Company: **Royal Philips**

Conference Title: **Royal Philips Analyst call**

Moderator: **Leandro Mazzoni, Frans van Houten and Abhijit Bhattacharya**

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Operator: Welcome to the Royal Philips Update on Financial Performance on Q3 2019 on Thursday, 10th October 2019. During the call hosted by Mr Frans van Houten, CEO, and Mr Abhijit Bhattacharya, CFO, all participants will be in a listen-only mode. After the introduction, there will be an opportunity to ask questions. Due to limited time, we ask you to please keep it to one question per person. If any participant has difficulty hearing the conference at any time, please press the star followed by the zero on your telephone for operator assistance.

Please note that this call will be recorded and will be available on Investor Relations website of Royal Philips. I will now hand the conference over to Mr. Leandro Mazzoni, Head of Investor Relations.

Leandro Mazzoni: Good morning everyone, and thank you for joining our third quarter 2019 update call. I'm here with CEO, Frans van Houten, and CFO, Abhijit Bhattacharya. After some remarks by Frans, there will be an opportunity to ask questions. Over to you, Frans.

Frans van Houten: Yeah, thank you, Leandro. Good morning, ladies and gentlemen. Thank you all for joining this call this morning. I'd like to provide some color on the update on the financial performance in the third quarter 2019 that was published early this morning on our website. During this call, Abhijit and I will gladly take some questions. But in terms of the numbers, we need to restrict ourselves to the information contained in the press release for obvious disclosure reasons.

In the quarter, we continued to see good growth momentum across our businesses. Group sales are expected to amount to approximately €4.7 billion, reflecting a strong 6% comparable sales growth with actually all businesses contributing. I am pleased with the continued adjusted EBITA margin improvement in Diagnosis, in Treatment and in the Personal Health businesses, which are in line with our expectations.

It is disappointing that the margin in the Connected Care business is expected to decline by 4.5 percentage points to 11.3% of revenue in the quarter. The decline was due to increasing headwinds from tariffs but related to that a delay in the impact of the mitigating actions to offset those headwinds. We also saw a factory under coverage as production levels were lower to reduce inventory and an adverse product mix impact.

As a result of this and additionally shortfall of around 20 million of license income in the segment Other, Group adjusted EBITA for the quarter is expected to be around €583 million, or 12.4% of sales, and that compares to 13.2% in the third quarter of 2018. I wish to underline that the fundamentals of the Connected Care business are strong, but we do need to acknowledge that the businesses are affected by headwinds and have several transformations underway that are impacting results in the short-term.

I am going to stay very close to those businesses in the weeks and months to come to make sure that they deliver on the improvement actions that have already been rolled out. And as I mentioned, we saw a delay in the impact of these actions but there are very good actions underway.

So, we will drive execution of these mitigating actions and we also plan to elaborate further on the progress of these plans in due course and in particular of course at the end of October call.

So, let me conclude. As you know, since 2016, Philips has been on a consistent performance improvement trajectory. We have delivered three consecutive years of mid-single-digit comparable sales growth and at least 100 basis points of annual adjusted EBITA margin improvements.

We expect the good growth momentum to continue. Given the overall significant headwinds and the current underperformance of the Connected Care businesses, we now expect the full year 2019 adjusted EBITA margin improvement for the Philips Group to be around 10 to 20 basis points.

And if I look ahead to 2020, I can tell you that we expect to deliver 4% to 6% comparable sales growth and an adjusted EBITA margin improvement of around 100 basis points. I'm sure that you have many questions, so we'll now open the line to try to answer as many as we can in the limited time available. Thank you.

Operator: Thank you sir. If any participants would like to ask a question, please press the star followed by the one on your telephone. If you wish to cancel this request, please press the star followed by the two. Please limit yourself to one question. If you're using speaker equipment today, please lift the handset before making your selections. There will be a short pause while participants register for a question. The first question comes from Veronika Dubajova from Goldman Sachs. Please go ahead.

