ConvaTec 2017 Full-Year Results

Thursday, 15th February 2018

Transcript produced by Global Lingo
London - 020 7870 7100
www.global-lingo.com

Opening Remarks

John Crosse

VP Investor Relations, ConvaTec

Good morning everybody. Welcome to the annual results for 2017 for ConvaTec. It is good to see you here. I am John Crosse, VP of IR. First let me begin with a couple of housekeeping matters. On fire alarms we are not expecting a fire drill this morning so if the fire alarm does sound during the presentation please follow the instructions. There are fire exit doors by the auditorium and there will be security personnel around to escort people and direct you to the right place. Could I ask to put your phones on silent please? That would be very much appreciated. Thank you for that.

Agenda

This morning I am joined by Paul Moraviec, our Chief Executive and our CFO, Frank Schulkes. Paul is going to start by taking you through the key points of the year including an update on our operations, the key points on our revenue and margin performance and then following that a review of our four franchises. Frank will then give you the financial update as well as insights into the margin story both for 2017 and the future. Paul will then return to conclude the presentation and then of course we are very happy to take your questions.

Before I hand over to Paul can I please bring to your attention the forward-looking statements and regulatory information in our announcement this morning. Without further ado I will hand over to Paul.

2017 Highlights

Paul Moraviec

Chief Executive Officer, ConvaTec

2017 Full-Year Results

Good morning everybody. Our results for 2017 met the revised guidance that we gave in October. However these are not the set of results that I wanted to be presenting to you today. We have made good progress across many areas in 2017 but I want to start this morning by dealing with the setbacks in performance in the second half of the year. During our last call I told you that together with our CFO Frank and Donal our new Head of Global Operations we would take the time to do a deep dive to analyse the business underperformance in 2017. We have done this work and we know the dynamics and the detail behind the issues that arose. We are taking action to get us back on track.

However, 2018 will be a year of stabilisation as we continue to work through this. One thing that is very clear to us is that the fundamentals of this business remain strong. We are in large and structurally growing markets and we have got a strong competitive position with differentiated products. Additionally we are very clear about the medium-term opportunities in terms of both revenue and margin growth.

Back to 2017, we delivered organic revenue growth of 2.3% which was ahead of our revised guidance range of 1-2%. Our adjusted gross margin was 61%. Excluding foreign exchange benefits this was a decline of 70bps. We are resolving the specific supply constraints that we encountered in Q3 in line with our guidance. I will come back to the operational issues in a

moment. As I mentioned, Frank, Donal and I have done a complete review of the MIP programme. We have made sure that we have got the best fact base available to us. In summary we actually delivered a sizeable part of the planned productivity benefits in 2017. However, those benefits were more than offset by headwinds and other cost increases. Frank will go into those in just a moment.

Moving to cash flow our cash generation remains robust with cash conversion of 77% in 2017. This is slightly below our historic range due to the additional costs on the MIP programme. Finally we have announced today our final dividend bringing our total dividend for the year to a 35% pay-out ratio.

Operations Update

What is the current status of our operations in Haina? As you know, in 2017 we undertook a significant project to rationalise our manufacturing footprint by transferring the production of certain wound and ostomy products from Greensboro in the US to Haina in the Dominican Republic. To be clear there is no question that this was the correct strategic decision for the long-term future of the business. However, operational delivery fell short.

What went wrong?

Firstly the transfer of manufacturing facilities is by far the most difficult part of any MIP programme. As you know, the highly experienced Mike Sgrignari, our Head of Operations, tragically and unexpectedly died in March last year at a critical time in this project. The vast majority of production lines were transferred as planned. For Wound Care the lines were transferred successfully however delays were experienced in obtaining regulatory certification. The last few lines we transferred, the Ostomy Convex and Moldable lines experienced significant delays to the ramp up of production volumes.

The root cause of this was unexpected mechanical failures as well as delays with optimising these lines to the level of production in Greensboro. This took effect at the end of the third quarter. These delays meant we used up our reserves of safety stock and with production levels in Haina running below current demand back orders quickly developed. We lost orders and patients which led to an immediate reduction in revenue growth which we reported in our third quarter update in October. We will continue to be affected by the lost orders and patients in 2018.

Current situation

In Wound Care the back order that arose following the regulatory certification delay has now returned to a normal level and the back order for Ostomy Convex products has also returned to a normal level. For Ostomy Moldable production we have increased production volumes to a level which now meets current market demand and we started to address the back orders.

Objectives for 2018

With our manufacturing issues now in hand what are our objectives for 2018? Firstly the Moldable back order. I am confident that we can address this and reduce the back order to a normal level by the end of the first-half in line with the guidance that I gave you in October. We are also going to increase the production yields in Haina to take these up to the levels we had in Greensboro. Finally, put simply we had to shift engineering resource to address these manufacturing issues at the end of last year. We can now put these resources into the right

place. We are going to focus on the productivity initiatives that were interrupted last year. We have also identified some new productivity initiatives which we will implement.

Revenue Growth

Revenue in 2017 grew 2.3% on an organic basis or 4.1% on a constant currency basis which includes contributions from EuroTec and Woodbury. We saw strong revenue growth in our CCC and Infusion Devices businesses in 2017. In Ostomy we also saw strong underlying momentum in the US, Latin America, Japan and in China. Whilst our revenue performance in 2017 was ahead of our revised guidance it was impacted by a number of headwinds and challenges. Some of these were planned, such as the $13m product rationalisation in CCC. Some of the headwinds related to manufacturing and supply issues in Haina. It has taken us longer to penetrate the market with new products than we expected due to longer selling cycles and approval processes. In the US our post-acute Advanced Wound Care business did not perform as strongly as we anticipated. However conversely and pleasingly Wound performed well in EMEA.

