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PHIA.AS - Q3 2016 Koninklijke Philips NV Earnings Call

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OVERVIEW:

Co. reported 3Q16 YoverY comparable sales growth of 2%.



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PRESENTATION

Operator

Welcome to the Royal Philips' third-quarter 2016 results conference call on Monday, October 24, 2016. During the introduction, hosted by Mr. Frans van Houten, CEO; and Mr. Abhijit Bhattacharya, CFO, (Operator Instructions). Please note that this call will be recorded, and is available by webcast on the website of Royal Philips.

I will now hand the conference over to Mr. Pim Preesman, Head of Investor Relations. Please go ahead, sir.

Pim Preesman - *Koninklijke Philips NV - Head of IR*

Thank you. Good morning, ladies and gentlemen. Welcome to Philips' third quarter fiscal year 2016 results conference call. I'm here with Frans van Houten, CEO; and Abhijit Bhattacharya, CFO.

On today's call, Frans will take you through our strategic financial highlights for the period. Abhijit will then provide more detail on financial performance and market dynamics. After that, we will take your questions.

Our press release and the related information slide deck were published at 7:00 AM this morning. Those documents are now available for download from our Investor Relations website. A full transcript of this conference call will be made available by tomorrow on our Investor Relations website.

Before I turn the call over to Frans, I would like to remind you of a few things. First, as you know, Philips retains a 71.2% stake in Philips Lighting and therefore, continues to consolidate Philips Lighting's results.



However, because Philips Lighting reported its Q3 results on October 20, we will focus our commentary on today's call as much as possible on the performance of our HealthTech portfolio. We encourage you to review Philips Lighting's third-quarter earnings materials which are available on their IR website.

Second, following the decision in 2014 to combine our Lumileds and Automotive Lighting businesses into one stand-alone company and to explore strategic options to attract capital from third-party investors, the profit and loss of these combined businesses is reported under discontinued operations, and the net assets for the business in the balance sheet on the line, assets held for sale. The cash flow of the combined Lumileds/Automotive businesses is reported in the cash flow from discontinued operations.

Finally, when we refer to adjusted EBITA, on this call, this represents EBITA excluding restructuring costs, acquisition-related charges and other charges and gains above EUR20 million.

With that, I would like to hand over the call to Frans.

Frans van Houten - *Koninklijke Philips NV* - CEO

Yes. Thanks, Pim, and good morning to all of you.

We had a solid third quarter with 5% comparable sales growth and 8% order intake growth in our HealthTech portfolio.

Overall, Philips posted 2% comparable sales growth. Adjusted EBITA increased by 120 basis points and amounted to 11% of sales compared to 9.8% of sales in Q3 last year.

We delivered solid sales growth and margin expansion as a result of successful product introductions in our HealthTech portfolio and our ability to continue to realize synergies from the integration of Volcano with Image-guided Therapy.

There were further improvements at our Cleveland site and decisive actions from the Accelerate! program continued to deliver performance improvements across the Group. These improvements are offsetting our investments in quality and innovation, such as health informatics, wearable patient monitoring solutions and digital pathology.

Overall improvements at the Personal Health and Diagnosis & Treatment businesses, combined with continued improvements at Philips Lighting, led to the 120 basis point increase in the adjusted EBITDA margin.

I'm encouraged by the strong order intake growth in Connected Care & Health Informatics which grew by double-digits.

Diagnosis & Treatment increased order intake by low-single digit, leading to an overall order intake growth of 8%.

Now moving on to our specific businesses. We continued our strong momentum in the Personal Health businesses as sales grew by 7% on a comparable basis and adjusted EBITDA improved by 130 basis points as a result of higher sales volumes as well as improved cost productivity.

Sales grew across the entire Personal Health portfolio, most notably double-digit growth in Health & Wellness and supported by high-single digit growth in Sleep & Respiratory Care and mid-single digit growth in Personal Care and Domestic Appliances.

We continue to see strong adoption around the world of our leading Personal Health solutions. Growth geographies in Western Europe grew in the high-single digits, while North America grew mid-single digit.

We remain committed to sustaining mid- to high-single digit growth in Personal Health, enabled by our strong innovation pipeline.



To give you a few examples, last month at the IFA trade show in Berlin, we introduced a range of personalized health programs that demonstrate our continued innovation in oral care, sleep and heart health; three areas where consumers are taking charge of managing their wellness, engaging with their personal care and integrating our solutions into their daily lives.

Our connected consumer health products such as the Philips Sonicare FlexCare Platinum connected toothbrush with built-in sensor technology which enables real-time feedback and coaching to further improve oral healthcare.

And as uGrow, medical-grade baby app, which enables parents to better monitor the development of their newborn based on data from a suite of connected devices, leveraging Philips HealthSuite, which is our Internet of Things and clinical data platform.

Another successful innovation is Philips OneBlade that targets millennial males and features patented technology to trim, edge and shave any length of hair in one stroke.

This product requires replaceable blades, approximately four times per year at average usage, so we expect to generate a nice recurring revenue stream, with the build-out of the customer base.

