PHILIPS

# Koninklijke Philips Q3 2022 Financial Performance Update

Wednesday, 12th October 2022

## Welcome

Leandro Mazzoni

*Head of Investor Relations, Koninklijke Philips N.V.*

**Welcome**

Good morning everyone. Thanks for joining our third quarter 2022 update at short notice. I am here with our CEO Frans van Houten, our CFO Abhijit Bhattacharya and our incoming CEO Roy Jakobs. Frans, Abhijit and Roy will make brief opening remarks and after that there will be an opportunity for Q&A. The third quarter 2022 financial results will be reported in full on 24th October so during today's call, we ask you to focus your questions on the information contained in the press release. Over to you Frans.

## Business Overview

Frans van Houten

*CEO, Koninklijke Philips N.V.*

Yeah, hello everyone and thank you for joining us today. We would like to provide some further background on the financial performance update announced this morning. Our financial performance in the third quarter was largely impacted by continued supply chain challenges that were more significant than anticipated, impacting deliveries and customer installations. While we see sequential improvement in the global supply chain situation, our progress has been slower than expected. Sales are expected to be approximately €4.3 billion in the quarter with a comparable decline of approximately 5%. As a consequence of the lower sales, adjusted EBITA for the quarter is expected to be approximately €210 million or 5% of sales. We will record a €1.3 billion non-cash charge in the third quarter for the impairment of goodwill of Sleep & Respiratory Care due to revisions to the financial forecast of this business. In addition, as a consequence of the previously announced initiative to enhance productivity in R&D, we will record a non-cash charge of approximately €165 million in the quarter.

I would like now to give the floor to Abhijit to go over the drivers of the financial performance in the quarter and these items in more detail. And then, everybody, as this is my last analyst call with you after 12 years, I have asked my successor Roy Jakobs to join us and also share a few thoughts with you. And after that, Abhijit and I will answer your questions.

## Financial Overview

Abhijit Bhattacharya

*CFO, Koninklijke Philips N.V.*

**Continued Supply Chain Challenges**

*Sales impacted*

Thanks Frans. Good morning everyone. As mentioned, while we were – while we have seen gradual improvement in the supply chain situation and continue to take action to strengthen our supply chain resilience, the environment remains very challenging with continued disruption, component shortages and low visibility. This impacted our sales compared to our earlier expectation for the quarter, notably in Diagnosis & Treatment and Hospital Patient Monitoring. Our Diagnosis & Treatment businesses are expected to show a low-single-digit comparable sales decline and the Connected Care businesses mid-teens decline in the quarter. The Personal Health businesses are expected to show mid-single-digit comparable sales growth.

On the back of a strong 47% comparable order intake growth last year, order intake declined approximately 6% in the quarter. The book-to-bill ratio remains strong, around 1.2, and the equipment order book grew further in the quarter. Orders were up around 3% for Diagnosis & Treatment businesses on the back of 16% growth in Q3 2021, driven by good performance in magnetic resonance imaging, image-guided therapy and enterprise informatics. Orders for the Connected Care businesses declined double-digit on the back of over 260% growth in Q3 last year. As some of you may remember, this was due to the partial cancellation of the ventilator order from the HHS in the US in Q3 2020. To look at this in context, the three-year CAGR is high single digit as we continue to experience strong demand for our patient monitoring solutions.

As a result of the lower sales, adjusted EBITA margin is expected to be 5% of sales in the third quarter. The impact of global supply chain disruptions is relevant across all modalities but particularly strong on higher volume and high margin businesses like patient monitoring and ultrasound. Our teams remain fully focused on everyday execution, delivering on customer demand and addressing the supply chain risks. As previously communicated, we are further accelerating productivity initiatives and other actions to mitigate the ongoing headwinds. We plan to provide further detail of that at the Q3 results later this month.

**Non-Cash Charges**

*R&D productivity enhancements*

As a consequence of the earlier announced initiative to enhance productivity in R&D, we are shifting the focus to fewer and better resourced projects in the innovation pipeline. This has resulted in a non-cash charge of approximately €165 million that Frans mentioned.

