

# **PHILIPS**

## **Royal Philips Q2 2017 Results**

Monday, 24<sup>th</sup> July 2017

## Introduction

Pim Preesman

*Head of Investor Relations, Royal Philips*

Good morning ladies and gentlemen, and welcome to Philips's Second Quarter 2017 Results Conference Call. I am here with our CEO, Frans van Houten, and our CFO, Abhijit Bhattacharya. On today's call Frans will take you through our strategic and financial highlights for the period. Abhijit will then provide more detail of financial performance and market dynamics. After that we will take your questions.

### Press release

Our press release and the related information slide deck were published at 7.00 am. 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 the end of today on our Investor Relations website.

#### *Accounting update*

Before I turn over the call to Frans, I would like to remind you of an accounting update regarding Philips Lighting. Following a sell-down on 25<sup>th</sup> April 2017, Philips's shareholding in Philips Lighting was 41.16% of the issued and outstanding share capital by end of the second quarter. And results continue to be consolidated in the IFRS. A loss of control is highly probable within one year due to further sell-downs.

Philips Lighting is presented as a discontinued operation in the financial statements of Philips as of the second quarter of 2017. Discontinued operations treatment means that the profit and loss of the lighting business is reported in the discontinued operations, and for the balance sheet the assets and liabilities of the business are reported on the lines assets held for sale and liabilities held for sales respectively. Cash flows are reported in the line cash flow from discontinued operations.

We have also published a reporting update to reflect the treatment of Lighting as discontinued operations. This document is also available for download from our Investor Relations website.

The combined lumileds and automotive lighting businesses continue to be reported under discontinued operations, including the deal result following the completion of the sale of an 80.1% stake on 30<sup>th</sup> June 2017.

In the third quarter the remaining 19.9% stake will be reported as an available for sale financial asset.

Finally, as mentioned in the press release, adjusted EBITA is defined as income from operations, excluding amortisation of acquired and tangible assets, impairment of goodwill and other intangible assets, restructuring charges, acquisition related costs and other significant items.

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

## Performance

Frans van Houten

*Chief Executive Officer, Royal Philips*

### Introduction

#### *Overview*

Yeah, thank you Pim and thank you all for joining us here today. Philips performance in the second quarter of 2017 was solid with a 4% comparable sales growth, driven by Western Europe, North America and China and a strong 8% increase in our order intake. We achieved further operational improvements, resulting in a 90 basis point increase in the adjusted EBITA margin.

After covering some of the key results in the second quarter, I will share with you some recent highlights of our exciting Health Tech journey. But let me first start with our results.

### Results

#### *Growth*

Our second quarter results demonstrate our progress in creating value. Philips comparable sales growth of 4%, which was led by the Personal Health segment, which showed a continued strong 6% growth in the quarter, while diagnosis in treatment and Connected Care & Health Informatics grew by 3% and 1% respectively.

We were able to further expand our backlog with a comparable order intake growth of 7% in Diagnosis & Treatment, with all businesses contributing. And in the Connected Care & Health Informatics businesses, the comparable order intake increased by 8%.

Geographically our 4% comparable sales growth in mature geographies was driven by 8% growth in Western Europe. North America recorded 4% growth, partly offset by a 7% decline in other mature geographies. In growth geographies sales increased by 3% on a nominal and comparable

#### *Profitability*

Moving to profitability, adjusted EBITA was 10.2% of sales this quarter compared to 9.3% previous year. That's a 90 basis point improvement. The increase in margins was driven by higher volumes, operational improvements and cost productivity.

Personal Health delivered 120 basis points of margin improvement; and maybe that's a good moment to come back to the announcement that Pieter Nota, the Chief Business Leader of our Personal Health businesses and Chief Marketing Officer, will be leaving Philips. Peter and I have worked very well together for six years and it is with regret that I see him leave after a successful tenure with Philips.

Based on our strong internal talent pipeline however, we expect to announce Pieter's successor in the current weeks, who we are sure will be able to build on the growth and margin expansion momentum achieved over the last couple of years in Personal Health.

#### *Performance*

Coming back to the performance, in a soft healthcare market our Diagnosis & Treatment businesses improved margins by 80 basis points, and the Connected Care & Health

Informatics businesses improved by 90 basis points. I am confident that the performance of the professional health businesses will continue to improve in the second half of the year, based on the strength of their order book.

### *Strategic journey to leadership*

Let me expand a bit on our strategic journey to leadership in health technology. As outlined at the last capital markets day, our Health Tech value creations story is built on three key levers. Firstly, we create value by improving margins through better serving customers and raising operational productivity.

Secondly, we create value in our core businesses by gaining market share through deeper, more comprehensive customer partnerships and pursuing growth by increasing the geographic coverage.

Thirdly, we create value by expanding our innovative solutions along the health continuum through R&D investments, co-creation with customers and partners and selective M&A.

Let me detail that a bit further.

### **Three key levers**

#### *Self-help productivity programme*

On the first level, our self-help productivity programme continues to be an important margin contributor and for the next three years we have committed a cumulative total net saving of €1.2 billion by 2019, averaging productivity savings of approximately €400 million per year.

In the second quarter procurement savings amounted to €61 million. The other productivity programmes resulted in savings of €48 million. So overall, we are well on track to deliver the yearly savings amount.

We continue to drive the digital transformation to serve our customers better and unlock value for them and Philips. For example, the Philips Sonicare diamond-clean smart connected toothbrush, reached a 94% customer satisfaction rating out of a full score of 100% with top online retailer JD.com in China, with consumers highlighting the benefits of the coaching app and the premium design. With this connected toothbrush we can directly engage with consumers and are leveraging the data related to the usage of the toothbrush, we plan to enhance the brush head replacement rates.

#### *Digital and online marketing*

Whilst staying on the topic of digital and online marketing and sales, I can tell you that already 27% of revenue of our consumer categories are sold online – a number that doubled over the last three years. Part of our digital agenda is to increase the online relationship and intimacy with our customers and users of our products, through which we expect to stimulate recurring revenues of our products and services.

With the acquisition of UK-based Health and Parenting, we have strengthened our global digital mother and childcare platform, uGrow. The Health and Parenting team creates easy to use and helpful apps to guide expecting parents through pregnancy and into parenthood.

