Surgical Innovations Group Plc

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Interim Report 2012

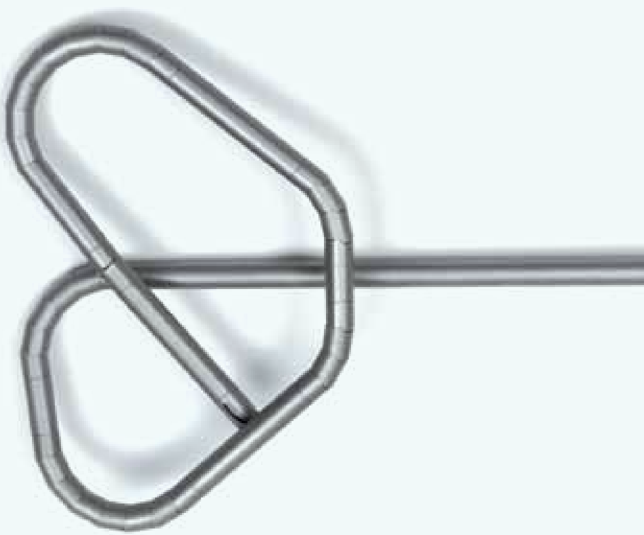
Surgeon-led solutions for minimally invasive surgery

THE QUEEN'S AWARDS FOR ENTERPRISE: INNOVATION 2010

Surgical Innovations Group plc specialises in the design and manufacture of creative solutions for minimally invasive surgery (MIS) and industrial markets.

A clear strategy for growth

To take our pioneering laparoscopic technologies and apply them to new areas of MIS.



Right: PretzelFlex™
Cover: SI medical devices used at one of the high definition laparoscopic suites at Leeds Nuffield Hospital

Review of the period

Interim accounts

Shareholder information

Review of the period

Highlights

Financial highlights

- Revenues of £3.02 million (H1 2011: £3.20 million) – entirely made up of Core MIS business revenue
- Gross margins in core MIS business increased to 44.8% (H1 2011: 41.9%)
- EBITDA* up 10.3% to £976,000 (H1 2011: £885,000)
- Operating profit* up 2.5% to £527,000 (H1 2011: £514,000)
- Pre-tax profit* maintained at £475,000 (H1 2011: £474,000)
- Basic earnings per share* of 0.14p (H1 2011: 0.12p)
- Net cash of £888,000 generated from operating activities* (H1 2011: £594,000)

*Adjusted to exclude exceptional costs of £294,000

Operational highlights

- Revenues from SI branded products up 8.9% to £2.13 million (H1 2011: £1.95 million)
- Revenues from OEM products down 28.5% to £0.89 million (H1 2011: £1.24 million) – due to timing of key orders expected to fall in H2
- Strong sales of Resposable® instruments with consumable pull through expected in H2 and beyond
- Disposable elements from SI branded Resposable® lines now represent 64% of total SI branded product sales (Full year 2011: 62%)
- US distribution agreement with CareFusion for the PretzelFlex® laparoscopic retractor
- FDA approval for the Logic® range of reusable instruments and PretzelFlex®
- US supply agreement with Integrated Medical Systems for YelloPort+plus™
- Booked orders for the full year already exceed Group turnover for year ended 31 December 2011

Review of the period

Chairman's statement

"Our strategy of continuous innovation and product development ensures that we remain at the forefront of minimally invasive surgery."

Doug Liversidge CBE, Chairman

Summary of Chairman's statement

- Our higher margin SI branded products saw continued revenue growth of 8.9% to £2.13 million (H1 2011: £1.95 million).
- Adjusted EBITDA increased 10.3% to £976,000 (H1 2011: £885,000) and adjusted operating profit rose 2.5% to £527,000 (H1 2011: £514,000).
- Continued investment in product development with capitalised R&D costs of £871,000 (H1 2011: £939,000).

I am pleased to report that we continued to make good progress in the first half of the year, with further growth in our higher margin SI branded products and a corresponding improvement in gross margins across the core MIS business.

