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PHIA.AS - Q1 2015 Koninklijke Philips NV Earnings Call

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OVERVIEW:

Co. reported 1Q15 comparable sales of EUR5.3b and net income of EUR100m.



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PRESENTATION

Operator

Welcome to the Royal Philips first-quarter 2015 results conference call on Tuesday April 28, 2015. (Operator Instructions). Please note that this call will be recorded and is available by webcast on the website of Royal Philips.

I will 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 first-quarter conference call. I'm here with Frans van Houten, CEO, and Ron Wirahadiraksa, CFO.

In a moment, Frans will make his opening remarks and will take you through our main strategic and financial highlights for the period. Ron will then provide more details on the financial performance during the quarter. After that, both Frans and Ron will be happy to take your questions.

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

Before I turn over the call to Frans, I would like to remind you of two things.

Following the decision in June 2014 to combine our Lumileds and Automotive lighting business into a stand-alone company, the profit and loss of these combined businesses is now reported under discontinued operations, and the net assets for the business in the balance sheet on the line assets held for sale.



The cash flow for combined Lumileds/Automotive businesses is reported on the cash flow from discontinued operations. Therefore, all commentary that will follow in terms of sales and earnings, and both at a Group level as well as the Lighting sector level, excludes the performance related to the Lumileds and Automotive lighting businesses.

Secondly, when we refer 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, and good morning to everybody on the call.

Earlier today, we announced that in the first quarter, our sales increased by 2% on a comparable basis to EUR5.3 billion, and our adjusted EBITA amounted to EUR327 million, or 6.1% of sales. That compares to EUR304 million, or 6.5% of sales in the first quarter of last year.

Q1 performance still reflects softness in certain markets, such as China, Russia, Brazil and Japan, as well as continued remediation cost in Cleveland, and some currency impact. But we are encouraged by the fact that our top line and order intake returned to growth on a comparable basis, despite a market environment that remains challenging.

We are also pleased with the continued strong performance in Consumer Lifestyle, and with the fact that lighting was able to improve its adjusted EBITA margin despite a decline in comparable top line.

Our Accelerate! program continues to drive improvements across the organization, thereby remaining a key driver for our improvements in operational performance.

We also made good progress in the remediation in Cleveland, which I will get to in just a moment; and we are on track to deliver on our profit improvement plan for our diagnostic imaging business relative to 2014.

Let me now take you through the three sectors, starting with healthcare.

We were encouraged to see healthcare grow comparable sales by 1% and comparable order intake by 3% in the first quarter. In line with our strategy to capture a larger portion of the HealthTech opportunities across the health continuum, we have made additional investments in areas such as healthcare informatics and quality systems.

While these investments impacted profitability in healthcare in the first quarter, we continued to invest to capture the highest return opportunities in healthcare. We expect these focused investments to deliver profitable growth over the longer term.

Over the course of the quarter, we signed a number of multiyear large-scale projects, representing a total value of more than EUR150 million. And I will now take a few minutes to highlight a few of these important customer wins and other developments.

In the United States, we signed a seven-year agreement with Providence Health & Services, the third largest not-for-profit health system in the United States. Our agreement includes the installation, maintenance and upgrades of Philips IntelliSpace Picture Archiving and Communications System, or a so-called PACS solution, across all of Providence Health & Services' hospitals.

The IntelliSpace PACS architecture is designed to improve workflow and efficiency across the entire enterprise for clinicians, technologists, the IT department and administrators. Today, nearly 400 million imaging informatics studies across 1,200 hospitals are managed by our clinical informatics solutions.

Our ability to engage on End2End solutions across the health continuum is increasingly proving to be a competitive advantage with customers. We signed, for instance, a joint development agreement with the Mount Sinai Health System in New York to create a state of the art digital pathology database from hundreds of thousands of tissue samples, and to develop innovative algorithms to ultimately enable more personalized patient care.

In Kenya, Philips is an important technology partner in the government's nationwide healthcare infrastructure modernization program. We signed a multiyear agreement with the Kenyan Ministry of Health for the installation of complete intensive care units at 11 county hospitals across the country. The agreement includes the installation and maintenance of the equipment, such as patient monitoring solutions, as well as the renovation and adaptation of the existing buildings in which the intensive care units will be housed, and we also provide staff training.

Another important milestone in the quarter was the successful completion of the Volcano acquisition in February, which substantially strengthens our position in the growing image-guided therapy market. Volcano's performance in the quarter met our expectations, and the integration process is progressing according to plan.

Turning to Cleveland, we continued to make good progress in ramping up production and shipments from our manufacturing facility, having resumed shipments of Ingenuity, our second major CT product line in March. We are on track to deliver on our profit improvement plan for our diagnostic imaging business for 2015.

Specifically, we expect Cleveland to positively contribute to EBITA for the full year, and for the production volumes of all Cleveland related products to return to 2013 levels by the end of this year.

Our commitment to quality remains very, very strong, and Quality and Regulatory compliance is our top priority. We have and we will continue to significantly upgrade processes and people at Cleveland, as well as other key sites, taking best practices from leading medical companies as well as Automotive and Aerospace industries into account. And we have lifted the quality control oversight to the highest level within the Company. We expect to work on this with full intensity for a prolonged period of time.

Let me now switch to Consumer Lifestyle. Consumer Lifestyle delivered, as I said earlier, another quarter of strong performance, in particular in Health & Wellness. Consumer Lifestyle's comparable sales increased by 10%, and the reported EBITA margin improved by 70 basis points to 11.3%, despite ongoing currency headwinds, mainly in domestic appliances.

We are also pleased to see broad-based market share gains as we execute on our strategy to offer locally relevant solutions supported by strong marketing activation and an increasing share of online sales. Our Oral Healthcare business delivered double-digit growth, as we are steadily attracting new users while expanding distribution.