It's leading product is the Pregnancy Plus app, which is one of the world's most downloaded pregnancy apps, with approximately 12 million downloads from the Apple App store and

Google Play store. Over one million active users, and in the UK approximately one out of two expectant mothers use the app.

#### *Strategic partnerships*

Building on the second level of creating value is - through building on the second level of creating value through deeper customer partnerships in increasing geographical spread. I can tell you that in the second quarter we signed multiple long-term strategic partnerships, or as we abbreviate it, LSPs.

For example, in France we signed a ten-year managed equipment services contract for patient monitoring systems with the Confluent Private Hospital. The agreement with the top three ranked French hospitals for cardio-vascular solutions includes maintenance, replacement and upgrades of patient monitoring systems, as well as bio-medical and clinical training.

In Singapore we entered into a multi-year partnership with the Singapore Institute of Advanced Medicine Holdings to provide solutions for its new oncology centre, with a range of Philips advanced diagnostic imaging systems, including the Icon Spectral CT and Vereos digital PET CT systems, combined with clinical informatics and services.

Our funnel for LSPs for the remainder of the year and next year is strong.

We are pleased with the success of One-Blade, the innovative new product that taps into the growing market trend of male facial hair styling. One-Blade effectively broadens the reach of our male grooming portfolio, leveraging our capabilities as the world's leading electric male grooming brand. One-Blade is on track for its rapid roll out and is currently available in 14 countries worldwide.

#### *Innovative solutions*

Thirdly, for the third level, we create value by expanding our innovative solutions along the health continuum through R&D investments, co-creation with customers and partners and selective M&A.

Our breakthrough R&D investments are delivering tangible results as we receive the regulatory clearance from the FDA for the Philips intellisite pathology solution, which is the first and currently only digital pathology solution for primary diagnostic use, enabling us to market the solution in the United States. This further confirms our position as a leader in digital pathology, an important solution that is used in the diagnosis of complex diseases such as cancer.

We also received FDA clearance for our IntelliSpace portal 9.0 and a range of innovative applications for radiology. The platform gives clinicians a comprehensive overview of each patient, helping them to diagnose conditions using advanced analytics and quantification of medical images.

During the previous quarter I spoke about the launch of Azurion within the Image Guided Therapy business. Azurion is a major breakthrough and is our next generation image guided therapy platform. The solution has been very well received by our customers and we are able to grow market share in the first quarter and strengthen our number one position in that market.

*Spectranetics acquisition*

In the second quarter we further strengthened the leadership position of our Image Guided Therapy business by expanding our portfolio of therapy devices with the agreement to acquire the Spectranetics Corporation. Spectranetics has an impressive product portfolio of catheters for the treatment of coronary artery disease and peripheral vascular diseases. This involves the opening of obstructed blood vessels around the heart and in the legs, with devices such as the laser atherectomy catheters and drug-coated balloons. In addition, they are the market leader in the minimally invasive removal of implanted pacemaker and internal defibrillator leads.

Spectranetics highly complementary portfolio, including these laser atherectomy catheters and the angioscope to with its drug-coated scoring balloon, the stavorex drug-coated balloon, will all support Philips expansion in Image Guided Therapy devices. The combined Spectranetics and Philips Image Guided Therapy device business, Philips Volcano, is expected to grow by strong double digits to approximately one billion euros by 2020.

This transaction is expected to be accretive to Philips adjusted EBITA and adjusted EPS by 2018, mainly driven by sales growth, channel synergies and overhead reductions. While we expect limited integration complexity.

With the acquisition of Spectranetics we are building on our successful track record of integrating acquisitions and rapidly improving growth and profitability.

To remind you, Volcano had a stagnant top line at the time of the acquisition in 2015. It reached double-digit growth rate in 2016 and we are continuing that trajectory. In addition we have reduced over \$40 million in cost to drive the business to profitability.

*CardioProlific acquisition*

The acquisition of CardioProlific will further strengthen our longer-term innovation pipeline of catheter based therapy devices. The development of CardioProlific's differentiated thrombectomy technologies, combined with our suite of Image Guided Therapy solutions will help our customers drive the procedure innovation for the treatment of peripheral vascular disease.

*TomTec acquisition*

Furthermore, to reinforce our leading position in ultrasound, Philips acquired TomTec Imaging Systems, a leading provider of clinical applications and intelligent image analysis software. This acquisition will strengthen our number one position in cardiac ultrasound and will support the further expansion in other clinical areas, such as obstetrics and gynaecology or OBGYN. TomTec will be accretive to growth in margins as of the first year.

*Respirtech acquisition*

Within the Personal Health segment of sleeper respiratory care, we signed an agreement to acquire Respirtech, a US based provider of an innovative airway clearance solution for patients with chronic respiratory conditions. Highly complementary products to our existing portfolio will help those patients to receive the care they need at home. Also Respirtech will be accretive to growth and margins as of the first year.

As you have seen we signed agreements for a significant number of bolt-on and strategic acquisitions during the last quarter. We have been following these companies for a long time

and we are pleased to reach final agreements, which coincidentally all came together in the second quarter. Spectranetics is obviously the only acquisition of real significant size and with these acquisitions we are executing on our strategy.

In line with our earlier guidance on 30<sup>th</sup> June, we announced completion of the sale of an 80.1% stake in the combined lumileds and automotive businesses. With the completion of this transaction and the recent sell down of our stake in Philips Lighting, we are nearing the completion of Philips transformation into a focussed health technology company.

#### *Share buyback scheme*

Additionally, we announced a new €1.5 billion share buyback programme, to be initiated in the third quarter of 2017 and to be completed in two years. This comes in addition to the €3.5 billion in share buy backs that were already completed between 2011 and 2016.

The programme is intended to more than offset the share dilution in connection with Philips long-term incentive programmes and dividend in shares. Philips intends to execute part of the programme through a series of individual forward transactions unevenly distributed over the two-year period.

The buy back is in line with our capital allocation policy, which aims at a balanced mix of investments in organic and inorganic growth opportunities, actions to drive balance sheet efficiency and returns to shareholders.

As stated in the press release and as previously reported we continue to be in discussions on the civil matter with the US Department of Justice, representing the FDA. The discussions are focussing primarily on the external defibrillator business in the United States and arising from past inspections by the FDA in and prior to 2015.