*Sleep & Respiratory Care goodwill impairment*

In addition, the €1.3 billion non-cash charge for the impairment of goodwill of the Sleep & Respiratory Care business is due to revisions of the financial forecast of this business. The drivers for the revised forecast include the current assumptions regarding the estimated impact of the consent decree and changes to the pre-tax discount rate. While we understand you may like to know more about the proposed consent decree, we are in discussions with the DOJ and cannot speculate on the outcome, content or the timing of any agreement. Philips Respironics will continue to provide updates as and when appropriate.

In terms of the recall, we have significantly increased our production capacity and will increase further in Q4, reaching four times pre-recall levels. As of today, we have produced 3.8 million devices and expect to produce and ship around 90% of the registered affected devices by the end of 2022.

**Outlook**

Now, back to our financial performance, we still expect a better second half of the year compared to the first half of 2022. However we do see prolonged supply chain disruptions and a worsening macroeconomic environment. Consequently, we now expect a mid-single-digit comparable sales decline for the fourth quarter of 2022 with a high-single to double-digit adjusted EBITA margin.

With that I'd like to hand over to Roy for a few comments.

## A Few Thoughts

Roy Jakobs

*CEO Designate, Koninklijke Philips N.V.*

**Improving Execution**

Thank you, Abhijit. Good morning, all. While our goal to improve people's lives with meaningful innovations remains unchanged, I am becoming CEO at a time when we face significant challenges. Improving execution is clearly my immediate near-term focus. In particular, restoring supplies to lever on the order book and customer demand, addressing the Respironics safety notification and further strengthening our quality processes. Improving business performance in a turbulent world impacted by supply chain disruptions and geopolitical issues, as well as further simplifying our organisation.

Looking ahead, I'm fully convinced of our ability to drive sustainable value creation. I will further work on my plans in the next 2-3 months and intend to update you on them more specifically with Q4 results in January 2023. While there is a lot to do, our priorities are clear and I'm laser focused on improving execution together with my broader leadership team. Our strong order book shows the relevance of our solutions for customers and we're going to stop at nothing to regain our upward performance trajectory. We must, can and will improve. Thank you very much.

**Frans van Houten:** Thank you Roy and with that, we now open the line for your questions.

## Q&A

**Operator:** Thank you sir. If any participant would like to ask a question, please press the star followed by two times one on your telephone. Due to time, please limit yourselves to one question. This will give people the opportunity to ask questions. There will be a short pause while participants register for questions. Your first question comes from the line of David Adlington from JP Morgan Cazenove. Please ask your question.

**David Adlington (JP Morgan Cazenove):** Good morning, thanks guys. Just one question. Then. So given your difficulties with supply, I just wondered if you were seeing customers become more cautious on making new orders or potentially even cancelling current orders. Thanks.

**Abhijit Bhattacharya:** Yeah, hi David. Good morning, this is Abhijit. We are seeing customers becoming more cautious in placing orders, not so much due to supply chain, more due to the macroeconomic conditions, as you see. Something that you guys hear all the time. But – and we have not really seen any cancellations because of the delay because let's say, almost all suppliers are affected by this. We were seeing an improvement in the situation in Q2 which led us to believe that there would be further improvements going in the second half of the year. And I think that's where those improvements have not come through as much as we had expected, plus the buffer in the supply chains are very, very low so the moment you have one disruption with the supplier, you just get a push out and there is no buffer inventory to take care of it.

So that's why we, kind of, have this – yeah, this short-term volatility that we see. Overall, our funnel remains strong but yes, in terms of the order intake, we will – we have seen a bit of caution with customers.

**Operator:** Thank you. Our next question comes from the line of James Vane-Tempest from Jefferies. Please state your question sir.

