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Smith & Nephew

Healthcare equipment & services

12 February 2018

Challenges being addressed

Smith & Nephew's (S&N) FY17 revenues of $4.77bn and trading profit of $1,048m were slightly below consensus estimates despite a strong Q4, which saw a reported 5% y-o-y growth. EPS exceeded consensus estimates. S&N's emerging market business retained its star billing for growth across all its geographies. A core focus of the business now appears to be improvement via the newly named, but broad-ranging APEX cost reduction and efficiency programme. Last year's announcement on the retirement of its CEO seems to have taken on a slow and steady route to CEO transition, with the high-level commitment, involvement and execution on the APEX programme.

Emerging markets justify their billing

Full-year 2017 reported revenues of $4.77bn were up a reported 2% compared to FY16, driven by continued strength in knee implants. Emerging markets retained their prime billing with an underlying 12% revenue growth for the full year. China, S&N's largest emerging market, demonstrated double-digit revenue growth, and the oil price-related revenue deferral weakness in the Gulf states of 2016 now seems to have been resolved. There was a $326m one-off benefit that helped EPS of 94.5c beat analysts' consensus estimates.

FY18 guidance builds on 2017

Back in Q317, S&N guided that FY profits would be towards the lower end of its previously announced range. Having now hit that, investors should have confidence in the FY18 guidance of 3-4% underlying revenue growth, an improvement in trading profit margin of between 30bp and 70bp, and a tax rate of between 20% and 21% (from c 25%). The 3% underlying growth in revenues for 2017 was mirrored by a similar growth in trading profit further down the income statement. This suggests the potential for cost savings from scale and synergies from the broad-ranging APEX programme. It is hoped that APEX will result in $160m annual by 2022.

Valuation: Between its bigger US peers

S&N currently trades at 17.6x FY18 P/E, between its US peers Stryker (21.2x) and Zimmer (c 14.9x), but S&N offers investors emerging market growth at a level (16% of S&N's global revenue) much higher than its US competitors. It is worth noting that in these volatile times, S&N, unlike GlaxoSmithKline and AstraZeneca, offers investors FTSE100 life science cash generation in 2017 after dividends, rather than consuming cash.

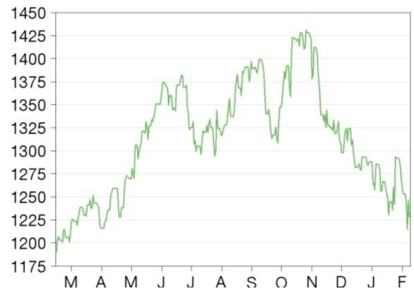
Consensus estimates

Year end	Revenue ($m)	PBT ($m)	EPSA* (c)	DPS (c)	P/E (x)	Yield (%)
12/16	4,691	959	82.8	30.8	20.5	1.8
12/17	4,765	996	90.8	35.0	18.7	2.1
12/18e	5,060	1,084	96.3	36.2	17.6	2.1
12/19e	5,269	1,152	103.4	39.6	16.4	2.3

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

Price	**1,228p**
Market cap	**£11bn**
	$1.38/£

Share price graph



Share details

Code	SN
Listing	LSE
Shares in issue	875m

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 orthopaedics, endoscopy and wound care.
- Recent acquisitions have been strategically sensible, alongside divestment of its gynaecology business, from which shareholders benefitted via a share buyback.
- The biggest European medical device maker, which the specialist and popular press have mentioned as an M&A target.

Bear

- Growth continues to be modulated by FX, a larger manufacturing base than competitors and economic conditions in various 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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