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PHIA.AS - Q3 2014 Koninklijke Philips NV Earnings Call

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OVERVIEW:

Co. reported 3Q14 comparable sales of EUR5.5b and net loss of EUR103m.



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PRESENTATION

Operator

Welcome to the Royal Philips' third-quarter results 2014 conference call on Monday, October 20, 2014. During the introduction, hosted by Mr. Frans van Houten, CEO, and Mr. Ron Wirahadiraksa, CFO, all participants will be in a listen-only mode. (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. Robin Jansen, Head of Investor Relations. Please go ahead, sir.

Robin Jansen - *Koninklijke Philips NV - Head of IR*

Thank you and good morning, ladies and gentlemen. Welcome to Philips' third-quarter results conference call. I am here with Frans van Houten, CEO, and Ron Wirahadiraksa, CFO.

In a moment, Frans will make his opening remarks and will take you through our main strategic and financial highlights for the period. Ron will then provide more details of the financial performance during the quarter. After that, both Frans and Ron will be happy to take your questions.

Our press release and a related information slide deck were published this morning at 7 am. Both documents are now available for download from our Investor Relations website. The full transcript of this conference call will be made available by tomorrow on our Investor Relations website.

Before I turn over the call to Frans, I would like to remind you that 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

Thanks, Robin. Good morning, ladies and gentlemen. Today we announced stable comparable sales growth for the third quarter of 2014, with sales in growth geographies actually up 2% and adjusted EBITA of EUR536 million, or 9.7% of sales.

Although our Accelerate program continues to improve operational performance in most of our businesses, we are not satisfied with our performance in the quarter and continue to view 2014 as a pause in our trajectory to our 2016 targets.

As already indicated at our Capital Markets Day last month, the voluntary production suspension at our Cleveland facility had significant impact on our third-quarter results, which were further impacted by continued currency headwinds and sustained softness in markets like China and Russia.

We were also confronted with an adverse jury verdict and surprised by the magnitude of the proposed award in this legacy IP dispute with Masimo Corporation, which we are going to appeal.

However, as few of the near-term headwinds start to abate and Accelerate continues to improve operational performance, we continue to expect our adjusted EBITA in the second half of 2014 to be slightly below the adjusted EBITA in the same period of last year.

And, as we continue to improve underlying performance across our businesses, we are also enhancing our ability to capitalize on fundamental market changes.

As you know, we announced the next strategic step of our Accelerate journey at our Capital Markets Day in September, whereby we will establish two market-leading companies focused on the HealthTech and Lighting Solutions markets respectively.

We heard positive and encouraging feedback about this strategic step from our employees, partners and customers, which only reiterates our belief that we will be even better positioned to capture growth and create value with the enhanced focus and agility that will come with the new structure.

Let me spend a couple of minutes on our third-quarter operational performance in the context of these opportunities.

In Healthcare, we are making a strategic shift from a provider of individual products to a proven technology partner that delivers integrated systems, services and solutions.

We gained significant traction in the third quarter with several new long-term partnerships across the globe.

Last week, for example, we announced a 15-year contract with the Reinier de Graaf hospital in the Netherlands that includes advanced imaging solutions, customized services and consultancy to improve the hospital's clinical and operational performance, as well as the patient experience at this 600-plus bed hospital.

In Sweden, we sealed a second long-term contract with the Karolinska University Hospital and the Stockholm County Council. The agreement includes now the delivery of image-guided therapy solutions and consultancy services to innovate the hospital's stroke care workflow.

In the Philippines, we signed a multi-year partnership with World City Incorporated, the owner of World City Medical Center, one of the leading healthcare providers in the Philippines, to modernize their Philippine orthopedic center.

We'll provide medical equipment, consultancy and services to the 700-bed orthopedic facility, which is currently under construction and which is one of the biggest healthcare projects in the Philippines.

Moreover, we have taken an important step in addressing the convergence of professional healthcare in consumer end markets across the entire health continuum from healthy living and prevention to diagnosis, treatment, recovery and home care.

Our first clinical applications for our recently-launched health suite digital platform, the eCareCoordinator and the eCareCompanion, received the FDA 510(k) clearance. These applications allow clinicians to provide more efficient and high-quality care to patients who are transitioning from the hospital to home by enabling better access to, and deeper analysis of, patient data and how patients manage their health.

We also received 510(k) FDA clearance for our VISIQ ultra-mobile tablet-based ultrasound system, which advances the accessibility of quality ultrasound imaging. As an example of our geographic expansion, we have launched VISIQ in India; an important growth market.

We are making good progress in the remediation of the quality management system at our Cleveland facility. We began to ship first products in the third quarter and we now have also resumed production of iCT and Ingenuity scanners. We will further ramp up production in Q4 and the first quarter of 2015, which will, of course, contribute to an improved performance in Q4 and in 2015.

