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PHIA.AS - Q2 2014 Koninklijke Philips NV Earnings Call

EVENT DATE/TIME: JULY 21, 2014 / 8:00AM GMT

OVERVIEW:

Co. reported 2Q14 sales of EUR5.3b, and net income of EUR243m.



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PRESENTATION

Operator

Welcome to the Royal Philips second quarter results 2014 conference call on Monday July 21, 2014.

During the introduction hosted by Mr. Frans van Houten, CEO and Mr. Ron Wirahadiraksa, all participants will be in a listen-only mode. (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. Good morning, ladies and gentlemen, and welcome to Philips' second quarter result 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 financial and strategic highlights for the period. Ron will then provide more details of 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 7.20 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 two things.

Following the decision in Q1 2013 to sell the Audio, Video, Multimedia and Accessories business, or the AVM&A business, we report a profit and loss on this business under discontinued operations, and the net assets for the business in the balance sheet on the line assets held for sale. The cash flow of the Audio, Video, Multimedia and Accessories business is reported under cash flow from discontinued operations.

Therefore, all commentary that will follow in terms of sales and earnings, at both the Group level as well as at the Consumer Lifestyle sector level, does not include the AVM&A-related information.

On June 29, 2014 the sale of this business to Gibson Brands was completed.

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*

Thanks, Robin. Good morning, and thank you for joining our second quarter 2014 conference call.

As you will have seen in our press release, we achieved stable comparable sales growth at EUR5.3 billion, with encouraging top-line results in growth geographies, where sales increased by 4%.

As expected, continued challenging market dynamics in the US, China, and certain other emerging markets, as well as unfavorable currency exchange rates, and the voluntary suspension of production at the Healthcare facility in Cleveland, impacted our results, as we focused on continuing to improve our fundamental performance.

EBITA was EUR415 million compared to EUR601 million in the second quarter of 2013. Excluding restructuring and acquisition-related charges, EBITA was EUR449 million, or 8.5% of sales compared to 9.4% of sales in Q2 2013.

Net income amounted to EUR243 million. It was helped by lower tax expenses, for which Ron will provide more detail later on this call.

While we were encouraged by some positive trends in each sector, and our operational performance is improving, we are not yet satisfied with these results. We are taking further action to increase profitability, as I will discuss in a moment.

Let me give you first a high level overview of the performance per sector, starting with Healthcare.

Ongoing softness in certain markets, unfavorable currency exchange rates, and the voluntary temporary suspension of production at the Cleveland facility continue to impact our performance this quarter, with a 4% comparable sales growth decline, and a low single-digit decrease in currency comparable orders.

Geographically, we saw strong order intake in Europe, to growth geographies, and most notably China, while order intake in the United States was down by double-digits, reflecting challenging market conditions and the production suspension at the Cleveland facility.

The remediation program at the Cleveland facility is progressing according to plan, and shipments are expected to resume gradually over the course of the third quarter. The gross cost associated with the facility closure and the corrective actions amounted to EUR51 million in Q2 compared to EUR32 million in the first quarter.



In line with previous guidance, we anticipate the total negative effect on EBITA for the year to be in the range of EUR60 million to EUR70 million, helped by partial recovery of sales in the first quarter that we were not able to generate during the production suspension.

As you will have seen in our July 8 press release, we are implementing a new leaner Healthcare management structure, bringing the three main businesses into the heart of Philips. With the aim to improve performance and respond better to customer demands, step up operational excellence, improve entrepreneurship, and speed up innovation to market.

We are confident that significant performance improvements are achievable over the next quarters, albeit that these are backend-loaded in the timeframe towards the 2016 objectives.

It is clear that we have a lot of work ahead of us in Healthcare, and our aim is to deliver a reported EBITA performance in Healthcare in the second half of the year that exceeds the level of the second half of 2013.

This pickup in performance will be back-end loaded and remains dependent on the speed at which we execute our recovery plan in Cleveland and our organizational restructuring.

Strategically we are very well positioned for future growth in Healthcare. There are significant opportunities for Philips to deliver connected solutions across the continuum of care from prevention, diagnosis, and treatment, including image-guided interventions and therapy, to monitoring and aftercare in the hospital, as well as in the home.

Our integrated solutions and systems in both professional care facilities and in peoples' homes make us an attractive partner for hospitals and health systems, which positions us to create more multi-year partnerships with medical institutions, such as the recently-announced partnership with the new Karolinska University Hospital in Solna in Sweden.

In Consumer Lifestyle we have shifted our portfolio to align our devices and solutions with the burgeoning trend toward making healthier choices every day, thereby increasing wellbeing and productivity of people. We are well positioned to capitalize on the increasing demand in growth categories and end markets, as evidenced by more than 10 consecutive quarters of strong comparable sales growth.

Consumer Lifestyle comparable sales increased by 7% in the quarter, with high single-digit growth in Domestic Appliances, and double-digit growth in Health & Wellness.

We are expanding our market reach and see strong potential in increasing connections to Healthcare, for example, in oral care, personal care, and mother-and-child care. We recently introduced the Philips' VisaCare and VisaPure Man facial cleansing brushes, which is a rapidly growing segment, particularly in Asian markets, such as Korea.

We also see strong potential in the digital opportunity, which we are capturing through our growing online presence, as well as our offering of connected products.

In Lighting, performance has been under pressure due to recent sales' trends and higher restructuring costs. We are taking decisive actions to improve profitability and increase focus on higher growth markets by accelerating the drive to LED, focused on connected LED lighting systems and services for professional consumer markets while, of course, treating performance gaps with the highest focus.

Our decision to combine the Lumileds and Automotive Lighting businesses into a standalone company within Philips will allow it to extend its leading portfolio of digital-lighting components and achieve robust growth, serving even more customers in the industry, as well as, of course, Philips Lighting. We expect this step to create significant value.

At the same time, our remaining Lighting sector is taking advantage of the many opportunities in the growing LED products, systems and services space, driven by increased demand for energy efficiency, as well as the versatility of digital lighting controls.

In the second quarter, our LED sales increased by 43% year on year, and now represent 36% of total Lighting sales, compared to just 25% a year ago.

Our connected LED lighting systems and services are embraced by customers throughout the world, as demonstrated by our recently-announced partnership with Football Club Bayern Munich and its Allianz Arena that will make that stadium the first in Germany, and the largest in Europe, to feature a dynamic light show made possible by hundreds of thousands of energy-efficient connected LED lights.