Veronika Dubajova: Good morning, and thank you for taking my question. I'll keep it to one. I was hoping Frans and Abhijit you could comment on how you think – sort of how you see the medium-term margin expectation for CC. Obviously, you had guided for 16 to 18 in the past. Is that still an achievable target? And is the issue here or just that you're achieving that target later or should we be thinking about this business is generating a lower margin not just in the short-term but more over the medium-term? And I guess related to that, just it sounds to me like a lot of the issues here are timing issues as opposed to fundamental issues. So, if you can kind of comment on that, that would be helpful. Thank you.

Frans van Houten: Yes. Hi Veronika. Thank you. The fundamentals of the Connected Care business are strong. The two main carriers of that I believe are obviously Sleep & Respiratory Care and patient monitoring, monitoring and analytics. These are very strong businesses with very good margin structures and market shares. We have been and are investing in the business. That is, of course, pressing on the results.

Connected Care has many product categories. The headwinds are therefore more complex to mitigate because you need to go into many different products components, subassemblies, factory locations. So, that is one of the reasons why it takes longer to have these mitigating effects take full impact as opposed to, for example, Personal Health where you have high volume products where you fix one mitigating action on a tariff issue, then you get instantly the entire benefit on the entire volume.

So, Connected Care, therefore, a more – a broader business. The example of the factory loading, that's a temporary thing also, right, so that will dissipate fairly quickly. The overall customer demand, we think is strong, has been lumpy but we continue to see a very strong funnel. So, overall, I'm absolutely convinced that the fundamental attractiveness of Connected Care is assured. I'm of course very much aware that we have now seen a couple quarters of lesser performance. We were expecting an improvement in the third quarter.

In fact, September also didn't work out as we had expected. So, in that sense, we really need to be very close and make sure that we drive these actions and that we materialize the improvement that has been targeted. And so, both Abhijit, myself and Carla Kriwet, we will all do that. And then we will see a gradual improvement over the next quarters, plural, into next year. And I'm convinced that we can get this business to strongly contribute to Philips overall.

We, of course, are also still dealing with the consent decree, right, so there is a lot on the plate of management concurrently.

Veronika Dubajova: Abhijit – that's fine. I'll take it offline. Thanks guys.

Frans van Houten: Thanks Veronika. Go ahead.

Operator: The next question comes from Mr. David Adlington from JP Morgan Cazenove. Please go ahead.

David Adlington: Good morning guys. Thanks for the question. Yeah, maybe just if you could give us some help with Q4 because with the reduced guidance, you still got to have a pretty decent improvement, I think about sort of 80 basis points given the flat year-to-date performance, and actually you've got a pretty tough comp in the fourth quarter. So, maybe if you could just sort of help us that the sort of trajectory on what levers you can pull for that Q4 performance, please?

Frans van Houten: Yeah. Of course, you know that always our fourth quarter is significant; and we have always said 2019 will be backend loaded; and in fact we expect a strong quarter in terms of revenue but also several of these mitigating actions are expected to further kick in. We have done our, yeah, math, and we feel this is a plan that is well-bridged to deliver the improvements so that we can get to the 10 basis points to 20 basis points for the full year. I'm looking to Abhijit, whether you want to provide some more technical color to it.

Abhijit Bhattacharya: No, I think if you look overall, Frans, you mentioned that in your introduction, right, D&T and PH are on a good trajectory. And let's say, one of the segments which have pulled us back. So, I think overall the trajectory will remain for the other two and if we are able to get some momentum back in Connected Care, I think driving improvement in Q3 is still – Q4, sorry, is very much on the cards. So, I think we leave it at that for now.

David Adlington: Thanks.

Operator: We will now take our next question from Michael Jungling from Morgan Stanley. Please go ahead.

