Research Update:

Koninklijke Philips N.V. Outlook Revised To Stable From Negative; 'BBB+/A-2' Ratings Affirmed

July 2, 2024

Rating Action Overview

- We anticipate Dutch health technology company Koninklijke Philips N.V. (Philips) will improve its operating performance over the next 12-24 months on the back of its recovering order book and stringent cost focus.
- In our view, the settlement agreement for its personal injury and medical monitoring claims diminished future uncertainty and improved earnings stability. In our base-case scenario over 2024-2025, we expect the company will maintain leverage of 2.0x-3.0x and average free operating cash flow (FOCF) of about €500 million-€1 billion.
- We therefore revised our outlook on Philips to stable from negative and affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings on the company.
- The stable outlook reflects our view of a better earnings predictability after the agreement on the pending legal claims, Philips' improved operating performance, and the company's ongoing cost-savings program. We expect these factors will lead to Philips maintaining leverage at about 2x-3x over the next 12-24 months.

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Rating Action Rationale

The outlook revision results from Philips' improved operating performance and debt maturity profile, and the reduced uncertainty about legal claims. We expect Philips will reach the S&P Global Ratings-adjusted debt-to-EBITDA threshold of 3x this year, mainly due to an improved operating performance, better earnings visibility after the recent litigation settlement agreement, and its continuously prudent discretionary spending. Since we last reviewed the outlook in 2022, the company has made substantial progress, resolved supply chains issues and the recall of its sleep and respiratory devices, and maintained overall prudent discretionary spending. We note the company's rapid response to rewire its supply chain network by expanding the supplier base, redesigning products during the global supply chain crisis, and reducing overhead costs and other expenditures to weather inflationary pressures and other operational hurdles. This demonstrates Philips' solid and resilient business model, which we expect will support growth. We also view positively Philips' recent pricing of its €700 million fixed-rate notes due in 2032 to repay existing debt due over 2024-2025 because it will improve the company's debt maturity profile.

Philips' recent announcement of a settlement deal in the U.S. for the remaining claims linked to personal injuries and medical monitoring reduced uncertainty about pending litigations. The announcement also increases earnings predictability. The company has agreed a lump-sum payment of $1.1 billion (about €980 million) that it will pay in 2025. We view this as positive as these claims were the last ones that had to be resolved. The company also managed to conclude an agreement with insurers to pay €540 million to cover partially Philips Respironics' recall-related product liability claims, which we also view as positive. That said, macroeconomic uncertainties and geopolitical tensions remain and could pose a downside risk to the company's operating environment over the near term.

We expect Philips will suffer from the soft demand in China over the near term but consider the company's resilient business model and cost savings program warrant a full recovery by 2025. The overall market in China continues to suffer from industry-wide anti-corruption measures initiated by the government that we expect will continue to weigh on consumer demand for the remainder of 2024. Philips' order intake decreased by 3.8% for the second consecutive quarter over the first three months of 2024, mainly due to the weak demand in China. Excluding China, we note a solid growth in mature geographies, with a solid overall order intake volume. We expect growth of about 3%-4% in 2024, led by growth in Diagnosis and Treatment and Personal Health, with Connected Care being stagnant overall. As the situation in China improves and order intake increases, we expect growth will improve to about 3.5%-5.0% over 2025-2026.