**James Vane-Tempest (Jefferies):** Yes, hi, thanks for taking my question. James Vane-Tempest from Jefferies. A follow-up really just in terms of the customers. Can you talk a little bit about the increased cost to customers now, which is obviously a different headwind for them in considering the broader macro drop? So firstly, how you are looking at your own pricing? And secondly – although this is – this isn't something the company does directly but can you talk about the financing for them? How much are they typically having to pay now versus a year ago as well? Thank you.

**Abhijit Bhattacharya:** Yeah, a couple of things. So, yes, input prices, whether it is our equipment or site construction, site readiness, all of those costs have gone up. Now, we have explained before and may be good to reiterate now, the orders that we are supplying for now have come – have been part of the order intake pre-price increase. So we are, of course, now booking orders at increased prices and they will come to revenue next year. So the impact on the P&L now that you see is coming from increased input cost but not yet the benefit that we expect to see from pricing.

Regarding customer financing yes, the interest rates have gone up so, therefore, customer financing rates have also gone up. It's still in the low-to-mid single digit range but depending on the geography. But our penetration, especially from Philips Capital, remains pretty good. So we are not seeing customers walking away from taking financial support from Philips Capital as they place orders.

**Operator:** Thank you. Our next question comes from the line of Sezgi Oezener from HSBC. Please ask your question sir.

**Sezgi Oezener (HSBC):** Hi, thanks for taking my question. My question relates to the – to the additional – to the goodwill impairment. I appreciate that you also mentioned that in the goodwill impairment and [inaudible] you're taking into account the consent decree, of which you cannot reveal the details. But can you maybe give a colour of whether you expect this to be the full impairment and provisions that you will be recording on this or do you expect this to go over the €1.3 billion that you've shared with us today?

**Frans van Houten:** Yeah, thanks, this is Frans. Details of the consent decree have not been fully negotiated at this time and therefore, we are, to our best of our abilities, looking at the future with an impact of a combination of margins and sales. It's very early days. There's really not much more detail that we give – can give today other than this is our reasonable estimate. And I would leave it to a future update to come back on your question. But at this time, this is it.

**Operator:** Thank you. As a reminder, to ask a question, please press the star followed by two times one. Our next question comes from Veronika Dubajova from Citi. Please ask your question.

Veronika, your line is open, please ask your question.

**Veronika Dubajova (Citi):** Hi guys, good morning. Can you hear me okay?

**Frans van Houten:** Yes.

**Veronika Dubajova:** Excellent. Sorry, I was just – some problem on my end. First, Frans, all the best for whatever comes next. And then as far as my questions are concerned, this is probably more appropriate for Abhijit and Roy but just curious. We've been in this disrupted supply chain environment for quite some time and I think – I'm asking you to predict something that's quite difficult. But I would just love to hear your preliminary thoughts as to where you think you'll end the fourth quarter in terms of the supply chain. And how quickly, as we transition into 2023, would you expect to return to a more normal operating environment from a supply chain perspective?

**Abhijit Bhattacharya:** Hi Veronika, good to have you back. Regarding Q4, we still see disruptions likely to continue, right, and therefore we signalled the mid-single digit decline. It's not because we don't have the orders. It's just the ability to fulfil those orders is just still a bit challenged. And that's why we have – we've talked about the decline in Q4. We expect this to of course ease next year but at this time, it would be a bit premature to say whether it's Q1, Q2 or Q3. You know with the overall economic situation, there will be easing of especially semiconductor supplies in the coming year. So we don't expect this to continue all of next year but whether it's the first or second or third quarter, is something we'll probably have a better view to more towards the end of this year or early next year.

And like you said, it's difficult to project so we're trying to be just careful of that and we continue with our actions to mitigate whatever we can, also, in terms of dual sourcing and all the rest. But being in the healthcare industry, it just takes time. If you see for our Personal Health business, we have been able to mitigate most of the supply chain issues. But the health systems take a bit longer, and with the installation related risks. Also from our customer side, right, because their supply chain also has to get – whether it's electrical fittings, switch gears which is a huge shortage today in the market. All of this adds up to just delays which hopefully should ease in the coming year.