After its successful launch in France, UK, Germany and our largest market, the United States in the second quarter, we now continue to expand the distribution of Philips OneBlade in these markets.

Sales have more than exceeded our already high expectations, and we plan to replicate this success in other markets.

The Diagnosis & Treatment businesses grew 6%, on a comparable sales basis and showed solid operational performance improvements. Adjusted EBITA margin improved by 210 basis points, mainly driven by cost improvements within Image-guided Therapy, as well as improvements at the Cleveland site, where our investments in augmenting our quality standards are continuing.

The Cleveland-related activities contributed to an improvement of EUR43 million year to date and for Q4, we expect this to be a similar amount.

Order intake showed low single digit growth overall, in Diagnosis & Treatment. Growth geographies showed strong double-digit order intake growth, particularly driven by China.

Another great example of bringing our innovations to market is the Philips IQon Spectral CT, which is the world's first and only spectral detector computed tomography modality. That provides clinicians with a comprehensive view of the patient's anatomy, with a single, low-dose examination.

We have been shipping this solution from March this year, and are achieving market success due to its superb image quality and disease assessment, in particularly for oncology, for cancer patients.

Philips Volcano continues to perform well, demonstrating also this quarter, both the benefits of the acquisition and the success of the integration.

In Q3, we delivered a third consecutive quarter of double-digit comparable sales growth and continued operational improvements, driven by growth across the smart catheter product portfolio, synergies with image-guided therapy systems and expansion into new geographies.

Philips is a pioneer and leader in image-guided, minimally invasive therapies, a fast-growing field because of the benefits for patients, hospitals and health systems.

Building on our expertise in interventional cardiology, we entered into a five-year collaboration with DeltaHealth in China for its new DeltaHealth hospital in Shanghai, which will specialize in cardiac care.

As part of the interventional cardiology solutions agreement, we will provide interventional x-ray systems, ultrasound imaging software and services.



We also have been expanding our efforts in interventional oncology, as we are convinced that image-guided therapies will have a positive transformational impact on cancer treatment.

In the quarter, Philips launched its next generation OncoSuite planning and navigation solution, for enhanced live, 3D image guidance, for liver tumor embolization and ablation procedures.

Moreover, through our collaboration with Elekta, we are making good progress in the new field of MR guided radiation therapy delivery, a potential game changer in cancer care.

The global increase in the use of MRI for radiotherapy planning is evidence that MRI is emerging as a promising oncology tool for disease localization and quantification, therapy planning, treatment guidance and therapy assessment.

Now turning to the Connected Care & Health Informatics businesses, where mid-single digit comparable sales in Healthcare Informatics Solutions & Services was offset by a low-single digit decline in Patient Monitoring Solutions.

Adjusted EBITA margin decreased by 180 basis points, mainly as a result of lower revenue in Patient Care & Monitoring Solutions, which is primarily a matter of timing and the installations are still largely expected for this year.

In Healthcare Informatics, Solutions & Services, we expect margins to continually improve as we transform this business from a hardware-oriented to a software-driven business, which is a higher-margin model, with a stream of recurring revenues.

We signed a sizable three-year agreement with a large healthcare provider in the United States, to deliver picture archiving communication solutions and associated services.

While Patient Care & Monitoring Solutions sales decreased slightly this quarter, order intake showed a strong performance. We are pleased with the buildup of our order book, as we continue to build our expertise in integrated solutions, consisting of smart devices, software and services, to address specific customer needs.

For example, we signed a three-year patient monitoring solutions agreement with Rush University Medical Center in Chicago, a hospital known for many specialties of care, areas of research and consistently ranked among the nation's top hospitals in the United States News & World Report.

We are excited about the possibilities in Population Health Management, where we already offer solutions to provide ambulatory care for high-risk patients outside the hospital and we help to deliver prevention and personal health programs for the general population.

The recent Wellcentive acquisition complements Philips' portfolio with cloud-based IT solutions to import aggregate and analyze clinical claims and financial data across hospital and health systems.

We see strong synergies between Wellcentive's upstream data aggregation and analysis capabilities of patient populations, and Philips' downstream care programs to facilitate a data-driven deployment of these care programs by our customers that will also be aligned with existing reimbursement models.

In the quarter, Advocate Doctors, a physician-owned network spanning more than 600 providers and 500,000 patients across New Jersey and Pennsylvania, selected Philips Wellcentive as its partner to drive population health and care management technology and delivery.

As a further example of Philips Wellcentive's success in the quarter, CHRISTUS Health, a large international not-for-profit health system, further expanded its existing partnership with Wellcentive.

As indicated in the last quarter, we expected the performance of Lumileds and Automotive to improve in the second half of this year, based on the good order book and the measures we have taken in the beginning of the year to improve cost productivity.

I am pleased to report the improved performance, as the 20% sales growth contributed to the EBITA improvement of 10 percentage points compared to the same quarter last year.

We continue to actively engage in discussions for the sale of the combined Lumileds and Automotive businesses, and we will provide more detail on this process when appropriate.

Our outlook for 2016 remains unchanged as we expect further earnings improvements in the fourth quarter of the year. Going forward, we remain concerned about risk due to volatility in the markets in which we operate.