In Consumer Lifestyle, we continue to expand our offering to help consumers make healthier choices every day and drive value from the Internet of Things and connected digital propositions. This strategic focus is driving excellent results, as we help consumers take control of their health.

In line with this, we introduced a number of digital solutions at the IFA trade show in Berlin this quarter, including a smart air purifier, an application to manage chronic pain and an oral healthcare app that helps children to brush their teeth more effectively.

Geographic expansion and localization of product innovations led to solid growth for Domestic Appliances worldwide, driven by continued strong consumer demand for the Philips Airfryer and the Philips NoodleMaker. The air fryer, for instance, provides families the opportunity to cook healthier food and this proposition has proven to be a huge success with 3.7 million units sold globally so far.

We are also continuing to leverage trends in Personal Care. We are launching the flagship Philips Shaver Series 9000 in 47 countries and are already seeing great traction in the market. The global Series 9000 launch was designed to drive loyalty and create more value among existing users.

Our latest innovations in skincare, the Philips VisaCare and VisaPure, and in hair removal, the Philips Lumea, are also delivering strong growth in markets across the globe.

In Lighting, we are solving customer needs with exciting energy-efficient LED lighting solutions. As the world leader in lighting, we are well positioned to capture profitable growth through LED innovations, connected systems and professional services.

This is demonstrated by encouraging wins in the quarter, including a partnership in Indonesia, with [Offermart], to install LED lighting solutions in nearly 1,000 convenience stores. In London, we delivered the LED pitch lighting for the Chelsea Stamford Bridge stadium, improving visual conditions for both players and fans in this world-famous football venue.

We also continued to expand the Hue ecosystem, further building out our portfolio of products that are connectable to the smart home ecosystem. The latest edition to this system is the Hue Beyond, the first of a range of connected luminaires.

We continued to make good progress in the turnaround of our Professional Lighting Solutions business in North America. The business started to build growth momentum in September and we expect PLS North America to deliver profitable growth in the fourth quarter on the back of good order book coverage.

Consumer Luminaires in Europe also continued to make good progress in the quarter, which is expected to result in profitable growth in the fourth quarter, thereby enabling the adjusted EBITA for the entire Consumer Luminaires business to be breakeven for the full-year 2014.

The LED Components business performed very well in the quarter, with Lumileds achieving double-digit growth at improving margins, and both Lumileds and Automotive are gaining market share.



We are making good progress in the process of combining Philips Lumileds and Automotive lighting businesses into a standalone Lighting Components company. The information memorandum has been shared with several interested parties and we remain on track for completion in the first half of 2015.

Our three productivity programs continue to deliver strong support for our underlying operational performance improvement.

Overhead cost savings were EUR37 million for the quarter, bringing the cumulative annualized overhead cost savings in the first nine months of the year to EUR264 million.

Our Design for Excellence, DfX, program generated EUR17 million of incremental savings in cost of goods sold in the quarter, resulting in EUR187 million of cumulative DfX savings to date. Our overall annual procurement savings are now about 50% higher than three years ago.

Our End2End productivity program achieved incremental savings of EUR18 million in the quarter, which will bring the cumulative amount of End2End productivity savings to EUR50 million to date.

We believe that all these strategic initiatives enable us to accelerate our value creation, improve performance and capitalize on higher growth opportunities in our business as we enter the next phase of our Accelerate transformation.

And, with that, I would like to turn the call over to Ron to discuss our financial performance and market dynamics in more detail.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Thank you, Frans. I will now provide you with more detail on our financial performance for the third quarter and recent developments.

Comparable sales in Q3 2014 of EUR5.5 billion were flat compared to the same period last year when adjusted for currency and portfolio changes. On a nominal basis, total sales decreased by 1%, due to negative currency effects of 170 basis points.

Comparable sales in Western Europe were down 2%. A low single-digit decline in Healthcare was partly offset by mid-single-digit sales growth in Consumer Lifestyle and flat sales in Lighting.

Sales in North America declined by just 1% on a comparable basis in the quarter, mainly as a result of Healthcare. The other material geographies delivered 4% comparable sales growth.

In our growth geographies, comparable sales grew by 2% in the third quarter, driven by Healthcare and Consumer Lifestyle.

Country-wise, performance in our growth geographies was driven by double-digit sales growth in countries including India, Poland, Africa, Argentina and Malaysia, which was partly offset by disappointing performance in Russia, China and Turkey.

Sales generated by the growth geographies represented 37% of total sales, in line with Q3 of last year.

Let me now provide you with more financial detail per sector.

In Healthcare, comparables sales in the growth geographies showed a mid-single-digit growth in the quarter, mainly driven by India, Mexico, Turkey and Argentina. Western Europe recorded a low-single-digit decline, while North America recorded a decline of 1%. The other mature geographies achieved mid-single-digit growth.

Currency-comparable equipment order intake declined by 1% compared to Q3 of 2013. Excluding the impact of our voluntary production suspension in Cleveland, equipment order intake actually grew by 4% in the quarter.