Looking forward to 2018 the impacts or back orders and the loss of demand we saw in 2017 will have an ongoing effect in 2018. We also expect to complete the SKU rationalisation in CCC in the early part of 2018. As for revenue growth we expect momentum to return as we progress through 2018. For the full-year we are guiding to organic revenue growth of 2.5-3%. In the medium-term we are targeting organic revenue growth in line with our markets which we continue to see as 4-5%.

Margin Evolution

Our adjusted gross margin in 2017 was 61%, an increase of 10bps over prior year. If we exclude the positive impacts of foreign exchange our gross margin decreased 70bps year over year. Whilst we did deliver a proportion of the planned productivity gains for the year this was more than offset by headwinds, manufacturing inefficiencies and higher other costs. We anticipate that some of these headwinds and challenges will reverse over 2018 although some will endure and they will restrict margin growth in 2018. In 2018 we expect EBIT margin to be between 24% and 25%. We continue to believe that material, structural gross margin expansion opportunities remain. There is still a significant gap between ourselves and the market leader and we believe we can reduce this gap.

Five Areas of Opportunity

There are five areas where we see clear opportunities: sourcing excellence, improved cost efficiency, supply chain and distribution, driving our lean or productivity programmes, continued footprint optimisation and reducing complexity in the business. We will continue to run the cost-out projects already underway in these areas and in the case of new projects we are building on the work done to date to develop detailed plans. While we expect only modest productivity gains in 2018 we continue to believe that material productivity increases are achievable over the medium-to-long term.

You will have seen in our announcement this morning that going forward we will be guiding you on EBIT margin rather than gross margin. Using EBIT margin provides the opportunity to discuss the business in a more holistic way, giving a better reflection of the total productivity opportunities ahead. It also provides a better comparator with our peers. The overall scale of the cost-out opportunities that we see ahead for the business in dollar terms is similar in

size to the target that we previously had but over the medium-to-long term. These opportunities include many of the initiatives we have already started as well as a number of new initiatives. These opportunities are stated before the impacts from pricing and mix. Our adjusted EBIT margin of 25.9% was 210bps lower than the prior year, driven by an increase in operating costs to drive regional growth, new product launches and Ostomy patient support.

We are currently building our internal capabilities and resources including an expanded project management office. We will provide more details on both our execution capabilities and approach and on the specific areas of cost we are targeting as we progress.

Franchise Summaries

Paul Moraviec

Chief Executive Officer, ConvaTec

Franchise Summary

At a franchise level Advanced Wound Care grew 2.6% in 2017. Ostomy Care grew just under 1% on an organic basis or at 3% at constant exchange rates, with the inclusion of EuroTec. CCC grew at 1.7% on an organic basis. If we include revenues from the acquisition of Woodbury in September CCC revenues grew 7% on a constant currency exchange rate. Finally, Infusion Devices which had a strong performance delivering 5.2% growth. Now let me turn to each of the franchises in turn.

Advanced Wound Care

Weakness from supply disruptions

In Advanced Wound Care we continued to see strong demand for AQUACEL with growth driven by foam, silver and surgical cover dressing products. Our performance was impacted by French reimbursement which was a headwind of 1% to growth. The supply constraints that arose in Q2 impacted growth for the full-year by around 1pp. As I have said earlier, the supply situation here is now resolved.

However, as the 2.3% organic growth in Q4 demonstrates we continue to be affected by the lost orders and the timing of order recovery. We have taken action to improve the performance of the US post-acute channel. We are focusing on accelerating our share gain through an expanded and upskilled sales force.

Other priorities for 2018 include the continued roll-out of Avelle. As you know, we launched Avelle last year and we are confident in the significant potential of this differentiated product. We are implementing enhanced plans to realise the full potential and drive greater account penetration.

Ostomy Care

Supply constraints impact growth

In Ostomy Care we continued to see good underlying momentum in the business and in particular from China, Japan, US and LATAM. The Ostomy strategy is working. Our performance was however impacted by the supply constraints that took effect in Q3, which impacted overall growth for the year by about 2pp. As you know, we also suffered roughly 0.5pp of headwind in the year from the GPO contract renewal in the US which annualised in

September. Our integration of EuroTec continues to go well and we are also seeing good performance from our new products, the Esteem Flex Convex and Natura Convex Accordion Flange. While we have seen a good underlying performance in Ostomy we expect to see an adverse effect in 2018 as the impacts from lost orders and supply constraints in 2017 fully work through the system.

In line with the guidance I gave in October we continue to target the resolution of the Moldable back order during H1 in 2018. We are delighted to have extended our contract with GHD, the largest home care provider in Germany. Together we expect to accelerate momentum in our Ostomy business in Germany. Finally, we will continue to execute our successful Ostomy strategy and drive further momentum with our direct-to-consumer programme, me+.

Continence & Critical Care (CCC)

Good underlying momentum – Woodbury acquisition strengthens US position

In CCC we saw a strong performance in 2017 with organic revenue growth for the full-year of 1.7%. This is of course after the $13m product rationalisation which equates to roughly 3.5pp of lost revenue. CCC growth was driven by our Home Distribution Group or HDG. This new business unit for catheter and incontinence-related products includes our US distributors 180 Medical, Woodbury, Symbius, South Shore and Wilmington. The integration of Woodbury remains on track and we have consolidated our position as the leading US distributor. We are pleased with the performance of GentleCath Glide following its launch in the US in 2017 and more recently we have entered the European continence market.

Looking ahead into 2018 we will continue to build our presence in Europe but, as you know, this is a country-by-country roll-out so it will take time to build new revenues here. In the short-term we also expect around a 1% impact from the final part of our product rationalisation programme.

Infusion Devices

Customer product launches driving timing of demand

Infusion Devices delivered a strong performance in 2017 with growth of 5.2%. This was driven by another strong performance in the diabetes pump market as well as new product launches by our partners. We launched our new Ulysses infusion set with its innovative insertion mechanism for both diabetes and for non-insulin therapies. In the second half of 2017 we saw a small benefit from a voluntary product recall.