We also had a great quarter for new product launches. We introduced a host of new oral healthcare products at the International Dental Show in Cologne in Germany in March, and we are receiving excellent feedback on these products.

For example, the Philips Sonicare for Kids Connected toothbrush works together with an app designed to instill oral hygiene habits in children, while the Sonicare AirFloss Ultra is a new improved interdental cleaning device designed to provide an easy and effective way to clean in between teeth and achieve healthier gums in just four weeks.

By making our products connected, there is a future potential for data generation and integration into the cloud-based HealthSuite Digital Platform to ultimately provide total health and well-being solutions.

Finally, the new Philips Sonicare FlexCare Platinum, featuring the AdaptiveClean brush head, removes up to 10 times more plaque than a manual toothbrush. We believe that this is an area where we are uniquely positioned to drive overall market growth as we continue to build out our position.

In our successful beauty line, the Philips Lumea is now the market leader in 'intense-pulsed-light' hair removal in 14 countries and; building on the success in Western Europe, we are now entering the beauty store channel in China with Philips VisaCare and VisaPure.



We also continued to gain transaction with our Mother & Child Care line boosted by product marketing, including online, in-store and professional endorsement activation.

Let me now turn to lighting. Comparable sales in Lighting declined 3% year on year. LED-based sales grew 25%, and now makes up 39% of total Lighting sales. This was offset by a decline of 16% in overall conventional lighting sales.

We remain confident in our ability to capitalize on the long-term lighting trends with the strong sales growth and further margin improvements in LED. We are also pleased that lighting was able to improve its adjusted EBITA margin, despite the faster decline of conventional lighting and the unsatisfactory overall performance in China and PLS North America, which we are actively addressing.

We continue to proactively rationalize our conventional lighting operations to secure the attractive cash and profitability profile of our conventional business as we continue to navigate through a somewhat faster than expected decline in the conventional lighting space.

We had some exciting developments in the quarter. We introduced Philips Hue Phoenix, which is an adjustable luminaire, something our customers have been asking for; and the Philips Hue Go, a portable wireless luminaire. Both of these products feature all the smart connectivity features of the Philips Hue family.

Also, Los Angeles will start to manage its street lighting through an advanced Philips management system that uses mobile and cloud-based technologies. The Los Angeles Bureau of Street Lighting can now remotely control lighting fixtures using the Philips' CityTouch connected lighting management system, as well as monitor the energy use and the status of every light individually.

By embedding mobile chip technology in each fixture, the street lights can network instantly. This plug and play approach does not only reduce the cost of programming each fixture, it also reduces the time of commissioning from days to just minutes, and it eliminates on-site commissioning completely.

While CityTouch is already in use in more than 250 cities globally, the Los Angeles solution is the first of its kind that connects directly to each light point using the Philips CityTouch connector node, which can connect street lights from any manufacturer.

Let me now continue with an update on the Accelerate! program.

In the first quarter, we continued to enhance customer centricity and customer service levels to drive better cost productivity and faster time to market for our innovations. To give an example, our Male Grooming team was able, by deploying lean, to reduce lead times for development and launch of the new range of shavers by 30%. The team was able to simplify the End2End processes and re-use existing technology platforms.

As another example, in Lighting, we were able to significantly improve our time to market and successfully launched a new range of basic LED lamps in North America within in only four months and at an every-day low price of less than \$5.

Our productivity programs also continue to deliver strong support for our underlying operational performance improvements. In the quarter, we took out EUR19 million of overhead costs, EUR47 million of cost of goods sold, and our End2End productivity program achieved incremental savings of EUR37 million in the quarter.

And, finally, as you all saw, we announced an agreement with the consortium led by GO Scale Capital which will acquire an 80.1% interest in the combined LED components and Automotive lighting business. We will retain a 19.9% interest in the business.

We are pleased with the terms of the agreement, and we expect the transaction to close in the third quarter of 2015, once the required regulatory approvals have been obtained.

Philips' Lighting Solutions business will remain an important customer of the new company, which will continue under the name Lumileds, and we will continue the existing innovation and supply partnerships.



We are also making good progress with the separation process that will create two stand-alone fit-for-purpose companies that will focus on the attractive HealthTech and Lighting Solutions' markets respectively. We are working on creating the optimal infrastructure and on defining the right perimeters for each business, including tax and legal structure, real estate footprint and IT systems.

We have simplified the operating model for our HealthTech related businesses, and we strengthened our leadership team with several new people, including Rob Cascella joining us to oversee our cluster of imaging businesses. Rob previously was the CEO of Hologic, and built a strong track record in the healthcare industry, and brings a wealth of healthcare experience to Philips.

The transition of the Lighting business into a separate legal structure will take at least until the end of 2015 in order to be ready for the separation which is currently intended to be effectuated through an IPO in the first half of 2016. At the same time, we will continue to carefully review alternatives.

As previously indicated, we continue to expect total separation costs in 2015 to be in the range of EUR300 million to EUR400 million, and we plan to provide more information about upcoming milestones, the reporting structures, IG&S allocation, the route to market for Lighting Solutions, and detail all the separation costs through regular updates during 2015.

In conclusion, we are making good progress in improving the fundamentals of our operational performance, and our separation process remains on track; but we also recognize that we still have a lot of hard work to do.

For 2015, we expect modest comparable sales growth, and we continue to be focused on driving operational performance improvements to increase the EBITA margin. As such, our 2016 target trajectory, as announced in January, remains unchanged.

And with that, I would like to turn the call over to Ron to discuss our financial performance and market dynamics in more detail.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Thank you, Frans. I will now provide you with more detail on our financial performance for the first quarter, as well as recent developments.

Comparable sales in Q1 2015 increased by 2% to EUR5.3 billion compared to last year, and adjusted for currency and portfolio changes. On a nominal basis, total sales increased by 14%, driven by positive currency translation effects of 10 percentage points and 2 percentage points due to consolidation changes.