The successful shift to LED caused Conventional Lighting to decline by 13%. Overall, the Conventional Lighting decline is no surprise, even though we will see some fluctuations market by market and quarter by quarter.

The important thing to remember is that we have been preparing for this golden tale. We are confident that we will offset this impact with our higher-margin LED solutions; ongoing rationalization of our conventional manufacturing footprint; as well as the additional actions that we are taking to align our overall cost base.

In that context, we plan to increase the restructuring charges in the Lighting sector in the second half of the year from EUR100 million to approximately EUR170 million, as we accelerate, or pull in, some of the manufacturing footprint rationalization initiatives that we had been planning all along.

We have strengthened the fundamentals of our Consumer Luminaires business in Europe. And our goal is for this business to be break-even for the full year. Our cost base and product portfolio, have been optimized. And this business will start to deliver better returns as macro trends improve.

The turnaround in our Professional Lighting Solutions business in North America is also on track. The restructuring initiatives have been largely implemented, such as our new go-to-market model; the rationalization of the product portfolio; and the implementation of the new SAP solution to support the sales function better.

As a result, we expect to see significantly improved quote response times, and more reliable delivery to customers going forward. Our agents and direct markets will be measured on their clean order performance.

Accordingly, the first signs of improved sales' momentum that we saw this quarter are expected to continue in the coming quarters. We can confirm improved sales' performance versus last year in Q3, and a return to profitability in the second half of the year.

All in all, we have a comprehensive Lighting offering with the agility to adapt to end-market demand, and continue to be on track to gradually improve performance.

Our three cost-saving programs are progressing well. Let me remind you, the overhead cost savings were EUR34 million for the quarter, bringing the cumulative annualized overhead cost savings realized in the first half of the year to EUR190 million.

The second program, the Design for Excellence program, generated EUR44 million of incremental savings in cost of goods sold in the quarter.

And the End2End productivity program, that's the third program, generated EUR5 million of savings next to other benefits, such as improved customer service, and higher growth.

With these actions, we are delivering on our promise to improve operational and financial performance Company-wide, as we transform Philips into a leading technology company in the areas of Health & Wellbeing.

Before turning the call over to Ron, I want to stress that we are working diligently to deliver the substantial potential of Philips, and to significantly improve the operational and financial performance of the Company.

Our strategy is progressing in each of our key markets with Accelerate! initiatives driving a solid innovation pipeline, profitable growth, and Company-wide focus on improved operational excellence and productivity.



Our actions in all three sectors in the quarter, the implementation of a new management structure in Healthcare; the start of the creation of the standalone Company consisting of Lumileds and Automotive; the sale of our AVMA business, demonstrates that we are firmly committed to ensuring that our organization, as well as our portfolio are optimally structured to capitalize higher growth opportunities across our business.

While 2014 is expected to be a challenging year overall, and we still have a lot of hard work to do, we expect EBITA for the Group in the second half of the year, excluding restructuring and acquisition-related charges and other items, to exceed the level of the same period of last year, as we resume operations in our Cleveland facility and continue to realize the benefits of cost controls.

We look forward to seeing you at our Capital Markets Day on September 23 in London, where we will provide more details on the next strategic and operational steps in our multi-year Accelerate! journey.

With that I would like to pass the call over to Ron.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Thank you, Frans. I will now provide you with some more detail on our financial performance for the second quarter, and some recent developments.

Comparable sales in Q2 2014 were flat when adjusted for currency and portfolio changes. On a nominal basis Group sales decreased by 6% due to negative currency translation effects of 6%.

Comparable sales in Western Europe were by and large flat on the back of relatively stable sales in Healthcare, and low single-digit sales growth in Lighting and Consumer Lifestyle.

Sales in North America declined mid-single digit on a comparable basis, as Healthcare sales declined high-single digit and Lighting declined low-single digit. Consumer Lifestyle delivered low single-digit growth in North America.

The other mature geographies delivered low single-digit comparable sales growth.

In our grow geographies, comparable sales grew by an encouraging 4% in the second quarter, driven by a double-digit growth in the majority of these grow geographies, which was partly offset by declines in countries like Russia, China and Thailand.

Sales generated by the grow geographies represented 37% of total sales, in line with Q2 of last year.

In Healthcare, comparable sales in the grow geographies decreased low-single digit in the quarter, mainly driven by sales declines in China and Russia. Comparable Healthcare sales in the mature markets were down mid-single digit.

Western Europe showed flat sales growth with strong growth coming from countries like the UK, France and Spain, while countries like Germany, Italy and the Benelux witnessed sales declines.

In North America, comparable sales were down high-single digit in the quarter, partly due to market weakness.

In Consumer Lifestyle, comparable sales in the grow geographies increased double-digit in the quarter. This was supported by most markets and most notably, China, India and Brazil.

Sales in Western Europe and North America were up low-single digit, while the other mature markets recorded mid-single-digit growth in the quarter, with continued strong double-digit growth coming from Japan.

In Lighting, our grow geographies, excluding the OEM, Lumiled sales, showed a low single-digit decline, which can largely be explained by challenging market conditions, specifically in conventional in China, as well as in Indonesia.

Sales growth in the mature markets was flat as low single-digit growth in Europe was offset by a similar low single-digit sales decline in North America.

Let me now provide you with some additional detail on the EBITA development in the second quarter. Slide 17 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 last year.

We believe that this illustrates how we are benefiting from improving operational performance and increased efficiency, as we continue to execute on our Accelerate! program.

As you walk through the adjusted EBITA bridge you will notice that operational leverage positively contributed 180 basis points to the margin development in the second quarter. This healthy performance continues to be supported by our three cost-savings programs.

Overhead cost savings amounted to EUR60 million year over year, while DfX, which is aimed at reducing cost of goods sold, delivered EUR71 million of savings year over year.

In addition, the End2End productivity program generated EUR5 million of saving year over year, but this was next to making significant contributions to improve customer service, as well as growth.

As such, these cost savings were able to more than offset, by negative price, pricing of 2.2%, as well as wage inflation and additional investments in future growth.

The drop of 90 basis points in the adjusted EBITA margin overall was driven by currency headwinds of 80 basis points, and 100 basis points, or EUR51 million, related to the production suspension in the Cleveland factory.

From a sector perspective, Lighting, Consumer Lifestyle and IG&S showed an improved operational performance, which was offset by a decline in Healthcare. The favorable performance in IG&S was driven by higher IP royalties and lower costs in the IT service unit.

Net income amounted to EUR243 million in the quarter, compared to EUR317 million a year ago. The year-on-year decrease reflects lower earnings, which was partly offset by lower tax charges.