Our strategy of continuous innovation and product development within laparoscopy coupled with our move into new therapeutic markets, such as hip arthroscopy, ensures that we remain at the forefront of minimally invasive surgery.

Financial results

Revenue for the period was down slightly at £3.02 million (H1 2011: £3.20 million). This is attributable to reduced OEM sales of £0.89 million (H1 2011: £1.20 million), however this simply reflects the often unpredictable timing of key orders rather than an underlying trend and we expect this drop to be balanced out by stronger second half OEM sales. Pleasingly our higher margin SI branded products saw continued revenue growth of 8.9% to £2.13 million (H1 2011: £1.95 million). We experienced particularly strong sales for SI branded products in the final quarter of the previous year as customers built up their stock levels and this resulted in slower order uptake in Q1. Sales growth quickly recovered and Q2 saw record sales for SI branded products up 14% on the previous period last year. No revenues were received for the Industrial Business (H1 2011: nil).

An important measure of our performance is the growth in sales of the higher margin disposable elements within our SI branded Resposable® products. Disposable elements from SI branded Resposable® lines increased 13% to £1.36 million (H1 2011: £1.20 million) which now represent 64% of total SI branded product sales (Full year 2011: 62%).

The natural consequence of this key revenue growth was to drive overall gross margins to 44.8% (H1 2011: 41.9%).

During the period we incurred a number of one off costs as a consequence of restructuring various operational areas of the business. In order to provide a more accurate picture of the underlying performance of the business the figures given below are adjusted to exclude these exceptionals and the reported figures are presented in the income statement.

Adjusted EBITDA increased 10.3% to £976,000 (H1 2011: £885,000) and adjusted operating profit rose 2.5% to £527,000 (H1 2011: £514,000). Adjusted pre-tax profit was maintained at £475,000

(H1 2011: £474,000). Retained profit (excluding exceptional items) rose 20% to £573,000 (H1 2011: £474,000) largely due to a tax credit of £98,000 (H1 2011: nil). This resulted in an adjusted earnings per share of 0.14p (H1 2011: 0.12p).

During the year the Group generated net cash of £888,000 from operating activities before exceptional items, enabling the Group to continue its investment in product development with capitalised R&D costs of £871,000 (H1 2011: £939,000).

Operational review

Trading in the first half was encouraging and revenues from our own SI branded products continue to be buoyant, which is particularly pleasing against the backdrop of a very challenging market place for laparoscopic products. The laparoscopic market has always been a highly competitive area and much of the appeal of our flagship Resposable® products, which employ reusable and disposable elements, is the cost savings associated with them. The effect of austerity measures on general surgery has meant that a number of larger instrumentation companies are maintaining market share by conceding margins and in some we cases we have seen a nearly 40% reduction in the prices of the traditionally more expensive single use products. Our Resposable® products still maintain a price advantage over single use alternatives but this challenging environment reinforces our strategy to develop innovative technologies to meet the needs of surgeons in other specialities and I address this in the Outlook section below.

Our focus on developing opportunities within the North American market has been rewarding, with combined direct and indirect sales in the US up 23% in the first half to £1.03 million (H1: £0.84 million). During the period we launched the Vikon branded laparoscopic instrument range for Integrated Medical Systems Inc. and received 510(k) clearance from the FDA for our Logic® Range of reusable instruments and our new advanced PretzelFlex® laparoscopic retractor in the US. We also reached a significant milestone by selling our 200,000th scissor blade in the US which demonstrates that our products have clinical acceptance in the lucrative US market and that the Group will continue to benefit from the pull through of higher margin consumables.

Our access into the US hospital network was also increased during the period with the signing in June of a supply agreement with Integrated Medical Systems Inc. for our YelloPort+plus™ range. The product complements their bespoke service offering to targeted US hospital groups and we believe this will provide the momentum YelloPort+plus™ needs to become an integral part of the US trocar market. In June we also announced the signing of a new eight-year exclusive distribution agreement with CareFusion for PretzelFlex™ and expect to see these sales impact the second half.

