

FINAL TRANSCRIPT

Thomson StreetEventsSM

SNN - Q3 2009 Smith & Nephew Earnings Conference Call

Event Date/Time: Nov. 06. 2009 / 8:30AM GMT



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PRESENTATION

Operator

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Good morning ladies and gentlemen and welcome to the Smith & Nephew 2009 Q3 results conference call. My name is Fay and I'll be your coordinator for today's conference. For the duration of the call you'll be on listen-only. However at the end of the call you will have the opportunity to ask questions. (Operator Instructions).

I'm now handing you over to David Illingworth to begin today's conference. Thank you.

David Illingworth - *Smith & Nephew* - CEO

Thank you Fay. Good morning everyone and welcome to our third quarter results presentation. I will talk to you about the progress in the business and our achievements in the third quarter and then Adrian will take you through the actual numbers.

Let me start with a few comments on market conditions. The climate has been tough in the third quarter but we're beginning to see some signs of stabilization. There are some clear signs of volume growth returning although price and mix are still under pressure in the orthopedics market.

Capital spending by hospitals is still very low. And as all of you know, the US government has announced the medical devices levy and we're working closely with AdvaMed to ensure that the government is fully informed of our point of view.

Turning now to our performance this quarter, we've had some very -- we've had some good outcomes -- very good outcomes in key parts of our business. Reconstruction continues to strengthen and the US appears to be very close to market growth rates. Our emerging markets business which we have a particular focus on has performed well across the board. Our repair business and endoscopy has grown at 12%. Our wound care business in Europe has grown by 8%. And negative pressure wound therapy or NPWT as we call it has contributed substantially to advanced wound care's revenue growth this quarter.

However we are disappointed with trauma and I'll talk in a bit more detail about that later. Margin is very good this quarter and we believe much of the improvement is sustainable but we do have a relatively weak comparator and margin of course varies quarter by quarter. But at 22.8% this is the highest margin we have achieved in a third quarter since we started quarterly reporting in 2004.

Our earnings per share is up substantially, partly as a result of a one-off tax benefit which Adrian will talk about in a few minutes. We do have a long-term focus on operational efficiency as part of our culture now and as we become more efficient we have more money to invest. So before I talk about each of our businesses I'd like to give you an insight into some of the investments we're making in the business for the longer term.

In advanced wound management the commissioning of the China factory has gone well. It's ahead of schedule -- it was ahead of schedule with production now going into the US market. Some of you may have seen the Chinese product as we've been showing it at investor conferences for about the last month. We're now installing a second production line for wound and have put the roof on a separate facility, orthopedics factory near Beijing. I personally toured the wound care factory two weeks ago and it truly is an impressive facility.

We continue to invest in negative pressure wound therapy and although we are engaged in a significant legal battle we are making good progress as we expected and have won the last five judgments in a row.

More importantly, we are more convinced than ever that customers want more choice and that's what we are giving them. A very high quality alternative indeed.



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We always had a strong focus on medical education in all of our businesses and now that we have real clarity in our compliance process we are increasing training and investing in training centers for our customers and a virtual training university for our sales force. We are also providing our sales force with more up to date handheld technologies, putting more power into the hands of our sales reps.

You've also heard me talk before about the importance of China for us as a long-term market. We have established this quarter a China Board which I personally am chairing to prepare ourselves for long-term customer relationships and a winning business strategy for China. Also we've worked hard to be the company synonymous with real innovation and this is a continuing process as we work with our customers to deliver better outcomes for patients and payers alike. The tougher the circumstances the closer we need to work with our customers.

The next few slides give you additional information about some of the projects we're currently working on. These larger projects will drive revenue growth as well as margin improvement for a long time to come. This first slide shows the second production line for advanced wound management in our China factory. This line will be producing ALLEVYN adhesives using the equipment that has been transferred from Largo, Florida. And we're also commissioning a brand new line which will produce OpSite Post-Op Visible, a really cool new product previously made in small quantities in Hull.

Now turning to the next page these are some images of our orthopedics facility in Beijing, China. This will be a 10,000 square meter facility which we anticipate will come on stream some time in 2010. We'll initially produce instruments here and then ultimately implants and other products.

On the next slide-- we're constantly looking for better ways to connect with our customers. On this slide you can see our new handheld device. It's a modified smart phone designed to facilitate the two-way exchange of information between the Smith & Nephew teams and our customers. Information will be available real time including product information, product demos, training, sales reports etc. And more importantly these devices will in time enable the real time exchange of information to and from our field sales teams.

Turning to the next page, this is the floor plan for our new bio lab that we're building in York in the UK. It will be a company-wide facility. The lab will add to our increasing global capacity for high quality training and it truly will be a world class facility.

Now turning to each of our businesses with a few comments, first starting with orthopedics. Orthopedics continued to see very strong growth in our core hip and knee businesses and improved reconstruction performance in the US where our revenue growth approached market rate. In Europe this quarter our new management team continued to work through a program of activities to expand the customer base as well as work closely with current customers. This has delivered a sequential improvement of 5% this quarter.

We are beginning to see a stronger overall market in the US as volume growth seems to be returning a little. Price and particularly mix continue to be under pressure. We continue to see a disproportionate impact of deferrals of procedures in our younger, more active patient segment and anticipate that this will continue at least until consumer confidence returns.

Our core hip and knee business is doing great with hips outpacing the market and knees nearly at market growth rates. We've seen a good improvement this quarter and have more to do.

Our trauma business again had a tough quarter in the US and in Europe, a performance we are not satisfied with and have as our key priority. Let me explain what this problem is not. It is not a problem with the product range. This business has an excellent product range and is capable of growing at accelerated rates again in the future as it has in the past. Sales force support, recruitment, training, these are all key priorities for us right now in this business. It's not something we can fix quickly. It will take time as it's a complex set of issues including sizeable military orders which we had in Q3 and Q4 of last year which have not repeated this year and a weaker external fixation market.



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We have just appointed a new VP of Sales for our US orthopedic businesses, Kevin Odle. He has over 20 years of experience in orthopedics and one of his immediate priorities will be trauma.

Turning to margins, we grew margins by 350 basis points in orthopedics in the quarter and although we had a weak comparator this represents very good progress and we believe this improvement is sustainable.

