S&P Global
Ratings

Research

Summary:
Koninklijke Philips N.V.

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Summary:

Koninklijke Philips N.V.

Business Risk: STRONG

Vulnerable — Excellent

Financial Risk: INTERMEDIATE

Highly leveraged — Minimal

Anchor	Modifiers	Group/Gov't
bbb+	bbb+	bbb+

Issuer Credit Rating
BBB+/Stable/A-2

Credit Highlights

Overview

Key Strengths	**Key Risks**
Diversity of products, increasing visibility and stability of revenues.	Public spending on health care is under pressure in mature markets.
Global scale, well-known brands, and strong innovation capabilities.	Could overpay future acquisitions in healthtech due to high valuation multiples.
Solid free cash flow base of €1.5 billion-€1.7 billion annually.	May face new regulatory and litigation risks in the health care equipment segment.
S&P Global Ratings' adjusted debt leverage to remain at slightly above 2.0x, assuming acquisitions.	Consumer spending on some personal health products can be relatively discretionary, in our view.

Revenue visibility is improving, thanks to the shift to health care solution with devices, services, and software.

Koninklijke Philips' (Philips') order book in health care equipment increased by 10% in the 12 months to September 2018, which we attribute to geographic expansion and winning market share from competitors by signing new contracts with private and public hospitals. We see notably growth prospects strengthening in the diagnosis and treatment segment in which Philips has stepped up investments. We also view positively the increasing level of recurring revenues (about 30% of revenues, excluding personal health) generated from services and maintenance stability. We believe this supports stable and predictable cash flows. In personal health, we consider Philips to be well-positioned to capture growth in emerging markets, notably China for oral care and male grooming. In connected care and health care informatics, growth is slowing down as it is taking time for clients to migrate to new systems and software.

EBITDA margin should gradually improve to 15%-16% in 2019-2020, if Philips maintains high profitability in personal health.

This division should continue to be the group's main cash flow contributor, generating over 60% of group EBITDA. Here Philips has a strong pricing premium in oral care and male grooming, enabling high operating margins. That said there is a risk, in our view, that in a cyclical economic downturn some consumers may switch to cheaper alternatives or private labels. It will take time for Philips to catch up with GE and Siemens in North America in diagnostic imaging (the most profitable market globally). Other profitability drivers are likely to be gradually decreasing restructuring and compliance costs, as the company exited lighting and is closing its CT scanner Cleveland plant in the U.S.

Stable free cash flows should enable the group to balance midsize acquisitions and cash distributions to shareholders.

We forecast free operating cash flow (FOCF) will rise to about €1.5 billion in 2018 and €1.7 billion in 2019 thanks to higher earnings, while we see working capital and capital expenditures (capex) stabilizing thanks to the group's consolidation of its asset footprint and better receivables/payables management. We are mindful that Philips is looking to be more active in acquisitions and that there is a risk of overpaying in healthtech due to the high valuations of some small companies. That said, we recognize that Philips has successfully targeted and integrated Volcano and Spectranetics and refrained from large acquisition spending in 2018 (only €600 million so far). We estimate that the company will spend an average of about €1 billion annually over the next two to three years on acquisitions. This would not put the rating under pressure with adjusted debt to EBITDA likely to stay at 2.0x-2.5x, assuming stable shareholder remuneration.

Outlook: Stable

The stable outlook on Philips reflects our view that its operating performance and free cash flow generation should remain solid over the next two years. We anticipate comparable revenue growth to be around 3.5%, notably due to increased new orders in diagnosis and treatment and connected care while we see personal health decelerate slightly. The large cost-savings program should support profitability until 2020.

At the current rating level, we forecast Philips maintaining a debt-to-EBITDA ratio of about 2.5x and a fund from operations (FFO)-to-debt ratio of 35%-45%.