Order intake in growth geographies showed a high-single-digit increase, with strong growth in the Middle East and Turkey and Russia and Central Asia, while China posted low-single-digit comparable order intake growth.

Western Europe achieved mid-single-digit growth, with strong growth coming from the UK and the Benelux.

Comparable order intake in North America was down high single digit, reflecting challenging market conditions and the Cleveland facility impact.

In Consumer Lifestyle comparable sales in the growth geographies showed mid-single-digit growth. North America recorded low-single-digit sales decline, while Western Europe and the other mature geographies delivered mid-single-digit growth.

Lighting comparable sales declined 1% year on year. Excluding Lumileds and Automotive, comparable sales showed a low-single-digit increase in mature geographies and a high-single-digit decline in growth geographies, primarily driven by China and Indonesia.

In the third quarter our LED sales increased by 28% year on year and now represent 40% of total Lighting sales, compared to 30% in Q3 2013.

The ongoing successful shift to LED caused sales of conventional lamps to decline by about 12% and overall conventional lighting sales to decline by 14%.

However, these percentages also reflect the above-average decline in conventional lighting in China, which is, next to the strong overall market decline in conventional, driven by our ongoing focus on reducing trade inventories, as well as a somewhat more cautious commercial activity, due to the tighter liquidity situation in China.

Excluding the above-average conventional sales decline in China, the underlying decline in conventional lamps and total conventional lighting sales is actually 3 percentage points lower and, thereby, more or less in line with the conventional decline we have seen in Q2.

As stated before, the conventional lighting decline is no surprise and we expect to continue to see fluctuations market by market, quarter by quarter. The important thing to remember here is that we have been preparing for the golden tail. Whatever the decline in conventional lighting will be, we can adjust our remaining conventional manufacturing footprint fairly quickly, and we are doing that as we speak.

Let me now provide you with some additional detail on the EBITA development in the third quarter.

Slide 16 of the presentation material that we posted on our website this morning provides an overview of the main drivers of adjusted EBITA when compared to the same period of last year.

Looking at the adjusted EBITA bridge, you will see that our underlying operational performance contributed 90 basis points to the margin development in the third quarter. This clearly demonstrates that our Accelerate program continues to improve operational performance and drives efficiency, supported by our three productivity programs.

Overhead cost savings amounted to EUR60 million year over year. DfX, which is aimed at reducing cost of goods sold, delivered EUR88 million of savings year over year, on top of normal run-rate savings, and our End2End productivity program generated EUR18 million of savings year over year.

These cost savings were able to more than offset negative pricing of 290 basis points, as well as wage inflation and additional investments in future growth.

The drop of 170 basis points in the adjusted EBITA margin was caused by currency headwinds of 90 basis points and by 80 basis points, or EUR40 million, related to the voluntary production suspension at the Cleveland factory.



From a sector perspective, Healthcare, Consumer Lifestyle and IG&S showed an improved operational performance, while Lighting remained stable. Bottom line, we generated a net loss of EUR103 million in the quarter, compared to a net income of EUR281 million a year ago.

This decline largely reflects the one-time charge related to the jury verdict in the legacy IP litigation with Masimo and lower operational earnings, which were partly offset by lower tax charges and higher results from investments in associates.

Income taxes amounted to a gain of EUR38 million, largely due to the earnings loss recorded in the quarter.

Looking at the remainder of the year, overall market conditions continue to show a mixed and fragile picture.

In the US, healthcare reform has led to 12 million new enrollees to date, with the 2015 enrolment period set to begin in November. However, the flat CapEx forecast and expected decline in new hospital construction foreshadow a flat- to low-single-digit growth rate through the remainder of 2014.

Unchanged to last quarter, the overall US construction market is expected to grow high single digit, of which non-residential construction is forecasted to grow by 4%.

The Architecture Billings Index also continues to point to a growth in the non-residential construction market. While lower than the record 55.8 mark reached in July, the 53 August level was above the 50 threshold.

The Western European construction market is still expected to show positive growth in 2014. Having declined by around 2% in 2013, it is forecast to grow by around 1.5% in 2014; reflecting a return to growth in both the residential and non-residential segments. Nevertheless, sentiment in Europe remains quite uncertain, so we remain cautious.

While we won't speculate on how foreign exchange rates will develop going forward, given current trends we do anticipate the negative impact of currency translation effects to start to taper off in the fourth quarter.

We expect continued support from productivity improvement programs and deployment of Philips' excellence practices to positively impact the remainder of the year and continue to anticipate the total negative effect from the Cleveland remediation on EBITA to be around EUR100 million in the second half of 2014.