**Operator:** Thank you. As a final reminder, to ask a question, please press the star followed by two times one. The next question comes from the line of Delphine Le Louet from Société Générale. Please ask your question.

Ask your question Delphine.

**Abhijit Bhattacharya:** A problem with the line of Delphine. Is there anybody else, operator, with a question?

**Delphine Le Louet (Société Générale):** Yeah, I am there. Sorry, I was so noisy on the line. Yeah, good morning everyone. I had a question regarding the restructuring charges and I was wondering if – on the R&D side, if it's part of the new plan that Roy decided to implement. And so is it just what we see on the top of the iceberg and we open up a box here. How do you see this envelope of €165 million going forwards and what can we expect? Thank you.

**Abhijit Bhattacharya:** Actually, Delphine, this is something we had said earlier in the year, even in Q2, where we said we are going to relook at our total innovation funnel and focus on fewer but bigger – sorry, better projects and bigger, so that the ones that really are scalable are properly funded and resourced. This has happened over an extensive review over a 3- to 4-month period of all our R&D programmes that is running. It's a few projects where we decided to stop so that we can, let's say, resource the bigger projects which have a – which are in the pipeline to get us to success quicker. So it's not something that has just happened overnight. It's something that was in the plan, mentioned and this is the logical conclusion.

**Operator:** Our next question comes from the line of Veronika Dubajova from Citi. Please state your question Veronika.

**Veronika Dubajova:** Thank you for squeezing me in for a follow-up. It was actually related to my question earlier. I would just love to understand Abhijit if you can, kind of, what you think, sort of, the guidance assumes in terms of lost revenues for the fourth quarter. Like what's the approximate amount that you expect to be short of, if I can use that term? And how that compares to Q3, what you've seen in Q3 and in Q2?

**Abhijit Bhattacharya:** I'm not clear about the question Veronika. Maybe…

**Veronika Dubajova:** Yeah, I think in the past you've, kind of, helped us quantify, you said 'Look, there was a €0.5 billion of lost revenues because of the supply chain.' I'm just curious if you can help, give us a number on what you think this would have been in the third quarter and what you're assuming in the fourth quarter.

**Frans van Houten:** It's not lost.

**Abhijit Bhattacharya:** Yeah. Yeah, it's not lost sales. That's – so this is largely postponed sales. So in the third quarter, let's say we lost, compared to our estimate, maybe around €200 million of sales, of which €150 million was supply related. In Q4 it is significantly more. So because we have, let's say, a much larger revenue in Q4. So for the time being, we have assumed a significantly higher number, more closer to the €0.5 billion or so.

**Operator:** Thank you. Our last question is a follow-up question from the line of Sezgi Oezener from HSBC. Please state your question.

**Sezgi Oezener:** Thanks very much. My last question was related to – of course I appreciate that you had changed your mid-term guidance and were guiding for 4-6% but the changes and impairments and the consent decree posed a question mark. So, can you give maybe a colour of when you now – or whether you expect to reach the 14-15% margin by 2025 or – and whether you expect a more [inaudible] or equally distributed trend towards that? Thanks.

**Frans van Houten:** Yeah, Sezgi, this is Frans. I, of course, understand your question. We have agreed that Roy will actually talk to markets and analysts in the January timeframe about, let's say, how he sees that future, giving him a few months to assess and of course distinguish the near-term disruptions and headwinds from the fantastic potential the company has. And therefore, I'm going to duck your question here today and give Roy the chance to do that in January. Sorry about that.

**Operator:** Thank you. Thank you gentlemen, that was the last question. Please continue.

**Frans van Houten:** Yes, then I guess my closing words here. I would have wished this final analyst call to be under different circumstances. It is what it is. I express a deep conviction about the potential that the company has. We will come back to the path of performance. I know that Roy and the Executive Committee are entirely committed to do that and they know what to do. And they're working on it. It just takes some time.

So thank you very much and perhaps we'll see each other in different circumstances. Goodbye.

[END OF TRANSCRIPT]