Despite continued volatility in the markets in which we operate, our outlook for 2017 remains unchanged as we expect further operational improvements and comparable sales growth in the year to be back-end loaded. This, supported by a strong order book. We are on track to deliver the 4-6% comparable sales growth and an improvement in adjusted EBITA margin of around 100 basis points per year.

And with that, I would like to turn the call to Abhijit, who will provide more detail on financial performance and market dynamics.

## **Financial Performance and Market Dynamics**

Abhijit Bhattacharya

*Chief Financial Officer, Royal Philips*

### **Second quarter growth**

#### *Mature geographies*

Thank you, Frans, and good morning to all of you on the call and webcast.

Let me start by providing some colour on the second quarter growth of 4%. On a geographic basis, mature geographies delivered 4% comparable sales growth. Western Europe showed a strong 8% comparable sales growth, mainly driven by the Netherlands, Iberia, Denmark and Norway with double-digit growth. North America grew by 4%, while other mature markets

posted a 7% decline, driven mainly by Japan. In mature geographies, Diagnosis & Treatment grew high single digit, and Connected Care & Health Informatics and personal health posted low single-digit growth.

#### *Growth geographies*

In the growth geographies, 3% comparable sales growth was largely driven by strong double-digit growth in countries like Russia, Turkey, Indonesia, Thailand and Argentina. We are pleased with the continued high single-digit growth in China in the quarter. In the growth geographies, personal health recorded double-digit growth, Connected Care & Health Informatics low single-digit sales growth and Diagnosis & Treatment mid-single-digit decline compared to Q2 of 2016.

#### *HealthTech Other*

In HealthTech Other, net sales decreased €9 million as royalty income decreased by €14 million due to the foreseen expiry of licences. This gave us a headwind of 30 basis points for the overall growth of the group in the second quarter.

### **Order intake**

Turning to order intake, as Frans mentioned, comparable order intake overall grew by 8%. The Diagnosis & Treatment businesses grew by 7%, with image-guided therapy business growing mid-single digit, and both diagnostic imaging and ultrasound growing at high single-digit rates. The Connected Care & Health Informatics businesses grew by 8%, recovering from a slower start in the first quarter.

#### *Growth geographies*

In growth geographies, order intake on a comparable basis grew mid-teens compared to Q2 2016, mainly driven by Latin America, India, Russia and Middle East and Turkey. Comparable order intake in Western Europe decline with 8% on the back of double-digit growth in the previous quarter, while North America posted a strong 9% growth. On the last 12-month basis, comparable order intake grew with over 4%.

### **Group EBITA development**

#### *Margin improvements*

Let me now turn to the EBITA development for the group in the second quarter. Adjusted EBITA margin of 10.2% in the quarter was 90 basis points higher than the year before. This margin increase was driven by an improvement of 120 basis points in personal health, mainly attributable to the operational leverage from growth. In Diagnosis & Treatment, the margin increased by 80 basis points, mainly due to higher volumes and product mix. In Connected Care & Health Informatics, the margin improved by 90 basis points, mainly due to cost productivity. In order to further improve our financial disclosure and to align with our new peer group, we have included adjusted EBITDA metric as from Q2 2017 in our press release, which also includes the bridge from income from operations and provides historical numbers for 2016.

#### *Performance improvement*

Our performance improvement in the second quarter is driven by higher volumes, improved operational performance and meeting our cost productivity targets. More specifically, net overhead cost reduction amounted to €15 million in non-manufacturing costs, the productivity



programme contributed €33 million to the gross margin and procurement savings, in part driven by our Design for Excellence programme, delivered €61 million of bill of material savings year on year.

#### *HealthTech Other*

In HealthTech Other, the adjusted EBITA of minus €32 million was €8 million better than our guidance. The decline of €18 million compared to Q2 2016 was driven by lower royalty income.

#### *Tax expenses*

In the second quarter, the income tax expense €44 million, which was a decrease of €19 million compared to the second quarter of 2016. The decrease was mainly due to the release of tax provisions, partly offset by higher tax charges resulting from the higher income. Q2 2016 also included tax costs related to the lighting separation.

#### *Net financial expenses*

Overall, net financial expenses decreased by €43 million year on year, mainly due to lower net interest expenses, as we redeemed bonds off in a total of \$1.5 billion during Q4 2016 and Q1 2017.

#### *Net income from discontinued operations*

Net income from discontinued operations, which now includes the results of Philips Lighting, along with Lumileds and automotive businesses, decreased by €185 million year on year, mainly due to the Funai arbitration award in Q2 2016. Net income of the Lumileds and automotive business decreased by €42 million. This was mainly due to €66 million net less from the sale of the 80.1% stake in the combined Lumileds and automotive business. Taking into account the gain related to the sale of the real estate of this business, which was recognised as income from continuing operations in Q1 2017, and in addition trademark licence revenues, which would be recognised in income from continuing operations in the future, the sale of the combined businesses will result in an overall net gain.

#### *Return on invested capital*

Return on invested capital, which is calculated on a five-quarter MAT basis was 15.4%, which is 7.1 percentage points above our WACC, and improved by 8.4% compared to Q2 2016.

#### *Working capital efficiencies*

Our drive to increase working capital efficiencies continue to yield results as inventory as a percentage of sales decreased to 14.4% year on year, an improvement of 120 basis points. Overall, working capital improved by 130 basis points to 9.8% of sales.

#### *Net cash flows*

Net cash flows from operating activities decreased by €104 million, mainly due to higher working capital compared to Q1, due to seasonality and higher tax paid.

### **US market update and outlook for Western Europe and China**

Let me now provide you with an update on the US market, and our outlook for Western European and China markets.

*US market*

Healthcare in the US is undergoing fundamental change. With our scope and scale in the US, we are well positioned to support public and private healthcare organisations to reduce healthcare cost, improve the quality and outcomes of care, and move from a volume-based to a value-based system of reimbursement and service delivery. For example, with the help of our intensive ambulatory care programme, Banner Health in the US reduced hospitalisations for chronically ill patients with multiple conditions by nearly 50%, reducing overall cost of care by more than one third.

The market uncertainties stemming from the ACA legislative process continued in Q2, particularly around larger and longer-term customer commitments. We continue to monitor events closely and stay focused on the needs of our customers. We saw continued slowdown of government spending. Given these uncertainties, we continue to expect the US market growth to be in the low single digits, while we closely monitor further developments.