Taking into account the provision of EUR43 million for various legal matters in this quarter, as well as the decision to pull forward A, Accelerate-related IT restructuring costs from [2015] (corrected by company after the call) into Q4 of this year and B, other smaller organization optimizations, we expect total EBITA for IG&S for the full year 2014 to be a net cost of EUR440 million, compared to the previous guidance of EUR350 million.

As a result of this pull forward of restructuring costs in IG&S, which, to a lesser extent, we are also seeing in Healthcare and Lighting, the total restructuring costs in the second half of 2014 are expected to be around EUR360 million, compared to the earlier guidance at CMD of EUR300 million.

For Q3, free cash flow was EUR166 million, including a one-off pension contribution of EUR45 million as part of the new funding agreement for the Dutch pension plan, under which Philips is no longer liable for future deficits.

Free cash flow for the year is expected to be close to EUR800 million, excluding the one-off pension contribution of approximately EUR400 million in 2040 (sic) related to the de-risking of that Dutch pension plan.

By the end of September we completed 32% of our EUR1.5 billion share buyback program.

Let me conclude by saying that we continue to expect the remainder of 2014 to be challenging and not without risks. We are confident about our ability to increase efficiency and drive profitable growth through our multi-year Accelerate transformation program and we remain committed to the 2016 targets, as presented at our Capital Markets Day in September.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Andreas Willi, JPMorgan Cazenove.

Andreas Willi - JPMorgan Cazenove - Analyst

My first question is on pricing, which seems to, quarter by quarter, slowly get a little bit worse. Maybe you could provide us some detail on a divisional basis the percentage of sales decline you show in your bridge.

A second question on Healthcare and the equipment order backlog. Maybe you could provide us some information how that is looking, in terms of the potential growth that could still come out of this backlog and what the impact of cancelations was on that backlog and on Q3 orders.

And lastly, on the disposal of Lumileds and Auto. There was a headline this morning that you stopped the IPO as a track. Does this mean just you have very high confidence in a trade sale or a change in plan in general in terms of how you want to deal with this disposal? Thank you.

Frans van Houten - Koninklijke Philips NV - CEO

Let me start with your third question and then I will hand it to Ron for the pricing trend and the order backlog on Healthcare.

We have just released the information memorandum to interested parties. The process is on track. There was never a plan to IPO this activity, so I don't know where this rumor comes from. So we have not dismissed it, because it was never there.

I think people are maybe confusing the process for Lumileds and Automotive versus the overall Lighting separation that we announced. Of course, for the Lighting separation we are talking about IPO as one of the possibilities. So maybe that is the background.

Overall for Lumileds and Automotive we are on track and we expect to close a transaction in the first half of 2015.

And with that, Ron, the other two questions.

Ron Wirahadiraksa - Koninklijke Philips NV - CFO

So the [290], if you look at Healthcare, that price erosion is not outside the 3% to 4% range that we normally guide for. It's, in fact, a little bit below that. In Consumer Lifestyle it's under 1 percentage point, so not very large. So the main part comes actually from Lighting and, within Lighting, it comes from the LED, and it's related to the LED growth. So particularly within that from LED lamps.

If you look at the conventional business, I can say that pricing holds out pretty well but for LED this is the impact on the results.

The order backlog. As you can see from the slide on Healthcare, the order backlog indexed is as strong as it's been before.



If you look at where we are in the order coverage, I would say that more than 80% of the sales to be realized is covered by the order book and it's actually a slightly better position than we have seen last year.

Now, if you look at Cleveland, as earlier said, there is an order intake impact, but that's more for the, let's say, the ensuing four quarters out that is, indeed, impacting order intake and we put that at close to 5% in this quarter.

So, execution wise, I think we should be in good shape and we should just deliver.

I hope this is an answer to the questions that you had, Andreas.

Andreas Willi - *JPMorgan Cazenove - Analyst*

Yes, thank you very much.

Operator

Martin Wilkie, Deutsche Bank.

Martin Wilkie - *Deutsche Bank Research - Analyst*

A couple of questions, the first one on Lighting. Obviously we've seen a decline in margin year over year. Just if you could go into some of the details behind that. You have mentioned credit in China. I couldn't quite tell if that mainly was driving the top line if there was also margin impact on that, and exactly what is behind that comment?

And the second question was just on your central cost. I think a little bit lower than perhaps you were looking for in the quarter. You're obviously giving some guidance for the total number, which is after restructuring, but on an underlying basis is it fair to say that the central costs are -- the run rate there is perhaps a little bit lower than you previously expected? If you could just give some comment on that? Thank you.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So the Lighting margin decline is quite unfortunate. The main reason is that, due to tighter liquidity in China and, as I said, in the other growth geographies some more difficult market circumstances, we took a provision for customer credit at the end of the quarter, reassessing, let's say, the landscape.

So that is in good order now and unfortunately that has led straight out to a decline in the margin versus last year, otherwise that would have been above that.

