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PRESENTATION

Operator

Welcome to the Royal Philips' second-quarter 2016 results conference call on Monday, July 25, 2016. During the introduction, hosted by Mr. Frans van Houten, CEO; and Mr. Abhijit Bhattacharya, CFO, (Operator Instructions). Please note that this call will be recorded, and is available by webcast on the website of Royal Philips.

I'll now hand the conference over to Mr. Robin Jansen, Head of Investor Relations. Please go ahead, sir.

Robin Jansen - Koninklijke Philips NV - Head of IR

Thank you. And good morning, ladies and gentlemen. Welcome to Philips' second-quarter FY16 results conference call. I'm here with Frans van Houten, CEO; and Abhijit Bhattacharya, CFO. Pim Preesman, who, as we announced this morning, will take over the responsibilities for IR from September 1, onwards, is also joining us today.

In a moment, Frans will take you through our strategic and financial highlights for the period; Abhijit will then provide more details on financial performance. After that, we will be happy to take your questions.

Our press release, and the related information slide pack, were published at 7:00 am CET this morning; both documents are now available for download from our investor relations website. A full transcript of this conference call will be made available by tomorrow on our investor relations website.

Before I turn over the call to Frans, I would like to remind you of three things. First, Philips Lighting was listed and started trading on Euronext in Amsterdam under the symbol LIGHT on May 27. Philips initially retains a 71.2% stake and, therefore, continues to consolidate Philips Lighting's results.



We encourage you, if you haven't already, to review Philips Lighting's second-quarter and semi-annual earnings materials, which were published on Friday, July 22.

During this call, we will, therefore, focus our commentary as much as possible on the performance of our HealthTech businesses.

Second, following the decision in 2014 to combine our Lumileds and Automotive, Lighting businesses in to a standalone company, and to explore strategic options to attract from third-party investors, the profit and loss of these combined businesses is reported under discontinued operations and the net assets for that business in the balance sheet on the line assets held for sale. The cash flow of the combined Lumileds, Automotive business is reported under cash flow from discontinued operations.

Finally, when referred to adjusted EBITA on this call, this represents EBITA excluding restructuring costs, acquisition-related charges, and other charges and gains above EUR20 million.

With that, I would like to hand over the call to Frans.

Frans van Houten - *Koninklijke Philips NV* - CEO

Yes, thanks, Robin. The second quarter of 2016 was a quarter that marked several important events. Of course, the important milestone for Royal Philips was the successful separation of Philips Lighting; but, sadly, also, several political events were happening with potentially significant consequences throughout the world. And I have to say that volatility has gone up with unsure outcomes.

As we said, we completed the separation process at the end of May with the successful listing of Philips Lighting on the Euronext Amsterdam stock exchange. I want to congratulate the entire Philips Lighting team on the successful offering and listing.

And, as Robin already mentioned, Royal Philips currently retains a majority ownership stake in Philips Lighting, and we aim to fully sell down over the next several years.

We can now fully focus on capturing the exciting opportunities in the health technology space, allowing Philips Lighting to do the same in the growing market for energy-efficient lighting.

Britain's decision to leave the European Union has increased volatility in the short term and uncertainty in the long term. And while not a choice that Philips would have favored, it's a new reality. We remain hopeful that a trade and other commercial arrangements that are negotiated with the UK over the next several years will maintain the close partnership that we have with a very important market for Europe broadly, and Philips specifically.

To that end, I want to make entirely clear that we remain 100% committed to our entire ecosystem in the United Kingdom, and, most notably, our customers and employees.

With that, let me now focus on our second-quarter results. On today's call, I will focus my remarks on our opportunities in the HealthTech market, and, therefore, will review the performance of the businesses in our three key segments: Personal Health, Diagnosis & Treatment, and Connected Care & Health Informatics.

This quarter, we again delivered a solid set results with operational improvements across the operating segments and 5% comparable sales growth in our HealthTech portfolio.

This level of sales growth performance underscores the compelling opportunity for Royal Philips as a Company focused on helping consumers to become healthier, and our B2B customers to deliver better clinical and financial outcomes through an integrated approach to healthcare delivery across the health continuum. This includes, among other things, capturing key opportunities in Population Health Management; improved enterprise-wide solutions for health systems and accountable care organizations; and coordinated care delivery across the health continuum.

Adjusted EBITA improved by 90 basis points to 9.3% of sales, driven by improvements in all operating segments, and within HealthTech, most notably, in the Personal Health business.

Our transformation program, Accelerate!, continues to drive top-line growth and deliver savings that, on an annualized basis, more than compensate for inflation, price erosion, and our ongoing investments in quality and new business areas, like Health Informatics, Variable Patient Monitoring Solutions, Population Health Management, and Digital Pathology, that all offer great long-term growth and margin potential.

Order intake dynamics remain quite uneven, and, as a result, currency-comparable equipment order intake fell by 1% in the quarter. But I want to stress that the somewhat disappointing level of orders in the second quarter, in our view, does not reflect the commercial activity that we see in our opportunity funnel. And based on this, we expect good order intake growth in the second half of this year.

Our Personal Health businesses grew by 9% on a comparable sales basis, with high single-digit growth in our mature and growth geographies, driven by double-digit growth in Central and Eastern Europe; and Middle East and Turkey; and Western Europe.

Adjusted EBITA improved by 18% to EUR234 million. And our margin improved by 170 basis points to 14.1%, including some small non-recurring items that contributed 80 basis points to the margin.

This quarter's performance clearly reflects the strength of the Philips brand, and specifically the Personal Health franchise for consumers around the world; as well as the positive impact of our operational improvement programs.

One of the strong performers in the Personal Health segment is our Sleep & Respiratory Care business. This business grew high single-digit, driven by mid-teens growth in sleep as a result of the rollout of the Dream Station portfolio, which is also driving increased customer satisfaction and market share gains.