And with that, I will turn the call to Abhijit, who will provide more detail on financial performance and market dynamics.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Thank you, Frans. Good morning to all of you on the call and the webcast. As Frans mentioned, in Q3, we delivered a 5% comparable sales growth in our HealthTech portfolio. Including the 3% declining in comparable sales for Philips Lighting, overall sales increased by 2% on a comparable basis.

Let me focus my commentary on the HealthTech portfolio, where comparable sales for growth geographies grew by double digits, driven by double-digit growth in China, as well as countries like Russia, Indonesia, Argentina and others.

Personal Health recorded high-single digit growth; Diagnosis & Treatment, double-digit growth; and Connected Care & Health Informatics showed mid-single digit growth.

Comparable sales growth in the mature markets was driven by low-single digit growth in Western Europe and North America, and stable comparable sales in the other mature geographies.

Personal Health recorded mid-single digit; and Diagnosis & Treatment low-single digit comparable sales growth in mature geographies; while our Connected Care & Health Informatics businesses saw a low-single digit comparable sales decline.

In HealthTech Other, sales reflected a EUR14 million lower royalty income due to the expected expiry of certain licenses, partly offset by strong double-digit growth in emerging businesses.

Let's have a look at the order intake. On a currency comparable basis, equipment order intake grew by 8% in the quarter. Connected Care & Health Informatics businesses generated a strong double-digit growth; and Diagnosis & Treatment businesses, a low-single digit growth in the third quarter.

Geographically, we reported a double-digit growth in comparable orders in our growth geographies, driven by double-digit growth in regions like China, India, ASEAN and Africa. In North America, order intake grew a healthy 6%, while Europe posted a low-single digit decline.

On currency comparable basis, order intake growth in Q4 last year was 15%, hence we expect Q4 this year to be about flat.

Let me now switch to the EBITA development in the quarter. The adjusted EBITA margin of 11% in the quarter was 120 basis points higher than in Q3 last year.

This strong margin increase was driven by an improvement of 130 basis points in the Personal Health businesses; 210 basis points in the Diagnosis & Treatment businesses; 250 basis points in Philips Lighting; and partially offset by a 180 basis points decline in Connected Care & Health Informatics businesses.

This was caused mainly due to lower sales in our Patient Monitoring & Solutions businesses, where some of the sales were not recognized in the quarter and will flow into Q4.

The overall improvement was good, considering the fact that we stepped up our advertising and promotion expenses to support the strong launch of our OneBlade proposition as well as increased activity in our Oral Healthcare businesses in North America. We had mentioned this to you in our Q2 call earlier this year.

Our Accelerate! program continues to improve operational performance and drive efficiencies. Overhead and end-to-end productivity programs were largely offset by higher manufacturing costs in the third quarter, which is partly due to timing, and the balance is expected to return to similar levels as we have seen in the first half, in the fourth quarter.

Design for Excellence, or DfX, which is aimed at improving value, delivered EUR102 million of additional bill-of-material savings year on year and are on top of normal run-rate procurement savings of EUR107 million.

Based on the cumulative savings achieved in the first three quarters and the outlook for the year -- and the outlook for quarter 4, we remain on track to achieve the cost-savings targets for the year that we have set for all three programs.

Our improvement trajectory in Cleveland remains on track and contributed positively with an additional EUR34 million, or 60 basis points, to the adjusted EBITA margin improvement.

In the third quarter, the income tax expense was EUR6 million, which is in line with the third quarter of last year, but lower than the normal run rate; main reason is tax benefit arising from a release of certain tax provisions. We still expect the effective tax rate for the full year of 2016 to be around 30% excluding incidentals.

Net financial expenses were EUR102 million higher in the quarter, of which EUR98 million was due to the tender offer related to the earlier redemption of debt which was completed in October 2016. A total amount of \$285 million were redeemed in the offer, which should result in approximately EUR18 million lower interest expense in the coming years.

The transaction will result in a cash outflow of EUR345 million in the fourth quarter, and will result in a EUR7 million positive impact in the fourth quarter which will be recognized in the financial income and expense line.

Net income from discontinued operations was EUR15 million higher than in Q3, which is mainly due to the improved operational performance of the combined businesses of Lumileds and Automotive.

The return on invested capital, which is calculated on a five quarter MAT basis, was 8.3%. Excluding the total one-off charges of EUR345 million related to pension liability derisking in the US and the UK in Q4 2015, the ROIC was 11.3%, which is over 2 percentage points above our WACC.

Our drive to increase the efficiency of our working capital continued to yield results, as inventories, as a percentage of sales, decreased to 15.4% year on year, which is an improvement of 140 basis points, both on nominal and currency comparable basis.

Free cash flow for the quarter amounted to an inflow of EUR280 million, compared to an inflow of EUR58 million in the same period last year. This was mainly due to improvements in income from operations and working capital, partly offset by the EUR63 million outflow related to pension liability derisking in the US.

By the end of the third quarter, we completed 98% of our three-year EUR1.5 billion share buyback program that we started in October 2013. The share buyback program was fully completed on October 20.