Michael Jungling: Thank you and good morning. My question is in relation to your order growth number for the quarter. I think you mentioned it is going to be flat. Could you please provide some color geographically where the weakness is coming from, and perhaps also some color in what product categories you are seeing weakness in your order growth? Thank you.

Abhijit Bhattacharya: Yeah. Hi Michael. I think if you look at the order book growth, first is, of course, last year we had a very strong Q3. We had a 11% growth. I think the order momentum in our D&T and service-related businesses is still strong, so it's nicely in the 4-6% range. Connected Care was flattish. And so also – actually we had in the informatics businesses a bit lower.

From a geographic point of view, couple of markets had, let's say, reasonably large declines in Western Europe, which is not something that we are particularly concerned because we believe that those are shifts between quarters. China was strong. So, China we expect to be in the double-digit. So, I think China being – is more or less offset by the negative growth in North America and Western Europe. I think that's how you should look at it.

Michael Jungling: And Abhijit, North America you said was positive or flat?

Abhijit Bhattacharya: No, was decline. So, that decline in North America and Western Europe actually offset the growth in China. So, China continues to be strong and performing extremely well.

Michael Jungling: So, is there a risk here that maybe we're seeing a slowdown in the capital equipment market that is leading to a slowdown? Is that the sense that you're getting or is it just coincidence that Q3 is flat?

Frans van Houten: Yeah. We have earlier talked about this and that we do, of course, see market headwinds. And I think I said that the North American market is a little bit less robust than last year, right, so where we saw maybe 4% growth last year in the US now it's more to 3%. Europe is largely flat and China continues to grow strongly.

In terms of LTM order growth, we are at 5% in year-to-date slightly below that. If I look at our funnel of opportunities, it's very strong. And I reiterate what I've said before. I see no reason why we cannot maintain an order growth that substantiates the 4-6% revenue growth. And it is a bit lumpy. I expect that several of those opportunities in the funnel will materialize also in Q4. So, let's not get hung up on one quarter of flat order growth. That I don't think is evidence of our overall change in the sentiment that we have with Philips.

Michael Jungling: Great. Thank you.

Operator: We will now take our next question from Patrick Wood from Bank of America Merrill Lynch. Please go ahead.

Patrick Wood: Perfect. Thank you for taking my questions. Just one. Just taking a step back, curious to see how this sort of came about in the sense of narrative. Obviously, the public commentary that you guys gave in the communication to us was still reasonably positive on the margin structure for guidance up until very, very recently. So, I'm just curious as to how it happened quite quickly that we came to a new view. Was it that internally people were sat on bad news or was there a delay in the management information systems internally sending the news upwards to you guys? How much control do you feel you have over the information being set up to you? I'm just curious for a little bit of color on that. Thank you.

Frans van Houten: Sure, Patrick. Well, so we have seen increasing headwinds, right, and we have said courageously we will mitigate many of those headwinds and therefore we have talked about a net impact of those headwinds. In fact, the gross impact of the headwinds have increased and we continue to work very hard to mitigate it.

Several of those actions take time to materialize. In parallel, we have our productivity programs that we are also working on. In parallel, we are working on the consent decree efforts. Shifting factory footprints is a lot of work, actually adds cost rather than that in the near term it reduces cost.

So, we had maybe a little bit too much optimism in how all these actions were coming together. And then, yeah, it did not completely pan out like that. And I don't mind to say that I was also more optimistic and then September materialized less, right. So, that is not great. This is also why I said in my opening words that we will be very close to this business to make sure that all those actions deliver.

I don't see a difference in the fundamentals of the quality of the business. Therefore, I remain convinced that just by sheer focus and hard work we will be able to deliver the improvements even though realistically we are now starting CC from a lower base and therefore we now need to work on improvements from that base.

This is also why we have said next year we look at 100 basis points and I, of course, very much realize that that's then from the lower base in 2019. Therefore, overall it is – we are behind on our original plan to get to the 15% next year. But overall, I think it's a realistic plan and we will deliver it.

