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Smith & Nephew

Healthcare equipment & services

14 February 2017

All parts now in place to move forward

Smith & Nephew (S&N) delivered a fair Q4 and FY16, which were affected by tough market conditions in China and the Gulf states. However, the company has announced that its fundamental restructuring is complete, enabling a stronger 2017 and beyond.

FY16 affected by tough market conditions

S&N reported trading profits of $1.02bn, down 7% on 2015, on revenues of $4.67bn vs $4.63bn respectively. This was a 190bp reduction in trading profit margin principally due to a foreign exchange headwind (120bp), the Bluebelt acquisition (60bp), and divestment of the gynaecology business. Also, underlying revenue growth of 2% was in line with consensus (reported revenue +1%) but affected by tough market conditions in China and the Gulf states. These impacts were partially offset by the group optimisation programme. It is important to note that, apart from the weakness in China and the Gulf states, the rest of the emerging markets demonstrated double-digit growth. Performance across the year was primarily driven by S&N's sports medicine joint repair division (8% growth) and its other surgical businesses division, which includes ENT and NAVIO robotic sales (15% growth). Advanced wound care and trauma & extremities were the worst performers, affected by weakness in China, UK and Germany, with revenue down 3% and 4% respectively.

Outlook for 2017

S&N expects stronger revenue growth in 2017 (3-4% underlying) and an improvement in trading profit margin (20-70bp). It states it will be able to deliver this through improved execution now the fundamental restructuring is complete and through continued focus on efficiency. We believe that, alongside its increased focus on innovation, this will deliver improved growth and margin. It has a strong near-term pipeline of product lines (eg REDAPT revision hip, COBLATION WEREWOLF, JOURNEY II Knee), which it can build on. Innovations that offer a strong value proposition such as improved cost effectiveness and outcomes will enable expansion in high-growth market segments.

Valuation: Improving prospects underpins premium

S&N currently trades at 17.1x 2017e P/E, in line with the average of US peers Stryker and Zimmer at c 19x and 14x, respectively. We believe the premium to the average valuation is underpinned by evidence of improving growth prospects, which could see S&N closing the 10% premium that Stryker trades at (due, in our opinion, to its improved portfolio balance and it leading the robotics focus).

Consensus estimates

Year end	Revenue ($m)	PBT ($m)	EPSA* (c)	DPS (c)	P/E (x)	Yield (%)
12/15	4634	1040	85.1	30.8	17.5	2.1
12/16	4669	965	82.6	30.8	18.0	2.1
12/17e	4782	1009	87.0	32.4	17.1	2.2
12/18e	4977	1079	94.6	35.5	15.7	2.4

Source: Smith & Nephew, Bloomberg. Note: *Before amortisation of intangibles.

Price	1,189p
Market cap	£11bn
	£1:$1.25

Share price graph

Share details

Code	SN
Listing	LSE
Shares in issue	886m

Business description

Smith & Nephew is a leading UK-based maker of medical devices. It is the world's number one in arthroscopy products; two in advanced wound management; three in trauma and extremities products; and number four in orthopaedic reconstruction products.

Bull

- Strength in attractive market niches, such as arthroscopy, endoscopy and wound care
- Recent acquisitions have been positive, alongside divestment of its gynaecology business, from which shareholders are benefitting via a share buyback
- The biggest European medical device maker, which may be an M&A target.

Bear

- Growth continues to be tempered by FX and economic conditions in the emerging markets
- Consolidation of hospital buying patterns plays in favour of even bigger medical device companies
- Product pricing is likely to stay challenging, as healthcare funding remains under pressure

Analysts

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