Continued Focus on R&D and Innovation

Following my recent organisational announcement R&D will now report directly into each of the new franchise president roles. During 2017 we launched 16 new products across our four franchises and you can see a few examples of these here on the slide. We continue to develop some highly innovative products and I look forward to sharing more of this with you in the future.

Financial Overview

Frank Schulkes

Chief Financial Officer, ConvaTec

My Initial Observations

Before we dive in just a couple of observations given I just started as CFO in November. Coming in I see a business that has some very strong fundamentals. It is operating in very attractive markets. The business is well-positioned with good-to-great product portfolios and healthy margins. It generates good cash flow as well. We have a very strong executive team. The business has great potential but in order to realise that potential the business also needs to improve in some areas.

From where I am sitting as CFO I see two areas that need focus. The first area is to continue to improve project management. Both in operations and product development from the planning stage to final execution this muscle can be further improved. Second I think statutory information reporting is good but in business intelligence we are not where I would like to be yet. We are working on it and this will take some time, effort and investment. However, when these things are improved they will provide a real upside for the business going forward.

Financial Highlights

As Paul mentioned, revenues came in at $1.765bn which is up 4.5% reported. If you strip out foreign exchange we grew 4.1% and stripping out the acquisitions we were up 2.3% organically. Adjusted gross margin came in at 61%, 10bps up versus 2016 and 70bps down operationally. That was in line with our revised guidance. OPEX came in at 35.1% for the year with 37% in the first-half and 33% in the second-half. This was up as planned driven by Plc costs as well as continued investments in go-to-market, R&D, infrastructure and acquisitions. As a result of the investments in OPEX our EBIT declined in 2017 with our EBIT rate coming in at 25.9%. EPS was up versus 2016 driven by a lower interest cost and partially offset by investments in OPEX as well as FX charges that we incurred largely in the first half of 2017.

As discussed, cash conversion was 77%, slightly down versus 2016 driven by higher CAPEX expenditures. Finally, our leverage at 3x was in line with 2016 while we did two acquisitions. Excluding the acquisitions our leverage would have come down to 2.8x.

FY 2016 – FY 2017 Revenue Bridge

Revenue growth was 4.5% on a reported basis with organic growth at 2.3%. Advanced Wound Care contributed $15m or 2.6% organic. Ostomy was up 3% FX-adjusted and just shy of 1% organic while CCC grew 7% FX-adjusted and 1.7% organically including the impact of product rationalisation. Finally ID had a strong year coming in at 5.2% organic growth. The acquisitions of Woodbury and EuroTec contributed $30m in revenue and FX was a modest tailwind of $8m.

Gross Margin Overview

Gross margin we came in slightly ahead of 2016 at 61% but this included an FX tailwind of 80bps so operationally we were down 70bps versus 2016. The original guidance for 2017 was set at 60bps improvement year over year and this was based on price being down 1% or

40bps in margin terms. Mix was expected to be positive and cost-out was planned to be positive fuelled by MIP projects. As I said, the actual margin came in 70bps operationally lower than 2016. Price was down versus 2016 which was in line with expectations. Mix was flat year over year so somewhat worse than expected. Cost-out came in slightly negative so also lower than expected and this was the biggest driver of the change from our original 2017 guidance.

Project Cost-Outs More Than Offset by Headwinds in 2017

Let us have a closer look at productivity and cost-out. Bottom line MIP projects delivered cost-out benefits in 2017 but this was more than offset by headwinds or other cost increases. The key projects that delivered benefits in 2017 are listed in the green box. First we benefitted from a lower labour rate at Haina that fell through to the bottom line. We simplified our footprint closing both Greensboro and a small plant in Malaysia. Third we had several sourcing programmes delivering favourable purchase price variances. We also had some lean project benefits although they were limited and they were below expectations. Overall projects delivered but they delivered below expectations.

As I mentioned, these benefits were more than offset by headwinds largely driven by what you see in the red box. First plant efficiency. The Haina plant is not yet operating at the same level as Greensboro. The yield is lower resulting in higher scrap and waste as well as higher machine hours. We are working it but it will take time to get yields up. Then we have expediting costs mainly in the form of additional freight and overtime to deal with the supply issues in Wound and Ostomy. Third we have invested in the operations teams adding resources in continuous improvement, supply chain as well as sourcing. Then there is the negative impact of wage inflation as well as higher depreciation cost. The impact of these costs were underestimated when the original MIP and margin guidance was developed. Finally, there were one-off credits in 2016 that did not repeat in 2017 like the inventory build ahead of our move to Haina and some sourcing credits.

Headwinds Restricting Margin Growth in 2018

Expanding our horizon: what does this mean for 2018? First the projects we started in 2016 and 2017 on the top-half of the page will continue to deliver but several will not give us additional productivity in 2018. We will get some extra benefit out of Haina labour rates and that is why you see the green plus sign there. On top of that we expect the lean projects to deliver more productivity and then we are going to supplement this with a wave of existing and new projects that I will lay out on the next page.

Going down the list I already mentioned that we are working on improving the yield in Haina and we expect this to be a positive in 2018. Our freight costs will still be elevated in the first half while we are working down the back orders but that should improve later in the year. Then wage inflation will stay. Depreciation will go up in 2018 and commodity prices are also going to be a headwind in 2018. 2018 will be a year of stabilisation with only a modest recovery from 2017.