At the same time, we are currently able to increase market share as we expect in the second quarter, and hence we remain confident in our ability to grow revenues.

*Western Europe and China*

In Western Europe, we expect modest/low single-digit market growth, and in China we expect mid to high single-digit market growth for 2017.

Overall, we estimate the global market growth to be in the low single-digit range for 2017.

**HealthTech Other and legacy**

Let me now give you some guidance on HealthTech Other and legacy items.

*HealthTech Other*

In HealthTech Other segment, we continue to expect approximately €60 million net cost at adjusted EBITA level for the full year. On an EBITA level, we now expect approximately €70 million of net cost for the year. The increase compared to the previous guidance of €40 million reflects higher restructuring charges and incidental items. For the third quarter, we expect a net cost of approximately €15 million at an adjusted EBITA level.

*Legacy items*

In legacy items we expect to – we expect remaining lighting separation costs for the second half to be around €10 million, and remain with our guidance for separation costs of €30 million for the full year. Other legacy items are expected to be €5 million for the second half. We now expect approximately €95 million of net cost at the reported EBITA level, an increase of €30 million, almost fully driven by the CRT legal settlement in Q2. At adjusted EBITA level, we expect €40 million net cost for the year. Mid-July we made a contribution of \$250 million to the US pension fund to further improve the funding ratio. This will further decrease Philips' interest costs going forward.

**Concluding remarks**

In summary, we are pleased with a solid first half of the year, with mid-single-digit order intake, growth, earnings improvement, working capital improvement and our cash flow performance. With the scheduled product launches and the development in our order book, we continue to expect further improvements in our operating margins for 2017 to be at the

backend of the year. We continue to target a performance trajectory to deliver 4-6% comparable sales growth, and around 100 basis points improvement in adjusted EBITA per year.

With that, we'll now open the lines for your questions. Thank you.

## Q&A

The first question comes from Ms Veronika Dubajova from Goldman Sachs. Please state your question, madam.

**Veronika Dubajova (Goldman Sachs):** Good morning, gentlemen, and thank you for taking my questions. I have one and one follow-up, please. My main question is around the outlook for the remainder for the year. If I look at – the organic revenue growth is at 3.2%, but in spite of that you've already delivered 90 basis points of margin improvement year on year. So I'm just trying to understand if we do see growth acceleration into the second half of the year, how much of that incremental growth would you expect to drive operating leverage above and beyond the 90 basis points that you already delivered in the first half of this year?

And then my quick follow-up is just on the M&A transaction. So far year-to-date it's obviously been a very busy second quarter for you. And Frans, can you maybe just talk about to what extent you feel that your team, both on the business development side of things and integration has capacity and capability to do more than the seven transactions that you've announced year-to-date?

**Frans van Houten:** Yeah, Hi Veronika. Good morning. Let me take the M&A question and then turn to Abhijit for the outlook question. So let's say a condition for me that I always apply is that the business group needs to be ready to absorb an acquisition.

Our image-guided therapy service group on the leadership of Bert van Meurs has proven with the Volcano acquisition that they are capable to handle that. The Volcano integration is mostly completely, and they are ready to take on Spectranetics. CardioProlific is a very small team, and doesn't require real integration.

TOMTEC goes into the ultrasound business group. That's a high-performing business group with very capable management – Vitor Rocha – and they can handle this. Moreover, TOMTEC, besides – they will also continue with serving the external customers, so I consider the integration not to be very complicated.

And then for example, RespirTech and APSS, both go into sleep and respiratory care. Again, a high-performing business group that is delivering steady mid-single-digit growth and high profitability. They are very capable to absorb these acquisitions.

And then lastly Health and Parenting is a very small team; goes in our high-performing health and wellbeing business group on the leadership of Egbert van Acht.

What you can derive from that is that we have looked for spread, we have not piled everything in the same unit and we – I can hold individual group leaders accountable for delivering results – exactly what we did before. So I think we are well positioned to take this along. Obviously, our focus will be on execution. We have said that this will all be growth

and adjusted EBITA and adjusted EPS-accretive next year in the aggregate, and for the most important ones like Spectranetics and TOMTEC. So that is now the name of the game. Everybody, you know, focused on execution. So for now I think our plate has been filled.

Abhijit, what about you?

**Abhijit Bhattacharya:** So I think on the outlook, Veronika, for the first half, you know, the growth was at 3%, 3.2%. We were slightly handicapped because of the loss of licence revenue. That impacted us by 30bps on the overall growth of the group. So if you see where we talked about the 100 basis points year on year improvement, we had said we expect about 100bps from volume, 190bps from gross margin and about 50bps from overhead reduction, which would be compensated then by price erosion of 130 and price inflation of 110bps. In the first half, because our growth has been slightly shy of the 4%, our volume impact is around 80bps. So as the growth picks up in the second half, we expect then the volume impact by about 20bps compared to the first half. And then, you know, for the first half we are about 85-86bps improvement, so we have to drive slightly over 100bps in the second half to make the average 100bps for the year, which we are pretty confident in doing, partly because we expect the volume growth in the second half, as I just mentioned, and then of course our productivity programmes will gather further steam as the year goes on.

**Veronika Dubajova:** That's very helpful. And can I just quickly ask, Siemens announced a review of MRI imaging in the US. Any thoughts you have on that, Frans, or expectations for what that means for your business? And I'll jump back into the queue on that. Thank you.

**Frans van Houten:** No, I need to study it further, Veronika. So no comment on that now.

**Veronika Dubajova:** Excellent. Thanks very much.

**Operator:** The next question comes from Andreas Willi from JP Morgan. Please state your question, sir.

**Andreas Willi (JP Morgan):** Yeah. Good morning, gentlemen. My main question is Connected Care & Health Informatics. We've had a period now with pretty lacklustre organic sales growth [inaudible] you had better orders now. You talked a lot about the product rollout, the breakthrough R&D you have spent. Should we now go into a period of a more sustained kind of mid-single-digit organic sales growth trend, or will this remain a bit more lumpy in terms of getting the confidence that these investments are driving superior revenue growth going forward?