Comparable sales growth in Western Europe of 2% and stable sales in North America were offset by a 2% decline in other mature geographies, driven by a high single-digit decline in Japan.

Sector-wise in the mature geographies, Consumer Lifestyle grew high single digit, while comparable sales for Healthcare were by and large stable, and in Lighting, decreased low single digit.

In our growth geographies, comparable sales increased by 6% in the first quarter, driven by double-digit sales growth in Consumer Lifestyle, and high single-digit sales growth in Healthcare, which was partly offset by a mid-single-digit sales decline in Lighting, driven by challenging market circumstances in countries like China and Indonesia.

Now on order intake, after three quarters of a negative growth, comparable order intake increased by 3% in the first quarter compared to Q1 of last year. Order intake in the mature, as well as in the growth geographies, showed a low single-digit increase.

Western Europe delivered high single-digit growth, with particular strong performance coming from the Benelux, France and Spain. North America's order intake growth was low single digit, while Japan was down low single digit.



The order intake growth in the growth markets was most notably driven by Africa and India, which was offset by a low single-digit order intake decline in China.

On the shift from conventional to LED, in the first quarter, our LED sales increased by 25% year on year, and now represent 39% of total Lighting sales compared to 30% in Q1 2014. Sales of our conventional lighting portfolio declined by 16%. While profitability of the LED business continues to improve, the rapid shift from the relatively more profitable conventional base to LED creates a negative mix impact for the profitability of lighting overall in this period.

For the period 2015 until 2019, we expect the comparable compound average growth rate for our LED-based sales to be around the 20% level. During that same period, we estimate the comparable compound average sales decline of our Conventional business to be around the mid-teens level.

Let me now provide you with some additional on the EBITA development in the first quarter.

Slide 16 of the presentation material that we posted on our website this morning provides a good overview of the main drivers of adjusted EBITA when compared to the same period of last year. Adjusted EBITA was 6.1%, and it was 40 basis points lower than in Q1 of last year.

You will see that our underlying operational performance contributed 30 basis points to the margin expansion in the first quarter, which is a clear demonstration that our Accelerate! program continues to improve operational performance and drive efficiencies, supported by our three productivity programs, and let me sum these up for you.

Gross overhead cost savings amounted to EUR36 million year over year, but as we show the savings in this bridge, the net effect versus last year's period is slightly negative, as the increase in non-manufacturing cost was larger than the overhead cost savings.

This increase in non-manufacturing cost can largely be attributed to the already mentioned investments in healthcare informatics, personal health solutions, the Healthcare Incubator and quality.

Design for Excellence, or DfX, which is aimed at reducing cost of goods sold, delivered EUR47 million of savings year over year. Our End2End productivity program generated EUR37 million of savings year on year. These cost savings and the positive impact from volume and mix were able to more than offset wage inflation and a negative price effect of 230 basis points.

Now of the mentioned 30 basis points operational improvements, these were more than offset by a drop of 70 basis points driven by currency headwinds of 50 basis points and Cleveland costs of 20 basis points.

The overall more favorable currency developments have, as I mentioned at the beginning of my comment, grown the top line by 10%. However, at the EBITA level, the currency impact was essentially neutral, mainly due to seasonality in US dollar sales, coupled with a higher US dollar cost footprint. We also saw adverse swings in some emerging market currencies, most notably the Russian ruble and the Chinese yuan.

Bottom line, we generated a net income of EUR100 million in the quarter compared to a net income of EUR137 million a year ago. This decline is largely explained by lower operational earnings as a result of higher restructuring and acquisition-related charges and some other items.

Return on invested capital, which is calculated on a five-quarter MAT basis, was 4.1%. Excluding the Masimo provision in Q3 of last year, and the additional provision for ongoing legal legacy matters we took in Q4, the ROIC was 7.9%.

The inventory as a percentage of sales on a constant scope of consolidation increased by 250 basis points to 17.3%. The increase can largely be explained by currency impact and the production ramp up at the Cleveland facility.



In the first quarter, we had an outflow of free cash flow -- sorry. In the first quarter, we had an outflow of free cash of EUR443 million, including the final pension contribution of EUR171 million related to the de-risking of the Dutch pension plan. We will apply as a result of this, contribution pension accounting for the Dutch plan from the second quarter onwards.

Following our pension de-risking initiatives in the US in [2013] (corrected by company after the call) and the initiation of the de-risking of the Dutch pension plan in 2014, we will continue to evaluate our options to initiate additional de-risking initiatives in the course of this year in the jurisdictions where we still have substantial pension liabilities.

This is an ongoing dialog with representatives of the relevant pension funds, and it would be imprudent and tactically to our disadvantage to speculate on amounts. As with the preceding pension de-risking initiatives, we will only decide to spend money on de-risking if it meaningfully improve our long-term exposure position.

By the end of the first quarter, we completed 50% of our EUR1.5 billion share buyback program. We continue to take a disciplined approach to capital allocation that allows us to fund growth while maintaining a solid capital structure.

Looking ahead, overall market conditions continue to show a mixed picture. Overall, we expect global market conditions in 2015 to be similar to or slightly better than they were in 2014.

In the US, despite increased procedure demand driven by a solid increase in new healthcare enrollees since the Affordable Care Act was signed into law, the related uncertainties from the ACA and reimbursement pressures continue to weigh on equipment purchasing, pushing providers towards delaying new equipment purchases. CapEx in the US, therefore, is forecast to remain flat in 2015 versus last year, although new hospital construction is expected to grow by mid-single digit.

From a relatively strong 2014, expectations are tempered across Europe for flat to low single-digit growth in healthcare in 2015.

In China, headwinds related to the government's anti-corruption initiatives and efforts to favor domestic innovation will continue to impact the Chinese healthcare market in 2015. The Chinese healthcare market is, therefore, expected to grow low to mid-single digit, with the majority of that growth expected in the second half of the year.

