady state was going to be. Our experience in Australia and some of the other major markets that we brought this product into was probably somewhere between 8% and 10% and I think it's sort of working out to be -- I think we still need more time on it, we need more competitors to really understand it, but it's probably going to be in that 8% to 10% range. So you could argue that BHR was a little bit over-penetrated in the UK and maybe there's a rebalancing of what's being prescribed to whom and when.

But we don't know that for a fact, but anecdotally we're not hearing a lot about substitution of products. Anecdotally what we're hearing is that the backlog of surgeries is getting shorter and the younger more active patient is getting disproportionately affected here in terms of deferral. So that's what we're going with but it clearly probably has some components of people being very conscious and selecting their products appropriately and we certainly would encourage that. The reason we have a full range of products is so that our customers can choose the most appropriate product for their patient at any given time.



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We've got to go to Yi-Dan, she's been waving at me very vigorously there.

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**Yi-Dan Wang** - *Deutsche Bank - Analyst*

Thank you. I've got two questions. One is on pricing. Can you give us a sense of how much like-for-like prices changed for you, particularly I suppose in the US and also globally for Orthopedics?

And then secondly, also I suppose stemming from pricing, can you give us a sense of how much of your business is done on contract and whether you're getting, whether hospitals are pushing you to renegotiate those? And how long we could see this process last for?

The third question is on Clinical Therapies. Would you be adding a third product to that portfolio any time soon or is that more of a medium term thought?

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**David Illingworth** - *Smith & Nephew - CEO*

Yes, it's pretty straightforward.

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

Yes, it's about 1% down like-for-like across the globe, slightly more down outside the US than in the US.

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**David Illingworth** - *Smith & Nephew - CEO*

But on balance about 1%. How much is contract? I don't know the exact number but I can give you a little bit of a steer here in terms relative to our competitors in the marketplace. We have less contract business than I think you would see some of our traditional competitors having. We tend to avoid aggressively moving into a contract situation unless we feel like there is some compliance on the part of the person writing the contract had some influence over choice of product. So that if we give discounts we'd like to get some volume impact as a result of it. And not every contract that's written, especially in the US has that type of guarantee associated with it. So we probably have -- I don't know that exact amount but we have significantly less contract business than some of our competitors have. So I don't think we're seeing a big impact there, Yi-Dan.

And really there's nothing to report on the Clinical side other than we're looking. We literally had our first review of what we might, some strategic thinking around what might be appropriate to move into that channel. We might not have anything added to that channel over the next year but we might have three or four products. It all depends whether or not you can acquire them, license them, pay royalties, I mean everything is different. And it also has to fit into our strategy longer term about what we're going to try to do with that business. We don't want to just fill it up with products, it really has to fit our strategic intent. But I wouldn't be looking for anything right away, but we are looking.

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

Morning, Ilan Chaitowitz from Redburn Partners. Just a couple of questions. Can you please quantify the mix impact, there's been a lot of discussion on it, but can you quantify what you've seen on your hips and knees businesses?

And secondly, there was a buildup of inventory and that's from last year and I was wondering is that relating to any moves or are you having a tough time pushing that product into the market?



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**David Illingworth** - *Smith & Nephew - CEO*

Do you want to take a shot at that?

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

Yes, can we quantify the mix impact? We mentioned we haven't seen a lot of change in like-for-like pricing and there was a question there just to confirm that. The reduction we've seen in the top-line growth is a combination of volume and less mix growth, we are still seeing positive mix but a lot less than we have been seeing traditionally in the prior years. So I'm not going to put an exact number around it but it is less and that's obviously consistent with the higher specification products being the ones that we're seeing the biggest weakness in.

In terms of inventory, yes, there has been a buildup in inventory, mainly in the Orthopedic business. We do see fluctuation -- well, first of all, it's a very inventory-intensive business as you know, it's a consignment industry and all that sort of stuff. The biggest part of the buildup we've seen in the first six months was we actually, the way we launch instruments, instruments are themselves capital but until they're reassembled (technical difficulty) inventory and we have seen a material increase in that, pending the deployment of the instruments. So once that works through that should deal with much of the short term increase.

**David Illingworth** - *Smith & Nephew - CEO*

Okay, nothing on the -- Michael, a follow-up here?

**Unidentified Audience Member**

Hello, just a (technical difficulty) in Q1 last year a question in the conference call, given that you had a slowdown in industry growth rates which you probably didn't expect, you indicated that the EIP Program was touch and go now. I'm not sure the words were used 'touch and go' but it was quite tough. Three months later you come out with a margin expansion that really is a blow out and I'm trying to understand what happened in Q1 compared to Q2 because the market has only become more difficult? Why suddenly this massive margin expansion?

And then a follow-up question on the deployment of these savings in the future. I don't think anyone in the investment community would have expected 3 points of margin expansion. What has caused you not to reinvest some of that out in perhaps sales force expansion in Trauma where you're now growing substantially below the market, and also in Reconstructive? What caused you to think I've got to capture the entire savings as an EBIT margin expansion?