Cost-Out Initiatives and New Programmes

We are targeting our cost-out projects in the following five categories: sourcing, supply chain, manufacturing, footprint as well as simplification. First we will continue to drive sourcing excellence programmes more than offsetting inflation. Think here of should cost activities,

improved life cycle management and make versus buy decisions. Second in supply chain we are going to drive cost out of our warehousing and distribution network as well as improving order planning accuracy. Then as I mentioned before we are working on stabilising operations and driving improved yields. In footprint we will continue to move more production to best-cost countries and simplify our footprint but that will not be done in the short term. Finally we are going to simplify our business through further SKU rationalisation and packaging simplification. On top of that we are starting to develop plans to take cost out of OPEX that we will reinvest into the business in go-to-market and in R&D.

We are now validating the opportunities, building our detailed plans with targets, owners as well as beefing up our project management muscle. We know the opportunity is substantial from a project funnel point of view and from a longer-term target point of view benchmarking our competition. We expect some of these programmes to have an impact in 2018 but the majority will hit in 2019 and beyond.

OPEX Overview

Increases reflect organic business investments, Plc costs and M&A

As I said before OPEX came in at just over 35% and that was up from 33% in 2016. The main drivers are the inclusion of the Plc costs of about $15m and then the continued investments in go-to-market in the regions as well as new product introductions. On top of that we have invested more in infrastructure as well as in acquisitions of course. We expect OPEX as a percentage of sales to go up in 2018 as we continue to invest in growth opportunities and capabilities.

FY 2016 – FY 2017 EBIT Bridge

In terms of EBIT let me walk you through the bridge starting on the left. 2016 EBIT was $472m. Gross margin added $29m which was more than offset by the OPEX investments while FX translation was a benefit of $20m, in total driving the rate from 28% to slightly less than 26%. The same logic works for EBITDA.

Good Cash Conversion and Strong Balance Sheet

Our cash conversion was 77%. As mentioned, that is slightly below 2016 because of higher CAPEX investments. Our leverage stayed flat including the cash outflow to fund the two acquisitions. Excluding these acquisitions the leverage came down to 2.8x.

Revenue Guidance and Principles

For 2018 our top line guidance is 2.5-3% organic revenue growth and for the medium term we expect this to be in line with the market. This is based on the following assumptions. We are looking at markets generally in line with 2017 although we see some softer markets in Wound. Price pressure will continue to be around the 1% mark and we expect to improve the US post-acute performance and expect continued pressure from the lost demand in Ostomy. Furthermore revenue contribution from our new products will continue to grow but the contribution in 2018 will be modest.

EBIT Margin Percentage Guidance and Principles

The EBIT margin in 2018 will be lower than 2017 driven by OPEX investments. We expect price to be negative, mix to be neutral and net modest contribution from cost-out projects. Increased OPEX will be driven by the annualisation of the 2017 investments including our

acquisitions, wage inflation, R&D and further commercial investment in specifically the US and Asia, as well as investments in IT and project management. We expect EBIT margin to be between 24% and 25% in 2018.

Medium-to-long term this is how you have to look at the business. Price will continue to be a negative driver of margin rate. Mix will move within a limited band. Inflation will be a negative driver and productivity cost-out will gain momentum in 2019 and beyond. OPEX will be a drag in the early years. We then expect it to stabilise after which we will get operating leverage resulting in EBIT rate expansion.

Technical Guidance: 2018 and Medium Term

Finally some technical guidance. We expect the tax rate for 2018 to be in line with 2017 and we do not expect any significant impact from the US tax reform. CAPEX will be in line with 2017 given overflow investments from 2017 as well as new investments in growth in all franchises. Finally, at current FX rates we see a positive impact on revenue and EBIT.

Summary and Outlook

Paul Moraviec

Chief Executive Officer, ConvaTec

Improving Structure and Execution in 2018

Let me now recap at a high level the challenges of 2017 and how we are addressing them in 2018. I have characterised the challenges we faced last year into two areas: commercial and operational execution. On commercial we are focusing our efforts on US Wound Care, particularly in the post-acute setting and we will continue to build momentum with foam and Avelle. We will also continue to execute our successful Ostomy strategy. These commercial initiatives will be the subject of greater focus and resource in 2018.

On operational execution, as I said earlier, the optimisation of Haina remains one of my top priorities for 2018. To capture the productivity initiatives that lie ahead we are developing our internal plans for the new projects in the five areas that Frank and I mentioned a little earlier. Our future programmes and projects will be subject to more rigorous stress testing and we will take a more balanced and thorough view of risks and opportunities.

Let me quickly recap here before we move to my final slide. We saw some good performances in 2017. Though this was offset by the challenges and headwinds that we presented to you today. I am confident that we now have the right capabilities, actions and initiatives to regain momentum and realise the full potential of this business and to deliver value creation for our shareholders in the future.

Fundamentals Remain

The fundamentals of our business remain. We have got a high-quality range of differentiated products and innovative product pipeline, and strong brands in market-leading positions. All of this in large, structurally-growing chronic care markets. Cash generation by the business is robust and there is material opportunity ahead in the medium-term to return revenue to market growth levels and to improve EBIT margins over the medium-to-long term. We are confident in the opportunities ahead and are investing now to build for success. Frank and I will be happy now to take your questions.

Q&A

Yi-Dan Wang (Deutsche Bank): First of all on the Ostomy guidance that it would impact Group growth by 50-100bps, the business grew by just under 1% in 2017 and do we take it that it would decline by 1-3% in 2018? If so, why would that be given that your fourth quarter showed flattish revenue? I would expect that it would perform a bit better than that.

Second question is on the OPEX investments. Do you think the amount you are investing is sufficient for the long-term sustainability of the business given that if you look at your nearest competitor their investments have been growing substantially? The investment gap between you and them is becoming increasingly bigger so just some comments on the level of investments in your business and why you think that might be sustainable. Maybe the business is not ready to absorb large investments at this stage so if you could provide some colour on that, that would be great.