Turning to endoscopy. In endoscopy this quarter overall revenues grew by 1% as the impact of weak purchasing in capital equipment drove visualization revenues down by 21%. By contrast our arthroscopy revenues, driven by knee and shoulder and from a small base hip products, grew by 8%. Our endoscopy business outside the US has benefited from investment last year and from increased training this year. We held the first of our fellowship program events in Andover -- Andover, Massachusetts in the quarter which was very well received by the surgeon community.

We are pleased with the progress we are making in the US business as our sales force investments are paying off. And the rest of the world revenues grew by 11% as these markets continue to generate excellent growth.

The margin improvement of 530 basis points in the quarter came through as we benefited from better cost of goods, our Six Sigma program and the closure of the San Antonio facility.

Now turning to advanced wound management. Advanced wound management grew by 3% in the quarter driven by strong growth in Europe and by negative pressure wound therapy which made a great contribution to revenue growth. In Europe we've seen the benefits of product launches and sales force investment as this business grew at 8%. In the US we're seeing some progress as the sales force is better balanced and selling both advanced wound care and negative pressure wound therapy products. We inevitably get some volatility in revenues from changes in distributor inventory levels.

Infection management grew well as the newly introduced ACTICOAT FLEX made a strong contribution. We're also pleased with the silver versions of ALLEVYN which we introduced in the last year. Negative pressure wound therapy continued in its growth path this quarter and we're now beginning to see real momentum in this business. Our sales bag is filling up and we are seeing our sales force becoming increasingly productive.

The margin in this business grew by 460 basis points to 21.8% as we made excellent progress in managing our SG&A costs as well as substantial progress in our cost of goods. Overall we're very pleased with the progress of the advanced wound management business and the progress that it's making. It is in much better shape than it has been in recent memory. It is running more efficiently, its margins are stronger, we're building an exciting negative pressure wound therapy business and we have very solid business fundamentals. The new management team is performing very well for us.

I'll now hand over to Adrian to take you through the numbers.

Adrian Hennah - Smith & Nephew - CFO

Thank you Dave and good morning ladies and gentlemen. If we could turn firstly to slide 14 and the income statement. Revenue in the quarter was \$915m. This represents underlying growth of 1% after adjusting for exchange rates on quarter three last year, a reported decline of 2%. Trading profit in the quarter was \$208m, giving underlying growth of 22%. Trading margin was 410 basis points higher than quarter three last year. Interest costs are down on last year reflecting lower borrowing and lower interest rates.

Moving to slide 15 and moving further down the income statement. With regard to the tax charge we now expect a charge before exceptionals and amortization of 29.3% for the full year. This is lower than the 31.8% rate which we had been expecting as a result of the favorable outcome of certain tax negotiations. This is a one-off reduction and we do not expect the lower rate to continue into 2010.



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Adjusting the year to date tax rate to the 29.3% expected for the full year gives a tax rate in quarter three of 24.1%. Adjusted attributable profit for quarter three was \$148m. Adjusted earnings per share was \$0.168 which is 38% higher than quarter three last year. EPSA growth is higher than the underlying 22% growth in trading profit, principally due to the change in the expected tax rate for the year.

Turning to 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. As in recent quarters the translation currency impact in wound is larger than in the other segments due to the higher proportion of its business in euro and in sterling.

Turning to the next slide. An analysis of revenue growth rates by business and by geography. As well as the numbers on this slide I will also refer to the growth rates of our main product types which are included as usual in an appendix to this presentation. At constant currency, sales in our orthopedics business in the quarter were flat and were flat on quarter three last year. Hips grew at 2%, knees grew at 2%, trauma fixation fell at 5% and clinical therapies fell at 5%.

In the United States ortho growth was 1%. As Dave has mentioned, we, like other companies, continue to see somewhat soft volume demand. This softening has continued to have a particular impact on our higher specification products. Growth in our US knee business was 5%, close to the market rate of 6%, despite the weakness in the higher specification products. US hip growth of 6% was slightly ahead of the market growth despite a decline in BHR sales in the USA which has been exacerbated by the macroeconomic pressures. As you know BHR accounts for about 25% of our USA hip sales. Trauma fixation sales in the US were 4% lower, materially below the market growth rate of about 7%.

As we mentioned a year ago, quarter three and quarter four of 2008 benefited from significant orders from the US military. This has not recurred this year. Excluding military orders sales declined by 2%. CT sales, clinical therapy sales in the USA fell by 6%. In Europe ortho sales fell by 3%. We again saw the impact of a somewhat weaker market in these European numbers. We also underperformed the market although this was by significantly less than in quarter two. We saw a particular impact from lower mix with continued greater impact on our higher specification products. As in quarter two year-on-year growth has been impacted in line with guidance by the tail end of the Plus lost sales.

In the rest of the world ortho sales grew by 1%. The positive underlying trends in the emerging markets continue. We again saw double-digit growth in the emerging markets in the quarter. We continue however to see some impact from the macroeconomic challenges in the more mature of our rest of the world markets, especially in Japan and in Australia.

Globally in orthopedics we've seen a like-for-like price reduction of about 1% on the same quarter last year. This represents only a very slight weakening from the recent trend. Mix is showing a similar reduction of about 1% on last year. This represents a larger fall from the trend over the last couple of years, again reflecting the impact on our higher specification products.

Endoscopy sales grew by 1%. We continue to see a significant fall in demand for capital equipment within this business. This fall is again most substantial in the United States with a more muted impact evidenced in Europe and elsewhere. Capital sales accounted last year for about 20% of global endo sales. Within endoscopy arthroscopy sales including both repair and reception grew by 8%. Visualization and related sales fell by 21%, similar to the year to date decline.

Wound. Wound sales grew by 3% in the quarter. This included a contribution from NPWT sales of over 2%. Total wound sales fell by 5% in the USA, grew by 8% in Europe and were flat in the rest of the world. In the United States NPWT sales continue to benefit from the new pumps and dressings and we are seeing gradual but increasingly clear signs of good progress in this market. In Europe we again saw solid progress. NPWT sales in Europe continue to do well as the new pumps and dressings were introduced and as the legal position gives confidence to customers.