We built on this momentum in the second quarter with the successful launch of our cloud-based Patient Adherence Management Service, which is the first of its kind connected health technology for sleep and respiratory conditions, allowing patients to stay connected to their care teams throughout the course of the therapy.

It enables the access to data, clinical management workflow, informatics and intelligence for providers, [payers], and patients within a single cloud-based platform.

We are helping to increase therapy-compliance rates among patients, and to improve the experience of new patients attempting to adapt to the therapy.

In the Personal Care businesses, we introduced a revolutionary new product concept, named OneBlade. OneBlade is a hybrid styler that trims, shaves, and creates clean lines. It was specifically designed for millennials, many of whom prefer to have beards or other types of facial hair.

OneBlade leverages our capabilities as the world's leading electric male grooming brands, and it's stepping in to the growing market trend of male facial hair styling.

OneBlade was already successfully launched in France, the UK, Germany, and North America, and has elicited a positive response from both consumers and retailers. And the first sign-ins -- signs of an in-market performance are exceeding our initial expectations.

As we continue to support these promising product launches in the coming quarters, we expect advertising and promotion to go up compared to historic levels.

In the Oral Healthcare businesses, we introduced the Philips Sonicare Flexcare Platinum connected toothbrush; our latest innovation that uses smart-sensor technology to help consumers optimize their brushing routine.



This advanced connected toothbrush synchronizes finally the Philips Sonicare app via Bluetooth to track brushing habits in real time, and provide a personalized 3D mouth map to help consumers identify the areas of the mouth missed in their current brushing routine.

As the data is stored in the cloud, patients can also choose to share their data and stay connected with their dental professionals, leading to improved brushing compliance between visits.

Switching to the Diagnosis & Treatment businesses, we posted comparable sales growth of 1%, driven by low single-digit growth in Image Guided Therapy and Ultrasound.

Order intake in Diagnosis & Treatment was down mid single-digit, largely driven by phasing in regions like North America, Japan, Germany, and the Nordics.

Adjusted EBITA improved by 20 basis points to 8.2% as operational leverage and ongoing cost savings were able to more than offset the ongoing investments in quality, mainly related to Cleveland.

CT production and shipments from Cleveland have been back on track for some time now. However, as we continued to work hard on further augmenting the overall quality standards across our facilities and among our supplier base, we continued to see elevated levels of quality and regulatory spend in the second half of 2016, and first half of 2017.

These costs remain in line with prior expectations, and, therefore, we continue to expect the Cleveland-related business to contribute improvements of around EUR100 million to adjusted EBITA in 2016; and around EUR75 million in 2017.

Philips Volcano is really performing well, demonstrating again this quarter both the benefits of the acquisition, and the success of the integration.

In the second quarter, we delivered another strong quarter of double-digit comparable sales growth and continued operational improvements, driven by growth across the Smart Catheter product portfolio; synergies with the Image Guided Therapy Systems business; and expansion in to new geographies.

Last month, we further strengthened our Digital Pathology business by acquiring PathXL. With this complementary acquisition, we can build on our digital pathology solutions offering and leverage PathXL's capabilities in the fast-growing image analysis and tissue pathology software field.

We will be an even more attractive partner for global medical institutions as they transition to digitized pathology workflows by solving needs in computational pathology, education, workflow solutions, and image analytics.

In the Connected Care & Health Informatics businesses, comparable sales grew by 6%, driven by high single-digit growth in Patient Care & Monitoring Solutions, and mid-single-digit growth in Healthcare Informatics.

This strong growth, as well as cost savings, enabled the adjusted EBITA to improve by 110 basis points to 7.6%.

In line with our long-term strategy of building low key strategic partnerships that allow health systems to expand access to quality care and manage costs better, we signed a \$36 million agreement with the Medical University of South Carolina Health, with a focus on integrated patient monitoring solutions.

Our ability to provide more cost-effective ways to monitor, diagnose, and treat patients, offering the most advanced technology, while improving the patient experience, was actually key to our selection out of a competitive field of bidders.

In Europe, we signed a EUR19 million agreement with the heart hospital in Tampere, Finland, to collaborate on a center of excellence for cardiac care.



Under the strategic partnership, we will install, integrate, and manage cardiac angiography imaging; cardiac ultrasound imaging; clinical informatics; and patient monitoring solutions; as well as providing maintenance, training, consulting services, all under a unified payment structure.

Our outlook for 2016 remains unchanged. We expect modest comparable sales growth and continued progress on our operational performance improvements that will drive further earnings improvements in the second half of the year. At the same time, we are concerned about the increase of risk, due to volatility in a number of markets, and the potential impact that this may have on Philips' businesses and performance.

And with that, I will hand over the call to Abhijit to discuss our financial performance and market dynamics in more detail.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Thank you, Frans. And good morning to all of you.

Before delving in to the Q2 financial performance and market dynamics, I would like to take this opportunity to thank Robin, who has decided to leave Philips after three years, as our primary point of contact with the investor community.

I know that many of you would agree that he has been instrumental in optimizing our industrial -- our investor relations' program. He's been a key member of the Philips finance leadership team, especially as we executed on the separation of Philips Lighting. We will miss his valuable contribution, and wish him all the best for the future.

Pim Preesman, who joined Philips 13 years ago, and who many of you will know from his time in IR from 2009 to 2012, will become Head of Investor Relations, effective September 1.

Apart from his time in IR, Pim has performed many key roles within Philips's global finance function, and is currently Head of Finance for Brazil. Please join me in welcoming him back to investor relations. I know that he looks forward to engaging with all of you, going forward.

Let me now provide you with more granular information on our Q2 results. In Q2 2016, we delivered 5% comparable growth in our HealthTech portfolio.

