

PHILIPS

Philips – Q2 2019

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Introduction

Leandro Mazzoni

Head of Investor Relations, Royal Philips NV

Good morning, ladies and gentlemen, welcome to Philips' Second Quarter 2019 Results Conference Call. I'm 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 on the financial performance and market dynamics. After that, we will take your questions.

Our press release and the related information slide deck were published at 7 a.m. CET this morning. Both documents are available on our Investor Relations website. A full transcript of this conference call will be made available by end of today on our website.

Finally, as mentioned in the press release, adjusted EBITA is defined as income from operations, excluding amortization of acquired intangible assets, impairment of goodwill and other intangible assets, restructuring charges, acquisition-related costs and other significant items. Comparable growth for sales and orders are adjusted for currency and portfolio changes. With that, I would like to hand over to Frans.

Overview

Frans van Houten

CEO, Royal Philips NV

Thanks, Leandro, and good morning to you all. Thank you for joining us today. I'm pleased with the 6% comparable sales growth in the second quarter with all businesses contributing. We also recorded a strong 8% comparable order intake growth, driven by the continued demand for our innovative product portfolio across the Diagnosis & Treatment businesses.

Adjusted EBITA margin for the group improved 60 basis points despite adverse currency and tariff impacts of 60 basis points in total. I am also pleased with the double-digit comparable order intake in the growth geographies. Mature geographies' order intake growth was flat on the back of double-digit order intake growth during the second quarter of 2018.

Our Diagnosis & Treatment businesses as well as our Connected Care businesses delivered 6% comparable sales growth for the quarter. The Personal Health businesses delivered comparable sales growth of 5% for the second quarter in a row, driven by new product introductions and investments in advertising. Sales in Oral Healthcare remained strong with high single-digit growth in the quarter.

Let me expand on our strategic journey to leadership in health technology. Our value creation story is built around 3 key levers: driving growth in our core business, innovating solutions and driving operational excellence in all our activities. Let me expand on that. As a way to create value in our core businesses, we continue to drive market share through deeper, more comprehensive customer partnerships and pursuing growth by increasing geographic coverage and market penetration.

During the second quarter, we entered into several new long-term strategic partnerships with leading hospitals in the United States and Europe. For example, we signed a 10-year agreement with the Centre Hospitalier Régional Universitaire de Nancy in France to implement our IntelliSpace Enterprise Imaging Solution. The collaboration will enable the hospital, which by the way, provides 1.2 million consultation visits and inpatient stays each year, to actually streamline complex medical image data management across its departments.

We also announced a 10-year agreement with Rutherford Diagnostics to deliver advanced imaging solutions to its 5 new diagnostic centers across the United Kingdom. As the technology partner, we will provide advanced imaging systems and software as well as manage technology services, including training and consultancy, and establish a joint innovation program.

As health care continues to transform from a volume- to a value-based approach and the amount of data available for each clinical decision is growing, our customers are seeking seamless integrated solutions to enable more precise diagnosis and treatment as well as optimized patient care pathways inside and outside hospital. We continue to bring new solutions to the market in the areas of Diagnosis & Treatment, Connected Care and Personal Health.

Diagnosis & Treatment unites the businesses focused on precision diagnostics and treatment selection and planning and the businesses related to image-guided, minimally invasive treatments. We continue to roll out adaptive intelligence-enabled applications, combined with successful innovations in our systems platforms. For example, in cardiac ultrasound, we extended the advanced automation capabilities on our EPIQ CVx cardiology platform. The complexity of ultrasound exams of the heart can be a barrier to accessing high-quality care. We have addressed this by leveraging artificial intelligence to make exams faster and easier to conduct. The new release of the EPIQ CVx is a major step forward and increases clinician productivity significantly.

Image-Guided Therapy continued to deliver double-digit growth, driven by both our systems and devices businesses. The combination of our interventional imaging system, such as Azurion platform, our range of devices, such as the recently introduced IntraSight intravascular diagnostic application and associated services enables clinicians to decide, guide, treat and confirm the appropriate coronary and peripheral vascular treatment.