Paul Moraviec: On Ostomy first of all, if you think about it we did 0.8% last year and we had back order impact, lost patients etc. of about 2%. That shows that the underlying business has been growing quite nicely and NPC is doing very well actually in all of our major markets so we are quite pleased about that. Having said that we are going to suffer in 2018, as we said before, because of those lost patients. Q4 was a good quarter and one of the major drivers of that, it took it up a little bit more, was we are doing very well in Japan at the moment. The NPC is up pretty substantially, mostly driven by the Convex launch there and there were orders from distributors in Japan which we will not see all of those in Q1. You will see a lower position in Q1 on Ostomy.

This is a business that will return back to the incremental growth that we have said we would see in this business. We are very confident of that. The strategy is working but I think we need to be cautious about the 2018 performance of that business, particularly in the first half.

Then from an investments point of view the way that we look at this is that I think our competitors have been investing heavily on a continual basis, certainly in the last few years. There have been continual stories of X number of headcount in certain countries and sales pressure and lots of investments coming through. I think that level of competitive intensity has always been there. We will increase our investments to make sure that we keep in step with those things but the guidance that we put out there we are very comfortable with in terms of what we need to invest. I do not think there is a major step change that is going to take place. I think this is just going to be a gradual situation. As a business we have opportunities to reduce cost in our gross margin. We have opportunities in the medium-to-long term to take cost out of our OPEX as well. Many of the things that we have seen our competitors do over the last seven or eight years are still opportunities for us. We believe that we can still take structural cost out of this business in the medium-to-long term that can help to fund any funds that we need to put into commercial or other areas.

Yi-Dan Wang: If I could follow up on that I suppose it might help to put some numbers around it. Based on the numbers you have reported historically and what your competitor has reported the amount of OPEX investments that has gone into the business for you relative to your competitors we estimate to be just under $700m. With a step-up in investments that your competitor announced back in November that could increase to $1.7bn. Now, not all of the areas that they are investing in you are active in currently so maybe the direct impact on

your business in the short-to-medium term is not going to be as big as that. However, clearly that is a material investment gap and it is a bit difficult to see that the step up in your investment is sufficient to address that.

Paul Moraviec: I cannot comment on investments from our competitors. All I can judge is what we see in the marketplace, the level of competitive intensity, the initiatives that we see from competitors and when we look at what is going on in the marketplace we do not see any reason why we need to make a substantial change or any change really to the levels of investment that we have and the step-up that we are planning to do at the moment.

Lisa Clive (Bernstein): You mentioned in the presentation that Avelle is now launched in 20 markets. How has that been going? Particularly curious about what sort of level of academic studies you have backing the product to-date and also any updated timeline on FDA approval.

Then turning to Continence Care what is the timeline for launching a more modern portfolio of hydrophilic catheters, perhaps more compact ones? Do you need these products in order to be effective in getting a foothold into the European markets?

Paul Moraviec: First of all on Avelle, it is our first full-year in MPWT. The feedback on the product itself has been excellent particularly around the key USPs, the AQUACEL interface, very well received by doctors, nurses and patients. The longer life of the product but also the flexible SKU package that we have for that. The way we think about that is that we have been continually improving and will continue to improve both the product but also the go-to-market in terms of the types of sales people that we have, the product positioning and also resource allocation decisions we are making in each of the markets there. We are actually very confident that that business will continue to grow. It made a contribution last year and it will make a larger contribution this year.

The 510(k) is with the FDA at this point in time and so we will see how long that takes. These things can be a little bit difficult to predict accurately but I think if we are thinking Q2 that will be the right way to be thinking about that.

In terms of the Continence business we have some very exciting products in our R&D pipeline for Continence which we have hinted at before. The first of those we would expect to go into for clinical evaluation towards the middle of the year so that will be the timing. Are they important for the European market? They are absolutely. The European market is the higher end compact devices, different to the US of course although that is changing over time. Those products will also have a good position in the US market as well where we have such a strong platform to be able to launch it.

Lisa Clive: You said clinical evaluation by mid-year but then what would be the timeline from that point to actual commercial launch?

Paul Moraviec: By the end of this year we should be in the market. We will see how those go. If we need to tweak we will do that. We will make sure that we get the right product in the market. That is the sort of timeline we should be thinking about.

Veronika Dubajova (Goldman Sachs): My first question is for Frank. Can you help us understand what material EBIT margin improvement actually means? Companies use material in different ways so maybe you can give us a sense of how you think about that and

what the timeframe is. When do we start seeing the balance of investments versus the savings coming through actually translate into a positive margin direction? That would be helpful.

Frank Schulkes: If you look at, and I laid it out on the slide as well, the different variables that basically determine EBIT rate. The short-term and the long-term price will be a negative. Mix will be plus and minus, could be going both ways. Inflation is of course a negative in margin rate. Then, as we mentioned, our cost-out programmes, the original ones and the ones we are now supplementing, will have a very modest impact in 2018. However, then we will start to build 2019 and beyond. Productivity will be much more meaningful starting in 2019 and beyond. If you then look at some of the other elements within, for instance gross margin, price will be a drag, inflation will be a drag but in 2019 we expect productivity to outperform these negative elements within gross margin. Productivity and gross margins should be positive in 2019.

Now in 2018 our OPEX is going up. As we mentioned, we continue to invest given that we see great opportunities in the markets we serve. I expect at this stage that the OPEX as a percentage of sales will continue to grow in 2019 but probably at a slower pace. Then bottom out or level and then start to provide operating leverage in the medium-to-long, so three-to-five years. There are a couple of reasons driving that. One is that we are making a lot of investments now and we see that rate of incline coming down a little bit. The second is that, as Paul mentioned, we see opportunities to take cost out of OPEX. For instance, in some of the supporting functions thinking about shared services, thinking about consolidations. We are going to reinvest that into OPEX in front line and into R&D. That is the second reason. Then of course the third reason we are seeing our revenue growth returning to market in about three years. That is the medium-term, two-to-three years. A higher revenue growth also will drive that OPEX rate down.

