Research Update:

Koninklijke Philips Outlook Revised To Negative Due To Supply Chain Constraints And Weak Credit Metrics; 'BBB+' Affirmed

November 8, 2022

Rating Action Overview

- We expect Koninklijke Philips N.V. (Philips) will report a 25% year-on-year decline in adjusted EBITDA, up to €2 billion of total cash outflows, and an increase in adjusted leverage to 4.5x-5.0x at year-end 2022 due to persisting supply chain issues and costs related to the respiratory care device repair and replacement program.
- In our base case, from 2023 the group's cash flow will stabilize and credit metrics significantly improve, with leverage back below 3x, as a result of its expected ability to deliver most equipment and solutions currently missing critical components and phase out the respiratory device repair and replacement program early next year.
- We revised our outlook on Philips to negative from stable and affirmed our 'BBB+' long-term issuer credit and issue ratings.
- The negative outlook reflects uncertainty in the group's ability to turn the current inventory of semi-finished products to cash flow rapidly, since it will continue to rely on availability of components to finish equipment orders, which may prevent leverage from returning below 3x in 2023.

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Rating Action Rationale

Due to Philips' weak year-to-date performance, the group will not meet its profit and leverage targets for 2022. According to Philips' recent profit warning, the group's limited ability to source critical components to finish orders has not dissipated as previously anticipated. For third-quarter 2022, group sales amounted to €4.3 billion, with a 5% comparable sales decline, while income from operations stood at negative €1.5 billion, mainly due to a €1.5 billion noncash goodwill and research and development (R&D) impairment, compared to positive €358 million in third-quarter 2021. Group adjusted EBITA totaled €209 million, or 4.8% of sales, versus €512 million, or 12.3%, in third-quarter 2021. Positively the book-to-bill ratio stood at 1.18, and the equipment order book expanded in the quarter to an all-time-high.

The more serious than previously expected supply chain issues come on top of already known extraordinary costs related to the group's repair and recall program for respiratory devices. As a result, we anticipate a steep reduction in profitability and negative free operating cash flow (FOCF) for the full year despite the expected improvement in the fourth quarter, which is typically the strongest in terms of profit and cash flow for Philips. We believe that S&P Global Ratings-adjusted EBITDA margins will fall to about 8% in 2022 from 11% in 2021 and 15% in 2020. We also expect the group will report materially negative FOCF of up to €600 million in 2022 and total cash consumption of up to €2 billion over the year. Moreover, we forecast that debt to EBITDA will reach 4.5x-5.0x versus 2.5x in 2021, which is significantly higher than our expectation for the current rating.

Although performance is likely to recover in 2023, the challenging operating environment could derail our projections. In our view, there's a reasonable likelihood that Philips' credit metrics will improve in 2023, particularly with adjusted debt to EBITDA strengthening to below 3.0x. We estimate that Philips will have invested more than €1 billion in inventories of semi-finished goods by year-end 2022. Our understanding is that these inventories could be unwound as soon as supply chain pressure eases, enabling it to finish work-in-progress orders of diagnostics systems and devices. We expect the constraints in sourcing of critical components to not disappear but gradually soften due to declining global demand, and measures already implemented by Philips, such as widening the supplier base and redesigning products. We therefore expect a major part of the inventory to be released in 2023, enhancing operating cash flow and allowing recognition of profit, after which we assume working capital will normalize. Additionally, we expect the group's respironics field action to be phased out during first-quarter 2023, since the company expects 90% of the repair and replacement program units to be produced and shipped by year-end 2022. We estimate the cost of the repair and replacement program and other recalls, which already strained profitability in 2021, at about €500 million in 2022. We do not expect such costs to recur at this magnitude from 2023, which should improve profitability over the next two years. Philips has not disclosed an estimate of potential future litigation costs related to the recall. A major litigation expense is not a part of our updated base case and we currently do not expect significant related amounts to materialize, at least in the short term.

Overall, in our base case for Philips we forecast S&P Global Ratings-adjusted EBITDA of about €1.4 billion in 2022, increasing to €2.1 billion 2023, and €2.7 billion in 2024; FOCF at negative €600 million in 2022, increasing to positive €1.8 billion in 2023, and €1.7 billion in 2024; and leverage of 4.5x-5x in 2022, reducing to less than 3x in 2023, and less than 2.5x in 2024. However, factors such as ongoing geopolitical tensions, high inflation, lockdowns at production facilities, or port closures, might further aggravate existing economic uncertainty and adversely affect Philips' fragile global supply chain. In turn, this could lead to higher input costs, create additional supply chain bottlenecks affecting availability of materials and working capital levels, and ultimately postpone the expected recovery of profits and cash flows beyond 2023. Furthermore, the risk of a significant cash hit over the coming years, due to U.S. Department of Justice's proposed consent decree, cannot be ruled out.