The double-digit growth in our Image-Guided Therapy Devices business was driven by all major coronary and peripheral vascular device families. We announced the 3-year results from the 2 major Stellarex clinical studies involving approximately 600 patients, demonstrating that Stellarex is the only low-dose drug-coated balloon with a significant treatment effect and strong safety profile through 3 years. Both studies showed no difference in mortality compared with the current standard of care.

We participated in the FDA's Circulatory System Devices Panel of the Medical Devices Advisory Committee meeting on June 19 and 20. Philips presented the safety data of our Stellarex drug-coated balloon and collaborated with industry players and clinicians to reinforce the benefits of the paclitaxel-coated devices in treating patients with peripheral artery disease. At the end of the meeting, the panel agreed that the benefits outweighed the risk for the paclitaxel-coated products but confirmed there was a need to continue to monitor safety and accurately inform patients of the risks. The FDA will contemplate the information in the panel summary before making a final decision. In the meantime, we are in continued discussions with the FDA to

reinforce our confidence in Stellarex as a safe and effective treatment option for patients with peripheral artery disease.

Let me switch to Connected Care. There, the focus is on patient care solutions, advanced analytics and patient and workflow optimization inside and outside the hospital and aim to unlock synergies from integrating and optimizing patient care pathways and leveraging provider-payer-patient business models. We entered into a 10-year agreement with the Kantonsspital Winterthur, one of the largest hospitals in Switzerland, to standardize patient monitoring across the hospital enterprise. We've also teamed up with the United States insurance company, Humana, to improve care for at-risk, high-cost populations. The pilot program will support independent living for high-acuity patients with congestive heart failure by providing them 24/7 access to care.

Our therapy solutions to treat obstructive sleep apnea, a condition that affects more than 100 million patients globally, continues to garner healthy demand, supported by the strong reception of the DreamStation GO expanded portable therapy options.

Our Personal Health businesses focus on healthy living and preventative care. In the United States, we launched the Sonicare DailyClean entry-level proposition to address lower price segments next to the Sonicare ExpertClean, which features premium brush heads, connectivity and design. This has broadened our leading portfolio of power toothbrushes to cover more price points, attracting a wider consumer population.

Following the successful rollout of the Philips Shaver Series 9000 Prestige in Q4 of 2018, we have gained significant market share in the premium shaver market, especially in China, Germany and the United States. Consumers appreciate the new shaver with global rating and review scores of 4.7 stars.

Now moving on to our initiative to improve margins through customer and operational excellence. Our productivity programs to drive over EUR 1.8 billion in savings for the period 2017-2020 are well on track as we delivered EUR 146 million savings during the second quarter. The main 3 programs, such as the procurement savings, manufacturing productivity and overhead cost reduction, all delivered on their milestones.

Let me now give a progress update on regulatory matters. We continue to fulfill our obligations under the Consent Decree. The FDA reverted to us with follow-up requests, which we are currently acting on over the coming months.

We continue to expect our performance momentum to further improve in the second half of the year supported by growth and productivity programs. Since 2016, we have been on a consistent growth and profitability improvement trajectory, and we remain confident in meeting our 2017-2020 targets of 4% to 6% comparable sales growth and an average annual margin improvement of 100 basis points as we expect to become a EUR 20 billion health technology company with an adjusted EBITA margin of around 15% by 2020.

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

Financial Overview

Abhijit Bhattacharya

CFO, Royal Philips NV

Thank you, Frans, and good morning to all of you on the call and the webcast. Let me start by providing some color on the second quarter comparable sales growth of 6%.