We just spoke about the price erosion to Andreas's question, but what we see in the FX and the (inaudible) material reduction actually is almost offsetting all of that. So that is a good sign, I would say, that we're able to hold to our promise to keep improving the gross margin in LED, which is now, I think, almost at the level of conventional, which is very encouraging and, of course, we need more volume to leverage also the cost below gross margin.

The IG&S lower in Q3, yes, there was, as I said, some pull up of restructuring for particularly IT in there in Q3. The adjusted EBITA for Q4 on a comparable basis was somewhat higher than the consensus was.

So the underlying cost we also have to see that some of that is coming (inaudible) in the quarter, so some of it may take place more in the fourth quarter. So I wouldn't say that the underlying costs are necessarily far below what we anticipated.

Martin Wilkie - *Deutsche Bank Research - Analyst*

Okay and just coming back to Lighting, that provision you've taken in Q3, that is essentially done, so we're not expecting any rollover into the fourth quarter. So we can almost see that as a slight aberration in Q3 when thinking about where the trajectory of lighting margin should be going in coming quarters.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. This follows the quarterly assessment. Of course, we do it, let's say, more regularly in a quarter, basically monthly, if you will, but at the end of quarter, particularly it appeared that for some larger customers we needed to provide a little bit more for.

That's not saying it is not going to be collected; it's just seeing the length that it takes to collect somewhat more uncertainty. And if that would prolong then there would also be something needed in Q4, but that is not foreseen now because this is representing where we are in the credit portfolio at the end of Q3.

Martin Wilkie - *Deutsche Bank Research - Analyst*

Okay. Thank you very much.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - *Morgan Stanley - Analyst*

I had a couple. The first was just on Healthcare. Obviously it's difficult to figure out what's going on in the market, given the Cleveland effect, but last quarter, Frans, you kindly talked a little bit about the Patient Care business and there had been a temporary slowdown there due to a change in the sales channel.

When I look at your -- when I look at your slide, slide 61, in the sales -- in the slide deck, it looks as though sequentially the North American business is actually improving a little bit. I may be wrong. But then, at the second time, we're hearing your largest, or one of your largest, competitors talk about achieving double-digit growth in ultrasound.

So what I was really hoping for would be an explanation as to what is going on between Patient Care and Ultrasound and some of your other major markets in the United States if we strip out the Cleveland impact. What is the competitive dynamic in that market right now? So that was question number one.

Question number two was more straightforward. Just on Consumer Lifestyle, the press release alluded to gross margins being the reason behind the fallback from 10.6% to 10.2% in adjusted EBITA margin. Could you just -- could you elaborate on that? If it's not price, what is impacting the gross margin?

Frans van Houten - *Koninklijke Philips NV - CEO*

Let's first talk about Healthcare. We have seen that in the United States order intake was still negative for Imaging Systems and this is related to the Cleveland situation. PCMS is actually improving and also Ultrasound is on an uptick. And we feel confident that Ultrasound going forward will continue to benefit from new product introductions.

We also feel that the larger equipment deals that we are doing are inclusive of PCMS going forward, so we see also good traction in the opportunity funnel there.

Overall, I think Healthcare is turning around and if you put the Cleveland impact on the side for the moment we actually saw order intake of plus 4%. Specifically, Ultrasound recorded a plus 13% (multiple speakers) improvement. So it gives you a little bit of color. (multiple speakers)

Ben Uglow - *Morgan Stanley - Analyst*

So the point is, if we strip Cleveland out you're not losing significant -- obviously you are losing share via Cleveland, but there's not a specific competitive dynamic in your Imaging Systems business where you're losing to any one competitor. Is that fair?

Frans van Houten - *Koninklijke Philips NV - CEO*

That is absolutely fair, Ben, and thank you for drawing that conclusion. I can also make a geographical comparison.

Now, in Europe, actually we gained share also in Imaging in many countries. And if you take the Reinier de Graaf hospital in my own country, that is actually about Imaging. So customers are signing up for long-term deals in Imaging because they believe that we have very competitive product.

Now, what is happening in the US besides the Cleveland situation is also the transformation of the sales force that we talked about earlier in the year and it may have gotten off the radar screen a bit.

We took a measure on the leadership of the sales organization. We believe that, under the leadership now of Brent Shafer, we are on the right track there and we expect a normalization in the course of 2015.

So there's upside to be gotten once all the measures take their effect; both Cleveland and the sales force effectiveness. You remember that we transitioned to a key account-based sales model instead of a product-orientated sales force.

Ben Uglow - *Morgan Stanley - Analyst*

Okay. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Then on Consumer Lifestyle, yes, there is a marginal reduction there.

What we have seen in the quarter is a mix shift from, let's say, the highly profitable Personal Care products in favor of more Domestic Appliances, Kitchen appliances. That can happen. We have product introductions on Personal Care that will benefit the fourth quarter that was just outside the third-quarter window, so there's a phasing issue there.

We also had some investments in Personal Care to prepare for the new launches in the market. So, in that respect, cost benefits are one quarter part.

