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Smith & Nephew

AAOS Feedback - Focus On Robotics

📈 Stock Rating
Equal-weight

👁 Industry View
In-Line

🎯 Price Target
1,457p

We provide feedback from the AAOS including SN's investor meeting, which focused on its Navio surgical robotics solution.

We provide feedback from the American Academy of Orthopedic Surgeons (AAOS), which was held 6-10 March in New Orleans, US. The congress is the world's largest orthopedics meeting and thus provides feedback on industry trends; furthermore amongst other companies, Smith & Nephew hosted an investor meeting providing an update on Navio, which is its handheld robotics solution for hips and knees.

Surgical Robotics Solutions: the 2018 meeting followed in the footsteps of 2017, with surgical robotics once again equating to the most important sector theme. Arguably, surgical robotics has gained momentum with corporates, hospitals and surgeons investing in this area. Our physician expert lunch emphasized that surgical robotics was here to stay and should not be compared to the short lived buzz of image guided surgery solutions of the early 2000s. Most physicians who were using surgical robot technology suggested that greater surgical accuracy/precision was likely to result in better clinical outcomes, which was especially relevant in an era where care coordination reimbursement models (Bundled Payments for Care Improvement Initiative and Comprehensive Care for Joint Replacement Model) are gaining momentum and importance. Although comprehensive clinical data is still some time away (Stryker's Mako is leading these initiatives), confidence is building in the physician community that surgical robotics is unlikely to be fad, and instead should show better outcomes, especially with knee joints, where patient satisfaction remains well below hips. With respect to technology, Stryker's Mako robotic solution was considered by many physicians we have spoken to, as the gold standard, although several also raised praise for Smith & Nephew's Navio solution, due to its simplicity, flexibility and mobility.

Smith & Nephew Investor Meeting: the company invited the experienced physician, Dr. Jimmy Chow, who practices in Phoenix, Arizona, and has used several robotic systems including Navio and Mako. Dr. Chow pointed out that Mako was an excellent system, but preferred Navio for a number of reasons: **a]** Navio is cheaper than Mako and thus makes it more cost effective; **b]** It is relatively simple to roll-out new indications/implants with regular software updates allowing to add new indications more quickly; **c]** Offers advantages in doing revisions as there is no need to use CT imaging, which is problematic due to

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Smith & Nephew (SN.L, SN/ LN)

Medical Devices / United Kingdom

Stock Rating	Equal-weight
Industry View	In-Line
Price target	1,457p
Shr price, close (Mar 9, 2018)	1,331p
52-Week Range	1,442-1,173p
Mkt cap, curr (mn)	US\$16,202
Net debt (12/17e) (mn)*	US\$1,281
EV, curr (mn)*	US\$17,752

* = GAAP or approximated based on GAAP

Fiscal Year Ending	12/16	12/17e	12/18e	12/19e
Revenue (US\$ mn)**	4,669	4,765	5,117	5,288
EBITDA (US\$ mn)**	1,305	1,364	1,482	1,587
EBIT (US\$ mn)**	1,150	1,178	1,254	1,324
EPS (US\$)**	0.80	0.87	0.97	1.05
ModelWare EPS (US\$)	0.79	0.87	0.97	1.05
P/E**	18.9	20.0	19.0	17.6
EV/revenue*	3.2	3.5	3.3	3.1
EV/EBITDA**	11.3	12.1	11.5	10.4
EV/EBIT**	12.9	14.0	13.6	12.5
Div per shr (US\$)	0.31	0.35	0.37	0.40
Div yld (%)	2.0	2.0	2.0	2.2
FCF yld ratio (%)**	2.3	4.2	4.5	5.2
Net debt (US\$ mn)*	1,550	1,281	869	362
Net debt/EBITDA**	1.2	0.9	0.6	0.2
RNOA (%)**	14.2	14.2	14.2	15.1
ROE (%)**	17.9	19.2	18.2	18.2