The Diagnosis & Treatment businesses delivered a 6% comparable sales growth as well, driven by strong performance in North America and the global geographies including China. Image-Guided Therapy grew double digit in both systems and devices and Ultrasound grew high single digit. Diagnostic Imaging sales were in line with last year on the back of tough comparables in the Advanced Molecular Imaging business or AMI, which had a comparable sales growth of 50% in the second quarter of last year.

The sales for the Connected Care businesses in the second quarter also grew by 6%. The Monitoring & Analytics business showed mid-single-digit growth and our EMR business delivered strong double-digit growth. Sleep and respiratory business grew mid-single digits, driven by the success of the DreamWear Full Face mask and the launch of our DreamWisp minimal contact mask in the first quarter. The Personal Health businesses delivered 5% comparable sales growth during the second quarter, led by high single-digit growth by our Oral Healthcare business. The Personal Care and Domestic Appliances businesses' comparable sales grew by mid-single digits.

Group sales in mature geographies in the second quarter increased by 5% on a comparable basis, reflecting growth in Western Europe, North America and other mature geographies. Sales increased by 9% on a comparable basis in our growth geographies, led by double-digit growth in China, Russia and Central and Eastern Europe.

For the second quarter, comparable order intake overall grew by 8%, with Diagnosis & Treatment businesses up double digit due to strong performance across the portfolio and further building on the double-digit growth in Q2 2018. China and overall growth geographies continued to perform strongly with a double-digit order intake in the quarter.

The Connected Care businesses declined mid-single digits during the quarter, continuing on the uneven pattern of order intake that we witnessed during the last quarters. With the strong comparable sales and order intake growth in the second quarter, the comparable sales growth for the first half of the year was above the 4%, which is now within the target range, and the order intake is now above 5%.

Let me now turn to profitability development for the group in the second quarter. Adjusted EBITA increased by EUR 67 million and the margin improved by 60 basis points compared to the second quarter of 2018 despite adverse impacts of 30 basis points from tariffs and of 30 basis points from currency as well investments in advertising. This margin increase for the group was driven by strong improvement of 190 basis points in the Diagnosis & Treatment businesses, achieved mainly through growth and productivity, partly offset by the impact of tariffs.

The adjusted EBITA margin in the Connected Care businesses decreased in the second quarter as operational leverage from growth was more than offset by mix, tariffs and an adverse currency impact. I would like to reiterate that productivity measures are in place and will start contributing more significantly to margin improvement during the second half of the year. The overall fundamentals of this business remain strong. And we are confident in showing improved performance as the year progresses.

Adjusted EBITA margin in Personal Health was 13.4% as the operational leverage from growth was offset by investments in advertising, under-coverage as production levels were lowered to reduce inventory and cost related to new product introductions. In the segment Other, adjusted EBITA amounted to a loss of EUR 27 million, EUR 18 million better compared to the prior year mainly as a result of higher IP royalty income.

Our productivity program delivered EUR 146 million net savings in the second quarter. More specifically, procurement savings in part driven by our Design for Excellence program delivered EUR 48 million of bill of materials savings year-on-year, the manufacturing productivity contributed EUR 62 million to the gross margin and the net overhead cost reduction amounted to EUR 36 million in non-manufacturing costs. The savings delivered by the productivity programs remain on track and will support further margin improvement for the rest of the year.

Overall adjusted EBITDA in the second quarter improved by 120 basis points to 16.6% of sales compared to Q2 2018. This includes the impact from the implementation of IFRS 16 lease accounting as of January 1, 2019. The impact on adjusted EBITDA is approximately EUR 150 million increase for the full year of 2019, reflecting the depreciation on leases capitalized under the new standard.

In Q2, income tax expense increased by EUR 11 million mainly driven by higher income in 2019. Net income increased by EUR 244 million compared to the second quarter of 2018 mainly due to improvements in operational performance, lower net financial expenses and lower charges from discontinued operations. As for the fourth quarter of 2018, we started reporting adjusted diluted EPS from continuing operations. The adjusted EPS increased by 23% in the second quarter and by 24% in the first half of 2019 compared to the same periods of 2018.