If you look at it, starting in the end of 2018 I think we are bottoming out and the direction of travel will start to change in 2019 because productivity will gain momentum, OPEX as a percentage of sales will not be the drag that it is in 2018 and net/net is where you will see the change. Then going forward we will build and given the funnel we are looking at from a total productivity and cost-out point of view we believe that there is material opportunity for growth there. We are not indeed at this moment putting a number on it, but it is more than 50bps.

Veronica Dubajova: Then can I ask a question on the investment opportunities that you see? You gave us a little bit of a preview but Paul maybe you can talk about, where do you think those investments are most needed, especially on the selling and marketing front? How long will it take for those benefits to materialise?

Paul Moraviec: As Frank said, we are looking at medium-term to get back onto those market growth rates and beyond. I think that is the timeframe that we should be thinking about here. We are having good success in the Asia Pacific market so we will continue to invest there. The Ostomy market is doing very well for us in places like the US and key Asia PAC markets. We will continue to roll out that DTC focus in the investments there and other markets, particularly in Europe where we are not doing as well as the US. Those are going to be the key areas and then as we go forward and we launch new products, particularly the new platform technologies, that is where we will be investing.

Amy Walker (Peel Hunt): I have a couple of follow-ups please to drill down into some of the comments that have already been touched on. Frank could you help us understand the split between some of the OPEX increase this year between things like wage inflation, depreciation that you mentioned versus positive investment to drive growth? Just so we understand what is a negative and what is a positive driver.

Frank Schulkes: If you look at the overall increase this year I would say about 25% is pure commercial. Then there is probably about 20% related to the acquisitions because they of course come in with OPEX as well. Plc cost is 25%, about $15m. Then we also see a R&D increase which is about 10%. Then we have wage inflation that is typically a couple of percent extra every year so that will add up as well. Then the rest is a combination of IT investments in HR systems and those type of things. Then there were a couple of credits in 2016. The majority is related to commercial investments, 25%. 25% Plc and then a pretty significant chunk coming from acquisitions.

Amy Walker: Thank you, that is helpful. Just to be crystal clear have I understood that you are walking away from the original target of the MIP programme that you set out at IPO and that now there is a different shape and a different base and we are starting from scratch again? Or I accept you are not going to guide on gross margin but is this now MIP Plus? Just so we conceptually understand.

Frank Schulkes: Our thinking around margin has evolved and we believe, as Paul also mentioned, that EBIT rate is probably the better way to guide going forwards. It gives a more holistic view of the business and it is very much in line with our peers. Of course cost-out is one of the many elements in that EBIT rate. We are at this moment having existing programmes that we are supplementing with new programmes. In total we believe if you purely look at the cost-out opportunity that the opportunity is similar to the original programme. We are in the process of validating specifically the higher end of the range and we will report on that later in the year and give a little bit more insight in that total cost-out framework, which is now a subset with the EBIT rate framework.

On top of that we will continue to have price. We will continue to have inflation. We will continue to have mix +/-. Then, as I mentioned before, we are adding OPEX as an element as well where we are going to target cost-out projects that we will reinvest in the business specifically in go-to-market and in R&D.

Amy Walker: That is very clear. I just have one more. I think you mentioned that you expected a modest contribution in 2018 from new launches and I wondered, can you give us a sense of relative to where you were at IPO with regard to your expectations for what the new launch contributions were going to be, where have we ended up? Are you on budget? It feels like you might be a little bit behind where you had anticipated. If that is the case can you give some flavour as to why that might be?

Paul Moraviec: Yes, sure. If you look at the contribution of the new products we launched over the last couple of years into 2017 then they contributed to our revenue. As we go into 2018 they will contribute more. There is no question about that. Is it the level that we expected? It is a little less than that. I would say it has taken a little longer to get the penetration, particularly in things like Avelle in those areas. Sometimes these things do take a bit longer in that first year than you anticipate but we have made a lot of changes to that

product, the go-to-market, the resourcing and the positioning. We are very much looking forward to 2018 and expect a lot more from it. The short answer to your question is we would have liked to have seen more but it has made a contribution and will make more of a contribution in 2018.

Ian Douglas-Pennant (UBS): First a question on the guidance please. On the revenue side why have you gone for a 50bps range? It is a very narrow guidance range given you are not happy with your business intelligence systems. Why not broaden that a bit?

The second question is on inventory levels. We have seen them increase year-over-year. Could you remind us why this is the case? Is this safety stocks and therefore could we assume that those safety stocks have now recovered to an extent and so your revenue guidance is cautious? Or is this just a new higher level that we should expect going forward? Or is it just random volatility?

Paul Moraviec: On the guidance first of all we have only just started the year. If you think about the headwinds that we are facing as we go into that first half of the year we lost patients in Ostomy and some in Wound as well. We have modelled out what we think that impact is and hopefully we can do better than that. We are certainly very focused on improving that situation. We still have some MIP impact as well, albeit small. The guidance that we put together takes into consideration all of those factors. We are comfortable that that is the right guidance to give at this point in time. If that starts to change as we go through the year we will come back and update you.

Ian Douglas-Pennant: Picking up on a comment you made there you said you had lost patients in Ostomy and Wound. Does your guidance assume none of those will come back or some of those will come back?

Paul Moraviec: Basically a certain percentage will come back. Obviously we are going to work hard to increase that but it is right for us to take a cautious approach because it is very difficult to quantify it exactly. We put guidance out there that we feel confident in and let's see how the year develops.

Frank Schulkes: Inventory levels, the increase is largely in raw material and work in progress so it is not so much finished goods. Second, because we are now producing more out of Haina than for instance out of Greensboro last year we have a little bit longer shipping line. Typically you see therefore a little bit higher stock levels in specifically the raw. My expectation is that this will improve in fact in 2018 when production is stabilising and we get to normal levels.