We expect Philips will drive further operational efficiencies that will also contribute to EBITDA growth over 2024-2025. The company has taken several improvement measures since 2022, including restructuring and productivity initiatives. We expect the company will conclude these measures over 2024-2025. Over the past two years, Philips has also made efforts to enhance performance and productivity in the supply chain via dual sourcing, supplier consolidation, and warehouse footprint rationalization. It has shifted the focus to fewer, high-impact projects in the innovation pipeline, enhanced processes, reduced overhead costs, increased capabilities, and improved product management. These measures and the company's cost focus were key to offset inflationary pressures and we expect they will continue benefiting EBITDA generation. These initiatives delivered total savings of €151 million in the first quarter of 2024--€55 million in operating model productivity, €56 million in other productivity savings, and €40 million in procurement savings--and a cumulative €1.1 billion in savings between now and 2023. Considering all these factors, we expect EBITDA of about €2.2 billion-€2.6 billion in 2024. We forecast EBITDA margins of about 11%-12% in 2024, from 8.9% in 2023 and 7.1% in 2022, and 13%-14% in 2025. FOCF will be stable at about €1.0 billion-€1.2 billion in 2024, from €1.4 billion in 2023 and minus €0.98 billion in 2022, and about €400 million in 2025 (taking into account the effect of the settlement payment). This will translate into adjusted debt to EBITDA of 2.5x-3.0x over 2024-2025.

Our 'BBB+' rating hinges on Philips' commitment to prudent discretionary spending. The current rating is reflective of the company's commitment to deleverage back to historical targets of 2x-3x. Over the past few years, the company has been committed to a prudent financial policy that will reduce leverage below 3x this year. Notably, Philips maintained a stringent M&A policy--M&A spending was about €73 million in 2023, from €712 million in 2022--and paid a full stock dividend in the second quarter of 2024. We also note Philips' cash preservation measures, such as reducing noncritical capital expenditure (capex). Although we expect discretionary spending will normalize in 2025--with M&A spending of €500 million, a return to give investors an optionality between cash payment dividends or shares, and capex of about €700 million-€800 million--we expect the company will aim to keep leverage within the 2x-3x threshold for the rating category.

Outlook

The stable outlook reflects our expectation that, despite near-term demand challenges linked to China and the effect of anti-corruption measures, Philips' resilient business model will continue to support the current rating level. We expect the recent settlement on pending litigations, the company's growth strategy, and ongoing productivity savings will translate into solid EBITDA and FOCF generation such that adjusted leverage will remain at 2x-3x over the next 24 months, below the 3x threshold for the current rating.

Downside scenario

We could lower our ratings on Philips if the company fails to keep adjusted leverage below 3x on a sustainable basis. The most likely causes of a deterioration in credit metrics include:

- Longer-than-expected soft demand in China causing a sustained decrease in EBITDA margins and lower-than-expected operating cash flow;
- Large debt-funded acquisitions that increase leverage; and
- Shareholder returns that exceed our base case.

Upside scenario

We could raise the long-term rating on Philips if:

- The company increases profitability and market share gains, especially in Connected Care; or
- Adjusted leverage remains sustainably below 2.0x, supported by a clear commitment from the company and a financial policy on debt-financed acquisitions and shareholder distributions that is in line with a higher rating.

Company Description

Philips is a leading global health technology company. It generated adjusted revenues of €18.2 billion in 2023, with an S&P Global Ratings-adjusted EBITDA margin of 8.9%, versus 10.6% company-reported. Philips operates across three major segments:

- Diagnosis and Treatment (about 50% of 2023 group sales): Diagnostic imaging, ultrasound, and image-guided therapy;
- Connected Care (30%): Hospital patient and home monitoring, sleep and respiratory care, and enterprise informatics (both connected care and enterprise diagnosis informatics); and
- Personal Health (20%): Oral health care, mother and childcare, and personal care.

Philips has a presence in over 100 countries. Its largest markets are North America (about 42% of

2023 revenues), Asia (28%), and Western Europe (21%).