Overall, we estimate the global healthcare market to grow low single digit in 2015.

The overall US construction market is expected to grow high single digit in 2015, of which non-residential construction is forecasted to grow around 10%. The Architecture Billings Index continues to point to growth in the non-residential construction market as well.

The Western European construction market is forecasted to grow by 2.4%, reflecting a slight improvement versus 2014, and largely driven by a slight pickup in non-residential construction. Nevertheless, overall sentiments and market expectations in Europe remain quite uncertain and vulnerable, so we remain cautious.

For IG&S, we continue to expect reported EBITA for full year 2015 to amount to a net cost of around EUR900 million. The increase versus last year is mainly driven by additional investments in innovation, higher overhead costs, a decrease in IP royalty income, the estimated separation costs of EUR300 million to EUR400 million, as well as approximately EUR50 million of restructuring costs related to the implementation of the Lean operating model, plus some other incidental items. On an adjusted EBITA level, this therefore implies a net cost of around EUR450 million.

Now let me briefly summarize before opening the line for questions.

Market volatility and uncertainty in various regions remains a concern to us in 2015. Currency movements are expected to contribute positively to profits in 2015. And overall, we anticipate operational performance improvements in all our businesses, and we expect to improve adjusted EBITA by at least 100 basis points, but expect this improvement to be backend loaded.

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). Phil Wilson, Redburn.

Phil Wilson - Redburn Partners - Analyst

My first question then. Can you comment on how the margin in the backlog of the healthcare equipment orders compares to the current healthcare equipment margins? And perhaps comment on that globally and then specifically for the US.

Thanks.

Ron Wirahadiraksa - Koninklijke Philips NV - CFO

Yes. Thanks for the question. It's a very good question. We do see some increased price erosion in the backlog. I would say maybe 1% to 2% above what we normally see and we normally communicate on.

So this is in the order book which will work itself through, depending on, of course, when the backlog turns itself into revenue. So more second half/beginning of 2016.

Of course, on the back of that, we're also continuing, as you have seen also on the bridge chart, cost reduction programs, our DfX programs and our productivity. So this is intended to offset that.

Phil Wilson - Redburn Partners - Analyst

Okay. And then, staying with healthcare, in China, you talk about a low single-digit decline for yourselves, but expectations for the market to grow low single digit. How is your market share trending at the moment in China?

Frans van Houten - Koninklijke Philips NV - CEO

Hi, Phil. Frans here. Indeed, we are seeing a small gap between the market growth outlook and our own performance. This is very much impacted by the temporary production stop in CT, which is in China a very big market. We expect to recover that as we are now shipping again, and we can over time, let's say, grow more in line with the market.

Phil Wilson - Redburn Partners - Analyst

Okay. And, sorry, I do have one final question just on lighting. In a letter to your shareholders in March, you stated that you'll probably only offer a minority interest in lighting on a solutions IPO to begin with. Can you give some sort of timescale -- I appreciate it's difficult, but some sort of timescale over what period you would expect Royal Philips to actually fully exit lighting solutions?



Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. In the circular, Phil, we describe various scenarios, of which the IPO is one possible scenario. If it is an IPO, then a phased floating is likely. Therefore, technically speaking, we will first float the minority interest gradually rising. How fast that grows is very dependent on market sentiments and opportunities. Of course, if we follow an alternate strategy maybe with a strategic buyer or private investors, that whole trajectory could go a lot faster.

So what you can derive from my answer is that the options are still open. And as we've signaled before, only later this year will we have a better light of sight as to the best strategy to give lighting access to capital markets during the first half of 2016.

Phil Wilson - *Redburn Partners - Analyst*

Is it your ambition to exit lighting solutions in full by the end of 2016?

Frans van Houten - *Koninklijke Philips NV - CEO*

I think it is our ambition to put Philips Lighting on its own feet with access to capital markets. At this time, we cannot put a timing on that as to when exactly we go to minority interest.

Phil Wilson - *Redburn Partners - Analyst*

Okay. Thanks very much.

Operator

Martin Wilkie, Deutsche Bank.

Martin Wilkie - *Deutsche Bank Research - Analyst*

Just coming on to the growth in healthcare, you obviously made some investments in the first quarter. I just wonder if you could clarify how you expect that to progress, because obviously, it was something of a margin drag; and whether that's a one or two-quarter thing that you've had to catch up to spur the order growth that you've seen this quarter, or whether that's something that could persist for a bit longer.

And related to that, also in that shareholder circular that you sent out, it did imply that a lot of the proceeds from lighting would be used to invest in growth for healthcare. And just to clarify. Is that largely acquisitions? Are you going to be making a lot of other organic investments with those proceeds? Just if you can clarify what you meant by those investments in healthcare growth that you might need to make using the lighting proceeds.

Thanks.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right. Hi, Martin. Well, let's first talk about healthcare and the first quarter. We saw various impacts on the results in the first quarter.

First of all, healthcare was impacted by currency headwinds as one of the sectors with a larger exposure. Secondly, we see ongoing costs related to improving our quality management system in Cleveland, as well as in a number of other sites. Thirdly, versus early 2014, we did step up investments

in the healthcare informatics area, which we think is an important growth area as well as enabling us to participate on a more strategic level with the healthcare providers.

The cost, or the investments, are of a nature that they will stay with us for a longer period of time, of course, gradually earning their return. But as such, they should not be seen as a one-off that's only in the quarter.

Also, I'd like to remind you that from a quality remediation point of view, the step-up in investments in Cleveland started really in Q2 of last year and, therefore, the first quarter is relatively unfavorable from a comparison point of view.

I'm positive about growth opportunities in healthcare and in health technology overall. This is also why we feel that it is justified to make these investments. The HealthTech market is expected to be strong in the coming years as both consumers and healthcare providers realize that technology can drive for better outcomes at lower cost.