Net cash flows from operating activities increased by EUR 260 million in the Q2 2019 mainly due to higher earnings and lower working capital outflows. In the first half of the year, net cash flow from operating activities increased by EUR 181 million. We reiterate our target for free cash flow between EUR 1 billion and EUR 1.5 billion for 2019.

With regard to the full year, let me make the following remarks. In the first half of the year, the adjusted EBITA margin for the group improved by 40 basis points. The profitability momentum will further improve in the second half of 2019 due to growth, operational improvements and the impact of the implemented mitigation actions to offset the identified headwinds.

While this will lead to a full year margin increase that is higher than in the first half of the year, we expect adjusted EBITA margin for 2019 to be shy of the 14% as we continue to navigate global geopolitical challenges and market volatility. As Frans mentioned, we remain confident in meeting our 2017-2020 target of 4% to 6%

comparable sales growth and an average annual margin improvement of 100 basis points as we expect to become a EUR 20 billion health technology company with an adjusted EBITA margin of around 15% by 2020.

Let me now provide you with an update on the U.S. health care market and our outlook for Western Europe and China health care markets. North American health care customers continue to focus on priorities around the quadruple aim: lower costs while delivering better outcomes with improved patient and employee experience. We see positive momentum around value-based care, which confirms our priority of bringing value-based solutions to the market. The continuing consolidation of health care systems underlines the importance of our focus on developing long-term strategic partnerships with key customers. Overall, we continue to expect U.S. health care market growth in 2019 to be in the low to mid-single digits.

For Western Europe, we continue to expect modest low single-digit market growth in 2019. For China, we expect mid- to high single-digit health care market growth in 2019 mainly driven by government policies to further increase access to care via existing Tier 2 and Tier 1 hospitals and expansion of private sector investments in health care facilities. Consumer sentiment in China remains a bit subdued while our Personal Health businesses showed good sales performance in the quarter.

The imposition of tariffs between the U.S. and China, which were announced in several rounds, create headwinds. Based on the announcements made so far, we continue to estimate a negative net impact after mitigating actions, consisting of supplier-based adjustments, reconfiguring the supply chain and selective pricing actions, of around EUR 45 million in 2019. This is in line with the previous guidance provided and does not include potential U.S. batch 4 tariffs, which will bring an additional EUR 20 million headwind in the year if made effective immediately. We continue to invest in the necessary countermeasures to compensate for trade tariff risks. And the results of these actions are expected to take most effect in the second half of the year.

Let me now provide some additional guidance for certain areas of our business. In the segment Other on an adjusted EBITA level, we now expect full year cost at EUR 80 million, which is a decline of EUR 52 million compared to last year, mainly due to lower expected royalties in 2019 on the back of a strong Q4 finish in addition to a positive movement in our environmental provisions in 2018. At EBITA level, we expect a net cost of around EUR 40 million in the third quarter and around EUR 120 million for the full year. Included in these numbers are EUR 15 million restructuring cost and other incidental items in Q3 and around EUR 40 million for the full year.

To round off, I'd like to update you on the topic of capital allocation. In the second quarter of 2019, we completed the EUR 1.5 billion share buyback program for capital reduction purposes that was announced in June 2017. The share purchases under this program were made through a combination of broker-led open market purchases and forward contracts, which enabled us to significantly optimize pricing compared to gradual open market repurchases only. I'm pleased to inform you that due to this approach, we were able to buy back over 3 million additional shares, representing an additional value of more than EUR 100 million.

In addition, at the end of the second quarter -- as of the end of the second quarter, we completed 21% of our new EUR 1.5 billion share buyback program for capital reduction purposes that was announced on January 29, 2019.

In the second quarter of 2019, we also completed the cancellation of 30 million of our shares. The canceled shares were acquired as part of the share buyback programs mentioned above. We have also been steadily selling down our holdings in Signify.