**David Illingworth** - *Smith & Nephew - CEO*

All right, well, let me take the first part on the EIP, and you sort of have to get into our head a little bit here, if you can try to do that. We went from a phase where when we started this project we thought, and made the commitments that we did, that we pretty much thought it was slam-dunk, we're going to make this, we've got plenty of contingency, we have people in the organization that have done this before and it's just a matter of executing properly and going after it. And that worked pretty well for us until we got to the point where we had the greatest global economic calamity of the last 100 years. And we started thinking to ourselves we're going to have to be a little bit more cautious here because there's going to be some challenges in making this number. And it was really important for us to signal that to you and to the marketplace in general, that here was more risk in making the numbers in this program and that's essentially what we did.

Now it's certainly understandable that maybe someone might have overreacted to our signaling of that risk but that risk is there. We don't know, I mean it is tougher for us to make this number, period. And it is, we didn't use the words touch and go

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but that would not have been a bad way to describe it because it is a little bit touch and go. If we make it it's going to be close and we still believe we're going to make it, so it is going to be close. And we have to, all the stars have to align, we really have to get people energized, we even have to find some new opportunities, be extra vigilant. We don't have to have any kind of impact on the long term business. We want to do the right things and we've done that all along and we've instilled that in the people.

That's why we called it Earnings Improvement Program, versus cost cutting program because you can sell your way to earnings improvement as well and we wanted to send that message to the organization that this was not just cost cutting this was build a bitter business. So that's what we did and maybe we over signaled it a little bit but I think it's a much riskier environment and there was a lot of unknowns that we were dealing with -- that we continue to deal with and that's kind of where we were.

Do you want to take the other?

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

Well, I think the second question was why not reinvest. I mean I sort of struggle with the question in the sense that we are reinvesting, there's been no change in our philosophy, it's not as if we sit around at the end of Quarter 2 and think gosh, there's more money here than we expected, shall we reinvest it? It just doesn't work like that, Michael. There is going to be variability quarter-by-quarter and we've had some quarters where you guys have looked and said, "Christ, that looks pretty poor" and we've said, "Well look, steady on this does vary." And this was a particularly good one and it's the nature of the business. Don't over read it, yes, don't over read --

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**David Illingworth** - *Smith & Nephew - CEO*

Yes, and if you sat in our executive meetings and our strategy meetings, the tone is where can we invest? We're pushing our people to look for opportunities to invest in the business, we are, I can't think of something that we've said no to very recently.

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

Well, a few things but --

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**David Illingworth** - *Smith & Nephew - CEO*

Well, a few things because --

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

We can't think of any good thing we've said not to.

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**David Illingworth** - *Smith & Nephew - CEO*

No, we've said no to some things that we just didn't feel were the right things for the company, but I can't think of anything that we said no to because we weren't willing to invest in it.

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

Least of all R&D, back to those earlier questions, we are very focused on finding new things in that area.



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**David Illingworth** - *Smith & Nephew - CEO*

Yes, so we're still moving along.

**Peter Cartwright** - *Fiske - Analyst*

Thanks very much. Peter Cartwright at Fiske. If President Obama is successful in passing the Health Bill and your industry is asked to make a contribution towards the saving, is that just a straight price cut or is there anything else you can do?

**David Illingworth** - *Smith & Nephew - CEO*

Well I, it's kind of hard to answer the question the way you asked it, so allow me to tell you what I know about the situation. We are working very closely with AdvaMed, we have a seat on the Board, the President of our Orthopedics business sits on the Board of AdvaMed. It's our industry body in the US and they are coordinating a response on behalf of all of medical devices, not just orthopedics.

And the industry's position is essentially that we remain committed to the overall goal of achieving broad-based reform that offers every American Citizen access to healthcare, that would be the first thing, so we want to be part of that solution. And to that end we're maintaining an open line of communication through AdvaMed with the Whitehouse and leaders on Capitol Hill. But I don't believe there have been any, I mean there certainly hasn't been anything that's been presented to me in terms of a solution. And I think they're very, very much at the very beginning of any types of discussions and brainstorming about how this part of the industry could be a part of the solution. So I don't think there's really a lot to report as of yet.

And this will have to be the last question unfortunately because we are out of time.

**Unidentified Audience Member**

Yes. Four years ago we saw Hurricane Katrina hit your numbers, I just wondered how concerned you were that a severe flu pandemic might have a similar impact?

**David Illingworth** - *Smith & Nephew - CEO*

We haven't seen an impact yet, David. If, we're certainly not the experts in this business but we haven't seen an impact yet. We have dealt with flu seasons in the past and we've hardly ever really even talked about them. Could this be substantially worse? I think if it does impact, there's clearly the chance that we might have a global pandemic with swine flu. If that chance becomes a reality I think we're going to be impacted relatively, in relation to all of our competitors equally and I think it will be a fairly passing event. There might be deferral of procedures during that time but I think the market would recover pretty quickly, that's kind of how I would think about it.

So we don't, we spend more time thinking about what is our corporate reaction to a flu pandemic in terms of what would we do to make sure that our employees got treatment properly and quickly. But in terms of the impact on our business we haven't seen a lot of impact nor are we expecting a big impact.

Okay, thank you very, very much. I appreciate everybody's attendance and see you or talk to you next quarter.

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**Operator**

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