That maybe bridges also to your question on the lighting proceeds. It's really early days. We are talking about a 2016 event. We will carefully consider the use of those proceeds against our capital allocation policy. It may include acquisitions, although we will apply careful yardsticks to judge such acquisitions.

Maybe while I'm on the topic, and anticipating a question around the capital allocation of the proceeds of Lumileds, which may come in expectedly in the third quarter, there we have flagged before that we see first the repayment of the bridge loan that we put for the Volcano acquisition; and secondly, that we have the ongoing share buyback program; and thirdly, that we foresee considerations around further pension de-risking as topics that are high on the priority list. And then I think we'll take it from there.

Martin Wilkie - *Deutsche Bank Research - Analyst*

Thanks. So just if I think about the margin progression in healthcare, obviously, we understand that the Cleveland costs follow a -- you've guided that currency becomes a benefit in the second half. But given these growth investments persist, the margin target in healthcare still seems quite a challenge given where you are in the first quarter.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, Martin. I would agree with that. We are going to be backend loaded. I think there is significant improvement possible and we will make that happen. We have guided for the total Philips Group. In January, we said that we are trailing 100 basis points behind on our 2016 target, both on growth as well as profitability and ROIC.

Obviously, that is the Group result, which is a weighted average of Consumer, Lighting and Healthcare, with healthcare being behind, and actually, Consumer performing very, very well. You saw in the first quarter also lighting improving its profitability despite the challenge on the top line. So that is a mixed situation, and I think in that light, you should also see the ramp of healthcare.

Martin Wilkie - *Deutsche Bank Research - Analyst*

Okay. Perfect.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Also, Martin, this is Ron. So to add to Frans' point, bear in mind that we foresee for the year EUR100 million improvement from Cleveland, just to help you understand it.



Martin Wilkie - *Deutsche Bank Research - Analyst*

Okay. That's helpful. Thank you.

Operator

Andreas Willi, JPMorgan.

Andreas Willi - *JPMorgan - Analyst*

My first question is on pricing and FX, and also pricing related to healthcare in Q1 which you mentioned earlier. Your price pressure year on year offsets more than your cost savings. Is that just what we should expect as the normal going forward? Or is there more you can do on pricing, particularly also to offset foreign exchange transaction headwinds?

We've seen other companies basically expecting or having the ambition to offset FX transaction headwinds in some of the markets where they import with a dollar base cost to basically recoup that from price increases. Is that something you hope to be able to do this year?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, Andreas. Thanks for the question. This is Ron. Yes. So of course, besides the hedging, but hedging is always temporary, we do focus on price increases where possible, what's also depending on the competitive circumstances, and also manage costs accordingly.

For healthcare of course this year, we also have significant improvement in the cost around Cleveland, and we expect some ramp in the volume to contribute. So those we expect to offset so that the margin will not be entirely -- or the cost improvement will not be entirely eaten up by price declines.

On your question in general on ForEx, yes, if you look at the ForEx pressure, we're seeing the 10% on the top line. And as I explained in my prepared remarks, just because the footprint in the first quarter, typically driven by revenue and cost footprint in dollar, plus seasonality on the back of that, the first quarter didn't look that great; and the dollar was, for us, therefore, a headwind within the EUR3 million that we anticipate. But we're taking various measures to offset this.

And go-forward, on the ForEx, we expect for the full year positive contribution for ForEx at current prevailing rates for the full year, as I said. And the margin, probably it will be flat.

Andreas Willi - *JPMorgan - Analyst*

So for the profitability, we should expect the Q1 headwind to basically be fully compensated as we go through the year?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. That is correct.



Andreas Willi - JPMorgan - Analyst

Yes. And my follow-up question on North America, professional luminaires, you still seem to struggle there in overall very good market. There was earlier hope that you will be back on track as we go into 2015. What should we expect there now? Is that still going to happen this construction cycle in terms of you fully participating in it?

Frans van Houten - Koninklijke Philips NV - CEO

Yes. That's right, Andreas. We are facing some difficulties there. We did intervene in the leadership late last year with Amy Huntington taking the position. She knows the customer base very well and we think that that will help us restore confidence.

Technically speaking, I think we have done a lot to improve our performance in North America. We have upgraded the IT systems. We've consolidated factories. We have upgraded the product range.

The product range is very competitive. You could also see Los Angeles choosing the Philips street lighting with CityTouch. It's a sign of confidence in our competitiveness from an innovation point of view.

So we relate the slowness in recovery very much to a customer confidence and relationship aspect where we hope and expect to make progress during this year and thereby still being able to benefit some of the market sentiment that is going on there. Of course, we have to work very hard to recover market share.

Now while we are on the topic of North America, I'd like to point out that our LED lamps business is doing very, very well, growing more than 26% in the quarter. We believe that we have a very competitive LED lamps range. And not only is the top line improving, but the bottom line is improving as well.

So therefore, North America, mixed picture all in all, much more work to be done on the professional luminaires side.

Andreas Willi - JPMorgan - Analyst

Thank you very much.

Operator

Olivier Esnou, Exane.

Olivier Esnou - Exane BNP Paribas - Analyst

The first question, please, would be on the lighting side. Part of the challenge the past few years was that conventional decline was always a bit higher than market participants believe, and I saw you increase now on the decline going forward, that the current rate is already somewhere a little bit ahead.

So can you maybe comment on what's driving the current rate of decline currently, which is a bit faster than you expected; and what makes you confident that it's going to trend now towards your new medium-term guidance?

Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Hi, Olivier. Indeed, the conventional decline has been edging up over the last year, and you saw that in the first quarter at 16%. 39% overall of our sales is now already in LED. And, of course, as that goes up, the relative base of conventional is going to be lower and, therefore, the decline will also start tapering.

