Smith & Nephew

Q4 FY23 Results: Margin expansion story is still on: 17.5% 23', >18% 24', >20% 25'

Reiterate Rating: BUY | PO: 1,320 GBp | Price: 1,126 GBp

17.5% margin in FY23, >18% in FY24, >20% in FY25

All eyes were on margin for FY23 and beyond, as the investor community has questioned S&N's ability to deliver on targets given the past record. This time seems different. In addition to surpassing its organic growth target of +6-7% (+7.2% reported), S&N met its 17.5% margin guide for FY23 while our discussions with investors suggest the bar was lower. But margin isn't an overhang for FY23 only. The company guides for +5-6% organic growth and at least 18% margin in FY24 (despite inflation, -70bps from China VBP and -30bps from FX), which is above investors' expectations, in our view, despite consensus at +4.9% organic growth and 18.3% margin (implying a c2% cut at the trading profit level). On a negative note, we stress the slower Q4 for Hips/Knees in the US due to set deployments behind expectations. However, management confirmed the FY25 target of at least 20% margin, as they see the 12PP starting to bear fruit. Bears are likely to continue to stress risk on MT targets, and it might be key for the new mgmt team to show their joint commitment to the targets in the coming quarters. Low expectations, appealing valuation (c15x 24' P/E) and improving performances leave us with a Buy rating.

Sales/Profits beat despite weaker Ortho in Q4

The Q4 beat occurred despite softer Orthopaedics (product availability, slower set deployments, sales force change). It was a record quarter for the CORI robot in the US. Sports & ENT delivered +8.7% excl. China, as distributors reduced inventory ahead of VBP. AWC was fuelled by Bioactives (+12.5%) and NPWT (+14.9%). FY23 margin of 17.5% was achieved despite -130bps from inflation, -120bps from FX, offset by productivity gains (+160bps) and operating leverage (+110bps).

Exhibit 1: Both revenue and margin in line with expectation for FY23

Actuals vs VA consensus. Data in $mn

	Actual		VA Consensus		% diff	
$mn	**Q4 23**	**FY23**	**Q4 23**	**FY23**	**Q4 23**	**FY23**
Revenue	1,458	5,549	1,448	5,543	0.7%	0.1%
% organic growth	6.4%	7.2%	5.3%	6.8%	114 bps	40 bps
o/w Orthopaedics	4.9%	5.7%	5.8%	5.9%	-88 bps	-16 bps
o/w Sports Medicine & ENT	7.1%	10.0%	4.0%	9.1%	315 bps	90 bps
o/w AWM	7.8%	6.4%	5.9%	6.0%	186 bps	39 bps
Trading profit	N/A	970	N/A	962	N/A	0.9%
% margin	N/A	17.5%	N/A	17.4%	N/A	13 bps
EPSA	N/A	0.83	N/A	0.82	N/A	0.5%

Source: Visible Alpha, company reports

BofA GLOBAL RESEARCH

27 February 2024

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Stock Data

Price (Common / Common)	1,126 GBp / 28.53 USD
Price Objective	1,320 GBp / 34.00 USD
Date Established	17-Jan-2024 / 17-Jan-2024
Investment Opinion	A-1-7 / B-1-7
52-Week Range	887.00 GBp-1,316 GBp
Market Value (mn)	9,839 GBP
Shares Outstanding (mn)	874.2 / 437.1
Average Daily Value (mn)	25.51 USD
Free Float	99.9%
BofA Ticker / Exchange	SNNUF / LSE
BofA Ticker / Exchange	SNN / NYS
Bloomberg / Reuters	SN/ LN / SN.L
ROE (2023E)	13.8%
Net Dbt to Eqty (Dec-2022A)	48.0%
ESGMeter™	High

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Abbreviations:

12PP = 12 Point Plan
AWC = Advanced Wound Care
ENT= ears, nose & throat
MT = mid-term
NPWT = Negative Pressure Wound Therapy
VBP = Volume-base procurement

Price objective basis & risk

Smith & Nephew (SNNUF / SNN)

We arrive at our 1,320 GBp (US$34) PO by valuing S&N using the average of three core metrics, including DCF (£13), P/E (£14), and EV/EBITDA (£13) using one year forward multiples. Our valuation methodologies have the following core drivers and assumptions.

1] Price / earnings: we use a 19x multiple on earnings before converting to GBP at spot rates and discounting back at the cost of equity. We value S&N at a c. 15% discount to EMEA MedTech peers given exposure to slower growing end markets.

2] EV / EBITDA : we use a 12x multiple, again at a 15% discount to peers as per the rationale listed above. Debt is then stripped out and the value discounted back at the cost of equity

3] DCF we use a market risk premium of 3.8%, beta of 0.9x, a risk-free rate of 4.0%, and terminal growth rate of +2%. Our DCF-derived model implies a c. 20x earnings in FY24E, which is broadly in-line with our target earnings multiples.