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework

* = GAAP or approximated based on GAAP

** = Based on consensus methodology

e = Morgan Stanley Research estimates

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the metal from the primary hip or knee implant; **d**] No need to have a separate robot for hips and knees (i.e. not practical to change hip and knee indication with Mako); and **e**] Smith & Nephew's Journey 2 knee implant is a newer and better implant to Stryker's Triathlon system. While Navio may have several advantages (equally we have heard of several advantages of Mako from other physicians), the biggest challenge for Smith & Nephew is likely to be share of voice in a market which will see new and additional solutions enter the market, by companies with significantly larger resources (e.g. Zimmer Biomet is working on a Rosa robot and expects to launch its solution for total knee procedures during 2H 2018). Smith & Nephew remains quiet about how many robots it has placed to date for competitive reasons, but given that its system was launched well after Mako's, the first mover advantage of Stryker is material. Nevertheless, we view Navio as a significant opportunity for Smith & Nephew, and we understand from the company that it will step up its investments, which includes an increase in the number of capital equipment sales people (we estimate that there are ~20% in the US). So far Navio has not materially contributed to Smith & Nephew's above market knee growth numbers, but early indications are positive with hospital systems who are using Navio, showing a +20% increase/pull through of total hips and knees. In our current forecast, we treat Smith & Nephew's Navio opportunity as optionality; in our view, we are 12-18 months away from getting a better feeling of whether Navio can have a material impact on the company's mid-term organic sales growth potential.

CEO Search Resolved By Summer: although not a focus at the Smith & Nephew investor meeting, we understand that the company should be in a position to announce its new CEO by the summer of 2018. We understand that the preference is for someone with a medical device background and both Europeans and Americans are being considered for the role. It appears, however, that several potential American CEOs have very high compensation expectations, which limits the number of US candidates. In our view, this could mean that a potential US CEO candidate is more likely to come from a larger conglomerate, where they are currently in charge of a division.

Other Tid Bits: the interest in cementless knees is increasing, helped by improved rough and innovative surface textures that can help improve osseointegration and fixation of the implant to the patient's bone. Our physician panel remains a touch sceptical, based on some of the historical challenges these implants have faced over the past ~20 years. Nevertheless, Stryker re-affirmed the success it is having with its cementless technology, with the mix now standing around ~20%. Our discussion with Smith & Nephew highlighted that it continues to follow this space closely and emphasized that the company has a well developed 3D printing program.

Investment Conclusion: while we found AAOS interesting, we remain uncertain whether Smith & Nephew's Navio can equate to a material opportunity over the mid-term. In this evolving space, significant investments are required for both technology leadership and share of voice, and with more competitors entering this space over the coming 12-18 months, the path for success is unlikely to be an easy one for Smith & Nephew. We remain Equal-weight as we believe Smith & Nephew's share price performance will settle in the middle of our coverage universe for CY18E. Over the next 3-6 months a key focus for investors is likely to be the identity of the new CEO, following the announcement in 2017 that the

current CEO is retiring.

Stryker and Zimmer Biomet covered by David Lewis

Risk Reward

Limited catalysts override attractive valuation driven by organic growth acceleration and margin leverage



Source: Thomson Reuters (historical share price data), Morgan Stanley Research estimates

Price Target £ 14.57

We apply a 2 year forward EV/EBITDA of 11.5x, with the multiple in line with its industry peers.

Bull £ 17.47

12x 2 year fwd EBITDA of \$ 1802m

FY18E Sales constant currency growth +5.1%

FY18E EBITDA of \$1662m, FY18E EBITDA margin of +31.8%

FY18E EPS of \$ 113.40c

Base £ 14.57

11.5x 2 year fwd EBITDA of \$ 1587m

FY18E Sales constant currency growth +3.0%

FY18E EBITDA of \$1482m, FY18E EBITDA margin of +29.0%

FY18E EPS of \$ 97.10c

Bear £ 8.63

8x 2 year fwd EBITDA of \$ 1390m

FY18E Sales constant currency growth +1.0%

FY18E EBITDA of \$1311m, FY18E EBITDA margin of +26.1%

FY18E EPS of \$ 81.52c

Exhibit 1: Segment Sales (FY17A) Segment EBITA (FY15A)*

Source: Company Data, Morgan Stanley Research, Segment EBITA no longer disclosed post FY15

Why Equal-weight?