Including the 1% drop in Philips Lighting's comparable sales, overall sales increased by 3% on a comparable basis.

Geographically, comparable sales growth in the second quarter was driven by 4% growth in Western Europe; and 6% in the growth geographies, which was partly offset by stable comparable sales in North America and the other mature geographies.

Sales of our HealthTech portfolio in the growth geographies grew by 9%; and the mature geographies delivered 2% growth.

Comparable sales growth for our HealthTech portfolio in the mature market was driven by mid-single-digit growth in Western Europe; low single-digit growth in North America; and stable comparable sales in the other mature geographies.

Person Health and Connected Care & Health Informatics businesses recorded high single-digit comparable sales growth in mature geographies; while our Diagnosis & Treatment business saw low single-digit comparable sales decline.

In the growth geographies, comparable sales growth for our HealthTech businesses was driven by double-digit growth in countries like Poland, Indonesia, Argentina, and others. China delivered mid-single-digit comparable sales growth in HealthTech.

Let's have a look at our order intake now. On a currency-comparable basis, equipment order intake declined 1% in the quarter, resulting in 4% currency-comparable order intake growth on a 12-month rolling basis. I say this as we have signaled often earlier about the unevenness of the order intake trajectory.



A low single-digit growth in our Connected Care & Health Informatics businesses was offset by a mid-single-digit decline in the Diagnosis & Treatment businesses in the second quarter.

Geographically, we reported a high single-digit growth in comparable orders in our growth geographies, driven by double-digit growth in regions like China, Russia, and Africa.

In Western Europe, order intake grew low single-digit; while North America posted high single-digit decline, mainly reflecting the lumpy nature of the order intake.

Looking at the strong commercial activity we have seen in the first half of the year, and the related order funnel, we remain confident that we will see good order intake in the second half, offsetting the slow start of the year.

Let me remind you that in our HealthTech portfolio approximately 30% of sales are related to the order book in the next quarter.

Let me now switch to the EBITA development in the quarter. Slide 24 of the presentation material that we posted on our website this morning provides an overview of the main drivers of adjusted EBITA when compared to the same period last year.

As you see on the slide, the adjusted EBITA margin of 9.3% in the quarter was 90 basis points higher than in Q2 of last year. This margin increase was driven by a margin improvement of 170 basis points in the Personal Health businesses; 110 basis points in Connected Care & Health Informatics businesses; and 20 basis points in the Diagnosis & Treatment businesses.

And finally, 180 basis points delivered by Philips Lighting, who delivered an overall strong performance, and remains on track to return to positive comparable sales growth in the course of 2016, which is the first time since the fourth quarter of 2013.

Our underlying operational performance, excluding FX effects and the EUR12 million positive contribution from Cleveland, contributed 80 basis points to the EBITA margin in the second quarter as our Accelerate! program continues to improve operational performance and drive efficiencies.

More specifically, in the fifth bar you see a net contribution of EUR34 million from our Overhead and End2End productivity programs as year-on-year incremental cost savings of EUR97 million were partly -- were partially offset by higher non-manufacturing cost, as a result of investments in emerging business areas; and investments in selling expenses in the quarter.

Our Design for Excellence, or DfX, program, which is aimed at improving value, delivered EUR86 million of additional bill of material savings year on year, and are top of the normal run rate of procurement savings of EUR98 million.

Based on the cumulative savings achieved in the first half, and the outlook for the second half of the year, we remain on track to achieve the cost savings started for the year that we have set for all three programs.

In addition to the operational improvement of 80 basis points, the improvement in the adjusted margin was supported by 20 basis points coming from the positive financial contribution of Cleveland, which was partially offset by negative impact from currency translation effects of 10 basis points.

In the second quarter, the income tax expense was EUR48 million, which was similar to the second quarter of last year; but EUR27 million lower than in the first quarter of 2016.

Due to the sequence of activities related to the separation of Lighting, the tax line in Q1 included tax expenses related to the separation; whereas, in Q2, it included tax benefits related to the separation that largely offset each other. For 2016, we expect the effective tax rate to be around 30%.

Net financial expenses were EUR25 million higher in the quarter, which was mainly due to an interest reversal related to a release of long-term provisions in 2015.



Net income from discontinued operations was EUR151 million higher than in Q2 2015, which is mainly due to the EUR144 million we were awarded in the Funai arbitration case in the quarter.

The return on invested capital, which is calculated on a five-quarter MAT basis, was 7.1%.

Excluding the total one-off charge of EUR345 million related to the pension liability de-risking in the US and the UK in Q4 2015, the ROIC was 10.1%, which is about 1 percentage point above our WACC.

Inventory as a percentage of sales decreased by 180 basis points to 15.2% year on year.

Excluding currency translation effects, inventories as a percentage of sales were down 90 basis points year on year, driven by all operational segments.

Free cash flow for the quarter amounted to an inflow of EUR127 million, compared to an outflow of EUR30 million in the same period last year.

By the end of the fourth quarter, we completed 91% of our three-year EUR1.5 billion share buyback program, which we started in October 2013.

Let me now provide you with some healthcare market perspectives from the US, Western Europe, and China. In the US, we expect to see flat to low single-digit growth in the healthcare market in 2016, following a strong 2015.

We expect acute care providers to continue to make operational process changes to avoid penalties for hospital readmission; a first step in the gradual movement from reimbursement for episodes of care to payment for management of health of populations. These changes are expected to result in fewer patient admissions in the hospital; and those remaining will be the ones that have more acute conditions to be dealt with.

The uncertainty of the impact of these changes will likely continue to cause some delay in the capital spending of hospitals, and, therefore, capital spending for hospitals is expected to be flat in 2016.