John Crosse: Christian from Nordea has said, could you make a few comments around your expectations for AWC growth? You have mentioned before 6% CAGR through to 2020 at your 2016 Analyst Day. Is that still a benchmark? In particular which countries do you see a little bit softer as you noted in your prepared remarks?

Paul Moraviec: If you look at Advanced Wound Care we grew 2.3% last year. We had a couple of significant impacts. One was the supply issues, about 1% and the other one was pricing actions, around 1%. You can see where the baseline would have come out last year. In terms of where the markets are we are seeing a good performance out of our EMEA business. The US market is very strong but we have seen a few challenges there in our

post-acute business which we have taken action on already as we go into this year. In the European markets it has been said that there is a little bit of softness in some of the markets, maybe the UK in particular.

As we move forward as we are seeing these headwinds neutralise and the new products picking up I would expect us to get into the market growth rate of 4-5% but you will see a regional split there. I think we will do better in some markets and maybe less well in other markets. However, that will be my expectation.

John Crosse: I have got two questions here for you Frank from Peter Dalton of Soros. The first one is, can you walk through your fresh pair of eyes assessment of the Group tax structure and its long-term sustainability in the changing world of international tax? How exactly does the US tax reform not impact?

Frank Schulkes: If you look at our business major operations we have in US. We have of course our set up in Switzerland in CIG. Then we have a major operation in Denmark and then we have a major operation in the UK. This structure has been set up, has been tested, audited and we feel very comfortable that this is a very robust structure for now and for the future. We do not see any change there and I think it is tested.

Second, regarding the policy reform in the US we do not see any impact there because at this moment for instance we are not using any of the NOLs so it has no impact on our specific position. If you look at our tax rate development technical guidance is 15% for 2018. We expect the book rate to move up to about 20% over a Strat plan period of about five years. Of course that is a little bit dependent on country mix and those types of things but taking that into account what we know today. The Swiss tax rate is going up so that is one of the drivers and then we expect later in the middle of that Strat plan period to start making profits in the US. Therefore you see a part of that tax rate book rate going up. The cash tax rate is low teens at the moment and we expect over that same time period that the cash rate will probably go to the mid-teens by 2022.

John Crosse: There is a second question here as well. Can you expand upon the level of investment required to establish a more appropriate standard of management information systems and general IT investment that you mentioned? What is the timeframe for that investment?

Frank Schulkes: We kicked off a business intelligence strategy a couple of months ago which is really around data warehousing, getting dashboards and getting management information faster. It gives us an opportunity to move faster because we have the information faster. Today we can get that information but it is more work to get there. We are rolling that out in four waves over the next two years starting with pure financial information. Then we are going to add operational information and the last phase of this will be that we will become more predictive. You are talking about certain algorithms that you can start to utilise. However, that is the last wave of this. The overall investment is, in the grand scheme of things, pretty limited. You have to think something like $5-6m probably.

John Crosse: Then the final question on the web is from Paolo Mortarotti at Tower House Partners. The question is, when taken into account first of all price deflation, secondly inflation in COGS and the increase in OPEX to sales ratio due to higher investment and

potential FOREX headwinds, do you think your 24-25% range is conservative enough given the timing of productivity improvements?

Frank Schulkes: As we have said before I think we are not banking on massive productivity increases. We are banking on modest productivity increases. I think we have a pretty good handle and insight into what price is going to be through the market intelligence from all of the regions that we have. Inflation at this stage I think it is pretty well known. The foreign exchange as an example, if I look at current FX rates then revenue will be positive and margin will be positive but the overall rate impact from foreign exchange in 2018 given what we see today is extremely limited. I feel that 24-25% is the right level of guidance.

John Crosse: There is a final question just come in. Can you please clarify the magnitude of a meaningful margin expansion?

Frank Schulkes: I think we already had that answered.

Nick Keher (RBC Capital Markets): The question I had was on the APAC emerging market strategy. Essentially 8% of your revenue comes from the region today and I am quite interested to know, do you think you have the right product range across each of your franchises for the expansion strategy there? If you need to look at reinvestment in those areas. Then also from a structural perspective if this is going to be a growth driver for the business, what is the EBIT margin potential for that region? How does that relate to European or US markets? Where is it today and where do you think it can get to?

Paul Moraviec: From a product point of view we are always developing the portfolio. A good example of that is a lot of the success we are seeing, in Japan in particular at the moment, is because of the launch of the Flex Convex product which has been extremely well-received there. We are seeing very strong NPC growth as a result of that. We will continue to look for opportunities and make sure we have got the right products in the right markets. From a margin point of view I think you see a variation across that region, is the bottom line. We will continue to develop different products and to segment from a product point of view.

Frank Schulkes: Can I add something to that? From a margin point of view in the end it all comes down to critical mass. We are building our capabilities there therefore we are seeing good OPEX investment because the overall opportunity long-term is absolutely terrific. Once you get that critical mass the margins are in general going to be positive, very good and I think in line with total Group. However, you need to build that critical mass to get there. That is why we are investing in OPEX in the capabilities.

Nick Keher: If I was to read that I would say it potentially diluted the margin today until you have got that critical mass in place.

Frank Schulkes: That is right.

Nick Keher: Then opportunity for M&A. Obviously two smart bolt-on deals in the year. You are leveraged at 3x. Are you comfortable with that level so we can see free cash recycled into acquisitions? Then quite interested to know how fragmented the markets are within each of the franchises you operate in from a new opportunities/acquisitions perspective. Or will you be looking for new technologies maybe at a higher price?