Turning to the next slide, slide 18. This shows the usual analysis of revenue and trading profit by business segment. As we have already noted the trading margin for the Group was up 410 basis points in the quarter on quarter three last year. This was clearly



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a good performance. The orthopedic margin increased by 350 basis points in the quarter. We continue to benefit from our focus on a combination of tight budgetary discipline and investment in improving efficiency and effectiveness of our main processes.

The endo margin increased by 530 basis points in the quarter. This too reflects tight cost discipline. Also the margin in quarter three last year was reduced by high legal and business development costs.

Margin in wound was 460 basis points higher in the quarter. NPWT was, as expected, again loss-making in quarter three. 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 other businesses the improvement was due to a combination of EIP programs and budgetary discipline.

Our planned efficiency improvements are being delivered. Our goals in this area remain unchanged. And in this context it might be helpful to remind you of our position. We continue to target an exit margin of 24.5% for 2010 but there remain caveats on this. As we have previously indicated, 24.5% margin has more risk now than when we set it. Economic headwinds, compliance costs and NPWT investment have all contributed to this risk. The target continues to have a valuable role internally in focusing attention on operational efficiency. Very importantly it has always been efficiency and not our margin target per se that are our focus in running the business. As you would expect, we will not achieve a margin target at the expense of the value of the business.

It may or may not make sense to get to a 24.5% margin by the end of 2010. Internally our focus is moving beyond the end of 2010. Indeed much of the systemic effort we have underway will not deliver benefits until beyond that date. We continue to see significant opportunities to improve the efficiency of the business.

Turning to the next slide, slide 19, and the cash flow statement. We generated \$152m of free cash flow in the quarter and \$216m in the year to date. Capital expenditure in quarter three was \$66m, the largest part of this investment instruments as usual. Restructuring spends on the EIP program and on the Plus integration continue in line with expectations. Net debt decreased to below \$1.1b in the quarter principally as a result of the free cash flow generation.

Turning then to the next slide and the outlook. There's been no change in our view of the overall outlook from last quarter. David's commented on our views on overall market growth. In the orthopedic reconstructive area we believe that underlying global market growth increased slightly quarter-on-quarter to around 5% in quarter three. We continue to 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 and the tail end of the Plus effect in Europe.

Within orthopedic trauma we believe that the underlying market growth remained at about 7% in quarter three. Despite our disappointing performance in recent quarters especially in the USA we continue to expect to return to a sustainable market growth rate but this will take time. Quarter four growth will be impacted to a greater extent than in quarter three by about 5% as a result of a large military order last year.

Within orthopedic clinical therapies we continue to see market and competitive challenges for our joint fluid therapy and bone stimulation businesses 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.

Within wound we continue to expect to grow ahead of the market including NPWT and at around market growth excluding NPWT.

As I already mentioned there is also no change in our position on margin improvement. We should however reinforce the message that we have repeatedly given that margins will vary quarter by quarter. After three quarters of strong margin growth



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you should not be surprised to see a weaker quarter. We expect for the full year an effective interest rate on net debt of 3% to 4% and as I mentioned earlier a tax rate of 29.3%.

And with that outlook on 2009 I'll hand back to Dave.

David Illingworth - *Smith & Nephew - CEO*

Thank you Adrian. Before summarizing on the quarter I'd like to just remind all of you of the main drivers of our strategy. First we are customer led and intend to outperform in the markets that we participate in. Secondly is we have a strong drive to be more efficient -- much more efficient actually and we have long-term programs in place to achieve this. Thirdly, as we invest for growth with a history of innovation and an ongoing objective to drive significant revenues from new opportunities. And fourth, we are increasingly aligned and from 2010 onwards there will be a stronger and very clear link between the achievement of our goals and employee compensation within the company.

And then lastly before we take questions, I'll just put some summary comments to what Adrian has said. Although we continue to expect tough conditions for some time, overall market conditions do seem to be stabilizing. With that said, we had a productive quarter as most of the key areas of our business are reporting better performance and our margin improvement efforts are really paying off.

Adrian has talked about the specifics related to the outlook. I am confident that we will have a good outcome for the year, particularly given the conditions we are dealing with. In our internal communications when we talk about making our business more customer-focused and more efficient we emphasize that there is no finishing line here. We've made good progress but there will always be a lot more to do. And this is the key element of our business strategy. We have clear goals for Smith & Nephew. We have a lot to do and we're doing it.

Now I'm happy to turn it back over to Fay and happy to take questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). The first question comes from the line of Matt Miksic at Piper Jaffray. Please go ahead.

Matt Miksic - *Piper Jaffray - Analyst*

Good morning. Thanks for taking our questions.

David Illingworth - *Smith & Nephew - CEO*

Hi Matt, how are you doing?

Matt Miksic - *Piper Jaffray - Analyst*

Good thanks. So just first a question for Adrian and I guess for Dave also just on the aspirational goal of the EIP for next year. If you look at your ability to hit that you said it may or may not make sense to hit that goal. Is that -- what kind of assumptions are you making in your ability to hit it or not? In other words if the market stays the same you're not likely to be able to hit it or it

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doesn't make sense, if the market gets better and you feel more confident about hitting it? Any color you could provide there and one follow-up.

David Illingworth - *Smith & Nephew - CEO*

I'll give you my two cents worth first and then I'll let Adrian drill down into some of the details. I think the spirit of that comment is that -- maybe by example, if you go back to early 2008 where we made some significantly higher investments in negative pressure wound therapy than we had originally planned to do because we really thought that that was the right thing to do in our business. And it clearly had a short-term effect on the margins in our business. And we took a lot of abuse quite frankly from folks in the marketplace because of that. But we have to manage this business for long-term growth. We have to manage the business and not to hit a margin target for a specific time on a calendar but to have long-term sustainable profitable growth for the business and get much more efficient.

So we still have an internal target of 24.5% as an exit rate and we still have plans to get us there. Do we have risk? Yes we do. If something comes up along the way that changes our mind about some of the timings on those margins will we do it? Yes we will because we have to run the business in the best way possible. Adrian?