The European healthcare market, coming off a slight growth in 2015, is expected to see flat to low single-digit growth in 2016. We continue to see an uptick across Europe in multi-year solution-oriented deals, although cuts to public spending budgets have offset this growth driver.

In China, headwinds related to government's anti-corruption measures, centralized tendering, and price erosion continue the overall slowdown across healthcare markets in 2015. We expect this to stabilize in 2016 and grow modestly, bolstered by the need for more capacity and replacement of aging equipment.

Overall, we estimate the global healthcare market growth to be in the low to mid-single-digit range for 2016.

Let me briefly summarize our financial performance in the second quarter, before opening the line for question.

Our HealthTech portfolio delivered strong 5% comparable sales growth, and our improvement programs continued to drive operational performance across the segments.

Following the successful IPO of Philips Lighting in May, we expect separation costs in the second half of the year to be in the range of EUR65 million to EUR85 million, and represent the majority of what we expect to report in legacy items in the second half.

In the HealthTech other segment, we continue to expect to incur approximately EUR50 million of restructuring costs and other incidental items, which will be slightly offset by cost savings in 2016. As a result, we continue to expect a net cost of EUR80 million to EUR100 million at EBITA level in 2016.



On Lumileds, as you know, Lumileds' performance has been under pressure for a couple of quarters, which is inherent to the cyclical nature of the industry. We continue to expect the performance to improve in the second half of this year based on the good order book for Lumileds, and measures we have taken in the beginning of the year to improve cost productivity. These measures typically take about six months to take an effect.

At the same time, we continue to engage with parties that have expressed interest in the combined Lumileds and Automotive business and will provide more detail on this process, when appropriate.

For the full-year 2016, as Frans mentioned, our outlook remains unchanged as we continue to expect earnings improvements in the second half of the year. But we are concerned about the increased risk, due to volatility in a number of markets.

With that, let me now open the lines for your questions, which Frans and I will be happy to answer. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ian Douglas-Pennant, UBS.

Ian Douglas-Pennant - UBS - Analyst

(technical difficulty) your outlook statement, please, and the qualifying commentary there? Why did you not lower the guidance, based off what you're seeing politically? Or is it fair to say that if it wasn't for the macroeconomic uncertainty that you would have upgraded guidance today? And can you put any quantification on how far head of your expectations you are, in that case?

Frans van Houten - Koninklijke Philips NV - CEO

I'm afraid the first half of your question dropped away a bit; would you mind repeating it quickly, please?

Ian Douglas-Pennant - UBS - Analyst

Yes, sure. In summary, just on your guidance, why did you not lower the guidance? Is it fair to say that if not for the macroeconomic uncertainty you would have raised your guidance today, given when you've been seeing in the margins?

Frans van Houten - Koninklijke Philips NV - CEO

Interesting. Let's say, we gave guidance in the beginning of the year; or rather, we quoted the outlook. And we said we would end the year around 11% adjusted EBITA and have modest growth. We maintain that outlook.

I think it's fair to say that many analysts were doubtful about that outlook. I can tell you that we believe that in the first half of the year we feel that we are on track to deliver on that outlook. It is true that we still have a lot to do in the second half of the year.

We've always said we are back-end loaded when it comes to improvement. We are confident that we can deliver that. But when we look outside to the world, a lot of stuff is happening and that concerns us.



We need to manage those risks as best as we can. Today, those risks are not having a direct negative effect at this time, so we continue to be a case of self-help, mostly.

We are happy with the 5% growth in our HealthTech portfolio in the second quarter. We see sizeable profit expansion in the second quarter that leads us to stay committed to reaching this around 11% outlook.

Ian Douglas-Pennant - UBS - Analyst

Okay. So it's fair to say that the risk of that guidance is now to the downside?

Frans van Houten - Koninklijke Philips NV - CEO

Yes, look, we still have a lot to do. We are confident in our own abilities. And let's first work to achieve our guidance, before we even dream about a different guidance.

Ian Douglas-Pennant - UBS - Analyst

Okay, fine. But given the uncertainty that you're seeing today, the risk is to the downside with your guidance? Would you agree with that statement?

Frans van Houten - Koninklijke Philips NV - CEO

Given the fact that it's external risk, yes, you're right. External risk has increased.

Ian Douglas-Pennant - UBS - Analyst

Okay. That's my one question. I'll jump back in the queue.

Operator

Andreas Willi, JPMorgan.

Andreas Willi - JPMorgan - Analyst

My question is also related to the guidance, and the implied second-half margin improvement year on year. If we use the 11%, you will need about 250 bps improvement in H2. You did 80 bps in H1. The Cleveland guidance gives you another 70 bps in the second half, so there's a 100 bps gap.

Is this a specific division you see that weighted to in terms of your plan if you get to 11%? Or is this a more broad-based improvement that you see coming to support the 11%?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

You're right; Cleveland is one factor. But also, if you look at the phasing of our cost savings, including our DfX savings that is also second-half loaded, like Frans mentioned, we expect stronger growth, and with that operational leverage in the second half, to also drive improvement.



Last, but not the least, in terms of our royalty income, we have a higher weightage in the second half compared to the first half; and also, an improvement year on year in the second half.

These are a few things that, hopefully, will get us across the line and closer to the around 11% that we've talked about.

Andreas Willi - *JPMorgan - Analyst*

The follow-up question on Lumileds, Auto, are you still committed to agreeing a transaction in the second half of this year? You didn't specifically mention that in your speech earlier.

On the Automotive side, given how good the peer results are, I'm still a little bit surprised that doesn't offset some of the LED weakness there. Are you losing market share on the Auto side?

Frans van Houten - *Koninklijke Philips NV - CEO*

Andreas, we remain absolutely committed to trying to do a deal on Lumileds, Automotive in the second half of the year. We are in dialog with various parties. We are also optimistic about the results development of Lumileds, having visibility on the design-ins of the various components with customers, and so we believe also that the dip in performance is largely behind us.