We have decided not to start a new program at this point of time as we plan to further improve the efficiency of our balance sheet by, for example, redeeming some more high-coupon debt and further derisking of our pension position.



Let me provide you with some healthcare market perspectives for US, Western Europe and China. In the US, we expect to see low-single digit growth in the healthcare market in 2016, following a strong 2015. This was partly driven by increased procedural volumes as more people are under the insurance umbrella. The number of uninsured has gone below 10% for the first time in the US.

We expect healthcare providers of all types to continue to implement process changes as Medicare introduces incremental steps in the transition from fee-for-service reimbursement to value-based payments.

Examples include penalties for hospital readmission and recently, pilot programs bundling reimbursement for all steps in an episode of care, from pre-hospital assessment to post-hospital recovery into a single-risk shared payment. These incentives continue emphasis on coordinated decision making across the health continuum.

The European healthcare market coming off slight growth in 2015 is expected to be flat in 2016. We continue to see an uptick across Europe in more sophisticated multiyear solution-oriented deals, although cuts to public spending budgets have offset this growth driver.

In China, we see a gradual recovery from a slowdown in healthcare spending in 2015; government investment focus has been on primary care with recent attention to rural hospitals.

In urban hospitals, we detect a gradual change in our customers' purchasing decision making, shifting perspective from the impact of price and performance of individual equipment items on hospital departments to the impact of integrated solutions enterprise-wide.

Overall, we estimate the global healthcare market growth to be in the flat to low-single digit range for 2016.

Let me briefly summarize our guidance for HealthTech Other and legacy items. In the HealthTech Other segment, we expect net costs to be in the range of EUR85 million to EUR95 million at EBITA level in 2016.

We expect to incur approximately EUR40 million of restructuring costs and other incidental items. Following the successful IPO of Phillips Lighting in May, we expect separation costs for the fourth quarter to be EUR45 million and consequently, approximately EUR165 million for the year.

Other legacy items are expected to be in the range of EUR10 million to EUR15 million for quarter 4, meaning EUR70 million to EUR75 million for the year.

As Fran has mentioned, our outlook for 2016 remains unchanged, as we expect further earnings improvement in the fourth quarter of the year.

Before we open the line to questions, I'd like to remind you that we will host our Capital Markets Day in London next week on November 4, where we will provide a strategic update and deeper insights on our Path to Value of our HealthTech portfolio.

We look forward to meeting most of you in London and hence, will not be on roadshow this week. As such, we would limit the Q&A session to the performance of this quarter and leave the discussion on strategic issues to next week.

With that, let me open now the lines for your question, which Frans and I will be happy to answer. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mark Troman, Merrill Lynch.



Mark Troman - *BofA Merrill Lynch - Analyst*

Just one question, please, on the profit bridge I think you have on slide 24 in your presentation. Generally, we're seeing the price/wage inflation component be a bigger drag than the COGS improvement, driven by DfX, typically 60, 70 basis points each quarter.

And I notice that the overhead productivity was pretty low this quarter. I guess that was due to some investments. But going forward, when you look for margin improvement, should we expect bigger overhead productivity? Or can we close that gap between the price/wage inflation and the COGS in terms of the initiatives you have running? Thank you very much.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

If you have seen for the last couple of years, we have had an operational improvement, a bigger amount which was roughly about 80 basis points or so.

I think this quarter is a bit of an aberration. Couple of reasons: I think we had mentioned to you last time that we would do bigger spends in A&P. That has partly -- let's say about 30 bps has gone from that bucket.

We also have had lower than anticipated growth, as we mentioned earlier, on Patient Monitoring, which is a high-margin business, so that also has affected for the quarter. And then, as I said earlier during my introduction that we had certain expenses which came into this quarter, which offset the productivity saving.

So the productivity savings at the gross level are still at a very good level. In this quarter, things like our investments in the cybersecurity program and a couple of other things have, from a timing perspective, made the number look low. But I think overall, if you look year to date, and if you look at the year as a whole, we will still be in the 70 to 80 bps improvement, operationally, going forward.

Frans van Houten - *Koninklijke Philips NV - CEO*

Let me just echo that. The self-help story at Philips will definitely continue over the next years, and more to come at our Capital Markets Day.

Mark Troman - *BofA Merrill Lynch - Analyst*

Okay. Thanks very much.

Operator

Max Yates, Credit Suisse.

Max Yates - *Credit Suisse - Analyst*

I just wanted to understand a bit more about the Connected Care division. Because if I look at the Patient Monitoring part of that, it looks like it's lost between EUR15 million and EUR20 million of revenues year on year, if it was low-single digit decline. But the EBIT decline on that is around EUR13 million, if we assume that all of the Connected Care EBIT decline was from Patient Monitoring. So that seems like quite a high drop-through.

I was just trying to understand whether any of the investments within Informatics or Population Health Management had also stepped up year on year. And if not, then why the operational leverage on the declines in volumes were as high as they were on Patient Monitoring?

Frans van Houten - *Koninklijke Philips NV - CEO*

The PCMS revenue shortfall, we see that as a blip. It's a timing matter. We expect that revenue to come in, in the fourth quarter. It had to do with customer installations that were just taking a bit more time and could not be finished in the quarter.