We do believe in a long tail of lighting sockets that will continue to use a conventional bulb. We are able to manage our cost base better than our competitors. We think that our margins are strong so we continue to believe that conventional lighting has a strong positive cash flow profile.

So I think we now have a realistic view on the average of the decline over the next years. Of course, within that timeframe, you can still have quarters that are relatively higher or lower. But on average, I think that guidance we feel comfortable with.

Olivier Esnou - *Exane BNP Paribas - Analyst*

Thank you. Maybe as a follow-up, in terms of going to the market with the lighting business, there are some other market participants that are planning to do similar things, and I was wondering. In terms of the profile of lighting now, which is mostly general lighting, do you think it's the right portfolio, or is there a scenario where you would consider maybe allocating some capital for M&A, even in lighting, ahead of an IPO? Maybe some thoughts there.

Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. I'd love to talk a bit about the strategy in lighting. As you know, we made a separate transaction in the first quarter on what we call lighting components, the LED components in lumileds. And we did that for the reason that we believe the components business will need to consolidate going forward. And Lumileds standalone has the best possible opportunity to participate in the industry consolidation. So that was, for us, a very important strategic step and we expect that to be very value creating.

At the same time, we have strong confidence that the value and profit pool will be more downstream, as we call it, more focused on the lighting applications and the lighting systems. As bulbs will gradually go down and lighting fixtures and luminaires will have integrated light sources, we will also see the emergence of what we call smart and connected lighting, and Philips is very strong in that place.

For the consumers we have the Hue lighting family. For the professionals we have smart street lighting. We have smart office lighting. We have city beautification lighting. And we can see that the margins are higher the more complete offering and systems we provide.

So in other words, we are excited about the profit pool in the downstream market. And Philips already has 40% of revenue in that downstream lighting marketplace. So we feel that we are well positioned, and maybe ahead of some competitors in anticipating the shift of the profit pool to the application side.

Now when is enough enough? And to your point should we consider, besides organic growth in lighting solutions, also non-organic growth? I think we never will exclude that. You may recall the acquisition we did in the Middle East in Saudi in order to strengthen our profile there. I think this is one of the reasons why Lighting Solutions as a standalone company with access to capital markets will have the opportunity and agility to participate in that market appropriately is an attractive strategy going forward.

So with that, I'll leave it at that, because we should not get ahead of ourselves. We don't exclude it.



Olivier Esnou - *Exane BNP Paribas - Analyst*

Thank you.

Operator

Gael De Bray, Societe Generale.

Gael De Bray - *Societe Generale - Analyst*

The first question is on the targeted margin improvement for this year. Based on the Q1 release and the 0.3% underlying operational margin increase you've achieved, it seems really you're running behind the targeted 1% improvement for 2015. So what do you see really in the coming quarters maybe division by division that will help you catch up with the guidance?

And the follow-up question would be on the Volcano integration. What's the current margin level for the business? And how is the integration progressing? Maybe more generally, what did you find at the business that was maybe pleasing; or maybe not that good, as good as anticipated?

Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right. Well, Ron will start with your first question and I will follow up with your second.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. Thanks, [for that]. It's a very good question. So on page 50 of the deck, of the IR deck that we publish, there's this bridge that takes you from 2013 to 2016. So when we said last time 100 basis points, that's half of the operational improvement, if you will. So that's a good observation.

Now how is it going to work? Because it's more back-half loaded, as we always said, particularly also driven by the strong improvement in the Volcano -- sorry; in the Cleveland ramp. I don't know where that came from.

So the Cleveland ramp, that is EUR100 million improvement. That is significant. As I also said earlier on a question that was asked, ForEx tailwinds will help us more in -- particularly the second half at prevailing rates and will drive further operational improvements.

So our overhead reduction program is well on track. Our productivity, we should push it a bit more up. And also, in our DfX program, we have ample opportunity to drive more margin improvement. And, of course, bear in mind that we expect contribution from volume.

So overall, we do believe that the 30 basis points on operational improvements, and I know that ForEx is outside of that but the rest is in, looks a little bit bleak; but you have to also bear in mind that Q1 is typically a very low season quarter.

Gael De Bray - *Societe Generale - Analyst*

Can I have a follow-up just on that, the EUR100 million for Cleveland? Is that on an adjusted basis or on a reported basis?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

It's on a reported basis. So the EUR100 million improvement, first there's the EUR225 million that you saw last year. That's EUR125 million. So there was EUR50 million inventory write-off that we don't have this year. And the rest is between systems and consulting and remediation costs.

Gael De Bray - *Societe Generale - Analyst*

So on an adjusted basis, it's closer to EUR50 million/EUR60 million, right?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. That's correct.

Gael De Bray - *Societe Generale - Analyst*

Okay. Thanks.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right, Gael. Then let me come then to your second question, which is the Volcano integration. As everybody knows, we closed that transaction in February, so it's relatively early days to talk about it.

Basically, we didn't find surprises. It was as per our expectation. Performance-wise, on an adjusted EBITA basis, the Volcano performed flat, to expectations. We had significant deal-related costs in the first quarter, transaction-related costs, as expected by the way.

And going forward, we anticipate the integration to go well. There's a very positive sentiment all across, from customers, employees on both sides, Volcano and Philips, as to what is possible to integrate Volcano's technology further with our cath labs, driving more holistic solutions for our customers in minimally invasive surgery. So we are very positive about the outlook and we will work on all the integration issues diligently.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - *Morgan Stanley - Analyst*

I have a couple, again, I guess relating to the trajectory in healthcare. I have to say, I was surprised that the margin decline year over year was as big as 3.5 percentage points. And I know, Ron, that you've qualitatively addressed this ahead -- earlier in the call. But is there any way you could give us a rough idea in that 3.5 percentage points how much is due to investments, how much is due to regulatory costs and how much is due to FX?