**Frans van Houten:** Yeah, thanks. Hi, Andreas – you're right. We will now go into a more sustainable growth period. In fact, we talked about it before that some of these orders deal with more complex, larger-scale installations that at enterprise level in the IDNs need to be signed off and integrated. In fact, some of the revenues again was pushed out into the third quarter. So you're right, we should expect a much stronger revenue in the second half year versus the first half, so that we can make up for the slowness and overall lend in a good growth rate in the same target area as we have guided.

**Andreas Willi:** My follow-up is for Abhijit on healthcare. Other OIT the run rate and the Q3 guidance implies quite an improvement, then also needed for Q4. How much visibility do you have on the licensing income which I guess is part of the positive you can kind of imply for Q4 and get generally better results for the second half?

**Abhijit Bhattacharya:** Yeah, we got a bit of a knock there in Q2, but for license income we are close to flat for the second half so the decline in the year was largely in the first half, and therefore, you'll see the second half year-on-year comparison been better than the first there. So we lost I think 28 million in the first half year and the second half will be about flat.

**Andreas Willi:** Thank you very much.

**Abhijit Bhattacharya:** Thanks.

**Operator:** The next question comes from Mark Troman from Bank of America Merrill Lynch. Please state your question sir.

**Mark Troman (Bank of America Merrill Lynch):** Yeah thank you very much. Good morning everybody. Question please on pricing fronts. 90bps in the quarter, I think from your profit bridge and the long term sort of guesstimate seems to be 130 a bit more than that. I wondered if you could comment on the pricing environment and maybe how that is developing by category. You always do it – obviously there is some innovation, but you're trying to do more system selling. There is more IGT. So is there a better pricing mix that we can expect. In other words, can we expect a little bit more robust performance in that pricing variable in the bridge? Thanks very much.

**Frans van Houten:** Yeah, it was a little bit lower than our longer-term guidance, but I would not say that that's a trend break. As you know we work very hard to move towards more of a solutions orientation, looking to have a combination of system software and services that improved mix – that improves the mix, but it also takes the direct attention away from a naked box sale. So maybe that's part of the explanation. But I'm not able to promise you that 90 basis points is the new normal. We will stick for now with our longer-term guidance.

**Mark Troman:** Okay thanks and just one quick follow-up. On where you're seeing the most shared gains. Your comment market share gains. Is that Cleveland or is that across other businesses other than that?

**Frans van Houten:** The strong order intake in North America clearly outpaced the low single digit market growth, and that is why we also believe we're gaining share. The order intake growth was across the board so also for DI, Diagnostic Imaging and notably strong was the order intake for the Enterprise Informatics, Healthcare Informatics area. And patient monitoring also, so across the board basically. Now the official reporting in North America will undoubtedly confirm this, but let's say, our overall track record of growth bodes well.

**Mark Troman:** Great thanks.

**Operator:** The next question comes from Mr Patrick Wood from Citi. Please state your question sir.

**Patrick Wood (Citi):** Patrick, thank you very much, good morning everybody. Thank you for taking my questions. The first one I guess would be on the oral care and personal care category. You guys have been taking about fairly considerably and consistently for quite some time versus sort of the FMCG peers. I wonder how long you feel you can keep doing that and whether that is – is that pure innovation, is that NPI, you know what's really driving the share gains and how confident are you those can keep going?

And just as a quick follow-up as well if I may, maybe following up on the North American imaging side of things, a bit stronger than I think some of us expected. Had the conversations with hospitals changed at all? There's a lot of uncertainty surrounding healthcare reform in the US and it's surprising that I guess you and peers have had pretty robust growth, and you've been taking share back. Have you had any change of discussion, has this pent-up demand or what's really driving that, that North American market growth that you're seeing? Thanks.

**Frans van Houten:** Thanks Patrick. Well so your question was specifically first is the FMCG guys right so. In oral care, you see an ongoing shift from manual brushing to electrical brushing. That is a macro trend that will continue so that that creates a fundamental for our oral care business that is very, very healthy. Moreover, we have completely overhauled the product range in oral healthcare, and we have been stepping up our investments in advertising and promotion. So – and lastly we're still adding countries to our franchise right, I mean to address the geographical expansion. So this is a potent recipe that has been working extremely well for us, and can continue to drive, let's say, the growth rate that we have been enjoying.

Then on personal care, a few years ago we kind of anticipated that male shaving with the traditional electrical razor was not necessarily appealing to young men and we started to invent the OneBlade. Now OneBlade is a kind of a hybrid between a traditional handle for wet shaving and an electrical shaver, and it's particularly targeted towards this grooming area. We are selling the OneBlade in the traditional shaving aisle, basically where the wet shaving classical competitors are, right. So, it's for us, an extension of our market reach into a new segment and it is in our opinion taking share away from the classical categories in shaving. And then moreover, we entered into let's say beauty segment.

So again because of this strategy we can sustain growth in personal care. We said in the introductory speech that OneBlade has just increased its geographical coverage to 14 countries, up from last year six. That means we are still in the ramp-up phase, and we expect more growth to come. So that is I think where this growth is coming from, and for at least the foreseeable future, we expect this to continue.

Then your second question on hospitals, let's say in North America, there is a little uncertainty around the ACA. And the conversation with hospital C-Suite is that people are concerned especially if you have a high exposure to Medicare, Medicaid then your funding is at risk.

This is in the market slowing down overall investments. Moreover, it has – there is a slowdown at the veterans administration due to their procurement rules that favour small veteran-owned companies. All of that has not stopped us from driving hard let's say our innovations in gaining some share. And I do see more reluctance in the near term for long term large scale project commitments. So that is something that I think we need to be a little bit more conservative in our estimations on because nobody is going to commit themselves structurally in this uncertain situation. So I hope that answers your question Patrick.

**Patrick Wood:** That's very helpful. Thank you very much.

**Frans van Houten:** You're welcome.

**Operator:** The next question comes from Ian Douglas-Pennant from UBS. Please state your question sir.

**Ian Douglas-Pennant (UBS):** Hi, thanks for having me on. So the first is on the process improvement costs in CC&HI. Can we, should we take this as a sign that you are acting in response to the concerns that FDA raised and the DOJ may not enforce already. I don't know whether you can give any comment on that or how new those cost have been, how quickly those costs have been rolled out how recently? And then the follow-up question is to –

**Frans van Houten:** Sorry Ian, did you say process improvement cost? I'm not sure I heard the word that you used.

**Ian Douglas-Pennant:** That's what I said, yes.

**Frans van Houten:** Okay.

**Ian Douglas-Pennant:** If that's not exactly the same language as this in your release, I apologise but.

**Frans van Houten:** Okay, no problem.

**Ian Douglas-Pennant:** And then the other one is a follow-up question related to after Veronica's question earlier. I wasn't quite sure what you were guiding for. Were you saying that you're going to hit the 100 basis points of margin improvement this year, or by the second half of this year you're going to be annualising at a 100 basis points as in if that makes sense? There's quite a big difference for the run rate for the next year.