Adrian Hennah - *Smith & Nephew - CFO*

Yes, that's exactly as Dave has said. We've had a good I guess three quarters now of margin growth and the key in re-emphasizing that there's no change in our overall guidance not to let there be an overreaction and think, well look you've had three excellent quarters, why don't I just extrapolate that going on. That's not how it's going to be. And so therefore we were particularly keen to repeat our guidance and say that doesn't change. The tone we had previously is the tone we've got now notwithstanding some good quarters which we'd expected and have delivered.

In terms of a little more specific answer to your question, what are the risks. Clearly price, volume, mix. Those are risks. And I guess one can add to them taxes now. But there are still risks out there. In some sense as the time horizon to the end of 2010 has got shorter you can say those risks are less but who knows? A year is still a long time (inaudible). And I guess reviewing what's going on in Washington is one example of that because things can move quite fast.

But a second area of risk is exactly what Dave has just said. As you can imagine, we're going through our budget process now for the next year and there are on the table a set of exciting investment opportunities. So we have to go through those and decide. As Dave has said we're running this business for the long term to increase value. We're going to stare at those and in the context of the progress we're making the opportunities on the table, our absolute commitment to improve the operational efficiency of this program, decide what it makes sense to do for what is essentially an arbitrary timetable around the end of 2010. So all those things will go into the mix and we will do what we will do to maximize the value of the business.

Matt Miksic - *Piper Jaffray - Analyst*

Thanks. One follow-up question just on the core ortho business, hips and knees. You mentioned mix in the US and in Europe now having an impact. What -- is there anything that you're doing, is there anything that you can do to start to turn those businesses up a little bit more? Or is this -- are you at a point now where you're competitively where you need to be, you're as active as you need to be or can be and it's just a matter of looking for some of the younger patients that you talked about coming back in to start driving growth again?



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David Illingworth - *Smith & Nephew - CEO*

That's a great question Matt. We're not displeased with where we are I guess is the way to say it. We're not jumping up and down but we're not displeased. We knew that we were going to be subject to some of those mix issues and the deferrals and we're very, very encouraged actually -- if you take a look at our core hips and knees, the non-Journey, the non-BHR, the high performance push the envelope type of products, we're way outperforming the market in those segments, in the core hips and knees segments. So we're actually feeling pretty good about it. We understand that there's going to be some deferrals and we're living with it and doing okay. And we're seeing sequential improvement in that business which is heartening for us as well.

We did put a lot of effort and continue to put a lot of effort into our compliance efforts in the US and we've extended that to a global scale. And we're also -- orthopedic reconstruction is our most complex business and we have a lot of effort going in to making that business more efficient operationally. And that's an opportunity cost as well. As you know, we changed the way that we talked about our business from outperforming the markets to at or slightly below market growth rates while we were working on these efficiency programs in our businesses.

So we're not displeased. We'd like to have a little bit higher growth rate but we're moving in the right direction.

Matt Miksic - *Piper Jaffray - Analyst*

Thanks. I'll keep it at two. Thanks again for taking our questions.

David Illingworth - *Smith & Nephew - CEO*

Thanks Matt. Take care.

Operator

Thank you. The next question comes from the line of Ed Ridley-Day from Barclays Capital. Please go ahead.

Ed Ridley-Day - *Barclays Capital - Analyst*

Good morning. Thanks very much for taking my questions. Just a follow-up actually on the question regarding orthopedic growth. If really very as you say solid performance overall in your core business. Could you give us a little bit more detail on the breakdown? You've given us some indication before of what proportion of your business you are defining as younger patients versus core business in the hip and knee business in the US? And then in terms of the core business which products particularly you are doing well in and outperforming the market with? That would be my first question.

And on the negative pressure business, excellent growth, which is obviously very encouraging. Could you give us a little bit more quantification of what form of uptick you've seen, what particular areas of the market or regions that you've seen that performance?

Adrian Hennah - *Smith & Nephew - CFO*

Yes, there's a limited number of bits of data we're prepared to give here because we really do not want to get into the area of numbers around specific products. But I guess there's a couple of ways we could maybe point you, as we've done others in the past, to the degree of orientation to higher spec, younger more active patient products.

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One is in the proportion of sales that is funded by Medicare as opposed to private insurance. It's a slightly fuzzy data because it's not perfect access to it, but broadly we think that for the market as a whole something like two-thirds of all implants are funded by government sources, Medicare principally, and a third private. For us it's more like 55% Medicare and the rest private. So you can see in there is a measure of our orientation to private reimbursed, and tends to be higher specification, products.

So that's one bit of data we do discuss Ed. And the second is one we mentioned in the presentation earlier, that obviously one of our higher specification products is VHR, which is now around a quarter of our hip sales in the United States, so that is meaningful. But beyond that no, we're not going to go giving numbers for individual product lines.

Ed Ridley-Day - *Barclays Capital - Analyst*

Fair enough, fair enough. And on negative pressure, could you just give us a bit more color about the improvement, obviously you've talked about the investment and you're starting to get traction with your sales force. Again, is there anything more you can give us in terms of the quantification of the impact on the business in the quarter, on the overall Wound business?

Adrian Hennah - *Smith & Nephew - CFO*

Well, the quantification we've been giving, or the type of quantification we've given for the last few quarters we can repeat this quarter. The overall Wound business grew at 3% and 8% in Europe. There are poorer performances in the US, but of that growth the vast bulk, significantly over 2%, was NPWT. So you can get back to see that NPWT sales, while still not substantial, you can clearly see -- we can clearly see growth, as you get down to the micro level, getting material, getting significant.

Ed Ridley-Day - *Barclays Capital - Analyst*

Very good, that's very helpful. I'll get back in the queue. Thanks.

Adrian Hennah - *Smith & Nephew - CFO*

Thank you.

Operator

Thank you. The next question comes from the line of Lisa Bedell Clive from Sanford Bernstein. Please go ahead.

Lisa Bedell Clive - *Sanford Bernstein - Analyst*

Good morning. First, on the reconstruction market, growth rates globally have appeared to slow by about 100 to 200 basis points a year since 2002. Given this long-term trend and the fact that European health stemming will likely be constrained over the next few years, what confidence do you have that the market will bounce back and why?