■ **Valuation** – in the context of global orthopedic MedTech peers such as Stryker and Zimmer Biomet, we feel SN's valuation is attractive on an EV/EBITDA basis

■ **Catalysts**: Despite seeing value in Smith & Nephew, we do not believe there is significant catalyst in FY18 to deserve an Overweight rating.

Key Value Drivers

■ **Organic Growth Acceleration**: a more consistent delivery of accelerating organic growth across all divisions would improve credibility and drive investor optimism.

■ **Margin Rationalization** – SN's margins continue to lag industry peers by >5% points; delivery on potential cost cutting faster than our expectations could result in a re-rating of the shares.

■ **M&A** – further M&A in the orthopaedic sector could provide upside for SN's shares while SN has the optionality to utilise its balance sheet to make bolt-on earnings-accretive deals.

Risks to Achieving Price Target

■ **Resurgent Competition** – we could begin to see a slowdown in SN's US Recon market share momentum following the return of a fully focused Zimmer-Biomet.

■ **Investment Returns** – slower than expected growth or a greater need for investment into recent bolt-on deals could limit margin expansion.

■ **Emerging Markets** – a further slowdown in emerging market demand (e.g. China, Middle East) or a further depreciation of emerging market currencies.

Smith & Nephew Financial Statements

Exhibit 2: Smith & Nephew: Profit and Loss

Dec Y/E (US\$m)	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Advanced Surgical Devices	3,436	3,509	3,814	3,947	4,080	4,206	4,334
Advanced Wound Management	1,233	1,256	1,303	1,341	1,384	1,429	1,475
Total Sales	4,669	4,765	5,117	5,288	5,464	5,634	5,809
Cost of Goods Sold	(1,272)	(1,248)	(1,325)	(1,359)	(1,393)	(1,425)	(1,458)
Gross Profit	3,397	3,517	3,792	3,930	4,071	4,209	4,352
Selling, General & Administration	(2,147)	(2,246)	(2,412)	(2,482)	(2,554)	(2,622)	(2,692)
Research & Development	(230)	(223)	(256)	(254)	(262)	(270)	(279)
EBITA	1,020	1,048	1,124	1,194	1,255	1,317	1,381
Amortisation	(130)	(130)	(130)	(130)	(130)	(130)	(130)
EBIT	890	918	994	1,064	1,125	1,187	1,251
Associates	2	6	6	6	6	6	6
Net Financial Income	(57)	(58)	(55)	(37)	(20)	(4)	11
EBT	835	866	946	1,032	1,111	1,189	1,268
Tax Expense	(257)	(237)	(230)	(249)	(266)	(282)	(299)
Net Income (b/f Minorities)	578	629	716	784	846	906	968
Share of JV Results	--	--	--	--	--	--	--
Net Income (b/f Abnormals)	578	629	716	784	846	906	968
Abnormal Items	227	13	(100)	(100)	(40)	--	--
Tax on Abnormal Items	(21)	125	52	53	38	28	28
Net Income (a/f Abnormals)	784	767	668	737	844	934	996
EPSA (b/f Abnormals & GW) - Basic (ModelWare EPS)	79.6	86.9	97.1	104.9	112.0	119.0	126.1
EPSA (b/f Abnormals & GW) - Diluted	79.3	86.8	97.1	104.9	112.0	119.0	126.1
DPS - normal	30.8	35.0	37.0	40.5	43.7	46.8	50.0

Change (%)	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Advanced Surgical Devices	2.0%	2.1%	8.7%	3.5%	3.4%	3.1%	3.1%
Advanced Wound Management	-2.6%	1.9%	3.7%	2.9%	3.2%	3.2%	3.3%
Total Sales	0.8%	2.1%	7.4%	3.3%	3.3%	3.1%	3.1%
Gross Profit	-2.7%	3.5%	7.8%	3.6%	3.6%	3.4%	3.4%
Selling, General & Administration	-1.1%	4.6%	7.4%	2.9%	2.9%	2.7%	2.7%
Research & Development	3.6%	-3.0%	14.7%	-0.8%	3.3%	3.1%	3.1%
EBITA	-7.2%	2.7%	7.3%	6.2%	5.1%	4.9%	4.9%
EBIT	-5.9%	3.1%	8.3%	7.0%	5.8%	5.5%	5.4%
EBT	-5.9%	3.7%	9.2%	9.2%	7.6%	7.0%	6.7%
Net Income (b/f Abnormals)	-4.9%	8.9%	13.7%	9.5%	7.9%	7.2%	6.8%
EPSA (b/f Abnormals & GW) - Diluted	-6.3%	9.5%	11.8%	8.0%	6.8%	6.2%	6.0%
DPS - normal	0.0%	13.6%	5.6%	9.5%	7.9%	7.2%	6.8%