As a consequence, you not only have the profit of PCMS missing, which is the most profitable business, but you, therefore, also have a mix change within the CCHI cluster. There is also some cost items that weigh on the quarter.

Overall, if I give you my perspective on CC&HI, that segment is on an upward trajectory with regards to profitability, let's say, if you even out the influence of the single quarter, so nothing to worry about.

Max Yates - *Credit Suisse - Analyst*

Okay. Thank you. And just one follow-up. When I look at FX for the quarter and the EBIT bridge, it was quite a bit better than I think certainly I expected. So, for guidance for the full year, for the impact from FX at current spot rates, what would you expect that to be in the EBIT bridge?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

We expect it to be flat. I think we had said that also in Q2. We expected for the full year to be flat, which meant that we would have a recovery in the second half. I think we have seen that. I think Q4 will also be flat. So I think for the whole year, you can take around a flat impact.

Max Yates - *Credit Suisse - Analyst*

Perfect. Thank you very much.

Operator

Andreas Willi, JPMorgan Cazenove

Andreas Willi - *JPMorgan Cazenove - Analyst*

If I look at the Accelerate! investments more broadly, there keeps being a headwind for the profitability development. If we look going forward, should this be flat, or are they actually going to drop out of the P&L in terms of are these just one-off investment boosts or are these going to stay at the current level?

Frans van Houten - *Koninklijke Philips NV - CEO*

I think you're referring to the step-up in R&D, especially in emerging businesses and adjacencies. Is that right; is that what you're referring to?

Andreas Willi - *JPMorgan Cazenove - Analyst*

Yes.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. So, over the last two years, we have gradually increased our R&D investments, as we are building the health continuum portfolio, putting more effort in health informatics, medical wearables, digital pathology. We expect the overall investment level now to be stable, with revenues gradually going to come in.

So, if you take R&D investments to be stable and the top line growing, then you would get operational leverage, or basically a return on those investments over the coming years.

Andreas Willi - *JPMorgan Cazenove - Analyst*

That was clear. Thank you. On the earlier question on foreign exchange, it's quite difficult to model from the outside what's going on. Now, basically after the big gain in Q3, you don't expect much in Q4 any more, but we had still headwinds last year in Q4.

So why is this jumping around so much and why don't we see a benefit, again, in Q4, given that some of the rates have continued to improve for you and the year-on-year comparable is still quite easy?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, I think, Andreas, a couple of things here. One is we had changed our hedging policy in the beginning of the year. The other is the movement of certain other currencies like the yen, etc., which, unfortunately for Q4, doesn't give us the benefit, that's also what we had seen earlier.

So I think overall -- and the last but not the least, we have also significantly reduced our cross-currency exposures on the balance sheet which I think we had also mentioned earlier in terms of redoing some of our contracts, and also changing our intercompany payment habit.

So all that results in a one-time gain and then we will not see that coming back in Q4, at least based on the current spot rates.

Andreas Willi - *JPMorgan Cazenove - Analyst*

Thank you very much.

Operator

Ian Douglas, UBS.

Ian Douglas - *UBS - Analyst*

So on your guidance for the full year, I'm just trying to gauge how positive you are on Q4, because at last quarter, you were trying to talk us down for the full year to get us below that 11% number.

I just wanted to get your updated thoughts there. For example, how much of those revenues are you expecting to shift from Q3 to Q4? How much of that strong order book will come in within CC&HI? And that, obviously, some of the other divisions are looking up as well.

Frans van Houten - Koninklijke Philips NV - CEO

Ian, I'm smiling a little bit because I'm not sure that we were trying to talk you down because the consensus was more like 10.4%, 10.5% and we maintained our around 11% guidance. We maintain that guidance, so we still aim to be around 11% adjusted EBITA. Did I miss anything in your question there?

Ian Douglas - UBS - Analyst

Yes. So sorry, maybe I framed it slightly wrong, but you were certainly trying to talk us towards the bottom end of that range, or say that the consensus was correct to be at the bottom end of that range. I wonder whether it might be reasonable to think we might be closer to 11% or even above 11% given what we've seen this quarter.

Frans van Houten - Koninklijke Philips NV - CEO

Yes, okay. Well look, we continue to see a positive path expecting a good fourth quarter. We say we will continue to see profit improvement.

Now, you all know that we are very dependent on the fourth quarter. We stay committed to that guidance, but I'm not going to be precise about 10 bps here or there. It's important that we as management feel that we are on this trajectory in a good sense with forward momentum.

Ian Douglas - UBS - Analyst

Fine. So if I could ask a follow-up question there, or to reframe the same question I just asked. For Connected Care & Health Informatics, would it be reasonable, if you were doing my job, to keep the full-year Connected Care & Health Informatics organic growth number unchanged, given the weakness this quarter, i.e., would you expect to see all of those sales shift from Q3 to Q4?

And in terms of the cost savings in Diagnostics & Treatment, you've done 200 basis points year over year in Q3. Would it be reasonable to assume something similar to that in Q4? I'm just talking about orders of magnitude; I'm not asking you to guide us on the division exactly.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

Yes, I think a couple of things, I would not change let's say. I don't know what is your specific number on year-on-year growth for CC&HI, but we have -- the growth trajectory that we have seen, we don't see a shift because of the shift between quarters for the full year.