Tax charges were EUR81 million lower than in Q2 2013, largely due to the application of the Dutch Innovation Box tax rule, in addition to lower earnings. The Innovation Box contributed, among others, to a lower effective tax rate in Q2 2014, due to the recording of the retrospective and current year impact.

As a result of the application of the Innovation Box tax rule, our effective tax rate is expected to come down by 2 percentage points going forward.

In the quarter we had a free cash flow of EUR261 million, which included a one-off pension contribution of EUR31 million as part of the new funding agreement for the Dutch pension plan, under which Philips is no longer liable for future deficits.

Looking at the remainder of the year, overall market conditions are expected to be stable or improve slightly.

In the US the PMI increased since the end of Q1 and consumer confidence is increasing. Healthcare CapEx in the US is expected to remain, by and large, flat for 2014 with an uptick in IT and down for diagnostic equipment.

US healthcare construction is also expected to remain flat through the remainder of 2014. The overall US construction market is expected to grow high-single digit, of which non-residential construction is forecasted to grow by 4%. So far, however, the recovery of non-residential construction spending in the US has not yet fully materialized.



The Western European construction market is expected to return to growth in 2014. Having declined by around 2% in 2013, it is forecasted to grow by around 1.5% in 2014. This reflects a return to growth in both the residential and non-residential segments.

In China we expect to see a bit of a pickup in performance in the second half of the year versus the first half, as market participants adapt to stricter policies and credit tightening, and the government continues macro stimulus.

This quarter, unfavorable currency exchange fluctuations impacted our results. While foreign exchange uncertainty remains going forward, on a year-over-year basis we expect the negative impact of those fluctuations to taper off in the second half, most notably in the fourth quarter, when compared to last year.

As mentioned by Frans in his opening remarks, we expect an improvement in the performance in Healthcare in the second half of the year as the remediation cost of Cleveland are largely dissipate and production gradually resumes in the course of the third quarter.

Free cash flow for the year is expected to be close to EUR1 billion and this excludes the one-off pension contribution of about EUR400 million in 2014, related to the earlier-mentioned de-risking of the Dutch pension plan.

By the end of June we completed 26% of our EUR1.5 billion share buyback program.

Let me conclude by saying that while 2014 will be challenging overall, we continue to increase efficiency and drive profitable growth through the execution of our multi-year Accelerate! transformation program. And we remain firmly committed to reach our 2016 targets.

We will provide more direction and detail about the next strategic steps of this second phase of our Accelerate! journey at our Capital Markets Day, which will be held on September 23 at the Hilton Metropole Hotel in London.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Andreas Willi, JPMorgan.

Andreas Willi - JPMorgan - Analyst

The first question is on guidance and communication to the market. You have provided quite specific guidance for the second half of the year.

A few years ago, earlier in your tenure, you moved away from being that specific on short-term guidance, focusing more on the longer-term improvement. And I guess also because the business doesn't have backlog, that kind of visibility, to give precise guidance.

What underpins your second half-year guidance and how do you assess the risks around it? Is it more driven by your confidence in the cost savings coming through, or does it require a substantial improvement in demand? And, for example, what kind of sales growth in Healthcare would you need in the second half to deliver that improvement in adjusted -- in EBITA year on year? Thank you.

Frans van Houten - Koninklijke Philips NV - CEO

Hi; good morning, Andreas. Yes, we felt that giving a bit more guidance in these turbulent times was appropriate, helping everybody understand how we are doing.



This, the underpinning of the second half, and presume you primarily are interested in Healthcare, is largely on the basis of order book on hand. You can imagine that with the resumption of the Cleveland plant we are going to deliver on the backlog of orders. Many customers have been prepared to wait; I'm very thankful for that. And we will see a spike in deliveries, especially in the fourth quarter.

So overall, underpinning looks good and I look now to my right to see if Ron sees -- would you like to add anything to this color Ron?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes. So, if you look at Healthcare, as Frans said, we have a lot of catchup demand coming in the second half. I think we would need to be growing a little north of mid-single digit for Healthcare to make that all happen. The underpinning of the slotting of the sales is very encouraging and we see a slightly better position than we were last year.

Andreas Willi - *JPMorgan - Analyst*

Yes. Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, thanks.

Operator

Martin Wilkie, Deutsche Bank.

Martin Wilkie - *Deutsche Bank - Analyst*

Just a question on the changes you've seen in Healthcare. I was wondering if you could talk through why you've decided to set up the organization as you have done, taking out a layer of management, and whether that's something we should expect elsewhere in the portfolio? And whether it's also a signal of perhaps a review of the strategy or something like that inside Healthcare?

Just if you could give us some idea as to why the decisions were made for the org changes as they were announced. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Right. Thanks, Martin. Well, I can straightaway flag that this is no change in strategy. I quite like the strategy in Healthcare to be focused on integral solutions along the continuum of care, helping large hospital systems to drive productivity from early diagnosis to minimally invasive intervention, to patient monitoring, and even home care. So I think it's a great space and we want to be in it.

Now, why did we intervene? Well, first of all, let's realize that, performance-wise, we were not at a level that we could be satisfied. The negative order intake trend started somewhere last year. Sales-wise, the first half was really not great and overall, on the Accelerate! journey, we can go faster.

Now, taking out a layer and having the three businesses report to me directly, I can imagine that people will ask: what does that mean? But actually, when you realize that the largest Healthcare business, Imaging Systems, that's where the scanners and the diagnostic imaging equipment sits, that business group is larger than Consumer Lifestyle in its entirety.



In other words, such an important business deserves to be directly reporting to me. I feel that with these moves we can become more agile and decisive in moving forward what is an extremely exciting time in healthcare technology.

We cannot sit on our thumbs. We need to move quickly forward, bringing the Healthcare businesses into the heart of Philips, is something that we think is a good move.

As such, it doesn't say anything about the other businesses. This is a Healthcare announcement where we intervene to step up performance of such an important business.

Martin Wilkie - *Deutsche Bank - Analyst*

Okay, thank you.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - *Morgan Stanley - Analyst*

I had a couple of questions about Healthcare. First of all, just in China, it looks as though you've had a fairly significant order improvement during the quarter. Could you elaborate on that? Is it broad based? Was there any single, large order effect?

And the trend that you're currently seeing in China Healthcare, is this something that you would expect to continue to improve over the second half of the year? What is your feeling on that geographic market in particular? So that was question number one.