Andreas Willi - *JPMorgan - Analyst*

Thank you very much.

Operator

Max Yates, Credit Suisse.

Max Yates - *Credit Suisse - Analyst*

My first question would be on healthcare orders, and specifically in North America. What is it that you're seeing that gives you a lot of confidence in the second half? Is it that consigning a couple of orders slipped in to the next quarter, or is it just broader conversations with customers?

If you could give us a little bit more of a feeling as to why you are confident in the second half picking up, and particularly in North America, where you said it was a timing issue.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, we did, indeed, see a couple of orders slip from Q2 to Q3; that altogether had a significant impact on orders. But, frankly speaking, we had strong order intake in 2015; then, first-half 2016 was a bit soft and, therefore, a bit disappointing.

But we know, of course, all the orders that we are working on, some slipped in to Q3. And we talk about good order intake expectations for the second half year, and that includes North America.



Max Yates - *Credit Suisse - Analyst*

Okay. My second question would be on the Legacy Items. When I look at the first-half impact from those it's around minus EUR50 million on the EBITA, and I'd just like to try and understand how you think about those legacy item costs running in to the second half of this year. Is this minus EUR25 million per quarter run rate what we should expect, or will those likely come down in the second half of the year?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Max, on a run rate basis you will see that coming down. So it would probably come down to roughly one-half of that in the coming two quarters.

Max Yates - *Credit Suisse - Analyst*

Okay. One-half of that per quarter, or one-half of that combined for the second half?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, one-half of that first quarter. So, on an adjusted basis, it would be between EUR12 million and EUR13 million per quarter in the next two quarters.

Max Yates - *Credit Suisse - Analyst*

Okay, that's very helpful. Thank you very much.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - *Morgan Stanley - Analyst*

A couple of questions, I guess, relating again to the issue of the North American orders. Frans, can you tell us, the double-digit decline in North American orders, is that -- is the Diagnosis & Treatment division in line with that?

And in terms of these deferrals or pushouts, what I'm trying to understand is, are these large specific contracts; i.e., if we had signed those contracts in 2Q would we be close to a zero growth in North American orders? I guess what I'm asking for is how big are these one-off impacts in that North American minus 10% number?

The second question is on understanding the margins in Connected Care. The division, as I understand it, is basically majority patient monitoring and then minority healthcare informatics. It's an 8% margin right now, which I would have thought, relative to peers, even in 2Q, is an extremely low number.

Can you give us a sense, over the remainder of the year, if you are expecting Connected Care to show a significant upward trajectory, the similar seasonality to what we've normally seen in Diagnosis & Treatment? Is that part of the big recovery as well that you expect in the second half?

Frans van Houten - *Koninklijke Philips NV - CEO*

Ben, so let's take North America a bit in perspective. If I would take you to visualize a rolling 12-month order intake curve then, actually, North America shows a healthy 10% level. So, in that sense, we are not concerned about our ability to compete in North America.

Structurally, we believe our market share is okay. We actually saw the Q1 report on market shares, which arguably look back at that time, and that was healthy.

As said, Q2 was impacted by pushouts that were quite sizeable, and multiple deals; not one big deal, actually, but multiple deals. And we believe that we will get back in to positive territory in the second half, in the third quarter; and that also this 12-month rolling OIT is something that we can maintain on a healthy level.

Then, your question on margins in Connected Care & Health Informatics, you're right that the largest business group in there is Patient Care & Monitoring Solutions, which has a very healthy EBITA margin.

The second piece is Health Informatics, which is rapidly transforming itself from a hardware-orientated business towards a software business. I must say that the leadership that Jeroen Tas is doing there really helps it. Because, frankly speaking, two years ago that Healthcare Informatics business was in negative territory. It has been turned around successfully. It is now showing high single-digit results. But as a software business, it will further improve to a healthy high-teens margin over the next quarters.

And then, the third piece that you need to know is that we are making sizeable investments within this cluster, or this segment; for example, in HealthSuite Digital Platform, in the medical wearable sensors. And to keep in mind, I'm talking about 10s and 10s of millions of euros.

So, three pieces, Patient Care & Monitoring Solutions, a well-performing business with strong profitability, with an increasing growth profile; a Healthcare Informatics business that is rapidly recovering and moving towards double-digit profitability territory; and then, these big investments that pull it down.

And you saw a good improvement from Q1 to Q2. We expect a further improvement in to the second half year; and then, of course, a further improvement next year.

Ben Uglow - *Morgan Stanley - Analyst*

Okay. Just one follow up, Frans. On the issue of the lumpiness of orders, and I completely take on board the fact that on a rolling 12-month basis it's been 10%, but what I'm perplexed by is why the orders each quarter are significantly more lumpy than what we see at the two main peers. Is there any natural reason why Philips, your imaging business, should be showing a more stop-start growth trajectory than the two main peers?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, we specifically talk about equipment order intake. I believe some of our competitors talk about some of equipment and service order intake, which, of course, has a dampening effect on the peaks and troughs of orders.

Nevertheless, yes, I think this lumpiness is something that we need to live with. You guys are now zooming in on North America, and rightly so. But I merely point out that our China performance was lumpy last year and is now strongly in positive territory, even ahead of what some of our competitors are reporting. So we also see strengths there.

Across the world, I see good health. So, I already talked about China. I see Europe with a strong resilience in orders. So, altogether, I think we're on a good path of both growth and profit improvement.

And we believe that the order book and the order intake supports the growth ambition that we have been talking about, and also been demonstrating, in Q1 and in Q2.

Ben Uglow - *Morgan Stanley - Analyst*

That's great. Thank you very much.

Operator

James Moore, Redburn.