Our Base-Case Scenario

Assumptions

- Revenue growth of 2%-5% over 2024-2025 on a comparable basis, largely driven by growth in Diagnosis and Treatment and Personal Health. Revenue growth is offset by weak consumer demand in China, foreign-exchange headwinds, and some contingency to sales.
- Sales growth of 4%-5% from 2024.
- Adjusted EBITDA margins to improve by 11%-12% in 2024, thanks to better sales prospects, the company's productivity programs, and cost restructurings. This will be partly offset by ongoing extraordinary costs related to the company's repair and recall program for respiratory devices. We expect margins of 13%-14% from 2025, driven by the synergies from the productivity programs, improved logistics, and a more regionalized supply chain focus and regionalized business level responsibility.
- Working capital outflows of about €200 million from 2024 as we expect inventory levels will normalize, with an increase in receivables, given the sales growth prospects in our forecast.
- Annual capex of about €600 million-€700 million.
- Bolt-on acquisitions of €200 million in 2024, with M&A spending normalizing to about €500 million in 2025.
- No cash dividends in 2024 as the company paid full dividends in stocks.
- Share buyback of €300 million in 2024 and €100 million in 2025.

Key metrics

Koninklijke Philips N.V.--Key metrics*

	--Fiscal year ends Dec. 31--				
(Bil. €)	2022a	2023a	2024e	2025f	2026f
Revenues	17.8	18.2	18.0-20.0	18.5-20.5	20.0-22.0
Revenue growth (%)	3.9	1.9	3.0-4.0	3.0-4.0	4.0-5.0
EBITDA margin (%)	7.1	8.9	11.0-12.0	13.0-14.0	About 14
Funds from operations	0.7	1.2	1.8-1.9	2.0-2.1	2.2-2.3
Free operating cash flow (FOCF)	-0.98	1.49	1.2-1.5	0.3-0.5	1.3-1.4
Adjusted debt	6.7	6.3	6.3-6.5	6.3-6.5	6.3-6.5
Debt to EBITDA (x)	5.3	3.9	2.5-3.0	Close to 2.5	2.0-2.5
FOCF to debt (%)	-14.6	23.6	19.0-20.0	6.0-7.0	20.5-21.5

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

Liquidity

We continue to assess Philips' liquidity as strong because liquidity sources will cover uses by more than 1.5x over 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 company's long-term debt exceeds eight years. Financial covenants on the debt do not exist. We believe Philips retains access to a diversified pool of lenders and to international capital markets.

Principal liquidity sources over the next 24 months will include:

- Estimated available free cash and cash equivalents of about €1.402 billion as of March 31, 2024;
- An undrawn revolving credit facility of €1 billion, maturing in March 2029; and
- Cash funds from operations of about €1.3 billion-€1.6 billion.

Principal liquidity uses over the same period will include:

- An estimated €1.141 billion in short- and long-term debt;
- Annual working capital outflows of €200 million-€300 million;
- Our forecast of total annual capex of about €600 million-€800 million;
- Our forecast of cash dividends of about €400 million-€500 million annually; and
- Share repurchases, according to Philips' financial policy.

Environmental, Social, And Governance

Philips has one of the highest environmental standards across its value chain in the medical equipment industry. The company distinguishes itself in the management of its indirect environmental impact. While many industry peers commit to improve the environmental footprint of their products, Philips has the infrastructure to regularly track, report, and set quantitative targets. Yet Philips could face challenges to maintain high environmental standards as it expands to regions with lower environmental regulations, such as China.

Cybersecurity is an increasingly material social risk factor, given the company's reliance on sophisticated information technology, sensitive data on patients' health, and connection to the IT infrastructure of customers, such as hospitals. Product safety remains another important social risk factor, similar to other medical device manufacturers, and could have a substantial negative financial effect on Philips. Only recently, Philips had to recall its sleep apnea and ventilator devices because of potential health risks.

Overall, Philips has demonstrated sound decision-making and strategic choices over the past few years.

Issue Ratings - Subordination Risk Analysis

Capital structure

Most of the debt is senior unsecured and issued directly by Philips.

Analytical conclusions

All long-term senior unsecured notes are rated at 'BBB+', in line with our issuer credit rating on Philips.

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 (no impact)
Liquidity	Strong (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb+

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Koninklijke Philips N.V.		
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Negative/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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.