Philips shareholding in Signify is currently about 12% of Signify's issued share capital.

With that, we will now open the line for your questions. Thank you.

Q&A

Veronika Dubajova - Goldman Sachs

I want to start talking about Connected Care actually. And two questions for me. One is just the strong recovery in revenue growth that you have seen here in the second quarter. Can you help us understand to what extent this is now sustainable momentum and how we should be thinking about growth from a revenue perspective for the year? And to follow up on that, if I look at the sort of margin performance here, you are tracking meaningfully below the 16% to 18% margin target that you have here for 2020. So Abhijit, if you can give us a bit of a bridge as to how will you get here in the next 18 months, that would be very helpful.

Frans van Houten – CEO Philips

Veronika, this is Frans. Connected Care has a lot of promise, and it is also a lumpy business as many hospitals are looking to adopt informatics platforms and expand monitoring and analytics to aid the workflow. So we are comfortable. We are positive, in fact, about the funnel of opportunities that we see. At the same time, we have seen quite a lumpy trajectory with orders coming in, for example, fourth quarter last year and then we see that now being translated into revenue. We do expect a stronger second half year also for Connected Care. That doesn't mean that the lumpiness is now behind us. And I think we need to continue to evaluate that business in that context. Margin is tracking below target. But we also had significant headwinds. And I'd like to go Abhijit for some more color on that.

Abhijit Bhattacharya - CFO Philips

Yes. So if you look at on a, let's say, full year last 12-month basis, we are around the 13.7% and the target is 16%. So we have a little more than 200 basis points to cover in the next 6 quarters. So we think that is, let's say, well within reach. A couple of things, we had this quarter the biggest FX impact actually happened in Connected Care, so did the biggest tariff impact because we make a large amount of our production in the U.S., which also goes to China. We also have a specific mix impact this quarter as we sold more stationary oxygen systems in our respiratory business, which we don't think are all, let's say, continuing impacts for the rest of the year. So confidence is reasonably good that for the second half, we will see performance improvement, not only in the top line but also in the bottom line that helps us to bridge to the target.

Veronika Dubajova - Goldman Sachs

That's very helpful. And Abhijit, can I just confirm, when you say you expect to be shy of 14%, what exactly does that mean?

Abhijit Bhattacharya - CFO Philips

Thank you, Veronika. But we don't guide specifically to the last decimal for the year. We said an average of 100 basis points for the last 3 years we have been slightly above. This year, with all of the headwinds, we'll be slightly below. So shy is just slightly below the 14%. That's the...

Veronika Dubajova - Goldman Sachs

But is it round up to 14%? Is it that way to think about the shy comment?

Abhijit Bhattacharya - CFO Philips

Yes. Absolutely.

Edward Ridley-Day - Redburn

My first question, also related to Connected Care. And Abhijit, you highlighted some mitigation efforts. Can you just remind us what you're specifically doing there, particularly on the cost side, to improve profitability in Connected Care? And secondly, just on obviously the excellent order growth in D&T, you gave us some color. Just backing that out, it would appear that perhaps your Image-Guided Therapy business had exceptionally strong order growth, more like in the high-teens, if you could comment on that.

Abhijit Bhattacharya - CFO Philips

Yes. So if you look at the mitigation effects, quite a few. So there are some reallocation or movement of production sites. So we used to produce masks in Sleep & Respiratory Care in China. We moved that to another location. There are some pricing impacts which are happening. And then there are quite a few cost actions, which we are taking within this business and largely in Europe. And that goes through, let's say, with our social partners, just takes time in the discussion. So that holds us back a little bit in terms of timing.

So all of those will get executed in the third and fourth quarter. Regarding the order intake in Diagnosis & Treatment, I think it has been very strong all over. So yes, IGT has been exceptionally strong but so are the other businesses as well. So if you look at Ultrasound, we have been in double-digit territory. If you look at Diagnostic Imaging, we are in double-digit territory. So it's not one of the businesses which is hugely skewing it one way or the other.