Question number two, I'm trying to understand the dynamics in the patient care business. It's a double-digit order decline. Is that simply the market, or is this something to do with one or two particular competitors? Has everybody else felt the same level of decline or is this down to Philips?

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, Ben, great questions. Let me start. In China, we saw for most of the first half of the year, a great reluctance of hospitals to award new orders. We believe that that, in part, is related to the clamp down on corruption and much more the carefulness in which administrative processes need to be done.

Of course, a second background reason is the overall slowdown of the economy. Late in the second quarter, we saw actually the order intake pick up again.

If you recall in April, we talked about it being a delay rather than a cancelation, and we were, in April, hoping that it would come back. And actually, it did with especially in the month of June with stronger order intake.

Now then your point is does that continue; what's the trend? I think we still need to brace ourselves for a slower market overall, so I wouldn't count that we are out of the woods completely now. I think it will remain a little bit bumpy. We will see how the third quarter develops before drawing stronger conclusions.

But we are positively encouraged by the fact that order intake came back and we have such a strong market position in China as the market leader in that space.



Then your second question on Patient Care. Patient Care is a very good business for Philips. We have a very strong market share and I think this slowdown is also a little bit our own doing in the United States especially.

If you recall, the patient monitoring market, although it is a global market, 50% of that market is actually in the United States. It is the more advanced from a technological point of view and more patients are being monitored there on a continuous basis.

We have, in the US, reorganized our sales force from basically a modality-focused sales force to more an enterprise, key account sales force. We feel that that is necessary as hospitals will move more and more to large-scale projects and integrated buying versus individual commodity buying.

We think, as an unintended consequence of that move, is that we have dropped the ball a bit with less attention on this important category of patient monitoring, thereby effectively slowing down the entire market, because we are so large in the US that if we slow down, the market slows down.

So at this point, we don't think that we have lost market share, but the market share numbers for Q2 are not yet out, so we still need to wait for that. But at this moment, we think it is a little bit of self-inflicted pain and we will work very hard to repair it in the second half of the year.

Ben Uglow - *Morgan Stanley - Analyst*

That's very helpful. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Thanks.

Operator

Mark Troman, Bank of America Merrill Lynch.

Mark Troman - *BofA Merrill Lynch - Analyst*

Just got a question again on Healthcare, obviously, going into the second half. Frans, what improvements can you do very quickly? We've talked about slightly leaner overhead and -- but, ultimately, what is the scope to take significant levels of cost or gain significant levels of efficiency in this business? And how long would that take given, I guess, the FX and product lifecycles are longer in this business and lead times are longer in this business, than they are perhaps on the other divisions?

And secondly, related to that, in terms of -- how should we interpret the increased restructuring savings? Is that more -- is that all in Lighting and Healthcare? Or is there real emphasis on getting cost out of Healthcare post the weak Q2 results? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Okay. Hi, Mark. Well, the improvements possible in Healthcare are multiple. Versus the other sectors, Healthcare is not yet as far in implementing the Accelerate! program and therefore, there is still a lot of unlocked potential.

Overhead cost savings is just a small part of that. Actually, I'm even more focused on the end-to-end effectiveness of the customer value chain. Indeed, bringing products to the markets faster, applying DfX, but also, shortening decision-making cycles; improving accountability of results; getting more entrepreneurship in what's still a somewhat conservative business. So I think that agility will have a positive effect.



You're right; the Healthcare business has somewhat longer cycles. Therefore, we should also not count on having a magic turnaround in one quarter; it will take us several quarters to come back on the past to value. We believe that, therefore, towards the 2016 targets, Healthcare will be back-end loaded between now and 2016 in realizing their objectives.

Of course, more to come at the Capital Markets Day where we, for sure, will come back on that topic.

Now, Mark, your second question, increased restructuring; did that apply to Healthcare or to the whole Group?

Mark Troman - *BofA Merrill Lynch - Analyst*

Well, both. I'm just trying to understand is the change that we're seeing -- or the incremental gross savings, for example, is that mainly because of Healthcare or Lighting? Or how should we interpret that, in terms of where the incremental effort is going you're reporting this quarter versus last?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Good question. So, of course, we apply our overhead cost-savings program across all sectors. But it is fair to say that Healthcare has been lagging a bit to, what I would call it, entitlement; what they should be doing.

The same holds true for DfX. So what Frans is saying is with bringing Healthcare BGs straight into the heart of Philips, we also, and he said it, are going to drive much stricter performance management to make sure that these programs remain on track, that there is no wavering or bailing out of targets set, and the whole thing comes together in the second half much better than we have seen so far.

So there will be an increased focus. But, otherwise, the programs apply, as you know, with the Accelerate! program across the whole Company.

Mark Troman - *BofA Merrill Lynch - Analyst*

Okay. Thanks very much.

Operator

Gael De Bray, Societe Generale.

Gael De Bray - *Societe Generale - Analyst*

I have three questions, actually. Maybe one follow-up question regarding the new management structure at Healthcare. I take your point that imaging is actually maybe larger than the Consumer Lifestyle division. But the Light Sources business within Lighting is also as large as CL. So maybe what's different at Healthcare which makes you not implement the same structure at Lighting?

Question number two is on IG&S. The quarterly run rate has been much better in the first half of the year than what the full-year guidance would actually suggest. So what do you foresee for the second half at IG&S?

And lastly for the Automotive Lighting business, I guess you're probably the number one or number two player there on traditional automotive lamps with Osram. But how do you assess your positioning on the automotive LED side, because it seems that some of the Taiwanese players have already significantly broken into the auto LED supply chains? So I guess I'd like to hear your thoughts on that, please.



Frans van Houten - *Koninklijke Philips NV - CEO*

Okay, I'll take questions number one and three, Gael; and then I'll ask Ron, please, to do the second one.

Let's start with the follow-on on the management structure in Healthcare and what that would mean for other businesses. Look, we are intervening in Healthcare, because we were not satisfied with the performance improvement, not just because the size of an individual business is of a certain size.

However, when people ask me then: would you consider re-implementing a sector leader for Healthcare later on? I say no, because these businesses are so large and important that they actually deserve to be reporting directly into the CEO.

Now in Lighting, I consider that Eric Rondolat is doing a great job. He is driving improvement in all these businesses. So it's not at all opportune to meddle with the structure. I'm not a great fan of structural changes, because just reporting lines in its own right are not always a solution.

It's all about leadership and short decision cycles and impactful measures. Eric Rondolat is doing, as I said, a great job in driving that forward, so no change there.