Paul Moraviec: From an M&A point of view the way to think about this is exactly the same thing as we have been saying for the last 18 months really. There is no change. We will

continue to look for the bolt-on acquisitions. They are relatively easy to do. They are non-disruptive. They will be accretive from a top line and bottom line. We look for deals that are either forward integration, technology or critical mass regionally. I think we have been very successful in that process and we will continue to do that. We will continue to be active there but these are relatively small deals.

Frank Schulkes: Our leverage in 2017 excluding the two bolt-on acquisitions we did was 2.8x. We are a highly cash generative business. In the medium-term we expect our leverage without acquisitions to go down to a level of about 2x or lower. We will continue to have an appetite for the right type of acquisitions and we feel very comfortable being able to fund those given the fact that we are very cash generative overall.

Alex Gibson (Morgan Stanley): I have a question on your five cost-out initiatives. How should we be thinking about the relative magnitude and size between each of the initiatives? For example, at the IPO you said one third would come from sourcing excellence. Is it around the same amount for this? A bit of guidance on that would be helpful.

Frank Schulkes: I would say sourcing has been already a pretty significant driver and will continue to be one. If you look at sourcing you have to then also look at the other parts of the business. For instance, if you think about life cycle management of products that is not only a sourcing activity but R&D will be involved in that and the franchises will be involved in that. Therefore I think sourcing will continue to be a pretty significant one. If you look at the supply chain thinking about optimising our warehousing and logistic network, including improving our overall order planning capacity I think there is some good material opportunity for cost-out there as well. Then we talked about it, getting for instance plants up to an increased OEE level so lower waste and scrap for the whole business by applying lean technologies, I think will be a lot of small projects but with relatively small benefits. However, because there are going to be a lot of them I think the overall mass will be pretty significant. Then the piece that we call simplification of course there is an element of margin rate accretion to that. If you do SKU rationalisation you do not necessarily get cost out but you take revenue away without any EBIT loss or in fact going from negative EBIT to no EBIT so that is a positive. Packaging would be a real cost-out opportunity as well.

I would say that the final thing is around footprint. This is an area we are continuing to look at but not in the short term. If you look at where you can expect the most in the next 24 months, it is not going to be on the footprint side but it is largely in the other areas.

Alex Gibson: A follow-up on the simplicity thing. With the SKU rationalisation what sort of magnitude do you think that will have on your revenue top line? We have seen the impact it has had this year. Is it a similar amount going forward?

Frank Schulkes: We are, as we said, validating some of these projects in more detail so at this moment I cannot really comment. However, I would say in some of the other product lines where we have not done the same exercise as for instance in CCC I would expect the opportunity to be at least at that level.

David Adlington (JP Morgan): Frank, I just wanted to pick you up on your comments about FY19. I think you mentioned that OPEX as a percentage of sales is going to go up in 2019 as well. Will gross margins improve enough to offset that or should we be thinking about flat to down margin in 2019?

Frank Schulkes: No, what I explained when Veronica asked the question, of course we are not guiding at this moment for 2019 but direction of travel. The productivity programmes, the cost-out programmes will clearly gain momentum in 2019 more than offsetting price and inflationary activities. We believe at this stage that even with an OPEX increase that we will bottom-out in 2018 and the direction of travel will start to become positive in 2019. Those two I think will be towards the second half of the year in favour of cost-out.

Martin Hall (Hardman): Paul, I am wondering could you flesh out a little bit more about the move to Haina. When that is running at full operational efficiency, and I would do a compare and contrast with Greensboro, how is it going to look in terms of capacity, yields and staff numbers? There has got to be a lot of benefit that I am missing I think.

Paul Moraviec: The way to think about this is everything is running well at this point in time but there is still opportunity for us to optimise, to get better yields out of the plant. We see that as one of the opportunities and Frank alluded to this as well in terms of things like scrap rates and OEE of the machines. We see that as a good solid opportunity for us and we are going after that as we speak.

Martin Hall: In terms of as you look at the medium-term, if Greensboro was 100 in terms of capacity, what has Haina got the potential to achieve?

Paul Moraviec: Exactly the same.

Martin Hall: You are not increasing capacity at all?

Paul Moraviec: No, we have just transferred the plant across.

Martin Hall: In terms of distribution costs my imagination is it costs more to get product and raw materials in and out of Dominican Republic compared to the US. Am I wrong there?

Frank Schulkes: It is a little bit more expensive but overall of course there is a big benefit with labour rates that are 8-10x lower than in the US. Also if you think about all things equal there is not capacity increase but our business is going to grow. Eventually we will add capacity like we would have added capacity in Greensboro. Then of course you have the benefit of that lower cost base and on top of that you get the scale. Therefore the benefits more than outweigh some of these additional items like you have to carry a little bit more inventory and you will have a little bit more transportation cost.

Lisa Clive (Bernstein): One question on the customer losses in Ostomy. Was this mainly individual patients in the community setting? Was there any disruption to your relationships with hospitals, either direct hospital relationships or indirectly through the GPOs? Was there any change in your GPO contracts?

Paul Moraviec: No change to the GPO contracts at all. When you look at the two differences if a patient cannot get a product in the community they will be forced to go to another product. That is where the patient loss really comes from. In the hospitals clearly the relationships will be strained there for a while but the way that people judge these things is not necessarily by the event itself because these things happen in the device industry. It is really the way that the company responds to it and the amount of care that we apply to it. I think we have done an exceptional job with our sales people making sure that we can get as much product as possible into the right places by moving it around. We will recover quickly from that situation from a hospital point of view.

Interestingly enough our NPC rates in our major markets, while we only look at the overall trending of that not the absolute numbers, we are actually very pleased to see very positive NPC trending even though we have had this. I think that provides the evidence that we are still getting the patients in the hospitals. I am not too concerned about that. The issue is really just that underlying loss that we had which we will need to deal with as we go through this year.

[END OF TRANSCRIPT]