Edward Ridley-Day - Redburn

And just a very quick add-on to that in terms of D&T, given where helium costs are currently, has that boosted your MRI franchise?

Abhijit Bhattacharya - CFO Philips

Yes. So that has impacted us a bit unfavorably in the first half. But as most of the mitigation impacts will come to us in the second half that gives us also, therefore, the confidence that margins will keep further improving here. So let's put it this way, the worst of the helium impact, we have seen in the first half of the year.

Frans van Houten – CEO Philips

By the way, those accelerate the interest in our helium-free operations MR system that has this closed cooling system and it doesn't need to quench pipe, which we launched late last year and that now is enjoying a very strong interest. And many hospitals are looking at that innovation as it would require significantly less helium going forward.

Edward Ridley-Day - Redburn

Yes. That's also what I thought in terms of the -- and you still, I think, will remain the only provider of that technology for -- on the market for a little while longer.

Frans van Houten – CEO Philips

Yes. That's our expectation.

Abhijit Bhattacharya - CFO Philips

1,500 liters of helium going down to 7.

Frans van Houten – CEO Philips

It's a 99% reduction.

David James Adlington - JP Morgan

Maybe just following up on the margin expectations for the second half because I think the comps get a little bit more difficult in the second half. How should we be thinking about maybe the phase between Q3 and Q4? And sort of mix-wise, how should we be thinking about the margins through those as well?

Abhijit Bhattacharya - CFO Philips

Yes. Again, David, thanks for the question. But we are not going to be guiding specifically per quarter. But if you talk about comparables, if you look back at last year, the first half of the year, we had actually our bigger improvement. So the second half of the year, although we did overall the 100 bps in the year, the second half of the year had lower improvement. So I would, in fact, argue to the contrary. Let's say the second half gives us a better opportunity to make those improvements and both the improvements will happen in Q3 and in Q4.

David James Adlington - JP Morgan

But one thing I'll point out, Abhijit, was the fact that I think you had some one-offs in the third and fourth quarter in terms of provision releases and a big fourth quarter in terms of order recognition so that's kind of...

Abhijit Bhattacharya - CFO Philips

Yes. I know. But let's say, this year, we will have -- so if you remember last year, we had also quite significant bps in the profitability of Connected Care. And that improvement then should help to cover for those one-offs of last year.

Michael Jungling - Morgan Stanley

I had two questions. Firstly, on Personal Health, if I look at your organic sales growth adjusted for comparisons, your momentum is probably the weakest now in at least 6 quarters. And with this in mind, I'm just curious how you see organic sales growth in the second half if the trend would have continued. It seems to me more likely that we would see a further deceleration as the comps get tougher. So some sort of outlook for you on Personal Health in the second half on the directionality of organic sales growth would be useful.

And question number two is on this China capital equipment plan that was announced in November of 2018, I think it was a couple of times at various meetings. And you're quite positive about the potential for an improvement in Chinese demand. Have we seen anything this quarter? I think last quarter, you mentioned there wasn't much activity besides what you normally get.

Frans van Houten – CEO Philips

Yes. Michael, I don't completely understand your reasoning because like-for-like, Personal Health is seeing an acceleration. Last year, we were in low to mid-single digit. Now we are strongly into mid-single-digit territory, second quarter in a row of around 5%. We, as management, have the expectation that, that will continue. That means that the full year will be a significant step-up from last year. Of course, when I say like-for-like, I mean, we have taken SRC out of PH, moved it to Connected Care. So you need to do the same. And then I think you will see that it is, in fact, strengthening. Does that help you understand the Personal Health comparison?

Michael Jungling - Morgan Stanley

I'm just looking at sort of the momentum indicator, where we look at the 2-year stack. And if you look at the math, yes, optically you see an improvement in Q1 and Q2 of 2019. But if you make an adjustment for comparisons, then Q2 is actually a reasonably weak quarter compared to what we had previous year. And if you then model for the second half, it seems to me mathematically speaking, without knowing what else you may have in the pipeline, it seems to me that the second half will be coming in somewhere around about 3%, 3.5%.