If I move to the third question, Automotive Lighting and Lumileds will be moved together into a standalone company. The reason for that is that automotive lighting -- or conventional lamps are also quickly moving to become LED components. And then the difference between automotive LED and Lumileds becomes negligible.

In fact, customers are looking for an integrating supply chain from R&D to manufacturing, to supporting customers. And by making this move, we are setting up both Lumileds and Automotive on a course of growth with lots of potential.

We have been gaining market share in automotive, not just in conventional, but also in LED. And as we integrate these businesses further, we think that our customers will appreciate that and that we can, from a technology point of view, even drive further benefit to them.

Taiwanese players have not made a great inroad in the most critical automotive applications. It's still more or less the traditional competitors in the automotive space, which, as you know, are in part Japanese, German, and Dutch; the latter ones being us, of course.

So we look with confidence towards the future on Automotive Lighting. And with this integration and standalone set up, we will be able to attract outside investors. We hope that this company can grow rapidly, expand capacity, and win more customers.

Ron, second one is for you.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Indeed, IG&S getting better in the second -- sorry, in the first half of the year. As I said, for Q2 there was mainly over-increased IP royalties and lower costs in the IT service unit.

So we think with this performance and looking at the second half, and also realizing that sometimes things come a bit lumpy, the guidance is now EUR350 million, where it was first EUR380 million.

Gael De Bray - *Societe Generale - Analyst*

Okay. Thanks very much.

Operator

Olivier Esnou, Exane BNP Paribas.

Olivier Esnou - *Exane BNP Paribas - Analyst*

My first question on the Healthcare recovery in the second half, I think heard well that you need above mid-single-digit growth in H2 for Healthcare; I guess that's organic. And it's above what I have seen in my numbers and consensus. Could you maybe separate out what has been the impact in H1 of Cleveland, and how much of that is actually into the H2 recovery of growth? That's the first question.

Second question about the Conventional Lighting trends, I think you said during the call that it's declining 13%. I'm not sure if that's last 12 month or year to date. Maybe you can just repeat that; I missed that?

I checked in your slide pack, I think your guidance is for high single-digit decline going forward versus previously a mid-single-digit decline guidance. Looking from here, what underpins your belief that it will go back to a less than double-digit decline, and why it shouldn't continue on that trend of double-digit?

Maybe the third question regarding the strategy and operating steps. You have taken two big steps this quarter, on Lighting and the Healthcare management. You said you're not a big fan of change. But when you mention the invite to the Capital Market Day, you said that you would update us on next strategy and operating steps in this journey. So I'm a bit wondering: is there another big step in Q3 or what you're alluding at?

Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

Olivier, I'm smiling because of your last question, but I'll come to that in a moment. Let me start by giving Ron the chance to comment on the Healthcare recovery and compare between H1 and H2.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, so I think, Olivier, to answer your question on what the impact of Cleveland is, it's about 200 basis points in the growth, around that.

Olivier Esnou - *Exane BNP Paribas - Analyst*

Okay.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, so that should help the second quarter, of course, as we recover.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Second half.

Frans van Houten - *Koninklijke Philips NV - CEO*

Second half, sorry. Second half; thank you, Ron.

Okay, second question has to do with the Conventional Lighting decline. Indeed, we saw 11% decline in Q1; 13% decline in Q2. It does look like an accelerated decline indeed.

In our own modelling, we expect that decline to slightly taper off to around high-single digit. Of course, the model assumes many variables. We still count, on an overall LED penetration, by 2015, of 45%. So we have not seen a dramatic shift there.

What also has played into the conventional decline is a relatively high stock in trade for certain categories, notably in China, and that has pushed up the decline temporarily.

As we think -- as we expect that stock in trade to normalize, if and when that happens, then that would be a reason why the conventional decline could normalize at high-single digit.

Nevertheless, given that we have increased the decline rate from what we previously guided, from a mid to a high-single digit to a high-single digit, we are pulling in our restructuring plans that were basically in the drawer already, but we are now taking a bit further action already this year. Therefore, we have raised the restructuring forecast for the second half-year from EUR100 million to EUR170 million.

Now then, the one that made me smile, strategy and next operating steps. I said I'm not keen to only look at organizational structure and that didn't have much strategic importance that remark. It's more that if you change reporting lines; that does not automatically improve performance.

Now somebody reports to another guy or girl, that, in its own right, is not performance improvement. That was the background of my remark and is a remark that I've made often inside of Philips as guiding people against only rehanging departments to other people.

So I believe in fundamental performance improvement. This is why we have here the Accelerate! program. This is why we have End2End and so on. So don't read anything specific into that little joke.

Now, of course, Capital Markets Days are always worth your attendance, and we will always have something to say. We do flag that we will be giving more detail on next strategic and operational steps, basically, as we are now firmly into the second half of our Accelerate! Journey, and there is more to come.

Olivier Esnou - *Exane BNP Paribas - Analyst*

Okay. So rendezvous there I guess, because it's -- but could it be at the same magnitude of the two recent announcements, or it's more of an update?

Frans van Houten - *Koninklijke Philips NV - CEO*

(Spoken in French), Olivier.

Olivier Esnou - *Exane BNP Paribas - Analyst*

Okay, so I'll wait for that. Thank you very much.

Operator

Simon Toennessen, Credit Suisse.



Simon Toennesen - *Credit Suisse - Analyst*

The first question I have on the healthcare market in Asia. Looking at the order trends you've seen, and I think you have this on slide 62 in your slide pack where you can see the rest of the world and part of that is obviously Asia. But also knowing how you've grown in China last year, I would have assumed that sales in Asia should have been quite strong still for 2014 given the order trends.

If I do a simple math and look at the share of Asia Pacific Healthcare sales, you obviously provide that pie chart in the slide deck. And I look at Q2 last year was 27%, now it's 25%, and doing the math on that, you must have declined by around 16% in Asia in sales this quarter. Q1 was minus 14%.

Is the majority of that just FX driven; i.e., that which has taken off the big hit, or is there anything else that I'm might be missing?

Second point is on the bridge. You provide that bridge on a Group level for EBITA, which is very helpful. Ron, could you maybe give us just a quick overview of how that minus 730 basis point drop in margins, how that roughly works out? We know pricing is 3% to 4%, but maybe you can give us a bit more help how this has looked.

And then the last question, just on Cleveland again and the impact. You said earlier, minus 200 basis points. Is that minus 200 basis points on the minus 17% roughly in orders that you are showing in the slide deck, or of the high-single digit decline on sales? Thanks very much.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So, thanks for the questions. So, on the latter, I was asked: what is the impact of Cleveland in the first half in sales? So that's around 200 basis points. I hope that clarifies.