Is the vast majority of this investment related going forward, so we should think that there's going to be 2 percentage points plus of headwind. Can you clarify that a little bit more?

The second topic which -- and it's very good that we've now got a clear price indication in the margin bridge, but could you talk just very generally, and maybe this is one for Frans, about the discounting and the pricing strategy that you are using at Cleveland in order to reenter or rebuild that order backlog in the US imaging market?



How big are the price discounts that you're having to offer? And is this just confined to CT, or is this something that's going to play out across the whole imaging portfolio over the remainder of the year?

And then final question, and again, it's going back to the order intake overall, I noted that whilst overall healthcare orders were up, the actual imaging intake in -- sorry. The order intake imaging specifically was flat. How much --? Can you give us an idea what happened to your imaging intake in the US and what happened in China; i.e., was it the case that the US is actually now picking up and China is offsetting it? Or is it the fact that we're not getting the imaging orders yet coming through in the United States?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Okay. Thanks for the questions. The second question, as you directed, go to Frans, so I'll take the first one.

So you asked about the 3.5% or so of difference in adjusted EBITA. Of course, we saw some positive volume impact, but then, as we also already indicated, there was an offset with the pricing, the slightly higher price erosion, that is partly in the order book and a small part of it already in Q1.

If you then look at our investments, I would say that the investments are about 200 basis points difference. ForEx is about 70 basis points. I would say Cleveland is 40 basis points. You saw Cleveland depicted. That's how I would break it down.

Ben Uglow - *Morgan Stanley - Analyst*

That's very helpful. Thank you.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. And the 200 basis points is between, as Frans indicated, the Q&R and investments in some of our businesses to further the health continuum, particularly digital platform construction.

Ben Uglow - *Morgan Stanley - Analyst*

Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Hi, Ben. Let me give you a bit of color around what you ominously called the discounting. We look at it slightly different, of course.

First of all, I was pleased to see in the United States a positive order intake in the quarter. If you dissect that, then imaging was still negative, indicating that we still have more work to do to regain confidence with our customers.

Certainly, pricing is not the only weapon we have. We have some very exciting products coming into the market later this year. The Vereos Digital PET and the IQon spectral CT are both products that are heavily talked about by leading thought-leader hospitals, and they would like to get their hands on that. And both are slated to be shipped after the summer.

I think that will help also on the recovery, while we still have a lot of work to be done.

That's the big iron. On the -- still on imaging but then more on the ultrasound side of the business, that's going very well. And we believe that we have a very strong ultrasound portfolio lineup that will help us drive a recovery in the United States market.



China. Overall, China market has slowed down significantly. It's now expected in the low to mid-single-digit growth area, also held back by anti-corruption measures of the China Government.

Within that market, CT is a very important modality, and obviously, we have suffered quite significantly due to the fact that we couldn't deliver certain products whereas China expects usually deliveries within three months after order. So you can imagine that as we were not able to give last year any confidence about that ability to deliver, that we have taken a hit on orders.

We do see that now picking up again. Back to your point on pricing, and I think as Ron alluded to that as well, in the sales in the first quarter, price erosion was already edging up a little bit, but maybe still in the usual 3% to 4% range for equipment.

Going forward, for imaging modalities, we probably see that a little bit higher than that when we look at orders coming in in the near term. And I would say that is then across the diagnostic imaging at large.

Yes. I think I've covered then most of it. Did I miss anything Ben?

Ben Uglow - *Morgan Stanley - Analyst*

That's a very transparent answer, but let me push you one more time. Does that mean --? And I don't want to use the ominous price/discounting terminology, but does that mean that you are --? I guess my question is: You need to rebuild the order book, in the US imaging in particular. Does that mean that the sales guys and the infrastructure is going to have to be more aggressive in 2Q than it was in 1Q? I'm just really talking here about US imaging.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. There are so many effects going on at the same time in the US, more enterprise-level selling, larger bundled orders that you really cannot talk about a Cleveland effect, per se.

Overall, imaging is a very important market segment for us and we do want to make sure that we participate in that consolidating market. We think that -- we look at the imaging not just from an equipment sale point of view but also with all the service income that is associated. And we take our decisions on an integral, total cost of ownership level, and we believe it's an attractive business to pursue.

Ben Uglow - *Morgan Stanley - Analyst*

That's very helpful. Thank you.

Operator

Fredric Stahl, UBS.

Fredric Stahl - *UBS - Analyst*

I was just curious on the 6% growth you posted in growth geographies. Where did that come from? If you can give us some more color. I'm just thinking with the background of Russia, weakness in China and elsewhere, if you could give us some more information there.



Frans van Houten - *Koninklijke Philips NV - CEO*

Okay. Ron, can you take that, please?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Your question is on the growth geographies, right?

Fredric Stahl - *UBS - Analyst*

Yes, exactly; the 6% like-for-like growth.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So India had really good growth for us. It was particularly driven by healthcare; also in Consumer Lifestyle very good.

In Brazil, we saw a slight decline, particularly on the back of healthcare. As you know, the Brazilian economy is not in the best of ways, so we've seen some muted order intake. I think that provides for a not too great environment there in Brazil, while Consumer Lifestyle is actually growing, and also lighting grew very well in the geography.

If I look at countries like Indonesia, Singapore and what have you, all grew. I have to say that Argentina, which of course last year was not a great year for Argentina, experienced very high growth, so that was very good.

As we said, Russia was not in the best of ways, as Frans already alluded to. But we can also see that Ukraine and Kazakhstan, for example, they grew very well.

Then you have countries like Egypt, for example, where we still saw some growth in lighting. But unfortunately, in lifestyle and healthcare, it was a bit down.

I think those were some of the important call-outs I would make. Is that sufficient for you.

Fredric Stahl - *UBS - Analyst*

That's fine. Thank you very much.

Operator

Margaret Paxton, Nomura.