**Frans van Houten:** Well we carefully phrased a 100bps per year as an average so it could be one year at 90, another year at a 110 averaging across the years at around a 100. For this year, we have said that the second half year will be stronger in terms of revenue growth than the first half. We have not specifically guided on what that does for profitability other than saying that for the full year, we intend to be around the 100bps without further precision.

On your first question, in CCHI, couple of things going on, yes, we are stepping up a bit to cost for to be ready for regulatory inspections. We are always ready, but you know you can certainly do more when you are in a situation as we are in. And that specifically relates to the Bothell and Andover sites. Moreover, in CCHI, we also have a restructuring and I turn to Abhijit to maybe say a few words about them.

**Abhijit Bhattacharya:** Yeah, the restructuring is part of the, let's say, overall footprint programme that we are running, but we are also stopping one particular product which leads to a slightly higher restructuring in this quarter. Okay?

**Ian Douglas-Pennant:** The reason for that discontinuation, is this just a standard reduction or is this?

**Abhijit Bhattacharya:** Yeah, that has nothing to do –

**Ian Douglas-Pennant:** It's nothing to do with FDA or anything like that.

**Abhijit Bhattacharya:** No, it has nothing to do with the whole FDA thing. It would have happened anyway.

**Ian Douglas-Pennant:** Okay that's fine. Thank you very much. I've got some other ones, but I'll jump back in the queue.

**Frans van Houten:** Okay thanks Ian.

**Operator:** The next question comes from Mr Max Yates from Credit Suisse. Please state your question sir.

**Max Yates (Credit Suisse):** Hi, thank you. Just my first questions on personal health. You've obviously shown another quarter of a very strong growth again a tough comp. You also talked about I think having advertising revenues that were burdening this quarter's margin. So should we be thinking that kind of as we move into the second half if we can sustain similar growth rates that we should get a greater amount of margin expansion or do you expect to have some further advertising costs and product launch costs in the second half as well?

**Frans van Houten:** There's no reason to expect a stronger second half than the first half. If we can continue to perform at this rate that would be outstanding in my book.

**Max Yates:** Okay. Then just the follow-up was just on China and what's happening. Now, I think you're sort of talking about the markets growing at mid to high single digits, and I think your business has been growing double digit for the last couple of quarter so. I think you've talked about in the past kind of the government or fa – or the government favouring local players there yet. You seem to sort of continuously be actually outperforming the underlying market that you talk about. So could you give us a little bit of a feel for how healthcare in China is developing, and maybe sort of explaining sort of your ongoing strong performance there and how sustainable that is?

**Frans van Houten:** Yeah, a couple of years ago there were several issues. One of which was the local players and the preference that they were being given by in some provinces and in some hospitals. The other one was the kind of clamp down on procurement methods in hospitals.

The latter factor has gone away. The China five-year plan clearly identifies healthcare as a growth area, in particular, in the more rural areas, and also favouring private hospitals expansion right. The share of private hospitals is expected to increase from around 10% to 25% in the next four or five years. That is good for us because private hospitals are not bound to this kind of political game in certain provinces favouring local vendors.

Nevertheless, this local preference thing has not gone away. We occasionally bump into that, and then we cannot really participate, especially when it is on larger bundled deals. So it's a reality that we try to work around.

The strategy that we have to become more of a solutions provider also is at work in China, and that increasingly is well received, in particular also with the private hospitals who look for solutions and are not necessarily keen to be a systems integrator on their, in their own right. So we have somewhat outperformed the China market, not by a lot I would say. We talk about the market being mid to high single digit, and we are kind of hovering around the 10% growth so it's nice performance. It also means we have recovered from 2015 when we were much slower.

I must say that Andy Ho and his management team are doing a great job that's our leader for China. And I for the foreseeable future, I see this as sustainable growth. So I'm confident about our ability to perform at least let's say for the foreseeable horizon. Longer term, look, I



read The Economist and other magazines and you can say longer term is there a macroeconomic issue, but at least nothing that the near term need to worry about.

**Max Yates:** Okay. And as you just following on this one, one number that would be really helpful. You talked about in personal health trying to do more to increase your recurring revenue and customer sort of relationships. Would you be able to give us an update of how much of personal health is now recurring revenue or at least on the sort of toothbrush and toothbrush and [inaudible]?

**Frans van Houten:** Off the top of my head, the recurring revenue in personal health is currently around 10%, and that has been steadily increasing.

**Max Yates:** Okay thank you very much.

**Frans van Houten:** You're welcome.

**Operator:** The next question comes from Mr David Vos from Barclays. Please state your question sir.

**David Vos (Barclays):** Good morning gents. Thanks for taking my question. The first one on the healthcare other line actually where you expect quite a bit of a break-in to trend between H1 and H2. Could you just comment on that, and particularly in relation to innovation line? Is that also stepping down quite a lot and if that's the case, if that done because you now feel that you need to invest less and therefore we can expect a similar amount going forward i.e. a lower amount? And I'll ask the second question after that. Thank you.

**Frans van Houten:** Maybe you ask your second question now so that we can look up the first question.

**David Vos:** Okay that's also fine. The second question was more of a housekeeping one around Lumileds. If you could confirm already what the expected net cash amount in will be once the – once you recognise I think Q3. And then also if you expect the stranded costs to run in the 5 million range for the foreseeable and so and if not how [inaudible]? Thank you.

**Abhijit Bhattacharya:** Yes, so maybe, let me just address your first question on health tech other. There is no real significant change in the run rate on innovation between the first half and the second, maybe a little bit. It's more that in the first half we had certain one-off charges which we will not have in the second.

And the other thing is, in the first half we had, compared to last year the deterioration in the license income and therefore the EBITA to that for about €28 million which is not there in the second half.