As I mentioned in my update at our AGM we are generating interest in our cost-effective devices from the NHS as they continue to face pressures to reduce costs. This increased interest will be well served by our five-year contract extension with our UK distributor, Elemental Healthcare, which, based on fixed minimum volumes, is worth £5.00 million over five years.

We were also very pleased to announce in May the appointment of Mike Thornton to the Board as Chief Financial Officer. Mike joined the Group in December last year from PwC and his appointment strengthens the Board at a crucial stage of growth.

Review of the period
Chairman's statement continued

"We remain confident about the future growth prospects of the business as our existing SI branded products continue to gain international clinical recognition."

Outlook

Surgical Innovations is recognised as a leading innovator within the laparoscopic surgery field as evidenced through the number of established OEM partners promoting SI patented technology. However, as explained above, it is an important aspect of our longer-term strategy to explore new areas of MIS and develop innovative surgeon-led solutions for other specialities.

Our concept team has been working on innovations within hip arthroscopy supported by the recently introduced hip arthroscopy experts on our Clinical Advisory Board. We are very excited about the development of these products and we are still on target to launch pre-production devices for hip arthroscopy at the end of September at the International Society for Hip Arthroscopy congress in Boston, MA. We have also identified other opportunities within Orthopaedics, particularly in spinal surgery, as well as thoracic surgery (lungs), cardiovascular surgery (heart) and neurosurgery (brain) and we believe our technologies can be used in these specialities as well as in the emerging specialist technique of Natural Orifice Translumenal Endoscopic Surgery, where abdominal operations are performed through a natural orifice.

Within the laparoscopic space we have made a strategic decision to position SI as a leading supplier of 3mm devices for enhanced minimal invasive surgery. This planned development has seen strong interest from paediatric surgeons who are keen to see our approach to 3mm devices, which are particularly attractive for operations in smaller abdominal spaces including children and neo-natals. We will shortly be showcasing our 3mm abdominal products at the European Paediatric Congress in Italy as part of our development programme.

As mentioned earlier, the drop in revenues from our OEM sales reflects the unpredictable timing of key orders rather than an underlying trend. Having already received firm orders from OEM customers for the second half we expect the lower first half revenues to be balanced out by stronger second half OEM sales. These OEM arrangements, generally focused on the US, provide a strong foundation to build our presence in this market. We continue to receive further interest from new OEM customers to develop innovative laparoscopic products on an exclusive basis.

During the first half we placed more emphasis on developing and supporting our distribution network for our higher margin SI branded products. We have extended the remit of our Clinical Advisory Board to provide clinical support to our distributors and have identified the needs of our top ten distribution partners and will work more closely with them to ensure they are best placed to drive further sales effectively.

As part of this process we have received commitments from a number of our key distributors for the remainder of the year in terms of agreed minimum volumes and combined with committed orders from OEM customers and our industrial customer we have already secured orders for the full year in excess of the Group's total turnover for the financial year ended 31 December 2011.

To help manage our anticipated growth we have been strengthening the senior management team and we were delighted to appoint Philippe Lhoest as Marketing Manager. In addition we expect to make another senior appointment in October and look forward to updating shareholders on our progress in this area.

The R&D team continues to work on generating both a wider range of new products and enhancements to existing product lines. We expect to see a regular flow of these which will help to drive future revenues, especially with the planned 2013 launch of the Laparoscopic Glue Delivery Device for Advanced Medical Solutions, currently being developed by our concept team.

Despite challenging markets we remain confident about the future growth prospects of the business as our existing SI branded products continue to gain international clinical recognition and offer an attractive value proposition to clinicians in these times of austerity. We expect to see further growth from new products that are launched throughout the year, as well as through the development of existing and new relationships with OEM customers. With booked orders for the rest of the year already surpassing last year's full year revenue levels we have great confidence in delivering further growth in the current financial year.