Simon Toennesen - *Credit Suisse - Analyst*

Could you say what it was in Q2 on orders, relative to the minus 17% roughly you've seen?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

I think it's also around 2%.

Simon Toennesen - *Credit Suisse - Analyst*

Okay, thanks.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, it's not much higher. Then your question on Healthcare, you mentioned Asia Pac and then you said it's 27% of total Healthcare sales, but I believe that's the emerging geographies.

Anyway, let me give you a little bit of color on the CSG in Q2. So India was 9%; China was minus 13% in Q2; LatAm was 6%; Russia and Central Asia, minus 35%; and then the others were up 10%. So that provides for the total growth geographies of -- am I saying this right? Yes, that's the CSG, so total growth geographies come then to minus 3% for Healthcare.

So that's a little bit a wider explanation. So Asia Pac, as you saw it on slide 61, has all the Asia countries inside them, also China and India, and typical things that sometimes are not defined under Asia Pac. So that explains the CSG. I hope that's an answer to your questions.

Then you said in the bridge, 730 basis points margin decrease. The bridge goes from 940 basis, adjusted EBITA, to 850 basis points, so could you maybe --

Simon Toennesen - *Credit Suisse - Analyst*

No, I just meant the reported margin. So you had 17.8% in Q2 last year and then 10.5% this year. If you prefer doing it on underlying, that's absolutely fine as well. Obviously, you had the one-off impacts from the gain and the pension impact last year.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, exactly, so that's the main driver. So the pension gain and we sold a business in Healthcare. Am I -- is it understandable, because you're talking Healthcare I guess, or were you talking Group?

Simon Toennesen - *Credit Suisse - Analyst*

I was just wondering whether you can just, in terms of basis points, give us the rough -- if I'm not missing anything, obviously the volume declines then the gain if you take in the reported.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

So you're looking for the Healthcare bridge on -- as a specification of the bridge that we have given; is that your question?

Simon Toennesen - *Credit Suisse - Analyst*

Basically, a bit more guidance on that, yes.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, okay. So we've given this bridge and we haven't given it by sector, but I can talk about it a bit directionally.

So, of course, Healthcare has a negative volume impact. That won't surprise you with the percentage that we gave and you can multiply that basically on the nominal sales of last year, then you get a good proxy.

Then price and wage inflation in Healthcare, price decreased. Price erosion is not outside the 3% to 4% range; I think it's even below 3%. So, of course, as we always say, we don't get each and every deal in, so inside our order portfolio price erosion may be a little better than you would see in the general market, could be.

Then wage inflation for Healthcare is around 2.5% to 3%.

Then if you look at the cost of goods, as I earlier said, Healthcare does its bit, but it has to do better. So there's not a spectacular development there and it's not enough yet to offset the inflation and the price decrease.

On overheads productivity savings, as you see on the bridge, well, Healthcare contributes. But it's, as I also earlier said, below par, so I'm talking really directionally with you.

Then the impact of Healthcare in currency was around EUR40 million; that I can tell you.



Then on the right-hand side you see the Cleveland impact, which is for the Group depicted as EUR51 million, but that only pertains to Healthcare. So I think that give you, by and large, the main building blocks of the adjusted EBITA variance in Healthcare.

Simon Toennesen - *Credit Suisse - Analyst*

That's very helpful, thanks very much.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Thank you.

Operator

Fredric Stahl, UBS.

Fredric Stahl - *UBS - Analyst*

Could I ask you in Consumer Lifestyle, do you have the same scope to drive growth from geographic expansion that you've had over the last few years? Or are you becoming more dependent on finding new product families or new avenues to the market, like your digital investments?

Frans van Houten - *Koninklijke Philips NV - CEO*

Hi, Fredric. Well, we continue to be very optimistic about the opportunities for CL to drive growth. Admittedly, the current growth rate is a little bit down from the growth rates that we saw in 2012 and early 2013. 7%, of course, very respectable, and there is a reflection in there that the emerging markets are a bit slower in their economy. China slower, the Southeast Asia countries are slower. We do believe that Russia is, obviously, slower.

So despite all that slowdown we are still making 7% growth. So it's a very healthy business and we continue to believe that it will be able to grow high-single digit -- mid- to high-single digit on a structural basis. And that is driven by both geographical expansion, as well as product line extensions.

Fredric Stahl - *UBS - Analyst*

But there's not change there from what you can see now?

Frans van Houten - *Koninklijke Philips NV - CEO*

No nothing, no change whatsoever.

Fredric Stahl - *UBS - Analyst*

Okay, very good, thank you.

Operator

Daniela Costa, Goldman Sachs & Co.



Daniela Costa - *Goldman Sachs & Co. - Analyst*

The first one just to follow up, sorry, on the Cleveland impact on orders of 200 basis points. I think you mentioned for Healthcare, US market overall for the year relatively flattish. Given if the impact on orders was 200 basis points, then I guess you were still well into double-digit territory for the quarter.

Should we see -- was the market as well at those levels, or were there market share variations? And should we expect on market overall a big pickup in the second half? Just wanted to clarify how we read that.

And then the second thing. Can you talk a little bit about the improvements in the European Healthcare equipment order? So growing mid-single digit; where exactly does that come from? Is that related with comps being easier or there's really an underlying trend there?

And the third thing, just to clarify -- so the headwind from FX in EBITA they were lower in Q2 versus Q1, how should we see it for the rest of the year, especially given the moving you're hedging or some of your hedges may be rolling off? Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

Overall, in Healthcare we do believe that our market share has been a little bit under pressure. Of course, this also relates to the earlier discussion on performance in Healthcare and the need to intervene and to drive performance stronger. This is especially in relation to imaging systems. And the modalities that we manufacture in Cleveland are, of course, the most affected from the rest.

As we resume shipments in the second half year I think we are then on a course to repair that and as we don't think there's anything that cannot be repaired. We have very competitive product. We have some great products in the pipeline in imaging. We've just launched a new ultrasound machine. We have the Varios coming, the Spectral CT coming so there's plenty to do. It will take us a couple of quarters to repair the trend line.

On Europe Healthcare, we earlier already quoted in the speech of Ron that the various markets show very different growth rates. Off the top of my head, Germany was a bit down, whereas the Southern European countries were up.

I do believe that Southern Europe coming back is structural and it's a good sign, but of course they come from a very low base. Compared to six/seven years ago, these markets are coming from half of what they formerly were. So there is a lot of growth opportunity as people give themselves the opportunity to upgrade hospitals.