For Diagnosis & Treatment, yes, we will see continued profit improvement into the fourth quarter, so, again, not to give a specific number on that. I think that is part of the plan which helps us to improve our Q4 profitability.

Ian Douglas - UBS - Analyst

Okay. So CC&HI is on track with your expectations. Okay, great, thank you very much.

Operator

Ben Uglow, Morgan Stanley.



Ben Uglow - *Morgan Stanley - Analyst*

I had a few questions around the Imaging businesses specifically. Frans, there was a very detailed geographic understanding of the order intake. Can you just give us a sense when you look at the Imaging business what's happening in MR, CT, ultrasound, how things are playing out by modality?

Second question, I was a little surprised to see the Ultrasound sales down in the quarter. Can you give us an idea what may be happening there?

And then finally, when I look at your slide, slide 35, it gives you an idea on the sequential evolution of orders. We see Europe tending down, and I noted that you seem to be guiding fairly cautiously around 2017 on European orders. Can you just give us a sense of what's going on there? Are you seeing a change in the market?

Frans van Houten - *Koninklijke Philips NV - CEO*

All right, that's quite a few questions. We'll try to answer them as good as we go.

Good order growth in the third quarter for Diagnostic Imaging; also good order growth for Ultrasound. Within Diagnostic Imaging, the year-on-year comparison is a bit difficult because 2015 had a very strong order intake for CT and, therefore, difficult to immediately replicate this year. This quarter, we saw strong performance in MR, for example, and in general x-ray. Overall, we are confident about Diagnostic Imaging.

On Ultrasound, the market had shifted a little bit away from the high-end cardiovascular area where we are the market leader, into a more point of care ultrasound, let's say the ultrasound machines.

We have, in the meantime, been able to adjust our effort and, as a consequence, we saw good order intake in the third quarter. So, even though the revenue was still lagging a bit, we see the correction already in the order intake. And therefore, going forward, we think that Ultrasound will be in a better upward trend.

And then Image-guided Therapy continues to do well, both on the equipment and on the device side.

Your questions around Europe, maybe I can first expand a little bit and look at the whole world. So last year, we were concerned about China. In the meantime China has recovered very nicely, both the market overall and then, in particular, our performance within the market, leading to double-digit order intake and double-digit growth. We expect that to be sustainable for the foreseeable future.

In the United States, we are growing slightly ahead of the market. The market we see as flat to low-single digit and we are growing faster than that; again, we would expect that to be sustainable near term.

That leaves Europe where the market is a bit more down. Some differences by country, but overall, the sentiment in Europe has been more subdued with, on one hand, Brexit unclarity, but on the other hand, also various countries with local elections coming up and budgets not expanding.

But as you realize, that Europe is just 24% of our overall revenue base, we need to see it in that context.

Ben Uglow - *Morgan Stanley - Analyst*

Understood, and one very quick follow-up. To get to flat orders, which you're guiding to year over year in the fourth quarter, and we can see, obviously, from the chart that it's a very, very tough comp, but without wanting to put too many words into your mouth, we should assume that sequentially things are still improving, correct?

Frans van Houten - *Koninklijke Philips NV - CEO*

I'm looking to my wise friend on my right-hand here.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, but sure, if you look also in the overall order book, the position of the order book is the strongest it has been in the last couple of years, so I think the order book is in a fairly good shape.

Ben Uglow - *Morgan Stanley - Analyst*

Okay. Thank you very much.

Operator

James Moore, Redburn Partners.

James Moore - *Redburn Partners - Analyst*

I've got one on orders and one on margins. Just on orders, I wonder if you could give us some flavor as to what the percentage growth was in China in the quarter.

And when we talk about flat for the fourth quarter, I think, if I'm right, at the last quarter, you talked about the full year seeing 4% growth. And I thought you needed something like 9% growth in the second half to achieve that. And after 8% in the third quarter, are you now a little less confident on orders and what's driven that? That's the first question. Maybe we could touch on that first.

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, James. Well, we don't detail out the exact number in China, but I've said double-digit order intake growth, double-digit revenue growth, so we feel very confident about the performance path in China. Let's leave it at that.

On the orders, in July, we said first half was quite weak and that we expect a stronger second half. That is materializing; 8% in the third quarter and also, we expect a strong fourth quarter. It's just that on the comparable order intake gross number compared to last year where we had about -- where we had a very strong increase, mathematically, that's more difficult but that doesn't take away from the fact that we do expect a solid order intake quarter in the year.

James Moore - *Redburn Partners - Analyst*

Okay. And switching to margin as a follow-up if I could. I think you need 150/200 bps year-on-year increase in the fourth quarter, without being overly precise, but I make it 180 bps. I'm just trying to understand which division we should see as driving that year-on-year change the most.

Frans van Houten - *Koninklijke Philips NV - CEO*

We will see improvements in all three segments.