James Moore - *Redburn - Analyst*

I wonder if I could start with the Diagnosis & Treatment business, and a little bit the medium-term outlook, if I might.

You have talked about some of the positive potential in CT, given your work at Cleveland, China, Israel; and in IGT from Volcano. But I wondered if you could help us understand the MRI piece, which I believe is lower margins, certainly below those of your peers. Could you talk to us a little bit about how you think that business could develop in the next couple of years?

Secondly, I wondered if we could touch on Personal Health. The growth there, 9%, very good. You've talked about products now for a while. You've kept the growth rate very high, Dream Space, OneBlade, Platinum, but could you help us understand the growth outlook in to the second half, and in to next year? Do you see a point where we compare unfavorably against some of this good growth? Or do you think it can continue?

And you mentioned advertising and promotion impacts inside that, and could you perhaps expand as to whether you're talking about a meaningful margin impact there?

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, let me give it a try. Our MR business is performing very well in Europe, in Asia with market shares well in the twenties.

In North America, we are a bit lower. We are working very hard to fix that. That comes also with some investment. We also have new product introductions in the MR space. We are one of the two leaders in MR in the world, and we believe that we can structurally improve profitability of MR in the coming era.

We have also tightened a bit how we manage pricing for MR. We believe that in some geographies we were a bit too low for the value that we have to offer to our customers. So we also expect that, therefore, equipment margins can gradually improve.

If I move to Personal Health, we believe that Q2 had an exceptional high growth. Nevertheless, we are committed to mid to high single-digit growth in Personal Health. We believe that, that is sustainable. We see that in multiple of the business groups; for example, Sleep and Respiratory Care performed very well, lots of innovation going on there with our cloud-based connected sleep solutions. We are outpacing competition there.

In Oral Care, the market is expanding. We are performing very well against competition. People are switching from manual to electrical brushing. We have great franchise in brush heads. So, we believe that the high growth can continue there.

Then, in Personal Care, we just launched the OneBlade. OneBlade is kind of a hybrid shaving concept between electric and wet shaving. That launch goes hand in hand with a significant advertising and promotion commitment. We think that that's a great investment.

I can quantify that a bit for you. We think that the impact on Personal Health in Q3 could be around 50 basis points, for Personal Health that is. So it is an overseeable amount; and with the growth, we can quickly find compensation for that in the next quarters as we see the traction of this product.



Does that answer your question James?

James Moore - *Redburn - Analyst*

Yes, it does. Thank you very much, Frans.

Operator

Andrew Carter, RBC.

Andrew Carter - *RBC Capital Markets - Analyst*

Thank you very much for taking the question. The first one I just wanted to go back to again, for which I apologize, it's D&T North America. I just wanted to pick up on I think that you said that the sales growth in the quarter, I think you said it was down high single-digit, and I wondered if you could just help us understand that a little bit.

I think you've explained what's going on in orders quite well, but it does also sound as though the sales performance in North America in the quarter was quite weak. And, I guess, if I take in to account the idea that the service side of the business should have been, I would have thought, reasonably stable, if not growing, it does seem to suggest that the equipment was down quite a long way.

And then, the other one I just wanted to ask, perhaps going on from what James asked, was just on Domestic Appliances. It does seem as though we've had a nice acceleration in the quarter there. I was wondering if there was anything in there that might relate to a prior-year comparison or be one-off in any way. I wondered if you could just talk a little bit about what's driving it, and what the sustainability is.

Frans van Houten - *Koninklijke Philips NV - CEO*

Sure, Andrew, let's first talk about D&T North America. In fact, your comment on comparability is applicable for D&T, more so, actually, than for Personal Health.

The year-on-year decline is close to 8%. And you may recall that Q2 2015 was a very good quarter, thanks to the recovery of the resumption of production and sales of Cleveland, where we started to deliver against the backlog, that resulted in a sales spike in that quarter. Now, that doesn't justify, of course, not growing it this year, so don't get me wrong, but the comparison was certainly not easy.

We have also seen that in Image-Guided Therapy some customer acceptance slipped also in to Q3, which made the revenue recognition a bit more difficult.

So, altogether, we believe that in Q3 we will see a resumption of the business growth.

Then, on DA, you talk about DA, but do you mean Personal Health, or specifically Domestic Appliances?

Andrew Carter - *RBC Capital Markets - Analyst*

I meant Domestic Appliances, specifically. Because, I guess, if I look back over the last four quarters or so the growth rate in Domestic Appliances, I think, has been a little bit lower, and so I was just quite interested in the acceleration that we're seeing.

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, that's very perceptive. As you know, Personal Health has several business groups; many of them have these very strong high profitability franchises. Domestic Appliances is a bit different, in the sense that it is a bit more generic.

We saw a nice recovery through a new leadership in Domestic Appliances that has enhanced the new product introductions and managing that business. Also, we saw, finally, the turnaround of Coffee coming through. And altogether, that has resulted, off the top of my head, in a mid-single-digit kind of growth rate for DA, a little bit better even being signaled; that, therefore, DA starts to perform more in growth terms as the other businesses.

Of course, that also has a nice fall through to the bottom line, thanks to operational leverage.

Andrew Carter - *RBC Capital Markets - Analyst*

Thank you.

Operator

Gael De Bray, Deutsche Bank.

Gael De Bray - *Deutsche Bank - Analyst*

Looking at the bridge, the price component was higher than in prior quarters, it was about 0.3% higher at 2.4%; and I find it a bit surprising given the slower growth seen in the LED lamps business this quarter. Do you see some higher price pressure in some parts of Healthcare now? So, that's question number one.