Overall, nothing to worry about. I think our ability to continue to grow even in a slow market -- 5% growth is maybe not as much as we would all like to have but I think it's still a very decent growth number.

And, again, to underline competitiveness in Europe, the Consumer Lifestyle division actually performed very well, and I think that underlines that we are able to compete.

China, Russia, especially Russia, significantly down. We had these massive home Multi-Cooker sales in 2013 where almost one out of 10 Russian families bought this device. Obviously in 2014 that has completely evaporated, with consumers now holding their hands on their wallet.

So I hope that that gives a better picture on consumer.

Ben Uglow - *Morgan Stanley - Analyst*

That does. Thank you very much.

Operator

Gael De Bray, Societe Generale.

Gael De Bray - *Societe Generale - Analyst*

The first one is basically on the increase in inventories. How do you explain such an increase in Q3 at both Lighting and Healthcare for inventories as a percentage of sales?

Secondly, maybe could you elaborate a bit more on the more active kind of M&A strategy you intend to have going forward, especially in the context of falling equity markets?

And maybe the final question, maybe that would be for Ron. I'm just curious to understand how come the negative currency impact is actually more severe on the margin in Q3 compared to what it was in Q2?

Frans van Houten - *Koninklijke Philips NV - CEO*

Let me take the M&A one and then pass inventories and currency to Ron.

Yes, we flagged a potentially more active M&A strategy during the Capital Markets Day in London last month in the context of the intended separation into two growth companies; one for HealthTech and one for Lighting Solutions.

In HealthTech we can identify several areas where we can strengthen our portfolio going forward. We have a great starting position in HealthTech. Customers ask us to become a solutions provider. We've talked about the four new contracts that we won in the third quarter, 15-year contracts. Obviously the more we can put into those contracts, the better it is.

So potential fill-in acquisitions would leverage the Philips' brand, would leverage the global access in the markets and would benefit from, let's say, the overall solution-selling approach. So that is, I think, the foremost focus.

Potentially in Lighting and Consumer, I don't exclude that either, we will continue to emphasize organic growth. It's just that, indeed, going forward there may also be M&A opportunities passing by.

Ron, on inventory and currency.



Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

If you look at the increases in the 120 basis points, we did consolidate the investment that we did in a joint venture in 51%, the General Lighting Company, as you remember. That is to boost our presence in the Saudi market. That was 20 basis points. Currency was actually close to 120 basis points.

So, overall, on a comparable basis, if you will, it's still quite under control.

I'm not saying that we're necessarily happy with it. There are definitely improvement areas ongoing in Imaging Systems, for example, and also in parts of Lighting to get the inventory on a better track.

But, on a comparable basis, I would say the picture looks a little bit different from the nominal 120 basis points.

How come the negative currency impact is severe in Q3 compared to Q2? Actually it's less severe because Q2 was EUR71 million and it's now EUR51 million.

I do have to say that part of the ForEx impact relates to the sudden derailment, I would say, of the Argentine peso, which hit us particularly in some of the translation. But, overall, the impact is mitigated; although, due to the way that we calculate it on a comparable sales basis, the 90 basis points looks higher than the 80 basis points.

But on an absolute basis, it's coming down and we expect it to abate fully in the fourth quarter at current rates.

Gael De Bray - *Societe Generale - Analyst*

Okay, fair enough. Thanks very much.

Operator

Olivier Esnou, Exane.

Olivier Esnou - *Exane BNP Paribas - Analyst*

I would just like to come back to the Consumer Lifestyle trend. The performance has been extremely good versus the market the last couple of years, three years. It's just starting to slow a little bit now. Do you think this is purely the macro? Or is there some element of what has been so far Philips' very specific development of product line in new countries, where you see maybe you've achieved a large part?

I'm just trying to get a sense of the trajectory from here, given you're still targeting mid- to high-single-digit growth. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, I would say this is largely macro. We track market shares very carefully. We believe that globally our Consumer Lifestyle sector is up by 3/10 of 1%; 30 basis points. And that's even including the effect that some of the new product categories are not well tracked by the GfKs of this world. Categories like Airfryers and so on that are relatively new are not tracked everywhere.

So, overall, we feel confident that Consumer is not at all losing traction.

And the slowdown is very much related to the market situation. Russia, China, to a degree also United States, where the market of the categories that we are in is not growing that much, we have important new product launches coming up, already referred to in my introduction. And we expect that these will have a positive effect on the future.

Olivier Esnou - *Exane BNP Paribas - Analyst*

Thank you.

Operator

Simon Toennesen, Credit Suisse.

Simon Toennesen - *Credit Suisse - Analyst*

My first question on Healthcare. Could you quantify a bit more the level of production ramp up you're seeing right now? So assuming you are going to be at 100% by the end of Q1 next year, so where are you now?