Downside scenario

We could lower our ratings on Philips if we see declining operating performance over the next two years, driven by a loss of market share in personal health and diagnosis and treatment segments, as well as declining profitability from competition intensity or an inability to maintain pricing power. We would view negatively debt to EBITDA rising to close to 3.0x, given Philips' large discretionary cash flow capacity of about €1 billion annually.

Upside scenario

We could raise the long-term rating on Philips if we see continued strong improvement in profitability in the diagnosis and treatment and connected care segments, as well as the company gaining sizable market share in diagnostic imaging compared with global peers GE and Siemens. Secondly, we would expect to see a financial policy that is compatible with a higher rating, notably regarding debt-financed acquisitions. We could also raise the rating if we see debt leverage sustainably between 1.5x-2.0x and FFO to debt comfortably in the 45%-60% range.

Our Base-Case Scenario

Assumptions

- GDP growth forecasts for 2018 and 2019: North America 2.9% and 2.3%; European Union 2.2% and 1.9%; Asia-Pacific 5.6% and 5.5%.
- A low-single-digit revenue decline in 2018 and 2019, but low-to-mid single-digit comparable sales growth, driven mostly by diagnosis and treatment and personal health.
- EBITDA margin of around 15%-16%. We see higher profitability in diagnosis and treatment and connected care, and gradually lower restructuring and compliance costs. That said, there are some near-term higher supply-chain costs in the U.S. and higher regulatory costs in the EU.
- FOCF of €1.5 billion to €1.7 billion, with capex spending of around 5% of sales.
- S&P Global Ratings' adjusted debt of €5.0 billion to €6.0 billion. We assume notably €1 billion of share buybacks already accounted as debt, acquisition spending of €1.5 billion annually, cash dividends of €400 million to €450 million annually, some cash proceeds from sale of Signify shares by 2020 and about €200 million of restricted cash.

Key Metrics

	2017A	2018E	2019E
EBITDA margin (%)	14.2	15.0	15.0-16.0
FFO to debt (%)	46	35-45	30-40
Debt to EBITDA (x)	1.7	1.9-2.1	2.0-2.4
FOCF to debt (%)	31	25-35	25-35

Figures are S&P Global Ratings' adjusted. FFO--Funds from operations. FOCF--Free operating cash flow.A--Actual. E—Estimate.

Company Description

Founded in 1891 and headquartered in the Netherlands, Koninklijke (Royal) Philips N.V. is a diversified health technology and consumer products group. In 2017, the group generated revenues of €17.8 billion and S&P Global Ratings' adjusted EBITDA of €2.5 billion.

Philips operates in three major segments:

- Personal health (41% of revenues; 60% of income from operations in 2017). The product range includes: oral care, mother and child care products, male grooming and skin care, small home appliances, home ventilators, respiratory masks
- Diagnosis and treatment (39% of revenues; 27% of income from operations). Products include: diagnostic imaging, ultrasound scanners, and image-guided therapy.
- Connected care and informatics (18% of revenues; 12% of income from operations). Products include: respiratory

drug delivery products, patient monitoring, and health care informatics.

The group has a presence in 100 countries, and its largest markets are the U.S. (36% of revenues in 2017), Western Europe (21% of revenues), and China (13% of revenues). Philips operates 38 production sites in 22 countries and employs 74,000 staff.

Philips still owns a 15.4% financial stake in Signify (formerly Philips lighting), which it intends to divest over the coming years.

Business Risk: Strong

In our view, Philips' operating performance and cash flow resilience has strengthened in most segments over the past two to three years. Since 2016, the group's revenue growth has been around 4% annually (on a comparable basis) and S&P Global Ratings adjusted EBITDA margin has risen by nearly 400 basis points to about 14.6% at June 2018. In our current base-case for 2019-2020, we see comparable revenue growth of about 3.5% annually, with an S&P Global Ratings' adjusted EBITDA margin improving by 50-80 basis points annually to about 15.5%-16.0%.