Organic Constant Currency Growth	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Advanced Surgical Devices	2.9%	3.3%	4.2%	3.5%	3.4%	3.1%	3.1%
Advanced Wound Management	-1.1%	1.8%	0.6%	2.9%	3.2%	3.2%	3.3%
Total	1.8%	2.9%	3.0%	3.3%	3.3%	3.1%	3.1%

Margin Analysis	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Gross Profit	72.8%	73.8%	74.1%	74.3%	74.5%	74.7%	74.9%
Selling, General & Administration	46.0%	47.1%	47.1%	46.9%	46.7%	46.5%	46.3%
Research & Development	4.9%	4.7%	5.0%	4.8%	4.8%	4.8%	4.8%
EBITA	21.8%	22.0%	22.0%	22.6%	23.0%	23.4%	23.8%
EBIT	19.1%	19.3%	19.4%	20.1%	20.6%	21.1%	21.5%
Effective Tax Rate	30.8%	27.3%	24.3%	24.1%	23.9%	23.7%	23.6%
Interest Cover	15.6x	15.8x	18.2x	28.4x	56.5x	269.6x	-118.4x
ROE	19.8%	17.8%	13.8%	14.1%	14.9%	15.1%	14.7%

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates

Exhibit 3: Smith & Nephew: Balance Sheet

Dec Y/E (US\$m)	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Cash & Equivalents	100	169	181	188	620	1,340	2,117
Trade Debtors	988	1,057	1,135	1,173	1,212	1,250	1,289
Inventories	1,244	1,304	1,382	1,428	1,475	1,521	1,569
Other Debtors	197	201	216	223	230	238	245
Current Assets	2,529	2,731	2,914	3,012	3,538	4,348	5,219
Intangible Fixed Assets	3,599	3,742	3,563	3,383	3,202	3,021	2,840
Tangible Fixed Assets	982	1,049	1,118	1,165	1,163	1,137	1,087
Investments	25	21	21	21	21	21	21
Investments in Joint Venture	--	--	--	--	--	--	--
Other Debtors	97	205	220	228	235	242	250
Non Current Assets	4,815	5,135	5,047	4,927	4,757	4,563	4,346
Total Assets	7,344	7,866	7,960	7,938	8,295	8,912	9,565
Borrowings	86	27	50	50	50	50	50
Trade Creditors	807	957	1,028	1,062	1,097	1,132	1,167
Other Creditors	455	362	389	402	415	428	441
Current Liabilities	1,348	1,346	1,467	1,514	1,562	1,610	1,658
Borrowings	1,564	1,423	1,000	500	300	300	300
Provisions	298	228	245	253	261	270	278
Deferred Income Taxes	94	97	104	108	111	115	118
Other Creditors	82	128	137	142	147	151	156
Non Current Liabilities	2,038	1,876	1,486	1,003	819	836	852
Total Liabilities	3,386	3,222	2,953	2,517	2,382	2,445	2,510
Net Assets	3,958	4,644	5,007	5,422	5,913	6,467	7,055
Profit & Loss Account	3,595	4,101	4,464	4,879	5,370	5,924	6,512
Share Capital	180	178	178	178	178	178	178
Share Premium Account	600	605	605	605	605	605	605
Total Shareholders Equity	3,958	4,644	5,007	5,422	5,913	6,467	7,055