Just to remind everybody in the call, in Q3 we had of course another setback and that was the license income, right. The license income is lumpy and we cannot always predict exactly when that comes in. That was €20 million in quarter that we missed. That is something that we think can come later.

Now I'm not going to make promises here whether – when exactly that is, but we do think that there is still upside there as well.

If I take a little bit of distance and put the scorecard up, since 2016, we have been improving 100 bps per year. We said, we will do an average of 100 bps. If you take a four or five-year perspective including next year, right, and divide that by five, you would actually get to an 80 bps to 90 bps average improvement, right. So, in other words this is – yeah, a temporary setback. But we largely stay committed to deliver on that overall guidance over that longer timeline.

So, of course, it's not – I'm not happy with it but we are entirely committed to make sure that we continue the very positive run that we have been having over the years.

Abhijit Bhattacharya: Yeah, maybe just to –

Patrick Wood: Got you. But it sounds like a tough September and too many projects at once rather than system is not giving you the information you need or employees sat on bad news.

Frans van Houten: No. Our employees did not sit on bad news. But for example, take the factory under loading, we drive hard on inventory reduction. Okay, maybe we should have been more realistic that that then comes as a consequence with an under coverage on that factory now. So, we'll take that on us.

Abhijit Bhattacharya: Maybe just a clarification. I mentioned the order intake, like I said couple of countries in Western Europe had declined. However, also Asia Pacific, Japan also had declines. So that actually offset most of the gains in China. So, it was not the whole of Western Europe, couple of markets in Western Europe, although overall Western Europe was still low single-digit growth. But let's say if you look at all the big negatives, then I would also add Asia Pacific and Japan to that list.

Patrick Wood: Super. Thanks for the color.

Operator: We will now take our next question from Mr. Scott Bardo from Berenberg. Please go ahead.

Scott Bardo: Thanks. It’s Scott Bardo from Berenberg. Yeah, just a few questions please just so we can better disentangle the profitability contributors for Connected Care. It was always my thought that the Sleep & Respiratory business was quite high margin for the company and now that’s been encapsulated within Connected Care and growing somewhat above the group I believe. The thought was that was going to confer some positive margin and development for this division. But, of course, in the first nine months we see about I think around 350 basis points year-on-year contraction. So, can you help us understand outside of Sleep & Respiratory, roughly the profitability profile of the previous business, are we kind of at a flat situation or very modestly profitable? And how much is this division being impaired by discretionary R&D investments which are currently loss-making? Thanks.

Frans van Houten: Scott, the Sleep & Respiratory Care business has a program in place to increase the direct to patient construct for which we are developing IT applications. So, that is weighing additionally on the P&L. Secondly, we have a mixed change actually started early in the year with higher respiratory care versus the sleep business, which has a different margin profile.

Much of the sleep and respiratory care business is affected by the tariff headwinds and there are a ton of actions going on to redesign out certain suppliers and design in other suppliers so that we can offset these duties, but that also costs extra money. We have been setting up a new factory for masks. So, there is quite a bit of burden on the sleep and respiratory care business as a consequence of transformation programs that we think overtime will pan out. So, it's a very strong business as such. We think that this is much more a temporary situation than a permanent situation.

Scott Bardo: Understood. And do you think, Frans, given that Connected Care has been somewhat muted grow for some time and a little disappointing on the margin front, are you convinced that the organization of Philips has the right management organizational structure for this division or is there things that need to be optimized to deliver its performance?

Frans van Houten: Well, we have actions in place to optimize the organization – and let's remember that one of the reasons we moved S&RC into Connected Care was to merge the hospital respiratory business with the out of hospital respiratory business in order to drive synergies, that is in play currently, that's being worked on.

Secondly, many of the COPD patients originate out of the hospital and then become out of hospital patients. And we see a growing interest from the providers to have an integrated care platform for those patients. And whilst Sleep & Respiratory Care was part of Personal Health, we were not seeing a strong enough integration from the go-to market on these propositions.