And number two on that point, we understand that a lot of European growth over the last few years has come, in part, from a reduction of waiting lists in the UK and Spain. How much of an impact do you think that has had on volume growth and what would be the potential impact if waiting lists start increasing again?

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David Illingworth - *Smith & Nephew - CEO*

All right, well I'll try to take a broad shot at this. Adrian please jump in. It's certainly difficult for us to predict what's going on in the market. You're right that the reconstructive market has declined in growth rates over the last few years, but we've also seen over the last few quarters a strengthening of those growth rates and that's what we're referring to.

It's certainly difficult for us to predict the shape of that recovery or what's going to happen in the future until some sort of consumer confidence returns and the market gets a little bit more stable for us. The way that we view the market in general is that we see a continued pressure on the funding in this marketplace, and thus the pricing on our products. And we think it's incumbent on us to make sure that when we innovate we're innovating with products that help reduce the cost of the overall procedure and the cost of the healthcare system and that's what we have our teams focused on.

It's not impossible to get a higher price in the marketplace and actually save the healthcare system money if we do it the right way and we're thoughtful and smart about how we innovate, and that's how we're focused. So we do think there's going to be continued pressure, what the ultimate growth rate in the reconstructive marketplace is going to be we don't really know, but we're pretty confident that, from a volume perspective, it's probably going to be around 5% or 6%.

Lisa Bedell Clive - *Sanford Bernstein - Analyst*

And then could you comment on potential waiting list impact?

David Illingworth - *Smith & Nephew - CEO*

Well we're still seeing it. We're still hearing anecdotal information coming from our field teams that say that people are still waiting to get procedures done and we do think there is a lengthening of the queues. That's really hard to validate and quantify. We don't get hard information or hard data on that. It's really just hearing our field teams talk about what's going on in the marketplace and talking to some of the surgeons. So I think we're still seeing deferrals from our point of view.

Lisa Bedell Clive - *Sanford Bernstein - Analyst*

Okay, thanks.

Operator

Thank you. The next question comes from the line of Charles Weston at Nomura. Please go ahead.

Charles Weston - *Nomura - Analyst*

Hello, I have three questions. First of all, just on a specific product of Allewyn, it looks like growth in the quarter was quite weak. Allewyn, I think that's what you referred to as your Exudate Management, at flat. Historically this has been a real growth driver for the business and I was just wondering if you could comment on that trend of decreasing growth over the last couple of quarters?

Secondly, one for Adrian, you mentioned in your guidance for the fourth quarter that having had three quarters of very strong margins don't be surprised if there is a weak quarter. I'm just wondering if you meant -- if you were specifically saying the fourth quarter may be weak in terms of margin, in which case I was wondering if you could elaborate on why, or whether you were just talking about general volatility on a quarter-to-quarter basis?



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And then lastly, also on margins, beyond 2010 looking into 2011 and 12, you were talking about systemic investments, and I was just wondering maybe you could pick out what you think is the most important one of those that could drive margins beyond 2010? Thank you.

David Illingworth - *Smith & Nephew - CEO*

All right, thanks Charles. I'll let Adrian handle all those, as he's furiously taking notes to try to keep up with the questions there. Do you want to comment on Allewyn?

Adrian Hennah - *Smith & Nephew - CFO*

Well I don't think there is a lot to say other than its not significant. We do get ups and downs on Allewyn because we do sell to wholesalers in Wound and we did at some point, I'm sure, get a question on why the US was bedded in Wound and a part of that answer is that we just do get fluctuations in that treatment. We are not at all concerned about the progress of Allewyn.

In underlying, when we look at the data we get for trace sales, sales actually in the market, its fine. We are absolutely not concerned about Allewyn and indeed some of the variations on Allewyn, like Allewyn Gentle and Allewyn AG are doing extremely well. So it's not a number you should be concerned about, it does bop around. And indeed if you just look back over the train of numbers we give you in the appendix, I see quarter four last year was down to 2%, so it just happens, Charles, I don't think that's something we are worried about at all.

In terms of the guidance and the point on margin, I think the core point we're trying to get across here is don't run away with the fact that we've had three very good ones and extrapolate excessively. I think Dave made it very clear how -- our philosophy in running this business, and that is unchanged.

Bringing that down to the nitty gritty, yes, as a general point margin is volatile quarter-by-quarter, we said that. In addition, quarter four last year was a relatively strong comparative and we do, as we look internally, see a little bit of bunching of some of the investments that just happen to be a bit more towards the end of this year than in other years. So it is a little bit of a hint about quarter four, Charles, well listened, but also a general reminder that volatility, it happens.

David Illingworth - *Smith & Nephew - CEO*

But there's nothing unusual going on there, I think it's just an issue of not extrapolating those first three quarters to the fourth quarter and then running away with a margin target for the year, Charles.

Adrian Hennah - *Smith & Nephew - CFO*

In terms of the longer term investment, and things that fall out Charles, I think the area we probably find most exciting in a broad sense of long-term potential, it drills down to the fact -- and we don't want too much about this, but it drills down to the fact that, at least in the orthopedic side of our business, one of the core activities that we and others in the industry do, is we have to get, we use as a rule of thumb, about \$100,000 worth of pretty sophisticated equipment, instruments, implants, sometimes multiple sets of instruments and implants, to exactly the right place at exactly the right time every time. And what we've got here, of course, is instruments and inventory to operating theaters for making a sale that's pretty modest when compared to that level of capital.

There's a huge logistics channel behind that, huge logistics channel behind that, and optimizing the way we do that gives us, we believe, huge potential for improving efficiency in this business, but it'll take time. This is an area that goes straight to the heart of customer service. It's absolutely not something you do quickly and in a knee-jerk where you take time.

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And so when Dave and myself refer to investments we're making that won't yield their benefits or they're beyond 2010, that is one that is definitely in that area.

David Illingworth - *Smith & Nephew - CEO*

That is one of them.

Charles Weston - *Nomura - Analyst*

Thank you very much.

Adrian Hennah - *Smith & Nephew - CFO*

Thanks Charles.

Operator

Thank you. The next question comes from the line of David Adlington, Cazenove. Please go ahead.