Doug Liversidge CBE
Chairman
17 September 2012

Interim accounts

Unaudited consolidated statement of comprehensive income

for the six months ended 30 June 2012

	Notes	**Unaudited six months ended 30 June 2012 £'000**	Unaudited six months ended 30 June 2011 £'000	Audited year ended 31 December 2011 £'000
Revenue	2	**3,022**	3,196	7,602
Cost of sales		**(1,666)**	(1,857)	(4,005)
Gross profit		**1,356**	1,339	3,597
Other operating expenses (including exceptional items of £294,000)		**(1,123)**	(825)	(1,830)
EBITDA*		**976**	885	2,825
Depreciation and amortisation		**(449)**	(371)	(1,058)
Exceptional items		**(294)**	—	—
Operating profit		**233**	514	1,767
Finance costs		**(54)**	(47)	(73)
Finance income		**2**	7	11
Profit before taxation		**181**	474	1,705
Taxation	3	**98**	—	33
Profit and total comprehensive income for the period attributable to the owners of the parent		**279**	474	1,738
Earnings per share				
Basic	4	**0.07p**	0.12p	0.44p
Diluted	4	**0.07p**	0.12p	0.42p

* EBITDA is earnings before interest, depreciation, amortisation and exceptional items.

Interim accounts

Unaudited consolidated interim balance sheet

as at 30 June 2012

	Unaudited 30 June 2012 £'000	Unaudited 30 June 2011 £'000	Audited 31 December 2011 £'000
Assets			
Non-current assets			
Property, plant and equipment	**3,242**	2,511	3,378
Intangible assets	**5,948**	4,053	5,243
Deferred tax asset	**563**	432	465
	9,753	6,996	9,086
Current assets			
Inventories	**3,159**	2,461	2,858
Trade receivables	**2,704**	1,985	3,311
Other current assets	**435**	849	511
Cash and cash equivalents	**3,436**	2,892	3,183
	9,734	8,187	9,863
Total assets	**19,487**	15,183	18,949
Equity and liabilities			
Equity attributable to equity holders of the parent company			
Share capital	**4,031**	3,947	3,952
Share premium account	**318**	215	226
Capital reserve	**329**	329	329
Retained earnings	**8,388**	6,844	8,109
Total equity	**13,066**	11,335	12,616
Non-current liabilities			
Obligations under finance leases	**997**	625	926
	997	625	926
Current liabilities			
Bank overdraft	**3,640**	1,757	2,983
Trade and other payables	**1,168**	829	1,859
Obligations under finance leases	**440**	358	385
Accruals	**176**	279	180
	5,424	3,223	5,407
Total liabilities	**6,421**	3,848	6,333
Total equity and liabilities	**19,487**	15,183	18,949

Interim accounts

Unaudited consolidated interim cash flow statement

for the six months ended 30 June 2012

	Unaudited six months ended 30 June 2012 £'000	Unaudited six months ended 30 June 2011 £'000	Audited year ended 31 December 2011 £'000
Cash flows from operating activities			
Operating profit	**233**	514	1,767
Adjustments for:			
Depreciation of property, plant and equipment	**282**	239	508
Amortisation of intangible assets	**166**	132	550
Share-based payment charge	**—**	1	2
Operating cash flows before movement in working capital	**681**	886	2,827
Increase in inventories	**(301)**	(428)	(825)
Decrease/(increase) in receivables	**683**	(153)	(1,141)
(Decrease)/increase in trade and other payables	**(415)**	336	987
Cash generated from operations	**648**	641	1,848
Interest paid	**(54)**	(47)	(73)
Net cash generated from operating activities before exceptional items	**888**	594	1,775
Exceptional items	**(294)**	—	—
Net cash flows from investing activities	**594**	594	1,775
Cash flows from investing activities			
Interest received	**2**	7	11
Payments to acquire property, plant and equipment	**(89)**	(95)	(349)
Acquisition of intangible assets	**(871)**	(939)	(2,498)
Net cash used in investing activities	**(958)**	(1,027)	(2,836)
Cash flows from financing activities			
Cash received from issue of shares	**171**	272	288
Repayment of obligations under finance leases	**(211)**	(149)	(472)
Net cash (used in)/generated from financing activities	**(40)**	123	(184)
Net decrease in cash and cash equivalents	**(404)**	(310)	(1,245)
Cash and cash equivalents at beginning of period	**200**	1,445	1,445
(Net borrowings)/cash and cash equivalents at end of period	**(204)**	1,135	200
Cash at bank and in hand	**3,436**	2,892	3,183
Bank overdraft	**(3,640)**	(1,757)	(2,983)
(Net borrowings)/cash and cash equivalents at end of period	**(204)**	1,135	200