And, in relation to that, is it fair to assume that your US Healthcare orders are still going to be down in the fourth quarter?

The second question on China and across the different divisions. It seems in Healthcare the trend is still quite volatile if you look at the first three quarters. What should we expect for China Healthcare for Q4 compared to this quarter?

And also in Consumer, where it seems you're seeing a bit of a slowdown in China. You flagged the mix effects. I believe China is a higher margin quarter. What are you expecting there, too? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, Cleveland manufacturing is ramping up, as we speak; several CT scanners on the line right now. We hope to be able to ship these products in the fourth quarter. This kind of expensive capital equipment you need to think in orders of tens of units.

Obviously further ramping up next year as more product lines will be brought back on line, as well as new product introductions are expected and [visualized]; new product introductions, such as the Vereos and the IQON Spectral CT that are also slated to come in the market next year.

We think that customers will come back to us with new orders once we demonstrate that production is smooth and we are fulfilling the backlog of orders that we still have on hand.

I understand that there is a lot of desire to go in more detail but let me leave it at that.

In China, Healthcare, indeed, is volatile. We believe that orders are being held back due to the anti-corruption process that the Government is implementing, which leads to much higher administrative burden and lengthy processes.

I'd like to bring to recollection that we have gained market share in China for the last three years and we are the number 1 in China. We think that the slowdown there is very much market related and not our own performance related.

So the pent-up demand in China is actually probably going to be released sometime next year. So that would mean good news for 2015 as we are able to act on those opportunities.



I believe you also, Simon, wanted to know about CL in China.

Simon Toennesen - *Credit Suisse - Analyst*

Yes, please.

Frans van Houten - *Koninklijke Philips NV - CEO*

So market shares in China are up. Again, we feel that we are performing well.

Consumer demand is shifting from offline retail stores to online. That poses a little bit of a challenge as, given that, let's say, the online shopping behavior is still more price orientated rather than feature orientated. We are working with the search engine firms to change that. We have excellent relationships with all of them. You could also see recently our announcement of strategic collaboration with Alibaba.

So I feel strong and good about the opportunities that we have in China for Consumer and I rate the temporary slowdown much more to the general economy than anything else.

Simon Toennesen - *Credit Suisse - Analyst*

Okay. Can I just have a follow up? I appreciate that you don't want to say too much more on the ramp up but, just looking at the trends, if you look out onto Q4, could you at least give a bit of guidance on order trends for the fourth quarter in the US in Healthcare?

Frans van Houten - *Koninklijke Philips NV - CEO*

For all of Healthcare? I'm looking at my team here to what extent we can do that.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So normally we don't comment specifically, but it's fair to assume that it will still be negative under the influence of, particularly, Cleveland, as we have seen in the past quarters also. So slightly negative is a fair assumption.

Simon Toennesen - *Credit Suisse - Analyst*

Okay. Thank you very much.

Operator

Fredric Stahl, UBS.

Fredric Stahl - *UBS - Analyst*

I'm going to continue on the topic of Cleveland. Could you clarify if you could, in theory, take more orders than you are right now because, given the length of your delivery cycle and the ramp up, is it the case that you're choosing not to take more orders, or is it the customers are staying away?



Frans van Houten - *Koninklijke Philips NV - CEO*

We never refuse to take orders, Fredric, but maybe let me take a slightly wider viewpoint.

So we have said this will never happen to us again, right. You can imagine how much upset we were internally about the whole Cleveland situation. So while we are remediating Cleveland, we are also ramping up CT manufacturing in Haifa as well as in Suzhou, thereby having three geographically disbursed manufacturing setups for big iron. We were able already to ship three CT machines out of the new factory in Haifa, thereby underlining the preparedness on this strategy.

So this is not something for the long-term future. No, right now, we are ramping up in Cleveland, we are ramping up in Haifa and we are ramping up in Suzhou.

We are expanding capacity quickly. We are clearly signaling to our customers that we are in this business to stay and the investments have been going on already. That's already in our results and we feel confident that the future we will recover.

I do think it will take us a while before the order intake is back at 2013 levels. That will take us, expectedly, up until the second half of 2015. So the first half, still improvements are coming; 2015, second half, we ought to be back to normal.

I hope that that will help in your assessment.

Fredric Stahl - *UBS - Analyst*

Very good. Thank you very much.

Operator

Daniela Costa, Goldman Sachs.

Daniela Costa - *Goldman Sachs - Analyst*

Two questions. One, I just wanted to understand. You kept your ROIC target of above 14% in the Capital Markets Day. But can you comment on relative terms between the various divisions on how things stay in level, so that we have an idea of what the Lighting separation could potentially do to ROIC?

And then a smaller question just regarding the Masimo litigation. Will there be -- will the cash out be delayed until the appeal is solved? Or will you have to cash it out before and then potentially, if things change, be reimbursed part of it? How does it work in terms of cash? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Let me start with Masimo and then hand it to Ron for the ROIC.