Downside risks to PO: (1) material deterioration of the economy in relevant geographies, (2) unexpected changes in reimbursement, (3) higher than expected product trading down (4) negative impact from GLP-1 on market growth

Upside risks to PO: (1) Material acceleration of the economy in relevant geographies, (2) faster-than-expected turnaround in core execution & culture, (3) stronger-than-expected economy in any region that would accelerate demand for elective procedures, (4) more accretive acquisitions, (5) major product launches

Analyst Certification

I, Julien Ouaddour, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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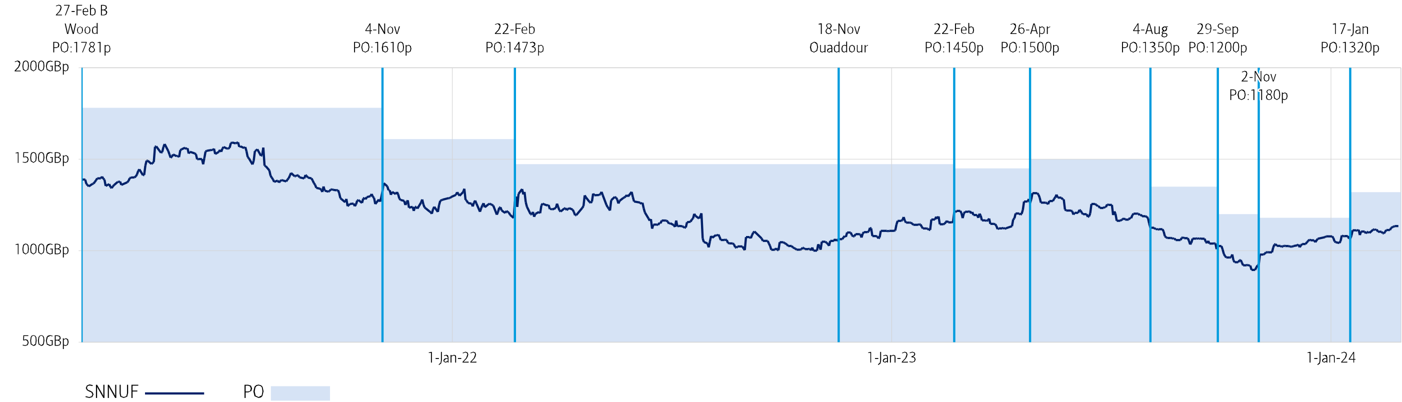
Smith & Nephew (SNNUF) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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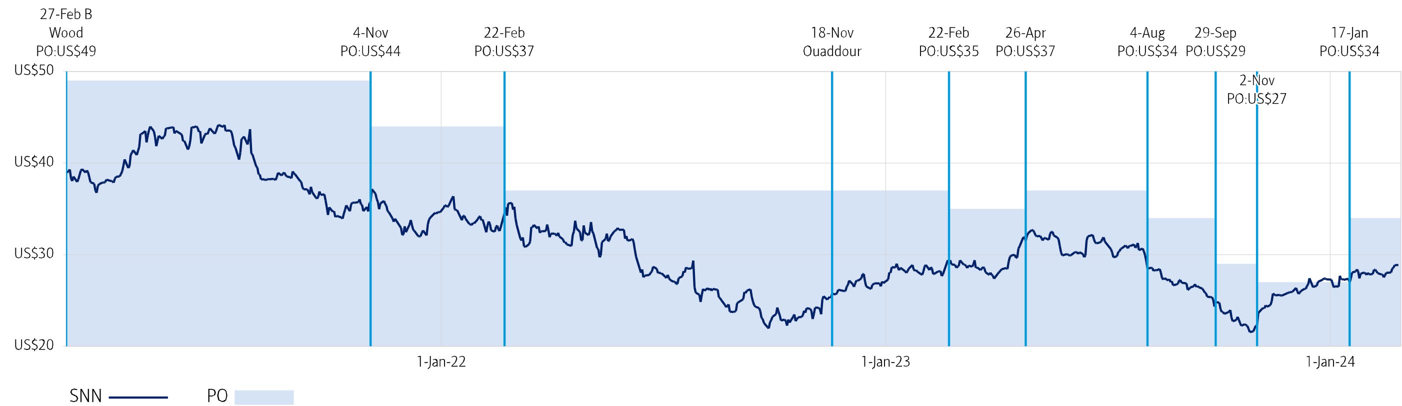
Smith & Nephew (SNN) Price Chart



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Equity Investment Rating Distribution: Health Care Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	234	60.94%	Buy	115	49.15%
Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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