David Adlington - *Cazenove - Analyst*

Morning guys, thanks for taking my questions. Just a follow-up on the mix, first of all. I just wondered if you could give us a bit more color, whether you're seeing a deterioration in actually what people are using currently and whether you're struggling to get new products, or the price on the new products to come through?

Secondly, just in terms of one of your competitors has announced that they're reinitiating their share buy-back program this morning. I just wondered if you had any comments on where you are on that.

And then finally, just on the -- Adrian, just a comment you said about intel and one of the things you're going to be focusing on is intel and some sort of investment going forward. I just wondered if that was internal or whether you were thinking about M&A. Thanks.

Adrian Hennah - *Smith & Nephew - CFO*

Yes, David, neither Dave nor I fully understood your first question, something around mix, was it price? We didn't quite understand it, could you repeat it?

David Adlington - *Cazenove - Analyst*

Yes sure, on the mix side I just wondered if you're seeing customers trading down in terms of the mix or whether you're just struggling to get new products that you're launching actually used?

Adrian Hennah - *Smith & Nephew - CFO*

No. To me this really goes to the core of a question that was asked earlier. We clearly are, as we look at our sales numbers, seeing very, very good progress in the core hips and knees and not so good progress in the higher specification products. And clearly,

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as we actually said last quarter when this issue was beginning to be quite evident in the numbers, there's probably two elements to that.

One is a greater of deferral rate for people that are paying privately, but also a trading down element, a mix element. And they clearly are both components, both of those factors are playing in. We're still, to repeat the obvious, we're still very happy to be oriented on this space, in time it's the right space to be because those things will turn round in our favor, but we're going to have to be a little bit patient as we --

David Illingworth - *Smith & Nephew - CEO*

There's no really good way, David, with only one or two data points, or a couple of quarters of data points, to really figure that dynamic out, because we don't have visibility to what the doctor, the surgeon, is thinking in preparation for a surgery. Nor do we understand the age of the patients, etc, etc, because of privacy laws.

So it usually takes us a little bit of time in talking to our reps and going through the sales training process, getting feedback, talking to docs, looking at the data and I just think having two data points, a couple of quarters, just doesn't get us there. But I think Adrian's right, it's a mixture of those two components. It's some deferrals and there's some substitution of other products, because our core products are doing great.

David Adlington - *Cazenove - Analyst*

May I can just follow up. Have you got any anecdotal evidence that hospitals are being successful in persuading surgeons to trade down the value chain?

David Illingworth - *Smith & Nephew - CEO*

No. I don't have any evidence that -- personally I do not have any evidence that says -- I have not had a surgeon come to me and say look, I've been forced to take a product that I don't think is appropriate because of cost.

David Adlington - *Cazenove - Analyst*

Great. That's very clear.

Adrian Hennah - *Smith & Nephew - CFO*

And then on the share buyback, David, no we -- when we suspended our share buyback program a while ago, we said in due course with more stable capital markets we'll come back and look at it. We haven't yet. We don't think it's appropriate just yet to be revisiting that question.

And on investment, the context in which we mentioned it a few minutes ago was very much in the context of internal investment. There's no change in our approach to external acquisition.

David Adlington - *Cazenove - Analyst*

Great. Thanks very much.

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David Illingworth - *Smith & Nephew - CEO*

Thanks David.

Operator

Thank you. The next question comes from the line of Ilan Chaitowitz from Redburn Partners in London. Please go ahead.

Ilan Chaitowitz - *Redburn Partners - Analyst*

Morning, thanks for taking my question. Actually I've got a few questions. Firstly, on inventory, I was hoping you could give us an explanation as to why that's been ramping up quite strongly. Is that related to currencies, any product launches or just what's going on there?

Secondly, I was hoping you could give us maybe a tighter steer on the Q4 and reconciling that with your comments on the margin. Historically there's been broadly a 300 to 400 basis point tick up in Q4 versus Q3, should we be looking for the same sort of thing this year?

And thirdly, can you give us an update when you expect to have first sales from your Chinese manufacturing plant?

David Illingworth - *Smith & Nephew - CEO*

Okay, well on the inventory piece we certainly have a focus on that in our business. It's a big number, you're right, it has been ramping up. I think it's due to several different factors. First is we've had some major product launches over the last couple of years that were very -- new platforms that were very intensive in terms of providing instrumentation.

Secondly is we have made a fairly major acquisition of Plus, and as we work through the rationalization of those products over time and getting the right products in the right hands of the right people all over the world. And our bias being customer service, we've probably overshot it a little bit on purpose, because we want to make sure that we don't disrupt the customer service levels.

And then thirdly is we're investing in basic infrastructure and processing systems and we're not there yet. So while we're doing that work we need to make sure that we don't disrupt the customers, and that's basically the reason why you're seeing it inch up a little bit. You should see that come down over the next few years as we get these systems and processes in place. Adrian, do you want to take over?

Adrian Hennah - *Smith & Nephew - CFO*

Well in terms of quarter four guidance, you know we don't give guidance precisely quarter by quarter, but I would urge you to the tone, we've been trying to say be careful about extrapolating margin growth that you saw in quarter three beyond that. I think that's probably as far as we can go in helping you on that.

And on the first sales from China, yes, we have the first sales from China but not to the extent that we're actually getting a great deal of benefit in the margin from the China sales yet, because it's pretty small beer at the moment. We won't expect any material benefit of that to be coming through --

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David Illingworth - *Smith & Nephew - CEO*

But there are products being shipped to the US, to US customers. It's working. I was over there three weeks ago now and I toured the facility and it's very, very, very impressive. You could be anywhere in the world, it's a very impressive facility.

Ilan Chaitowitz - *Redburn Partners - Analyst*

Thanks very much, just one follow-on question if I may. With regard to your Trauma business, are you expecting to have to significantly ramp up either R&D spending or selling expenses to turn that business around?

David Illingworth - *Smith & Nephew - CEO*

Not -- well I guess, broadly speaking, not really. We have a great product range. I don't think our sales force would trade our product range with anybody in the marketplace today, and we have some exciting new products coming out as well in Trauma that we reviewed just this week. We had a Board meeting down in Zurich, outside of Zurich, at our European Headquarters where they're doing a lot of work on the Trauma side.