Analytical Ratios	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Cash / Sales	2.1%	3.5%	3.5%	3.5%	11.3%	23.8%	36.4%
Working Capital	1,267	1,412	1,497	1,548	1,678	1,731	1,785
Working Capital / Sales	27.1%	29.6%	29.3%	29.3%	30.7%	30.7%	30.7%
Trade Debtors / Sales	21.2%	22.2%	22.2%	22.2%	22.2%	22.2%	22.2%
Other Debtors / Sales	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%
Inventories / Sales	26.6%	27.4%	27.0%	27.0%	27.0%	27.0%	27.0%
Trade Creditors / Sales	17.3%	20.1%	20.1%	20.1%	20.1%	20.1%	20.1%
Other Creditors / Sales	9.7%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%
Net Debt / (Cash) (m)	1,550	1,281	869	362	(270)	(990)	(1,767)
Gross (Debt) / Cash	(1,650)	(1,450)	(1,050)	(550)	(350)	(350)	(350)
Net Debt / Equity	39.2%	27.6%	17.4%	6.7%	-4.6%	-15.3%	-25.0%
ROE	19.8%	17.8%	13.8%	14.1%	14.9%	15.1%	14.7%
ROA	10.8%	10.1%	8.4%	9.3%	10.4%	10.9%	10.8%
Net Tangible Assets	359	902	1,444	2,039	2,711	3,446	4,215
NTA per Share (diluted)	0.41	1.04	1.66	2.34	3.11	3.96	4.84
Gearing	28.1%	21.6%	14.8%	6.3%	NM	NM	NM
Debt / Equity	39.2%	27.6%	17.4%	6.7%	-4.6%	-15.3%	-25.0%

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates

Exhibit 4: Smith & Nephew: Cash Flow

Cash Flow Statement	US\$	US\$	US\$	US\$	US\$	US\$	US\$
Dec Y/E (US\$m)	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Profit Before Taxation	1,062	879	988	1,058	1,119	1,181	1,245
Exceptional Items	(326)	- -	(48)	(47)	(2)	28	28
Depreciation & Amortisation	463	460	488	523	559	593	628
Loss / (Profit) on Sale of Tangible Assets	15	- -	- -	- -	- -	- -	- -
Share Based Expense	27	31	- -	- -	- -	- -	- -
(Increase) / Decrease in Inventories	(47)	(60)	(78)	(46)	(47)	(46)	(47)
(Increase) / Decrease in Debtors	(74)	(181)	(108)	(53)	(54)	(52)	(54)
Increase / (Decrease) in Creditors & Provisions	(49)	36	131	64	65	63	65
Other	(82)	108	6	6	6	6	6
Interest Received / (Paid)	1	(48)	(55)	(37)	(20)	(4)	11
Tax	(141)	(135)	(230)	(249)	(266)	(282)	(299)
Operating Cash Flow	849	1,090	1,095	1,219	1,360	1,486	1,583
(Purchase) / Sales of Fixed Assets	(392)	(376)	(378)	(390)	(375)	(386)	(398)
(Purchase) / Sale of Trade Investments & Own Shares	(2)	- -	- -	- -	- -	- -	- -
(Acquisitions) / Disposals	11	(167)	- -	- -	- -	- -	- -
Investing Cash Flow	(383)	(543)	(378)	(390)	(375)	(386)	(398)
Issues of Ordinary Shares	16	10	- -	- -	- -	- -	- -
Increase / (Decrease) in Borrowings	127	(123)	(400)	(500)	(200)	- -	- -
Settlement of Currency Swaps	(25)	- -	- -	- -	- -	- -	- -
Own Shares Purchased	(368)	(52)	- -	- -	- -	- -	- -
Dividends Paid	(279)	(269)	(305)	(322)	(353)	(381)	(408)
Financing Cash Flow	(529)	(434)	(705)	(822)	(553)	(381)	(408)
Net Increase/ (Decrease) in Funds	(63)	113	12	7	433	720	777
Analytical Ratios	FY16A	FY17A	FY18E	FY19E	FY20E	FY21E	FY22E
Operating Cash Flow Growth	-17.4%	28.4%	0.5%	11.3%	11.6%	9.3%	6.5%
CFPS - Basic	95.4	124.8	125.7	139.9	156.2	170.6	181.7
CFPS - Diluted	95.1	124.6	125.7	139.9	156.2	170.6	181.7