James Moore - Redburn Partners - Analyst

Okay. And just on CCHI then, I see that you've run up an 8% margin the last couple of quarters, a little bit down this quarter, a little bit up last quarter, but last fourth quarter it was 18%. So are you saying you can get back to 18% or above 18% because you're going to reverse these timing issues in the third quarter?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

Yes, James, I am not going to give a specific number for CCHI, but you've seen the trends of these businesses. Q4 are big quarters and we expect another big quarter also for CCHI.

James Moore - Redburn Partners - Analyst

And just so I understand, within CCHI, was it that the HISS and the PHM margins came down, or was it all driven by PCMS?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

No. So there were two things which Frans mentioned earlier. One was the PCMS, let's say, revenues going down, which has a big impact because it's one of the higher-margin business, but also step-ups in investments in PHM as well as the consolidation of Wellcentive, so altogether that had an impact.

James Moore - Redburn Partners - Analyst

Yes, I heard that. My question was more about margin because I guess the revenues are going to be growing in HISS and PHM I assume. So does increased investment mean a net negative picture to the margin?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

That was what happened in Q3, but not going forward.

James Moore - Redburn Partners - Analyst

Okay, thank you very much.

Frans van Houten - Koninklijke Philips NV - CEO

And we all need to remember that with a big sales quarter ahead of us, the operating leverage in that quarter will be very, very strong.

James Moore - Redburn Partners - Analyst

Very clear. Thank you.

Operator

Gael De-Bray, Deutsche Bank.



Gael De-Bray - *Deutsche Bank Research - Analyst*

My first question is on Cleveland. So, apparently, if I understood correctly, you're now guiding for the contribution from Cleveland to be around EUR80 million this year, so that would be slightly short of the EUR100 million guidance you had initially.

So do you still expect to recoup the EUR20 million shortfall next year, which means that one should see the Cleveland contribution on a year-on-year basis at close to EUR100 million again in 2017? So that's question number one.

And question number two is, again, on the innovation spending. Can I circle back on these research and development expenses, which obviously, were very, very high this quarter, probably now standing close to more than 100 bps higher than two years ago. And it seems you're currently spending much more on R&D in your HealthTech operations than GE or Siemens for example.

Is there actually any way you could optimize the spending here rather than just wait for the revenue to come in? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Let's first talk about Cleveland. We had a strong contribution in the quarter on Cleveland, and for the full year, we still expect close to EUR90 million profit improvement year over year; that's a little bit shy of the EUR100 million, but in the ballpark.

Of course, next year we expect to continue to improve, but I'm not detailing that at this moment.

On innovation, the choice to step up R&D was a very conscious choice as we have pivoted, let's say, from a diversified holding into a focused HealthTech Company.

We see the market opportunities in the health technology market. We see that customers are asking for more integrated solutions whereby informatics play a big role.

We have put significant efforts to step up our Healthcare Informatics activities; our HealthSuite cloud platform connecting smart devices throughout the hospital enterprise, but also to patients at home. I think this is going to pay us dividends in the years to come.

On your question whether we can rightsize in R&D, we think we are more or less at the right level with the EUR1.65 billion of R&D in HealthTech.

We expect to keep that more or less flat while, obviously, always looking for productivity improvement opportunities which means with the higher revenue going forward, there will be some operating leverage on the overall R&D line, with gradually the percentage coming down a little bit as a percentage of sales.

Nevertheless, we are an innovation company, and we are, in fact, proud of our innovation portfolio. We see that the innovations that we bring to the market are very well received by customers.

I was in Germany three weeks ago and spoke with most of the large university hospitals and also chains like HELIOS and Asklepios, and they all like our strategy very much.

They see that a more integrated technology offer is required to drive better patient outcomes and higher productivity for these hospitals. So I dare say we see the recognition that R&D investment is going in the right direction.

Gael De-Bray - *Deutsche Bank Research - Analyst*

Thank you very much, Frans.

Operator

David Vos, Barclays.

David Vos - Barclays - Analyst

Just one on the service business within Diagnosis & Treatment. I think we haven't discussed that for a while in terms of growth. Could you just comment on that, how that's ticking along? And then I have maybe a follow-up after.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

No, I think that is ticking along well, not only in the Diagnosis & Treatment business, but also in CCHI, we have launched a few initiatives to increase penetration there. So I think, overall, the growth has been good, and so also the profitability.

So we now look at it as integrated results, even internally, so that we drive, let's say, both the business and the service side to go to common improvement measures. That has helped to take out certain duplication of costs, etc., and drive the business to a good growth level as well.

Frans van Houten - Koninklijke Philips NV - CEO

Sorry, David, I may want to add that we are launching more and more, also, value-added services such as consulting, design services, lean services. Also, at the upcoming RSNA, we will talk about radiology solutions. All of that helps, of course, to move gradually the business towards a higher proportion of recurring revenue.

David Vos - Barclays - Analyst

Yes, absolutely. And should we be thinking about something like high-single digits in terms of growth rates there?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

No, I think maybe still a fair -- overall for service, mid-single digits is a good range.