We have during 2019 made several leadership changes in the businesses of Connected Care in order to strengthen the focus and effectiveness. So, if I listen between the lines, are you questioning some of that? We have taken action already. Now we need to give these people some time to get their hands firmly on the business and on the right path. So, we have not been sitting on our hands I assure you and we are very close to it.

Scott Bardo: Understood. And perhaps last question. It sounds that there's obviously a lot of plates spinning and a lot of actions being taken some temporary burdens. But as we look into the next planning periods for Phillips, which I understand you were due to communicate in H1 next year. I think consensus that the market had in a mindset that once you get to a 15% margin, further progression was possible, perhaps at a lower level than what we've seen historically from the company on the EBITA margin side. But could we expect actually given the slight underperformance of those targets when we get to the new planning period, similar sort of outlook of 100 basis points, i.e., catch up from some of the shortfall that you see currently?

Frans van Houten: Well, this is then for discussion next year. But I think I've been – and Abhijit we have been consistently saying that, yes, beyond 2020 there is further improvements to be made. We benchmark every business versus competitors and best-in-class and we know that Philips has a lot of room for improvement. In fact, there's now – let's say if you take 2019 as a base, then there is more room for improvement than before.

I don't want now to use this call to give you a perspective on how fast can be improved beyond 2020. But we will definitely talk about that and give guidance. In previous calls, I've also said it's not only in the adjusted EBITA that we will see improvement but we will also see improvement in the reported EBITA because as transformations come to a close, then some of that transformation cost that is now adjusted out would no longer burden the reported EBITA.

So, hence you could then see stronger reported EBITA expansion. I would like to leave it at that because this call was really focused on delivering insight in color on the third quarter. I recognize the desire to go deeper and wider. But if it is okay with you, we will, let's say, get to a close now and then I hope to welcome you in – is there one more question?

Leandro Mazzoni: Yeah.

Frans van Houten: Okay, I'm getting signals from Leandro that there is one more question. So, one more question and then we will wrap up.

Operator: The last question comes from Hassan Al-wakeel from Barclays. Please go ahead.

Hassan Al-Wakeel: Thank you very much for taking my questions. I have a couple, please. So, firstly, you mentioned September wasn’t as expected. Could you quantify this and perhaps mention how this compares to the rest of Q3 and your expectation – in relative to your expectation for Q4?

And secondly, if you could please talk through the adverse product mix and how you expect this to then pan out in Q4 onwards? Thank you.

Frans van Houten: Yeah. Hi Hassan. Well, if it’s okay with you, I’d not go into exactly quantify September versus July and August. But we are very backend-loaded in every quarter, right. Now, I'm sure that as of our own doing and our customers and us we have this elaborate game going on to say at the end of the quarter we want to get to certain results. I see the same with competitors, but so we were very dependable September.

That also means that forecast that gets made in August is – can be very much influenced by the realization in the last two weeks of September, right, and that makes it a little bit less reliable. Let's say normally in Philips we try to have enough mitigations, or let's say, compensating measures. But as you have more headwinds, let’s say, your compensating measures that you can work on become fewer, right, and then you are more exposed to a headwind.

So, I think that is a bit – we’ve all got together in – at the end of the third quarter. Maybe we can come back on this topic at the end of October where we have more time, and also frankly, we have had more time to, let's say, prepare because we now went as fast as we could to the market after adding up the quarter results.

The adverse product mix, this has been now with us for two or three quarters. So, I don't want to promise that that will instantly change in Q4, but of course it's very much on our radar screen to work on it. It’s not that we don't want to sell the lower margin products but we especially need to focus on the higher margin products and get the step up there. So, let us come back on that topic as well in the October call. Thank you.

Hassan Al-Wakeel: Thank you.

Operator: This concludes the Royal Philips Update on Financial Performance in Q3 2019 on Thursday, 10th October 2019. Thank you for your participation. You may now disconnect.