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates

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Global Stock Ratings Distribution

(as of February 28, 2018)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
Overweight/Buy	1175	37%	315	41%	27%	555	39%
Equal-weight/Hold	1369	43%	357	47%	26%	643	45%
Not-Rated/Hold	53	2%	5	1%	9%	7	0%
Underweight/Sell	552	18%	87	11%	16%	222	16%
TOTAL	3,149		764			1427	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

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Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

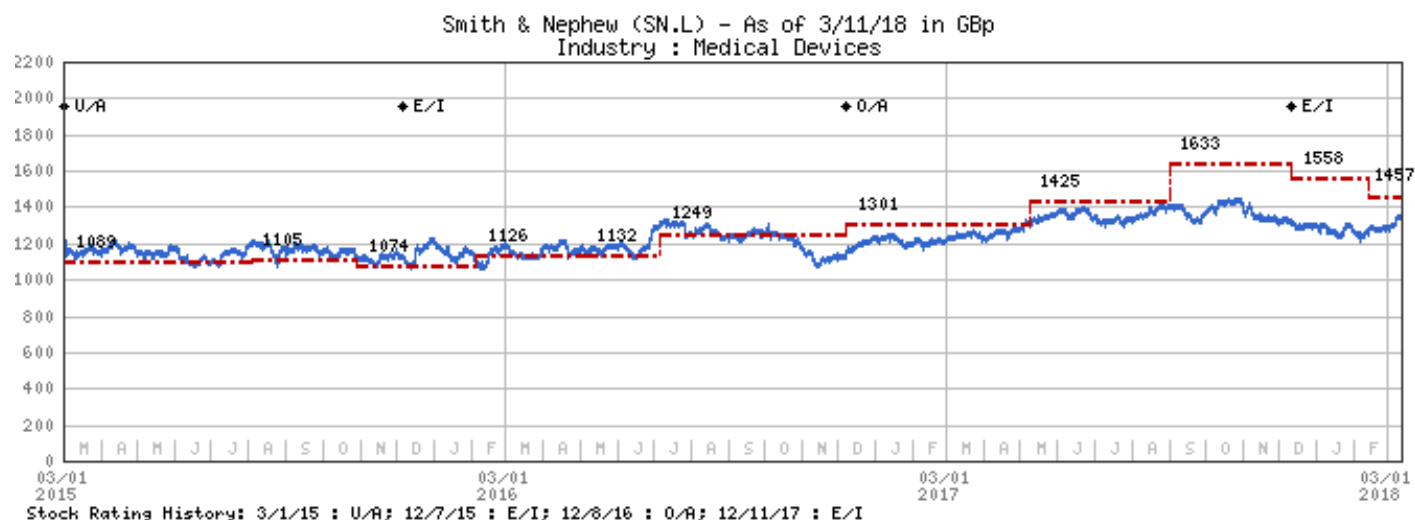
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

Stock Price, Price Target and Rating History (See Rating Definitions)



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Effective January 13, 2014, the industry view benchmarks for Morgan Stanley Asia Pacific are as follows: relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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INDUSTRY COVERAGE: Medical Devices

COMPANY (TICKER)	RATING (AS OF)	PRICE* (03/09/2018)
Michael K Jungling		
Coloplast A/S (COLOb.CO)	E (12/07/2015)	DKr 516.00
ConvaTec Group PLC (CTEC.L)	O (12/11/2017)	208p
Elekta AB (EKTAb.ST)	U (12/07/2015)	SKr 87.54
Essilor International (ESSI.PA)	O (12/08/2016)	€112.85
Getinge AB (GETIb.ST)	U (12/08/2016)	SKr 110.90
GN Store Nord A/S (GN.CO)	U (11/29/2017)	DKr 220.20
Smith & Nephew (SN.L)	E (12/11/2017)	1,331p
Sonova Holding AG (SOON.S)	U (11/29/2017)	SFr 156.30
Straumann Holding AG (STMN.S)	E (12/11/2017)	SFr 645.00
William Demant Holding (WDH.CO)	E (12/08/2016)	DKr 231.40

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* Historical prices are not split adjusted.