And the second question is on, perhaps, is a bit M&A related. At the latest CMD you indicated that there was a EUR37 billion addressable market for adjacent businesses for the Connected Care division, so could you elaborate perhaps on what you consider are the most attractive sub-segments within these adjacent businesses? Thank you.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Gael, on the price erosion, it's basically LED. And the LED growth was not particularly weak; it was a 25% growth year on year on a much bigger volume. So it's not that we are seeing high price erosion in HealthTech, so that should not be a concern at this point. We've always guided for a 2% to 3% price erosion; we are at the lower end of that range.

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, then I'll take your M&A question. Let's, first, talk a bit about Connected Care & Health Informatics. What we do there is, basically, patient monitoring and patient care, both in the hospital, as well as in an ambulatory fashion, after discharge and in to the home. So we envisage that we support patient care along the journey from hospitalization back in to the home with full recovery.

Now, we have a market-leading position in patient monitoring in the hospital, which we are extending with variable sensors so that we can also keep tracking the patient wherever they are. So that is one area where we are investing. We have chosen to do that mostly through organic investments, hence, the investment discussion that we had earlier in the call: that we are investing money in developing those sensors.

Then, secondly, we see strong opportunities in what we call Population Health Management. This is about analytics, on the one hand, and care coordination, supporting doctors, nurses, both in the hospital enterprise, but also with primary care and ambulances, to collaborate together in the cloud.

The acquisition last week of Wellcentive is a nice example to boost our analytics capabilities of data mining to enable Population Health Management.

Wellcentive is a software-as-a-service platform company. Their software is being used extensively by health systems in North America to identify patient populations that are in need for care. Now there, the interesting thing is, is that we can immediately cross-sell that to our own solutions, so we expect a synergistic play between Wellcentive and our device businesses and services business. That's the second area of the investment.

And then third is in Health Informatics. We are strong in imaging informatics; we see opportunities to extend that.

We are expanding in to pathology, as you know. The acquisition of PathXL is a nice example of a company that is very strong in image interpretation, thereby assisting the diagnosis of, for example, cancer patient.

Both Wellcentive and PathXL, at this time, are examples of relatively modest acquisitions. The acquisition that we did last year, Volcano, is performing very well; that would be an example of a somewhat higher value acquisition.

So, that gives you a bit of color around our interest to expand and strengthen our position in Connected Care & Health Informatics.

Gael De Bray - *Deutsche Bank - Analyst*

Okay. Thank you very much.

Operator

Philip Scholte, Kempen.

Philip Scholte - *Kempen & Co. - Analyst*

I had a question about the growth you mentioned about actually two areas where I was expecting a bit higher growth, is both in Imagine-Guided Therapy segment and within Connected Care in the Population Health Management, which you say was actually in line with. So can you comment a little bit about why those numbers are a bit low, at least compared to my estimates?

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, in IGT, which is the combination of our Systems business and the acquisition of Volcano, we saw a mixed picture. Volcano showed very strong growth for the second quarter in a row, and is delivering on its acquisition business case. I'm quite pleased with the performance there.

On the Systems side, sales, indeed, was quite a bit lower, and we saw that being caused by some slippages in to Q3.

I would like to bring to your recollection that in the first quarter we actually saw a 10% growth. Now, these larger installations of hospital operating rooms are a bit lumpy, so we had strong sales recognition in Q1, weak sales recognition in Q2, and we expect stronger sales recognition in Q3. That has to do when the customers actually accept and sign off on the installation.



Then, on Population Health, today, this is really still a very small activity compared to the rest of our businesses, and I would not read too much in the commentary on Population Health Management. We are still building that asset, and we expect over the coming 24 months to gradually come to a very solid and healthy profile.

Philip Scholte - *Kempen & Co. - Analyst*

Right. Can I have a quick follow up on Lumileds, which you used to report separately on the Lumileds, Automotive business combine. Why did you stop that? And are you willing to share the EBITA of that business, as previously reported, as the way you used to report that?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, we still show it separately. We don't provide all the lines, because earlier it was a bit consolidated from Lighting, as a result of which it helped to understand the Lighting results better. Now, with Lighting being a separate company, which is reporting all its lines, we have just simplified that layout.

You have seen that overall from a -- we show that as a separate line in the discontinued operation. So you see there is an improvement compared to last year, but that's largely because of lower tax. And, as we mentioned earlier, we expect, from Q3 onwards, the overall results to start beating last year, again.

Philip Scholte - *Kempen & Co. - Analyst*

Sure. But you're not willing to share the adjusted EBITA number?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No, we have -- it doesn't -- right now, as part of discontinued operations, we don't need to give that level of detail any more.

Philip Scholte - *Kempen & Co. - Analyst*

Okay. Thank you.

Operator

Alok Katre, Societe Generale.

Alok Katre - *Societe Generale - Analyst*

Thanks for taking my questions. I have a follow up, firstly, on the question around Connected Care and the margin improvement that's seen in the second half of the year.

If I understood correctly, is it just related to the improvement in the growth that you were expecting in Patient Care & Monitoring and the Informatics business? Or is it got to do just in the second half of this year with some phasing of cost and revenues? Is it just a phasing, or is it a part of the leverage from the growth as well? That was the follow up.

And then the question that I have from my side is just on Diagnosis & Treatment. I can appreciate the margins were up 20 basis points year on year. But if you strip out the EUR12 million improvement that is showing Cleveland within the bridge then the underlying profits were slightly lower



year on year. I was just trying to gauge whether there's something else that's going on in that business. Is it the FX? Is it some other investments, etc?

And then just within the same thread, working capital at that division was up 60 basis point year on year, whereas a decline everywhere else. I just wondered what's driving that, and how we should read in to this.

Frans van Houten - *Koninklijke Philips NV - CEO*

I think all are quite easily to be explained. Many of these healthcare businesses are having a reasonably high fixed cost component, and are dependent on its seasonality in revenue. And the second half of the year is always much stronger than the first half.