We think operating margins should benefit from the on-going cost savings program (€500 million annually in 2019 and 2020, mostly in procurement and overheads) and from lower restructuring costs going forward as Philips has now exited cyclical businesses like lighting. Philips is also trying to consolidate its manufacturing footprint, which should help reduce operational risks that have been costly for the group in past years, such as the defibrillators consent decree in the U.S.

We believe Philips' strategy to be a global Healthtech leader should continue to benefit positive growth prospects in a large number of product segments like oral care, image-guided therapy, or patient monitoring. We believe this is thanks to increasing needs by the health sector to address chronic diseases due to aging demographics in many countries, the necessity for public hospitals be more productive through digitalization, and the increasing interest of consumers to look after their health. The group's revenue growth is driven mostly by its expansion in emerging markets (about one-third of revenues in 2017). Revenues in these new markets have been growing at 8% annually (on a comparable basis) on average since 2015, driven mostly by personal health and diagnosis and treatment.

Philips' business standing is supported by its leading positions and strong profitability in personal health, ultrasound, image-guided therapy, and patient monitoring, which we expect will continue to support stable revenues. We view the group's strong pricing power thanks to innovation capabilities (€1.8 billion annual budget or nearly 10% of sales and a large intellectual property portfolio) and its strong brand among consumers and health professionals as supportive of the rating. Earnings visibility and stability are buttressed by the group's growing order book (+10% in the 12 months to September 2018), as well as the group's increasing level of recurring revenues and sales from integrated solutions between systems, devices, and services (both about 30% of total revenues in 2017).

Philips has been expanding its product range through acquisitions in fast-growing areas like image-guided therapy (Volcano in 2015, a U.S. manufacturer of imaging and measurement catheters; and Spectranetics in 2017, a U.S. manufacturer of vascular intervention and lead management solutions). We believe these deals have strengthened the group's revenue growth and market positions.

Business weaknesses in our view are firstly the likely low revenue growth prospects and pricing pressure coming from mature markets (two-third of Philips' revenues). This is mostly related to budget constraints on public spending for new health care equipment like the NHS in the U.K. That said, Philips is well positioned in out-of-hospital-care products. We also note that Philips remains a distant No.3 in diagnostic imaging in the very profitable North American market, behind GE Healthcare and Siemens Healthineers. We view some product segments as relatively more cyclical or discretionary like domestic appliances or male grooming.

Peer comparison

We choose peers in nondurable consumer products (Procter & Gamble [P&G] and Colgate) and health care equipment (Medtronic and Hologic) to reflect Philips' exposure to the two industries.

In our view, Philips benefits from its exposure to the noncyclicality of health care equipment unlike P&G. However, it doesn't have P&G's large portfolio of products, strong global brands, high and very stable profitability (27% EBITDA margin in 2017), and a large free cash flow base of about €8 billion annually. That said, P&G allocates most of its free cash flow to shareholder remuneration and Philips' debt leverage is only slightly higher at about 2.0x versus 1.5x for P&G.

Philips has more business and geographical diversity than Colgate. That said, Colgate has a larger portfolio of global brands, as well as a long track record of very high and very stable profitability (29% EBITDA margin). It also generated €2.2 billion of FOCF in 2017, which is slightly higher than Philips'. However, Cologate's debt leverage is similar to Philips' at around 1.8x.

Philips has more business diversity than Medtronic, but doesn't have its exposure to multiple high-growth medical device categories. Medtronic has also very stable profitability that is higher (33%-34% EBITDA margin) than Philips'. It generates a larger free cash flow base of over €3 billion annually. That said, the groups' debt leverage is similar at 2.0x-2.5x, reflecting large shareholder distributions at Medtronic.

We rate Philips higher than Hologic mostly due to business considerations. Philips is less concentrated in the U.S. (80% of sales for Hologic), its business has less competitive pressures, and is not exposed to risks stemming from influential medical advisory groups' recommendations to reduce the frequency of various health tests. However, 75% of Hologic's sales are recurring (from consumables) and profitability is higher (33% EBITDA margin). That said, Philips has a much larger FOCF base (only €400 million for Hologic 2017) and lower debt leverage (closer 2.5x for Hologic).