The Masimo jury verdict first needs to be taken over by the judge. That, in its own right, takes months. In the meantime, there's no cash out at all. In fact, cash out will only happen after appeal.

So, in summary, first the judge needs to take over the jury verdict, then we will appeal and so, expectedly, this will take two or three years before we will get to the moment that any cash would be affected.



We, of course, will try to avoid it. We had to take this provision because that's how the bookkeeping works. We feel very confident that, in appeal, that we can challenge this verdict. We know our own patent strengths, we know Masimo's claims and this is also why it was so unexpected for us to have such an adverse outcome.

Then on ROIC, I look at Ron.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So if you look at the ROIC target, it's lodged in at 14%. I think it's fairly balanced between HealthTech and Lighting Solutions.

Of course, as you know, we are in the midst of assessing what the split up of IG&S will be, for example, so there's many things that come into the equation. But I believe that the ROIC that we've seen last year for Lighting, which was, I think, slightly below the cost of capital, is not representative because, go forward, Lighting will grow further and make much better use of the asset leverage.

Of course, in a current situation, CL is way in the high 20s% on a ROIC basis and Healthcare is around, let's say, lower teens, I would say, lower to mid teens. So these also are going to drive more leverage, as you've seen Healthcare do, by the way. So that will bode very well for HealthTech.

Bear in mind that we still have, particularly in Healthcare, a fair amount of goodwill in the balance sheet. So profitable growth remains the key and that's what we're driving for.

I hope that's an answer to your question.

Daniela Costa - *Goldman Sachs - Analyst*

Yes, thank you.

Operator

Phil Wilson, Redburn.

Phil Wilson - *Redburn Partners - Analyst*

I've just got two, please. Firstly, on pricing in LED lamps, which you said is deteriorating, can you give some commentary? Is this the existing competition being more aggressive? Or are we seeing new entrants, like the Taiwanese, entering your markets here now with improved capabilities? That's the first one.

And secondly, on Consumer Lifestyle growth, just a follow up there. Just to be clear, do you still have confidence in your guidance of that mid- to high-single-digit growth in this sector? And perhaps if you can give some reasoning as to why you think we can stay at those levels. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Actually, we didn't say that pricing in LED lamps is deteriorating. We have said the price erosion is significant. In a way, that also has to happen because LED lamps need to come into the same price bracket as conventional lamps, as it is a consumer staple. So we have always anticipated that price erosion would be significant.

And the good news is that, thanks to our strong focus on procurement and DfX, we are able to offset that price erosion and improve gross margins.

So at the Capital Markets Day we extensively talked about the gross margins in LED and we were able to demonstrate that LED gross margins were actually trending towards being almost the same as conventional gross margins, while the non-manufacturing cost is still higher, also due to our R&D investments related to the volume.

So I think that's how to look at LED lamps.

We have, on the basis of technology, also been able to come with new concepts. I'd like to point out the SlimStyle LED lamp in the United States; a massive success and taking share from competitors there.

So yes, LED lamps is certainly a space where many people try to fight for share but I dare say Philips is coming out of this battle in a good shape.

With regard to Consumer Lifestyle growth, we do see the macroeconomic effect on our growth.

Russia, which was our number 4 country in 2013, has tumbled down because of the macro effects and consumers not spending. That has quite a significant pull down on the overall growth rate 2014 compared to 2013. In 2015 that, of course, will be a different compare and we are maintaining our mid- to high-growth bracket as our ambition level.

Phil Wilson - Redburn Partners - Analyst

Okay. Thank you. Could I just come back on the pricing point in LED lamps? I think you said that Group pricing worsened 3Q versus 2Q, which you see in your bridge, because of LED lamps.

Just to be clear, is that because there's a higher mix of LED lamps in your portfolio rather than a like-for-like deterioration in LED lamp pricing?

Frans van Houten - Koninklijke Philips NV - CEO

Exactly. Exactly. So the proportion of LED, of course, is up, yes. So good spotting; absolutely right.

Phil Wilson - Redburn Partners - Analyst

Okay. Thank you.

Operator

Thank you. Mr. van Houten and Mr. Wirahadiraksa, there are no further questions. Please continue.

Frans van Houten - Koninklijke Philips NV - CEO

Okay. Well, that was relatively brief. Usually we expect the intense questioning from all of you. I thank you for your time and questions.

We believe that the third quarter had a lot of one-time effects. We understand it will take some time to digest, but let me one more time underline our belief in the quality of the businesses, as well as the performance operationally continues to improve.

And, once you digest all these effects and you see the forest for the trees, I hope that you will share with me our excitement about our ability to improve results, make a big step forward in 2015 and on track for our 2016 financial targets. Thank you very much.



Operator

This concludes the Royal Philips' third-quarter results 2014 conference call on Monday, October 20, 2014. Thank you for participating. You may now disconnect.

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