So we expect margin expansion in the second half year. And that applies to Connected Care & Health Informatics, where the patient-monitoring business always is strong in the second half year. That should give us more growth and margin expansion.

But also, in D&T, we talked about earlier in the call that sales were a bit slow in D&T, and that you immediately see backed by negative operational leverage in that business. And we had some push outs, which explain the higher working capital. Because if an installation is being delivered, but not yet revenue recognized it ends up in working capital. So that whole story hangs together.

And as we then get to sales recognition in the third quarter, of some of these work-in-progress orders, we will see the trend reverse with an above-average market expansion; and, of course, a commensurate reduction of working capital.

Does that answer your questions?

Alok Katre - *Societe Generale - Analyst*

Yes, fair enough. Just on Connected Care, usually, that -- sorry, Diagnosis & Treatment, usually, that is to be the division with the sizeable FX headwind. So was there none at all, or nothing sizable in Q2?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No, nothing sizable in Q2, no.

Alok Katre - *Societe Generale - Analyst*

Okay. And do we expect, at the current rates, that there will be anything in the second half which we should keep in mind?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No, negligible in the second half. We expect it to be negligible.

And on the working capital, also, part of it is due to the inter-company payments. If you take that out, we also have quite a good improvement in working capital also for Diagnosis & Treatment. So we see that coming across the board.

Alok Katre - *Societe Generale - Analyst*

Okay, fair enough. Thanks.

Operator

Jonathan Mounsey, Exane.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Just going back to D&T, and, well, particularly in North America and the weak progress on orders in Q2, obviously, you're saying you're very confident in a second half pick-up. Can we assume from that as recently as July we've booked the orders that slipped from the second quarter in to the third quarter?

Frans van Houten - *Koninklijke Philips NV - CEO*

I'm not going to dissect the quarter for you; that goes a bit far. Let us just stay with the confidence that we've spoken about before.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Okay. Just one follow up then. On the M&A pipeline, obviously, you've done a deal quite recently. As we go to the second half, can we expect much of the proceeds from Lighting to be spent imminently? Or, basically, how does the pipeline look?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, thanks for raising that; it gives me an opportunity to, maybe a bit broader, talk about our capital allocation policy.

We've always said that we will use some of the proceeds for debt reduction. We have just paid down the Volcano bridge loan. We are planning to retire some of the more expensive debt. We will still do a little bit on pension liability reduction. We are finishing off the share buyback program in the second half year. We aim at dividend stability. Then, finally, yes, we will consider disciplined but more active approach to M&A.

With the two examples in Q2, I can't promise you that we do that every quarter. We will have our eyes and ears wide open about our selective possibilities, but I would not jump to the conclusion that we are now on a spending spree.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Thank you. Maybe, just one final follow up. If I look at the bridge that was given in the Capital Markets' Day presentation from last year, the aim to get to 11% adjusted EBIT margins by end of 2016, I think the biggest positive component, the 2% operational improvement. If we look at where you're tracking year to date, I think it's probably a little less than 1%. Can we really expect in the final half of the year to make all of that gap up? It feels as if, I think as already mentioned, the risk is to the downside now.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, I think we'll just be repeating ourselves. I think Andreas asked that question in the beginning. And, as I clarified, the Cleveland opportunity is an improvement over last year. As I mentioned, most of our cost saving -- because we have, for our enabling functions, a plan to get to benchmark levels by the end of this year, so we will get some cost savings there.

We, of course, are banking on stronger growth in the second half, as we have mentioned right through the call, which gets us better operating leverage. And the fact that royalty income gives us a bit of a tailwind in the second half, plus the way we have managed ForEx, I think gives us good visibility to come around the 11%, as we spoke about.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Okay. Thank you.

Operator

Ian Douglas-Pennant, UBS.

Ian Douglas-Pennant - *UBS - Analyst*

Thanks, very much, for taking my follow-up question. As you can imagine, most of them have been asked; I've just got a couple of boring ones left.

Firstly, on the tax rate, just semantics. You now say it's going to be about 30%. I have in my notes from the past that it's going to be low 30s, so can I just confirm that is an improvement?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, that is.

Ian Douglas-Pennant - *UBS - Analyst*

That is an improvement. Okay, good news. Thank you.

Then, the other one is on restructuring. Obviously, this quarter was much lower than what you're guiding for the full year, divided by four, if you see what I'm saying. Are we going to expect a lot of the charges to accumulate in Q4, as they have done in prior years? If so, why is that trend happening like that?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, sorry. Are you done?

Ian Douglas-Pennant - *UBS - Analyst*

That was the end of my questions, yes. Thank you.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Q3 and Q4, Q2 was a bit lower because a couple of Lighting restructurings which were planned in Q2 slipped to Q3. So you will see the lower restructuring in Q2 getting compensated by a higher amount in Q3.

And then, you will see some in Q4, as we put in to effect some of the new productivity programs that we will kick start in the second of the year to drive our margins up in the coming year. So that's something we are working on. And once we've started implementation of that, you will see some more restructuring charges coming in.

Ian Douglas-Pennant - UBS - Analyst

Okay, great. In terms of the tax rate going forward, are there further optimization programs that you've got going on, or however the correct way to phrase it? Should we expect the tax rate to come down further in the future?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

No, I think around the 30% is a fair number to go by. Could go up a tad, but it will be in and around 30%.

Ian Douglas-Pennant - UBS - Analyst

Okay. Thank you.

Frans van Houten - Koninklijke Philips NV - CEO

All right, I think that concludes our call. I appreciate everybody's question. And we will continue to work hard on achieving our aim for our business results. Thank you very, very much, and have a great summer period.

Operator

This concludes the Royal Philips' second-quarter 2016 results conference call on Monday July 25, 2016. Thank you for participating. You may now disconnect.

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