Financial Risk: Intermediate

Philips' financial position remains primarily supported by its relatively large and stable free cash flow base, which we forecast to be about €1.5 billion-€1.8 billion annually between 2018 and 2020. We believe cash flow growth should mostly be driven by the growth in personal health and higher profitability in diagnosis and treatment. Philips should be able to continue reducing working capital and maintain stable capex spending at around 5% of revenues. Lower financing costs following debt repayments on high coupon bonds have helped cash flows in 2017 and 2018.

We believe management will continue to pursue a consistent approach toward debt-financed acquisitions and shareholder remuneration. We forecast adjusted debt leverage to remain around 1.9x-2.4x and FFO to debt at 30%-45% over the next two years.

We see Philips remaining acquisitive as it seeks to increase its presence in the fast-growing segments of diagnosis and treatment or connected care. We have assumed €1.0 billion-€1.5 billion annually on acquisitions, based on potential midsize acquisitions at the high valuation multiples observed in the healthtech sector.

Regarding shareholder remuneration, we assume a stable dividend payout ratio (40%-50% adjusted net income) and the continuation of the share repurchase program to offset dilution from the proposed scrip dividends. We see Philips distributing to shareholders all future cash proceeds from its remaining stake in Signify (formerly Philips Lighting) and increasing shareholder remuneration should it not pursue acquisitions.

Despite emerging market volatility, we see limited currency mismatch for Philips given that it generates more than half of its earnings in North America and Europe, which helps service its euro and U.S. dollar denominated debt. Overall, we do not see near-term refinancing risks, since about €1 billion of short-term debt (20% of total debt) is linked to the share buyback program. Long-term senior unsecured notes remain the main source of borrowings (about 70% of total debt) for Philips. Meanwhile pension liabilities have reduced greatly limiting the risk of a widening net pension deficit in next years.

Liquidity: Adequate

We assess Philips' liquidity as adequate, based on our forecast that liquidity sources should exceed liquidity uses by more than 1.2x over the next 12 months. There are no financial covenants on the debt. Philips has a $2.5 undrawn billion commercial paper program only partially backed by €1 billion of long-term undrawn committed credit lines. We believe that Philips retains access to a diversified pool of lenders and to international capital markets.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and cash equivalents of €1.26 billion as of Sept. 30, 2018. • Forecast cash FFO of about €2.0 billion-€2.2 billion in the next 12 months. • Undrawn committed credit lines of €1 billion maturing in 2023.	• €1.7 billion of debt due in 12 months as of Sept. 30, 2018. This includes €1 billion of share buyback forward contracts. • Our forecast of total capex of about €900 million for the next 12 months. • Our forecast of cash dividends of about €400 million-€450 million annually.

Debt maturities

- Due within 12 months at end-September 2018: €1.7 billion, including €1 billion of share buyback forward contracts
- 2023: €500 million

- 2024: €500 million
- 2025: €350 million
- 2026 and after: €1.6 billion

Issue Ratings - Subordination Risk Analysis

Capital structure

Most of the debt is senior unsecured and issued directly by Koninklijke Philips N.V., the group's top holding company.

Analytical conclusions

All the long-term senior unsecured notes are rated 'BBB+', in line with our issuer credit ratings on Koninklijke Philips N.V.

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/A-2

Business risk: Strong

- **Country risk:** Low
- **Industry risk:** Low
- **Competitive position:** Strong

Financial risk: Intermediate

- **Cash flow/Leverage:** Intermediate

Anchor: bbb+

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Consumer Durables Industry, Dec. 12, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Health Care Equipment Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Netherlands-Based Koninklijke Philips 'BBB+/A-2' Ratings Affirmed On Stronger Business Performance; Outlook Stable, July 27, 2018

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	**a-/bbb+**	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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