**David Vos:** Yeah, I see that Abhijit, but I struggle a little bit to make a bridge then between you know, a first half in which you've done kind of a €70 million negative and a second half which then should be €10 million positive to reach the €60 million adjusted EBITA guidance. Unless I took that number down in the wrong way, I'm not really sure how we get there.

**Abhijit Bhattacharya:** Let me – I'm more than happy to give you that offline and here as well. Like I said, the first half was more severely impacted by the license income, so if we give you, let's say on a call separately, the view on license income for the second half, and in the first half we also, like I said, had some one-offs in the quarter which you see in the health

tech other line of €10 million; that also will not repeat in the second half. So I think those are the big – and we have quite a big quarter in Q4 in license revenue so although year-on-year it remains flat but through the years, the license revenue in the second half of the year is significantly more than the first half and that also is what created additional income in the second half.

**David Vos:** Okay, let's take that offline then.

**Abhijit Bhattacharya:** So if you keep the innovation cost the same but if you have a much larger license revenue you will have a much better income for the second half.

**Frans Van Houten:** And the cash amount for Lumileds?

**Abhijit Bhattacharya:** And the cash amount for Lumileds has already come in – was I think the €1.35 billion so it was what we had announced earlier and that money has come in in Q2.

**David Vos:** Coming in in Q2? Okay.

**Abhijit Bhattacharya:** Yeah and – sorry, what was your question on the Lumileds standard cost?

**David Vos:** Oh, the standard cost, yes, you mentioned €5 million in the other items and legacy –

**Abhijit Bhattacharya:** Yeah, that used to be there as standard cost but now that Lumileds has gone we will get rid of that cost so that will disappear in the coming months.

**David Vos:** Okay, perfect, thank you so much gentlemen.

**Operator:** The next question comes from Mr Yi-Dan Wang from Deutsche Bank. Please state your question sir.

**Yi-Dan Wang (Deutsche Bank):** Hi this is Yi-Dan from Deutsche Bank. Just one quick question; can you provide a bit more colour on the performance in the other mature markets? It seems to be a lot weaker than mature markets in general, and what are you doing there? When can we expect that to – that performance to improve? That would be great, thank you.

**Frans Van Houten:** Yeah that's a – I can be quick about it. That's mainly driven by a sales decline in Japan. What is now good is that in the second quarter we had a very strong, positive order growth, and therefore we are going to be able to turn around our performance in Japan and get back to positive sales growth in the coming quarters.

**Yi-Dan Wang:** So that's just quarterly fluctuations rather than something in the –

**Frans Van Houten:** Well I would call it a little bit more than a quarterly fluctuation because in fact our Japan performance has been a little bit on the soft side for the last several quarters. And we appointed new management about three quarters of a year ago and we are now seeing the positive impact of that new management; very pleased with the strong – very strong order growth in the second quarter, and therefore I'm optimistic that going forward, we will see a much more steady performance.

**Yi-Dan Wang:** What was wrong with it and what did they do to turn it around?

**Frans Van Houten:** It's just a matter of new energy and leadership into the team. I mean there was no specific single root cause other than that a newly appointed leader brings new energy and takes the team forward.

**Yi-Dan Wang:** Okay so products are fine but there was a management issue?

**Frans Van Houten:** Exactly, yes.

**Yi-Dan Wang:** Okay, thank you.

**Operator:** The next question comes from Mr Scott Bardo from Berenberg, please state your question sir.

**Scott Bardo (Berenberg):** Good morning, thanks very much for taking my questions. First question just relates to the order book bounce back of 8% this quarter which is encouraging and good to see. But I just wanted to understand in historical context because it appears that North America was major driver of the rebound but it was against a comp which I think was one of the worst growth comps for all of the company has had for some time. I think you were down something like 10% in the prior year so is this effect to a large extent normalisation rather than market share gains? Perhaps you could comment that a little bit about how we put that in the context of history?

**Frans Van Houten:** Well if you take last 12-month order growth for Phillips as a whole then we are a little over 4%, I think 4.1% off the top of my head. That I would say is a little bit above global market growth. With the strong order growth in the second quarter we probably will see this LTM average go up a little bit. North America specifically is also at a 4% LTM and I like to point out that this year we have not yet had orders from the VA given that the VA is withholding all orders due to this legislative issue around giving preference to veteran-operated enterprises. There are hearings going on with regards to this and the hope this will be resolved later this year, we are not certain yet. Phillips has a very strong market share in the VA so this is material for us. Notwithstanding the VA not ordering, we had 8% order intake growth hence my conviction about market share performance.

**Abhijit Bhattacharya:** 9% even.

**Scott Bardo:** Thanks very much, you've been very clear.

**Frans Van Houten:** 9%, okay thanks Scott.

**Scott Bardo:** And maybe just one follow-up if possible please. So free cash flow generation I think in the first half I think was about €165 million which is perhaps a little bit softer than the trajectory for €1 - 1.5 billion that you outlined for health tech; can you talk a little bit about the drivers for free cash flow in the second half and following on from this, if Abhijit could take a stab at what the net debt position for the business will be at the end of the year considering the Lumileds inflow and in the absence of further sell down for lighting? That would be very helpful for us to get a feeling for balance sheet position. Thanks very much.

**Abhijit Bhattacharya:** I think from a cash flow perspective, we are pretty good; well-placed if you look at the first half this year versus the first half of last year. As a business, our cash flow largely comes in Q3 and Q4 so we are actually pretty okay with the €1 - 1.5 billion guidance that we've given. Regarding the net debt we probably will be on the lower side of

the €1 - 1.5 billion turns of net debt to EBITA that we target, so closer to the €1 billion than the €1.5 billion.

**Scott Bardo:** That's excluding Spectranetics Abhijit or...?

**Abhijit Bhattacharya:** No that's including, I mean, we will pay for Spectranetics now right so we will find that as well.

**Scott Bardo:** Okay, thanks very much guys.

**Operator:** The next question comes from Mr James Moore from Redburn, please state your question.

**James Moore (Redburn):** Good morning everyone. I wonder if I can ask a little bit about the profitability in D&T; progressing nicely but maybe a little better than consensus was expecting, perhaps we were all a bit too high, but I was wondering if you could perhaps provide a little colour on the year-on-year development for margin between the units; DI, IGT, Ultrasound? Specifically I'm trying to understand how much big irons is coming up with or without Cleveland, and whether ultrasound, the step back that we saw last year, whether that's stopped or is still continuing?