So investments are going in that business, we will probably add some more sales people over time. We've lost some sales folks of late to some hiring by competitive companies, and that was a disappointment for us. We want to make sure we turn that around. But I think, broadly speaking, nothing unusual.

Ilan Chaitowitz - *Redburn Partners - Analyst*

Thank you very much.

Operator

Thank you. The next question comes from the line of Martin Wales of UBS. Please go ahead.

Martin Wales - *UBS - Analyst*

Hello. Could I ask one longer term question about price mix trends in the United States? Obviously over the course of the last eight or nine years there's been a -- the price mix compared to growth has been slowing. I guess the broad question is where do we go from here, particularly in the context of a tougher market in the US with or without whatever healthcare reform comes through?

Can you maybe just talk about where you see pricing trends going longer term? Do you think anything will reverse what seems to have been a structural decline in recent years?

David Illingworth - *Smith & Nephew - CEO*

Well I think if you take the market at a point in time, like today and, relative to today, I think five years from now it's going to be tougher in terms of price and mix, if you just compare it with today's products and today's activities. But that's not -- we're not going to stand still.

I think companies that truly can innovate, that understand that healthcare economics are important, that understand that clinical outcomes coupled with healthcare economics is going to differentiate a company in the future, those companies are going to win and we want to be one of those winners. So when we talk to our development teams, we no longer talk about

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incremental innovation and whether or not we're going to have a blue product or a red product or a green product. It's now about what is the compelling economic value proposition and how can we get a better clinical outcome.

So I think for us, it's easier for us to talk about us than it is of what's going on in the market, but I think generally the market, relative to today, is going to get tougher. And that's not a bad thing. That happens all the time in most markets.

Martin Wales - UBS - Analyst

So my question then, David, is where does R&D spend go in that context? Particularly in the light of proposals for more clinical data within 5-10ks, the European Medical Device Directives seem to be looking for more clinical -- (multiple speakers)

David Illingworth - Smith & Nephew - CEO

I think you're probably going to see our R&D nudge up a little bit over the next few years, but I think more importantly it's how we deploy those dollars internally in the Company. How can we be smarter about what we develop? If we just are developing the next incremental product then maybe we're not spending those R&D dollars properly. So I think it will nudge up a little bit and hopefully we'll be smart about how we spend it and we'll be bringing products to the marketplace that customers really value.

Martin Wales - UBS - Analyst

Okay and just one quick follow-up. No-one else has asked this, so what is your current thinking on the proposals in Congress in the Senate for medical devices around taxation?

David Illingworth - Smith & Nephew - CEO

What's our thinking? Well we certainly don't like taxes.

Adrian Hennah - Smith & Nephew - CFO

Who does?

David Illingworth - Smith & Nephew - CEO

We generally don't think it's going to contribute to innovation in the industry. We're very supportive of what AdvaMed is doing. We have a seat on the AdvaMed Board. We're active. We're engaged. We're working with AdvaMed and our partner companies, medical device companies, to make sure that we get the best possible outcome for not only the healthcare system but also for us as an industry.

I think it's probably inevitable that something is going to come our way. We're going to have to deal with it, but we're not really predicting what exactly that's going to be as of yet. I think there's still a lot more chapters to be written on this over the next few months. I think we'll just have to see how it goes.

Martin Wales - UBS - Analyst

Okay. Thanks very much.



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David Illingworth - *Smith & Nephew - CEO*

Right, we're going to take -- unfortunately we only have time for probably two more questions, as we're on a parallel schedule here.

Operator

Okay, the next question comes from the line of Michael Junging from Bank of America Merrill Lynch. Please go ahead.

Michael Junging - *Bank of America/Merrill Lynch - Analyst*

Great, thank you for taking my questions. I've got three questions. Firstly on inventory days, they're up 23% compared to where they were in Q3 last year. Is this one of the key drivers why your gross margin has improved so much in the third quarter of 2009?

Second question is on Reconstructive. You had a weak European result. Is this more driven by market conditions or is this more a Company specific issue? It seems in your press release it may be more Company specific.

And then the third question is in relation to the EIP program and the margin targets. If I look at the run rate today, in Q2 and Q3 and I can see that you've got higher sales in Q4, you actually should be getting pretty close to an exit margin of around 24%. Does that mean that for 2010 we should expect limited margin improvement for the entire year? Thank you.

David Illingworth - *Smith & Nephew - CEO*

Thanks Michael. All right, how do you want to split this up? I already did inventory once, you do it this time Adrian.

Adrian Hennah - *Smith & Nephew - CFO*

Yes, well I think Michael took out a sub-point. Is the reason your gross margin is high just because you've been building stuff for inventory? I think probably what Michael was asking us. The answer is no, Michael, we've got -- clearly if you've got more production going through the factories it helps your production cost, but that's not a meaningful driver here.

Our gross margin is improving because there are a lot of changes going on in our factory, and one could go on at some length about this, but since we recruited a chap from Danaher about 18 months ago, two years ago now, the work he has done with his colleagues has been what's driving our gross margins and it is bringing practices, which are common in industries which are focused more on the efficiency of their production, into our industry, into our Company. Lean Six Sigma, focusing on how you purchase in a much more professional way, all that sort of stuff, that's what's bringing the vast majority of the benefits Michael, not producing stuff for inventory.

As we do, as Dave mentioned earlier, get our arms around -- not arms around but as we get to be more efficient in the way we manage inventory in the field too, as well as the stuff in the factory, that will obviously have impacts on the flow of product through our factory and we will have to watch that in terms of the margin as we go forward over the next two or three years. But it's not a huge driver Michael.

In terms of your second question, which I think was orthopedics in Europe, your 3% decline why was that, was it a market issue or was it a Company issue? The answer is it's a bit of both. The European market has been weak, we've seen that in other peoples reported numbers too and it's for the sort of reasons that a number of questions have alluded to on this call already.



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But there were also a couple of things specific to us. One was this issue that's hitting us in the US, two of the higher specification products. We are feeling the impact of that in Europe, as we are in the United States. And secondly, we don't like to focus on the tail-end of Plus anymore because the issue is behind us, but there is this 12-month lag effect that comes into it and we were very clear, I think, well I hope anyway, at the end of last year that I think we said \$64m of loss to date, \$80m to go. Well \$80m to go meant another --

David Illingworth - *Smith & Nephew - CEO*

No, no, \$80m.