David Vos - Barclays - Analyst

Okay, perfect. And then, just one housekeeping question. I appreciate it might be a little bit too early for it, but we'll be tying up our models here on our end before the Capital Markets Day. So if you could just comment on what you expect for 2017 in terms of the Healthcare, Other and legacy item lines, that will be very, very helpful.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

David, I think we will wait for the end of the year. We always guide in Q1 -- or when we talk about the year-end results, we guide for next year. I think that's a better time.

David Vos - Barclays - Analyst

Okay, perfect. Understood. Thank you.

Operator

Alok Katre, Societe Generale.

Alok Katre - Societe Generale - Analyst

Well, one follow-up in terms of the order intake. It seems that the catch-up on Diagnosis & Treatment is a bit slower than what we would expect, given how much there was a bit of a decline in the previous quarter.

So maybe you could just explain perhaps what's going on in there. Is there any particular modality that's holding back the catch-up effect? So that was the first question, in terms of follow-up.

And then, just on the cash flow side. If you could probably just give us some sense of working capital. Obviously, you've been cutting it for several quarters now. Just how much more juice is there remaining on the working capital side? And is there any internal target for this over the next few quarters? Thanks.

Frans van Houten - Koninklijke Philips NV - CEO

In D&T, we saw 6% order growth in the quarter, especially driven by IGT and Ultrasound. The compare on Diagnostic Imaging was more difficult. Nevertheless, we expect that D&T order intake growth can continue to be solid, and as the effects of Cleveland start to wear -- go away, how to say this, it will become more even in the comparison and, therefore, less concerning to you.

We feel strongly that with the innovations in that area and the earlier discussion on Ultrasound, that we are in a good spot.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

Yes, but we had a tough year-on-year comparison also for Q3. We had high-single digit growth last year in Q3, in Diagnosis & Treatment. So I think, overall, the order book is in pretty good shape.

Your second question on working capital, I think when we talk about longer term, we will probably give you some indication when we are in London next week, but I think, overall improvements for the last two years have been pretty substantial, but we still believe that there is more efficiency which we can get in our overall working capital. So there is still some more juice left, Alok.

Alok Katre - Societe Generale - Analyst

Fair enough, I'll wait for the CMD then. Thanks.

Operator

(Operator Instructions). Jonathan Mounsey, Exane BNP Paribas.

Jonathan Mounsey - Exane BNP Paribas - Analyst

So a couple of questions. Just on Diagnostic & Treatment, could you give us an update in terms of the FDA and where you are with them? Is an end in sight, in terms of their involvement in Cleveland?

And then, in terms of Personal Health, obviously, from Q2 this year, we had a step-up in organic growth. I'm just wondering, by the time we get to Q2 next year, basically, the last three quarters of next year, are they very difficult comps?

And what's the product pipeline like to offset that? Can we expect strong mid-single digit growth next year, or is it going to be difficult, given how strong it's been back end of this year?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, with the FDA, I feel that we are making very good progress on the quality and the compliance side. We've had, across the world, many inspections and the rate of observations has improved significantly.

In Cleveland, we have not yet seen the FDA come back in. That's understandable because the arrangement was that every quarter we will have a so-called third-party audit doing the work for the FDA, right, so that's kind of an understanding. And that report is then sent to the FDA, so they know exactly how we are performing in Cleveland. And we feel confident about that.

Nevertheless, the chapter is not yet closed off and I think that was your specific question. We continue to invest quite a bit of money in further making the whole quality management system more robust and also, working with our suppliers because that was part of the problem, as you'll recall from the July discussion. And we also see suppliers respond very well to our involvement to improve quality and compliance. So, overall, on the right path I would say.

And then, on Personal Health. I see no reason why the growth rate of Personal Health would change on average. We are in a solid mid- to high-single digit, and we see good demand for our innovations.

Earlier this morning, I was, I think, interviewed by a journalist and I said that the uptake of, for example, oral care products in China is going very, very well.

We have worked diligently on supporting dental professionals, the dentists, in recommending to consumers to use Philips Sonicare toothbrushes. And as a consequence, we have seen really solid, solid, high-double digit growth already for many quarters and we expect that to continue.

This falls in the area of geographical adjacencies that I think we talked about earlier at Capital Market Days. It's a strategy that works very well, and we expect that to continue.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

And just one more part on that FDA comment then. Is it right to understand then that in terms of the audit process, the third-party audit process coming to an end, is there a set of things you can do that basically means if you meet that, then it ends? Or is it entirely up to the FDA to decide when that third-party audit process ends?

Frans van Houten - *Koninklijke Philips NV - CEO*

In the end, it is at the discretion of the FDA to decide when they want to do their own audit. So I cannot predict exactly when that will happen.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Understood. Thank you very much.



Operator

Thank you, Mr. van Houten and Mr. Bhattacharya, that was the last question. Please continue.

Frans van Houten - Koninklijke Philips NV - CEO

All right. Well, I'd like to thank everybody for attending this conference. Great -- again, very good sets of questions, which we certainly enjoyed responding to. And we hope that we will see all of you at our Capital Markets Day on November 4 in London. Thanks, and have a great day.

Operator

This concludes the Royal Philips' third quarter 2016 results conference call on Monday, October 24, 2016. Thank you for participating. You may now disconnect.

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