**Abhijit Bhattacharya:** So if you look at DI and the improvement in the first half, we see that actually pretty much across the board. So you see, you know, we have improvements in DI for sure because also the improvements in the CT, CT/AMI results. We have good improvements in the results of IGT, and what is also very good is that we have good improvements in the results of ultrasound because ultrasound growth is back, and therefore you know, these are high margin businesses which have very strong operating leverage. So I think that is helping us, and also the added growth so far from IGT and ultrasound gives us a positive mix impact in the overall numbers. So CT, AMI, fast reductions on track, good volumes so far and then a bit of mix that comes from the ultrasound and IGT businesses growing fast.

**James Moore:** Very helpful, thank you. And the other question was on trademark license revenues; I might have misheard you earlier, but will there be a change in the sales or profit and could you size the impact going forward from either Lighting or Lumileds/Auto?

**Abhijit Bhattacharya:** Sorry I didn't mention -.

**Frans Van Houten:** The brands' licensing comp.

**Abhijit Bhattacharya:** No, I didn't mention anything about that. So we had – we have said there are certain licenses which expire and we had guided to that earlier that we would lose this year around €28 to 30 million. The loss of that revenue is basically in the first of half of the year, so the second half year-on-year would be close to flat.

**Frans Van Houten:** So Lumileds will start contributing to the brand license income going forward now that they are from Q3 being deconsolidated.

**James Moore:** And that's what I was trying to understand; we've got this dropping out and then Lumileds coming out and basically big picture if we look at next year versus next year, licence income, is it broadly similar or how should we think about that?

**Frans Van Houten:** Brand licence income is seeing a steady increase over time.

**James Moore:** And in terms of the profit impact of that, does it move with it? They're things we need to think about.

**Frans Van Houten:** So you see within the licensing portfolio that we are losing license income from intellectual property patents and we are gaining license income from the brand. In terms of profitability it's probably similar, and Abhijit already said that the decline of IP&S was primarily in the first half whereas the second half year-on-year is more comparable.

**James Moore:** Very helpful, thank you.

**Frans Van Houten:** Yeah, alright.

**Operator:** Once again if you would like to ask a question, please press the \* followed by the 1 on your telephone. To cancel this request, please press the \* followed by the 2.

We have a follow-up question from Ms Veronica Dubajova from Goldman Sachs. Please state your question madam.

**Veronica Dubajova:** Thank you gentlemen for squeezing me in at the end. I just wanted to ask a question about the order book growth and the four plus percent that you're running at over the last 12-month period; how sustainable do you think that is? And other than US CapEx, which you have flagged as maybe an area of concern, are there any other risks that you see to that 4% growth rate? Thank you.

**Frans Van Houten:** Hi Veronica. That is sustainable, in fact, I would like to have the order growth to be in the same bracket as our guidance for revenue growth. We see that we have done that over the last 12 months. I flagged that Q2 will help that average, and also looking forward, looking at our opportunity funnel, we use Salesforce.com so we can actually analyse our opportunity funnel pretty well. I feel confident about our ability to do that.

**Veronica Dubajova:** That's great, thank you.

**Frans Van Houten:** You're welcome. Okay, are there any other questions?

**Operator:** And we have a follow-up question from Andreas Willi from JP Morgan. Please state your question.

**Andreas Willi:** Yes, thank you very much. I just wanted to ask about foreign exchange and the sensitivity to it. Obviously, we have a translation impact from the strong euro but historically Phillips have at times quite material impact on the transaction side. I mean, a weak dollar should generally be good for some of your sourcing costs but maybe you could just talk about that bit more in terms of what the implications are of the big currency moves we are currently seeing; how far out you're hedged and whether we should expect much in the earnings bridge in terms of margin impact in the second half and into next year.

**Abhijit Bhattacharya:** I think for the second half not really anything significant. If you see we are largely hedged in terms of our position than just a strengthening of dollar, you know you will get an impact both on the sales as well as the absolute amount of EBITA. But from a margin perspective, not too much so we have changed quite a bit on our hedging strategies in the past so therefore you've seen in the last couple of years we don't call that out as large as it used to be. Of course, if emerging market currencies fluctuate big time that could have an impact but if it's just the euro, dollar, we should be okay for this year and then for next year

it's bit long-term to see but then we'll hedge accordingly as well, or take pricing action so one of the two.

**Andreas Willi:** But do you have a big net exposure because I guess you export some products from Europe, you export others from the US; is there a big net exposure prior to –

**Abhijit Bhattacharya:** Not big no, not really.

**Andreas Willi:** Thank you very much.

**Operator:** The last question comes from Mr Scott Bardo from Berenberg, please state your question sir.

**Scott Bardo:** Thanks very much for taking my follow-up, it just relates to the ongoing regulatory discussion with the US Department of Justice. Obviously, this is an overhang that's been kicking on for some time now. I just wonder if you could – obviously there's limited things you can share here but can you share some sort of feeling as to the likelihood that these discussions culminate in a consent decree with the regulator? Perhaps you could share some thoughts there, thank you.

**Frans Van Houten:** Hi Scott. Well, discussions are still going on with the DoJ and obviously discussions with the DoJ are serious, otherwise you wouldn't have them so we take it very seriously. Now, it affects primarily the defibrillator business and therefore the impact of any measures would be targeted to let's say part of the PCMS business group. Other than that, I really don't want to run ahead of ourselves and first come to a conclusion with that discussion which is taking a little bit of time so – but let's take it when it comes and then we will inform you in detail on the next steps.

**Scott Bardo:** Okay, thanks very much Frans.

**Frans Van Houten:** Alright.

**Operator:** Thank you. Mr Frans Van Houten and Mr Bhattacharya that was the last question, please continue.

**Frans Van Houten:** Okay well, then I'd like to say to everybody thank you for attending. We had a strong let's say quarter, we look with confidence at the future; that is what we wanted to radiate and we will stay very focused on execution and that's what you can expect from us. Thank you very much for attending.

**Operator:** This concludes the Royal Phillips Second Quarter 2017 Results Conference on Monday 24<sup>th</sup> July 2017. Thank you for participating, you may now disconnect.

[END OF TRANSCRIPT]

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