So I do think that Europe is on a gradual path of improvement, but it will still be a bumpy ride.

On the ForEx situation, we need to distinguish two things. We saw that the impact in Q1 was on 180 basis points; the impact in Q2 was 80 basis points. Ron already mentioned that in the second half of the year, the compare becomes easier; that means as their currencies were already sliding in the second half of last year. So, therefore, we will see a smaller currency impact on a year-by-year comparison basis.

That is notwithstanding the fact that we all believe the euro is still too expensive and we are battling this expensive euro, and it affects our results. But, of course, we take many measures to offset and improve our results regardless.

Daniela Costa - *Goldman Sachs & Co. - Analyst*

Thank you.

Operator

James Moore, Redburn Partners.

James Moore - Redburn Partners - Analyst

I've got three if I could? Firstly, on your 2016 outlook comment, I know that you've dropped the very confident language that you used last quarter. I want to check is that deliberate and are you a little less confident in 2016 or is it just an accident?

Secondly, how much do you expect next year's LED margin to increase to offset the dilutionary effect of less traditional business? I presume we've got to lift the margin, let's say from mid-single to high single.

And aside from the increased restructuring how confident are you on keeping fixed costs fixed in the LED business, and what are the risks here? If you could just talk a little bit around that.

And thirdly, can you help us understand the size of the Cleveland impact better? You gave the EUR51 million and the EUR32 million numbers for the last two quarters, I just want to understand what those numbers are. Are they cost numbers or loss numbers? So do they take into account the lost sales effect or not? And if not, can you size that?

And also can you say relative to the EUR51 million what the impact will be in the stub quarter of the third quarter as you partially ramp up? Thanks.

Frans van Houten - Koninklijke Philips NV - CEO

Thank you. On the outlook we are firmly committed towards our [2016] targets (corrected by company after the call).

On the LED margin, you know the LED business has many sub-segments. The Components business we have been doing a great job at expanding margins. That was a loss giving business a few years and we have recovered fantastically, and now we believe it's a very healthy business.

I'm bringing that recollection just to make the point that it is possible to make good money in LED, it's just that you need to hit the right levers to do so.

When we look at the applications, or the downstream market, in LED, Professional Lighting, for us, already has better gross margins than Conventional Lighting. This is very good news, and the fact that the professional LED Lighting is not yet as profitable is, because we spend more R&D in it. But the gross margin is better than Conventional, therefore structurally it's a good profit pool in the making.

Now, that leaves then the Lamps business, and in the Lamps business we see strong price erosion, which is also necessary in order to make it a mainstream application with this fast consumer adoption.

So that is the most turbulent of businesses where we have more work to be done before it is a attractive profitable business. And especially in the Lamps area we will have to reduce cost further.

And in terms of modeling the Lighting sector we will, over time, see a lower non-manufacturing cost base in order to maintain good profit margins that we are ambitious on.

Then the Cleveland question I hope that I can look to Ron for further elucidation.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Thanks. So of course it's a combination both between sales and remediation cost. Of all the things that are in there, sales plays an important role, therefore you see the recovery.

I think in Q3 we're not completely out of the woods yet, but it will be better; meaning making a less negative impact than in Q2, that's the guidance I would give. And in Q4 we'll make up for that, so we stay for the full year with the EUR60 million to EUR70 million that we earlier guided for.

James Moore - *Redburn Partners - Analyst*

I understand, thank you. And just going back to the LED lamps specifically, what do you assume for the LED lamps EBIT margin in broad terms? Do you think that can go up next year basically? And does it have to go up a lot for you to really hit your overall Lighting target?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, both Ron and I love granularity, but it doesn't always mean that we can be as granular in a call like this. But, clearly, margins in Lighting will continue to improve, that's what we have promised you.

We have clear 2016 targets. We are on track to achieve that, and that includes the portfolio and mix shift that is taking place in Lighting. So no worries that, we just keep diligently improving all our businesses.

And let's also not forget that next year we get the full-year benefit of both Consumer Luminaires and Professional Lighting in North America which, this year, is making improvement on their turnaround; first half being still negative, second half becoming profitable as we promised. And then next year we have the full-year benefit of that, so that should help in modeling out the ongoing improvement trend for next year.

Now what is, let's say, the thing that, of course, weighs on the Lighting performance is the restructuring of the Conventional base. Given the faster decline of Conventional we are stepping up and pulling in some of the restructuring programs.

And in that light raising the second half of this year from EUR100 million to EUR170 million, and maybe a little bit more to come also next year would be prudent to take into account when judging next year's performance.

James Moore - *Redburn Partners - Analyst*

I see. Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

You're welcome.

Operator

Andrew Carter, RBC Capital Markets.

Andrew Carter - *RBC Capital Markets - Analyst*

I had a couple of questions please. Just, first of all, on Cleveland, could you just talk a little bit more about the restart of that facility? Is that something that you can do at any time, or are you actually waiting for some particular regulatory approvals?



And I guess a follow-on on that would be: are there any other factories that you've had a look at anywhere and found any similar issues to what you found at Cleveland?

And then the second one was still on Healthcare. In the statement that you put out a couple of weeks ago you were talking about paradigm shift there. I was just wondering what you were referring to specifically, and does that paradigm shift have any sort of impact on the competitive landscape that Healthcare faces?

Frans van Houten - *Koninklijke Philips NV* - CEO

Okay, great questions. So the Cleveland shutdown is a voluntary shutdown. We took it on our own accord in order to remediate certain quality controls in manufacturing and procurement, and in the design transfers.

We have made great progress in fixing these issues. We believe we are now at the tail end for the repair on the first products. And we think that we will be able to gradually resume production in the third quarter. Then the subsequent products will come through the rest of the year.

So it is not that all the product lines are back in production at the same time. You should see it as a gradual resumption where, line after line, it will be brought up to speed.

That is a decision that we take ourselves as we believe that our quality management system is back on track. We are being helped by independent auditors that we have invited of our own accord to do a validation of our quality management system to see whether it can stand the scrutiny of third-party eyes.

We are at the tail end of that audit validation and that gives us belief that we are on the right track. And, therefore, we make the statement with confidence that manufacturing can restart soon.

Of course, we have taken the Cleveland situation as a trigger to double scrutinize every other Healthcare facility. You may recall that earlier in the year we also had some quality issues in our Andover facility.