Philips is implementing measures to counter the drop in profitability and strengthen its balance sheet. Together with its third-quarter 2022 results, Philips announced general productivity actions, such as simplifying the organization and reducing operating expenses. This includes cutting about 4,000 positions globally across the organization. Philips expects costs of about €300 million in the coming quarters, and we assume annual cost savings of about the same amount starting 2023. More importantly, the group has announced actions to enhance performance and productivity in the supply chain such as dual sourcing, supplier consolidation, and warehouse footprint rationalization; R&D via shifting the focus to fewer, high-impact projects in the innovation pipeline; and quality by enhancing processes, increasing capabilities, and product management. We expect these to yield longer-term operational stability and efficiency. Furthermore, Philips has enhanced its short-to medium-term liquidity though additional credit lines totaling €1 billion, increasing the volume of available undrawn lines to €2 billion, and canceled its plans to settle share buyback forwards for 2023 and 2024 in 2022, announced earlier in the year. We understand Philips is committed to bringing leverage back to its historical target of about 2x and expect management to take further measures to preserve cash, such as reducing noncritical capital expenditure (capex) and other discretionary spending, so long as net debt remains elevated. We expect more details on management's plans to address the acute ongoing challenges, as well as measures to rectify organizational deficiencies laid bare through recent events, in January when it reports full-year 2022 results.

Koninklijke Philips N.V--Key Metrics*

	2021a	2022e	2023f	2024f
Revenue (bil. €)	17.2	17.5	17.7	18.6
EBITDA (bil. €)	1.8	1.4	2.1	2.7
Margin (%)	11%	8%	12%	14%
Free operating cash flow (bil. €)	0.9	(0.6)	1.8	1.7
Adjusted debt (bil. €)	4.5	6.4	5.8	5.7
Debt to EBITDA (x)	2.5	4.6	2.8	2.1

*All figures are S&P Global Ratings-adjusted. a--Actual. e--Estimate. f--Forecast.

Outlook

The negative outlook reflects the uncertainty in the assumptions used in our base case for Philips, and in particular the risk that the group cannot promptly address its current difficulties to source critical components necessary to deliver medical equipment and solutions orders.

In such a scenario, we would assume Philips is unable to significantly improve profitability and generate sufficient FOCF to push leverage back below 3x in 2023.

Downside scenario

Ratings downside could materialize if Philips' profitability and cash flow do not improve according to our current expectations in 2023, with a high likelihood of leverage remaining above 3x at year end.

In such a scenario we could see Philips engaging in a higher level of restructuring than currently anticipated to address the under absorption of its cost base, potentially causing continued low profitability and subpar credit metrics.

Any adverse developments relating to Philips' respiratory devices recall, prompting the program to continue or heightened litigation risk with potential cash outflows endangering deleveraging, could also lead to a negative rating action.

Upside scenario

We could revise our outlook on Philips to stable if delivery volumes start to meaningfully increase leading to lower inventory levels, with the group able to significantly improve profitability and generate cash prompting stronger credit ratios. We would also expect Philips to gradually improve its S&P Global Ratings-adjusted EBITDA margin toward 15% with leverage below 3x in 2023 and continuous improving performance.

Moreover, we would expect management to take appropriate measures to enhance Philips' organizational capabilities in terms of innovation and operational excellence to secure future growth and margin accretion, as well as higher profits and cash flow stability under adverse operating conditions. In addition, we assume Philips would curb discretionary spending to preserve cash so long as the current operational challenges and issues relating to the respiratory devices recall are not resolved.

Company Description

Founded in 1891 and headquartered in the Netherlands, Philips is a global diversified health technology group. The group generated S&P Global Ratings-adjusted revenue of €17 billion in 2021 with an EBITDA margin of 11%.

Philips operates in three major segments:

- Diagnostics and treatment (approximately 50% of group sales): Diagnostic imaging, ultrasound, enterprise diagnostics informatics, and image guided therapy;
- Connected care (30%): Hospital patient monitoring, emergency care, sleep and respiratory care, and connected care informatics; and
- Personal health (20%): Oral health care, mother and child care, and personal care.

The group has a presence in 100 countries and its largest markets are North America (about 50% of revenue), Asia (30%), and Western Europe (20%).

Liquidity

The short-term rating on Philips is 'A-2'. We continue to assess Philips' liquidity as strong because sources cover uses by more than 1.5x for the next 12 months. Moreover, we believe Philips would be able to withstand adverse market conditions over the next 24 months with sufficient liquidity to meet its obligations. The average tenor of the group's long-term debt is more than eight years and it has no long-term debt maturities before 2025.

Principal liquidity sources include:

- Estimated available free cash and cash equivalents of about €800 million.
- An undrawn long-term committed bank line of €1 billion maturing in 2027, with two extension options of one year each, and an additional €1 billion currently undrawn committed bank line maturing in 2023, with an extension option of one year.
- Cash funds from operations totaling about €3 billion over the next two years.
- A working capital release of up to €900 million over the next two years, mostly in 2023.

Principle liquidity uses include:

- Short-term debt maturities of about 500 million.
- Execution of committed share buyback futures totaling about €900 million during 2023 and 2024.
- Capex of about €700 million-€800 million per year, of which part is noncritical and therefore discretionary.
- Cash dividends of up to about €400 million annually, since we expect a meaningful portion to be paid out as script dividends.

Issue Ratings--Subordination Risk Analysis

Capital structure

The vast majority of 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 rating on Philips.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Negative/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 (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

ESG credit indicators: E-2, S-1, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Koninklijke Philips N.V.		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Senior Unsecured	BBB+	BBB+
Commercial Paper	A-2	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914