Interim accounts

Unaudited consolidated interim statement of changes in equity

for the six months ended 30 June 2012

	Share capital £'000	Share premium £'000	Capital reserve £'000	Retained earnings £'000	Total £'000
Balance as at 1 January 2012	3,952	226	329	8,109	12,616
Transaction with owners – exercise of share options	79	92	—	—	171
Profit and total comprehensive income for the period	—	—	—	279	279
Unaudited balance as at 30 June 2012	**4,031**	**318**	**329**	**8,388**	**13,066**

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1. Basis of preparation of interim financial information

The interim financial information was approved by the Board of Directors on 18 September 2012. The financial information set out in the interim report is unaudited.

The interim financial information has been prepared in accordance with the AIM Rules for Companies and on a basis consistent with the accounting policies and methods of computation as published by the Group in its annual report for the year ended 31 December 2011, which is available on the Group's website.

The Group has chosen not to adopt IAS 34 Interim Financial Statements in preparing these interim financial statements and therefore the interim financial information is not in full compliance with International Financial Reporting Standards as adopted for use in the European Union.

The financial information set out in this interim report does not constitute statutory financial statements as defined in Section 434 of the Companies Act 2006. The figures for the year ended 31 December 2011 have been extracted from the statutory financial statements which have been filed with the Registrar of Companies. The auditor's report on those financial statements was unqualified and did not contain a statement under Sections 498(2) and 498(3) of the Companies Act 2006.

2. Segmental reporting

Information reported to the Board and for the purpose of assessing performance and making investment decisions is organised into three operating segments. The Group's operating segments under IFRS 8 are as follows:

SI Brand – the research, development, manufacture and distribution of SI branded minimally invasive devices.

OEM – the research, development, manufacture and distribution of minimally invasive devices for third party medical device companies through either own label or co-branding.

Industrial – the research, development, manufacture and sale of minimally invasive technology products for industrial application.

The measure of profit or loss for each reportable segment is gross margin less attributable amortisation of goodwill.

Assets and working capital are monitored on a Group basis, with no separate disclosure of asset by segment made in the management accounts, and hence no separate asset disclosure is provided here. The following segmental analysis has been produced to provide a reconciliation between the information used by the key decision maker within the business and the information as it is presented under IFRS.

Six months ended 30 June 2012 (unaudited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Revenue	2,128	894	—	3,022
Result				
Segment result	858	332	—	1,190
Unallocated expenses (including exceptional items of £294,000)				(957)
Profit from operations				233
Finance income				2
Finance costs				(54)
Profit before taxation				181
Tax				98
Profit for the period				279

Included within the segment/operating results are the following significant non-cash items:

Six months ended 30 June 2012 (unaudited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Amortisation of intangible assets	121	45	—	166

2. Segmental reporting (continued)

Six months ended 30 June 2011 (unaudited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Revenue	1,955	1,241	—	3,196
Result				
Segment result	734	473	—	1,207
Unallocated expenses				(693)
Profit from operations				514
Finance income				7
Finance costs				(47)
Profit before taxation				474
Tax				—
Profit for the period				474

Included within the segment/operating results are the following significant non-cash items:

Six months ended 30 June 2011 (unaudited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Amortisation of intangible assets	96	36	—	132