So overall, I'm keen to step up what we call internally Philips excellence as the label for the quality standards that we set in all the Healthcare sites, by the way also CL and Lighting are doing that. I want to have very high quality norms everywhere, and there's certainly room for improvement in other sites and locations.

But you can rest assured that we are on top of it, and it is part of that bringing Healthcare into the heart of Philips that they -- that also the Group functions can have a deeper influence over the operations, and I'm quite pleased with that.

Then the announcement that I made a few weeks ago, or two weeks ago, the Healthcare paradigm shift. What I'm referring to there is the quite rapid shift from buying individual modalities and products towards larger scale multi-year technology partnerships.

Hospitals are realizing that in order to drive better outcomes for patients at lower cost, that you cannot create a patchwork of technologies and then hope that they will interwork into operate well.

And the second element of the paradigm shift is, of course, cloud computing, where clinical informatics, decision support algorithms continues monitoring of patients wherever they are, at home or on the go, these are all things that are accelerating, at the moment.

This has attracted attention also from the typical cloud-based companies. In that sense competition will come from non-traditional areas again underlining the paradigm shift.

We are, of course, on top of it; and you can count us to be on top of it. I was quite pleased to be part of the announcement that we made with Salesforce.com.

Now, Salesforce is a company that has particular expertise in cloud-based computing and in collaboration software. Those are two elements that are highly relevant to having -- to getting doctors to work together better across the continuum of care, and to have access to data wherever the patient is.

So we are going to leverage on the generic platform of Salesforce and apply our own clinical informatics on top of it, in order to drive efficiency and effectiveness between doctors as they support patients.

We think it's a great area to be in, we already launched our first two products, the eCare Companion and the eCare Coordinator; those are apps that run in conjunction with the Salesforce collaboration and cloud engines.

And therefore, in this paradigm shift, we think we have a great opportunity, but of course we need to go fast. And that brings me full circle to the announcement where we said let's cut out the management layer bring it in to the core Philips, and let's make sure that we act in an agile and entrepreneurial manner.

I think you will -- we will give you more data on this Healthcare transformation at the Capital Markets Day. It's an exciting area and we think that we can do a lot better than we are currently doing with higher growth and higher profitability.

Andrew Carter - *RBC Capital Markets - Analyst*

Thank you.

Operator

Margaret Paxton, Berenberg.

Margaret Paxton - *Berenberg - Analyst*

I've just got a few on Lighting please. The first one is could you just talk a little bit about the progression in pricing pressure in each conventional and LED lamps separately, has there been any change over the past few quarters, any alleviation or even acceleration?

And then secondly, you said Consumer Luminaires would be break-even this year, you've also said that you see double-digit profitability potential in Professional Luminaires would you be willing to say the same about Consumer, or would it be maybe a slightly lower margin potential there, and maybe in what timeframe would you be looking to reach that?

And then the last one on LED Lamps, given the Asian players are looking to enter this market, do you feel like you're losing share in LED lamps specifically? Thanks.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right, let me start with the Consumer Luminaires business, while we look up a little bit more data on the pricing question.

Consumer Luminaires is actually a high gross margin business; it's just that the sales level in Europe is too low to get a good bottom-line return.

With that answer, I'm implying that it can also become a good EBITA business once the volumes get back up and we have finished with the non-manufacturing costs, the sales organization and what have you.

Let's not forget that the European market is deeply affected by the economic crisis and consumers are not shifting house, they are not buying lamps and luminaires as they used to.

So this business unit as it becomes now a much leaner business unit, it will be set up well when the market recovers in Europe, especially given those very attractive gross margins on the LED luminaires.

So yes eventually it should be in the same ballpark as the way we talk about Professional Lighting Solutions.

Then the Asian competition, in fact it is nothing new in the -- if you compare it to CFL lamps, so the compact fluorescent lighting lamps is also an Asia-dominated supply market. We source many of these CFL lamps and are able to make good margins on it given our strength in innovation, our strength in the brand and in distribution.

And I would see that same for, let's say, the bread and butter Consumer LED lamps categories.

Of course it's a different answer when it comes to Professional Lighting, because there innovation plays such a big role, that's where we expect all the Lighting to become connected and we will see far less Asian players coming in.

Ron, can I ask you talk about the price pressure.

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Of course, any pressure. So if you look at the price pressure in Q1 in Lighting it was 2% to 3%.

We saw some elevation. Indeed, some acceleration Q2 which was a step closer to 3% to 4%, of course as LED lamps continue to grow that will be a bigger part in the price erosion.

Bear in mind that we have of cost to road maps in place, in principle intended to keep a good integral margin as we have it today. So we are working, of course, to sustain that, but yes there will be somewhat higher price erosion driven by the uptake in LED lamps particularly.

Margaret Paxton - *Berenberg - Analyst*

Thank you. So you're saying Conventional is reasonably stable?

Ron Wirahadiraksa - *Koninklijke Philips NV - CFO*

Yes, it's reasonably stable, so -- because as you know we have been quite advanced in ramping down the Conventional footprint through our -- earlier also two years ago quite a significant pool about restructuring. Something we are about to do now for exactly the same reason to keep in line with what we still see as somewhat of a golden tale.

Margaret Paxton - *Berenberg - Analyst*

All right, thank you very much.

Operator

Hans Slob, Rabobank.



Hans Slob - Rabobank - Analyst

Firstly, you have decided to combine Lumileds and Automotive into one single company, I think you indicated that this will lead to EUR30 million of integration costs. Are these included in the EUR170 million restructuring costs for the second half, that's my first question?

A second is the use of the Dutch innovation tax box. What will this mean for your tax rate guidance for 2014 and beyond? Thanks.

Frans van Houten - Koninklijke Philips NV - CEO

Yes, so the EUR30 million costs for Lumileds and Automotive in 2014 is not included in the EUR170 million restructuring, so it's on top of.

The innovation box will have an impact of about 200 basis points on the ETR, so the guidance will be anywhere between 28% to 30% for this year in ETR, and that's down from earlier 30% to 32%.

Hans Slob - Rabobank - Analyst

Okay, thanks; very helpful.

Frans van Houten - Koninklijke Philips NV - CEO

Thank you.

Operator

Thank you, Mr. van Houten and Mr. Wirahadiraksa. There are no further questions. Please continue.

Frans van Houten - Koninklijke Philips NV - CEO

Okay, well, thanks for a great set of questions from a very engaged call, I hope to see you all at the Capital Markets Day in September, in London. Thanks very much.

Operator

This concludes the Royal Philips second quarter results 2014 conference call on Monday July 21, 2014. Thank you for participating. You may now disconnect.



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