Margaret Paxton - *Nomura - Analyst*

Just one question from me on lighting, please. Could you talk a little bit more about the conventional decline? I know that you touched on it with Olivier's question, but what caused the acceleration? Was it more pronounced than lamps or luminaires? Is it simply a product of energy prices coming down, or is it something else?

And given the decline was quite far removed from the 10% decline you had previously expected, are you having to step up restructuring compared to what you were planning at the Capital Markets Day last year? I think you said that you expected restructuring costs of between 1.6% and 1.9%

of sales over the next three years. Is it now likely to be higher? And realistically, can you keep that adjusted EBITA margin stable or improving given what's going on here?

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. Hi, Margaret. I will start with the first part and then maybe ask Ron to talk about the restructuring outlook.

In the conventional market, we see a couple of effects coming at the same time. First, of course, the one-for-one replacement of conventional bulbs by LED bulbs, LED bulbs now being in such a price range that also for consumers they are within reach. We hit, in the United States, a price point without subsidies below \$5.

On the professional side, the refurbishment of conventional light points to LED light points has already happened to a large degree. And there, we see a second effect coming that the lifetime of a LED lamp is much longer than the lifetime of a conventional lamp. Thereby, the replacement cycle of LED lamps starts to have its effect on the overall marketplace.

Indeed, the decline of conventional is a bit steeper than originally anticipated. We have adapted our modeling. We are stepping up the restructuring.

And maybe that's a good moment to bridge to Ron to talk about how we restructure, while maintaining the positive cash flow outlook for our conventional lighting business.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. Well, I'll be specific on it. So I think for lighting, restructuring conventional wind-down, we expect EUR100 million to EUR125 million for this year. Bear in mind that it was last year, EUR175 million.

As you know, this comes in sometimes chunky or clunky. I don't know what the right word is. But this at this moment is the best estimate that we have.

And I want to add a little bit further to what Frans said. Bear in mind that we are also in luminaires. Of course, this is a key area in fact where conventional wind-down goes much faster than in conventional lamps only. That's good to remember when you look at the Philips portfolio. And that's a good thing, we feel, because that drives more of the higher economic, very attractive professional propositions.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. That's a great point, Ron. And indeed, on the professional luminaires side, the profitability of LED luminaires is better than conventional luminaires. So as such, we are quite pleased there with the shift to the LED part of our portfolio.

Margaret Paxton - *Nomura - Analyst*

Okay. Thank you very much. So just to clarify, you're saying that the luminaires decline is faster than the lamps decline?

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes. That's right. Let's say in lamps, you still have the cycle for replacement, whereas if somebody puts in a new luminaire, you're no longer going to put in a luminaire that's conventional. You basically shift to LED luminaires straightaway.

Margaret Paxton - *Nomura - Analyst*

Okay.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

In particular for professional -- sorry, Frans, just one more point -- it's very good, because as we also talked about in earlier interactions, the margin for professional in LED is far above the conventional one.

Margaret Paxton - *Nomura - Analyst*

Okay. Thank you very much, gentlemen.

Operator

Unfortunately, we only have time for one more question. Alfred Glaser, Oddo.

Alfred Glaser - *Oddo Securities - Analyst*

I had one question on China, please. Could you be a bit more specific on price evolution in the different businesses and the different divisions in China?

And then I also wanted to ask you on free cash flow. Q1 has been hit by a number of one-off effects. Could you give us a feel about what the underlying cash generation could be in 2015?

Frans van Houten - *Koninklijke Philips NV - CEO*

Sure. Let me take the first and Ron the second.

Price evolution in China. In healthcare, it follows the same discussion as I gave Ben Uglow for the United States market where we see in the imaging modalities the price erosion edging up a little bit above the usual 3% to 4% also on the back of bulk orders across hospitals in certain municipalities.

In lighting, we see a significant price erosion, and that's driven by LED. Again, similar pattern globally; there's quite some competition out there. Nevertheless, we are able to improve margins, as demonstrated in lighting.

And then in the consumer area, the price erosion is actually very modest, because you can see that from the bridge globally but it also applies to China, where we are, in fact, able to bring out exciting new products all the time offsetting any price erosion in any given category, and thereby maintaining and even expanding profit margins in Consumer Lifestyle.

I'll look to my right to Ron to talk about the first-quarter cash flow discussion.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Okay. So the cash flow for last year was a bit muted. If you look at Q1, free cash flow, as we said, EUR443 million. There was -- if you adjust for the pensions, for the CRT, then you actually talk about plus EUR37 million.

So free cash flow for the full year normally follows the EUR1 billion to EUR1.3 billion on an operational free cash flow basis. That will be somewhat more muted this year. As we said, we are also looking at pension de-risking. We have to invest a little bit in working capital. And we have the [separation] (corrected by company after the call) costs, of course, on the back of that.

Alfred Glaser - *Oddo Securities - Analyst*

Okay. Thank you very much.

Operator

Okay. Thank you, Mr. van Houten and Mr. Wirahadiraksa. That was the last question. Please continue.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right. Well, good. I'd like to share a few closing remarks.

I characterize the quarter with the word progress. It may not feel to you all like that, but nevertheless, we feel that we are on the right path. We are encouraged by sales growth and order intake growth in healthcare. We are able to show strong performance in lifestyle, improving margins in lighting. And we think we're on track to deliver modest comparable sales growth while improving the adjusted EBITA margins for the Company with at least 100 basis points.

We think that there are good things in the pipeline for Healthcare, even though we [took] many of your questions in Q1. But it's work in progress, and as such, our 2016 target trajectory, as commented on in January, remains unchanged.

Thanks very much for joining us in this call, and hopefully, we will see you soon at one of the conferences going forward.

Operator

Thank you. This concludes the Royal Philips first-quarter 2015 results conference call on Tuesday, April 28, 2015. Thank you for participating. You may now disconnect.

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