Year ended 31 December 2011 (audited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Revenue	4,725	2,807	70	7,602
Result				
Segment result	1,950	1,047	49	3,046
Unallocated expenses				(1,279)
Profit from operations				1,767
Finance income				11
Finance costs				(73)
Profit before taxation				1,705
Tax				33
Profit for the period				1,738

Included within the segment/operating results are the following significant non-cash items:

Year ended 31 December 2011 (audited)	SI Brand £'000	OEM £'000	Industrial £'000	Total £'000
Amortisation of intangible assets	386	143	21	550

Unallocated expenses include those costs that cannot be split between segments and which are not separately analysed in the management accounts including concept department, sales and marketing and head office overheads.

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Notes to the interim accounts continued

2. Segmental reporting (continued)

Geographical analysis

	Unaudited six months ended 30 June 2012 £'000	Unaudited six months ended 30 June 2011 £'000	Audited year ended 31 December 2011 £'000
United Kingdom	**747**	498	1,548
Europe	**1,016**	1,505	3,014
US	**902**	866	1,763
Rest of World	**357**	327	1,277
	3,022	3,196	7,602

Revenues are allocated geographically on the basis of where revenues were received from and not from the ultimate final destination of use.

3. Taxation

The charge for current tax is based on the results for the period as adjusted for items which are non-assessable or disallowed and any adjustment to tax payable in respect of previous years. It is calculated using the estimated effective rate for the period, based on the mainstream rate of UK corporation tax and on a basis consistent with that to be used in the full year.

4. Earnings per share

	Unaudited six months ended 30 June 2012	Unaudited six months ended 30 June 2011	Audited year ended 31 December 2011
Earnings per share			
Basic	**0.07p**	0.12p	0.44p
Diluted	**0.07p**	0.12p	0.42p
Adjusted earnings per share			
Basic	**0.14p**	0.12p	0.44p
Diluted	**0.14p**	0.12p	0.42p

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of shares in issue. Diluted earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the diluted weighted average number of shares in issue. Adjusted earnings per share is calculated by dividing adjusted earnings attributable to ordinary shareholders as set out below by the weighted average number of shares in issue.

4. Earnings per share (continued)

The Group has one category of dilutive potential ordinary shares being share options issued to Directors and employees. The impact of dilutive potential ordinary shares on the calculation of weighted average number of shares is set out below:

	Unaudited six months ended 30 June 2012	Unaudited six months ended 30 June 2011	Audited year ended 31 December 2011
Weighted average number of ordinary shares	**401,184,671**	390,115,571	392,716,121
Dilutive effect of share options in issue	**9,761,736**	9,176,016	17,975,781
Diluted weighted average number of ordinary shares	**410,946,407**	399,291,587	410,691,902

Earnings attributable to ordinary shareholders used in the calculation of basic and diluted earnings per share together with a reconciliation to adjusted earnings attributable to ordinary shareholders is as follows:

	Unaudited six months ended 30 June 2012 £'000	Unaudited six months ended 30 June 2011 £'000	Audited year ended 31 December 2011 £'000
Profit for the period	**279**	474	1,738
Exceptional items	**294**	—	—
Adjustable profit for the period	**573**	474	1,738

Adjusted earnings per share has been calculated so as to exclude the impact of exceptional items in the period which are one off in nature and thus have a distortive impact on the ordinary calculation of earnings per share.

Shareholder information
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Glossary of terms

Laparoscopic
Refers to minimally invasive surgery carried out in the abdominal cavity.

Minimally Invasive Surgery (MIS)
Surgery carried out through small incisions (keyholes), thereby minimising wound trauma.

Original Equipment Manufacture (OEM)
Manufacture of products supplied to other companies, for sale by those companies under their own brand.

Port access system
Devices used for gaining access to the abdominal cavity through small incisions.

Resposable®
A device or range comprising reusable main elements and disposable accessories.

Learn more at **www.sigroupplc.com**

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the design portfolio marketing services.
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