Adrian Hennah - *Smith & Nephew - CFO*

Sorry, \$80m in total, thank you. So another \$15m to go, \$15m/\$16m to go, and that's about what we're trending for, for about the \$80m that we forecast, which does mean that you lose about 3% each quarter in growth as we go through this year in Europe. So that also plays in, we don't like featuring on it because as an issue it's behind us. It's about running the business now, but it does eat away at the growth rate. So as I say, partly market, partly Company in answer to your question, Michael, on that one.

I'm not sure I fully understood your last question about margin targets, and I'm not sure there's a lot more we can say beyond what we said already on margin targets.

Michael Junging - *Bank of America/Merrill Lynch - Analyst*

Can I just follow-up then on the Plus Orthopedics. So does the impact of Plus then annualize this year and therefore the two or three points of lost growth, that you mentioned in Europe, does that come back to you in 2010?

Adrian Hennah - *Smith & Nephew - CFO*

On an annualizing basis, yes, that's exactly right. Again, just to repeat, we said at the end of last year we'd lost \$64m. We thought it would peak at \$80m over the next several quarters, so that'll be done by this year. It's basically a little bit of effect capping through this year as we thought it would, and so yes, you can say by the end of this year it will have annualized completely and it'll be out of here.

Michael Junging - *Bank of America/Merrill Lynch - Analyst*

And then on the EIP margin target, when you say the exit margin, we've had many discussion about this Adrian and I, I'm trying to work out when you say exit margin can I just confirm is that the fourth quarter of 2010 that that 24.5% relates to?

Adrian Hennah - *Smith & Nephew - CFO*

No.

David Illingworth - *Smith & Nephew - CEO*

No, what it means -- let me take a shot at it.

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Adrian Hennah - *Smith & Nephew - CFO*

Sure, please.

David Illingworth - *Smith & Nephew - CEO*

What it means is that when we get to the end of 2010, we should have a business that, if it was static in its improvement, no more improvement in the business, we should have a sustainable 24.5% operating margin in our business as an exit to 2010.

Adrian Hennah - *Smith & Nephew - CFO*

It is also deliberately slightly beneficial, because we don't want to be in a very precise box. What it is not is the quarter four number, because that would be a much easier target and we're not pretending that's that. But it is the notion of an annualized exit rate at the end of 2010.

David Illingworth - *Smith & Nephew - CEO*

Yes, we actually think that that's a tougher hurdle for us than just a quarterly number, that we have a sustainable margin rate ongoing. So that's what it is. Thanks Michael. I think we have time for one more question.

Operator

Thank you. The last question comes from the line of Hans Bostrom from Goldman Sachs. Please go ahead.

Hans Bostrom - *Goldman Sachs - Analyst*

Hello. Good morning gentlemen. I'd like to ask a question regarding pricing in orthopedics in the United States and whether you see any difference between urban and rural hospitals in terms of pricing dynamics. And in the context of that, could you give us a sense of whether and to what degree you are overexposed to rural hospitals in comparison to your competitors in terms of percentage points or some formal measure?

Secondly, I see that the 'other' finance line has actually risen to be quite a substantial negative this year. Could you give us a sense of what this is and whether we should expect it to be in the double-digit amount on a forward-looking basis? Thank you.

David Illingworth - *Smith & Nephew - CEO*

Well let me take a shot at the first one. We can't give you specific data on pricing on urban and rural hospitals, but I can tell you that -- it almost sounded like your question was presuming that there was a greater impact in pricing in the rural type hospitals.

Hans Bostrom - *Goldman Sachs - Analyst*

No, it's the opposite actually.

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David Illingworth - *Smith & Nephew - CEO*

Yes, it is the opposite as we see it Hans. Where we always see, quite frankly, where we have always seen the greatest pricing pressure is in the large volume accounts, because quite frankly they deserve to get better pricing if they're doing higher volumes and it's more efficient for us to deliver our services there.

As you know probably as well as anybody on this call, the orthopedic industry, it's not just about selling an implant for \$3,000 or \$5,000 or \$10,000. It's about all the services that go with it and all the inventory that has to support that one surgery. It's a very expensive proposition and if we can turn, not only the manpower but the inventory to support it, much more efficiently we can deliver better pricing to our customers, and that typically happens at the large accounts.

We have -- I would say that on balance we have more of an exposure to the rural type accounts than we do to the large urban accounts. I don't have specific data on that, but that would be where I would end up in terms of where I would steer you. So you can draw your own conclusions on connecting that with our comments on pricing. Do you want -- there was a second -- I didn't write down the second one, I'm sorry.

Adrian Hennah - *Smith & Nephew - CFO*

Other finance costs Hans. Clearly the main item in other finance costs is the notional interest on the pension deficit, and it's clearly bigger than last year because we went into this year with a bigger pension deficit, as almost everyone else did, with the defined benefit pension schemes, than last year. So the deficit at the start of this year was \$350m and that is the main driver of the other finance costs.

There's a small other component that goes in other finance costs, as I'm sure you're aware, which is -- well there are several other things that companies generally can put in there, but one other type of stuff that we put in there is the unwinding of the discount on the estimated payments for the Blue Sky, because as you know there's a contingent element in that, so you have to put your best guess in and unwind the discount that goes as well. It's pretty small.

What will it be next year? Well that all depends what the deficit is frankly, Hans, as we stand at the end of quarter three it was \$354m, almost identical to the \$350m at the beginning of the year. So if it were to stay that at quarter four, therefore it would be quite similar, but as we all know these things do bounce around in quarters as a result of all sorts of things. So we'll just have to see and then, when we know what the deficit is at the end of the year, we can give you more guidance.

Hans Bostrom - *Goldman Sachs - Analyst*

Thanks.

David Illingworth - *Smith & Nephew - CEO*

Okay. Well thank you all for your time today, we really appreciate it. We look forward to seeing many of you in Switzerland later this month and to talking with you about our Q4 results in February, so until then, thanks and see you later.

Operator

Thank you for joining today's call. You may now replace your handset.

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