Abhijit Bhattacharya - CFO Philips

No, no, no. Michael, there's some confusion. Let me clarify. When we reported, we also issued a restate of figures last year to make it comparable. And for the Q1 last year, our growth was 2.7%, the second quarter was 1% and the third quarter was 4% and the fourth quarter was 2%. So the growth for last year in Personal Health comparable for the same portfolio at the same exchange rate was 2%. And now for the last 2 quarters, we are in the 5% range. So I think there's something in the math that we could possibly sort out offline. But clearly, there is, on the comparable portfolio, significantly higher growth, so almost 3x the growth that we had last year in the first half.

Frans van Houten – CEO Philips

Yes. And driven by core products such as the Sonicare portfolio.

Michael Jungling - Morgan Stanley

I mean we have the same numbers. But I'll give you a call later on because I obviously have slightly differently, but maybe...

Frans van Houten – CEO Philips

We want to convince you, Michael, that it's not the case as you described. But the second question that you asked on the China CapEx plan, look, overall, I see strong demand for health systems in China. Abhijit just summarized in his introduction that we see mid- to high single-digit market growth. And in that market, we have been growing for quite a while in double-digit territory. So we have strong momentum. We do not think that, that is specifically related to the CapEx plan as announced. We have not seen a major shift in the market since that plan.

Of course, it is always good news that such a plan is announced because it basically underlines that the strategy of the China government is to invest in health care. And it also coincides with the health care 2030 strategy that the Chinese government has published, which calls for a significant step-up in capacity in China of both government and public -- as well as private hospital. We expect consequently that in the coming years, this demand can continue even when GDP growth may fluctuate as we currently see.

Michael Jungling - Morgan Stanley

But if I look at the initiative that was announced last year, category B, there was 3,500 new CTs added. There was 4,400 new MRIs added. And given that it was a plan between 2018 and 2020, one would hope that by 2019, one would see the additional demand in the provinces that was included in that category B. Have we seen anything so far in the second quarter that points towards these additional orders coming through at Philips?

Frans van Houten – CEO Philips

Yes. We have not seen any step change in demand. We see strong double-digit or teens growth, but nothing that such -- that, that CapEx plan would justify. And neither do we see that with competitors. So this is not

unusual that a plan is published that doesn't immediately translate in a major step-up in orders. I see it more solidifying the -- underpinning the growth overall as we are enjoying now.

Patrick Wood - BofA Merrill Lynch

I have two, please. The first would be on the composition of the order book, obviously good growth and off a tough comp. Just curious, is that a mix of longer-dated project that we should expect to see coming over the long term? Or is this more sort of vanilla single systems that we should expect to see come through around the next 3 to 6 months as per sort of usual?

And then the second question, just curious in China, with a lot of different confusing data coming out from companies operating in that market, both from the consumer side but also on the more industrial side, you guys are obviously big in the market. I'm very curious, just what are you seeing from the Chinese consumer in general? How do you feel about the health of that market overall? It would be great to get your views on that, please.

Frans van Houten – CEO Philips

Okay. Patrick, well, we have a policy for recognizing orders, where we basically cut off equipment orders on a horizon of 15 months. And then if we book a contract that has a longer horizon, then they will come into that window of 15 months as time progresses. Within the 15 months' window, products like Ultrasound have typically a shorter cycle and products or systems like Image-Guided Therapy have the longest cycle, in fact, quite often close to that 15 months and sometimes beyond and then we put it in the parking lot and then it will fall in the window of order recognition in due course. So it is certainly not the case that we only see short-term transactional sales. In fact, the ratio that we track on what we call solutions, which are all related to the more complicated advanced systems and longer-term contracts with customers, have been edging up. And we are currently touching around the 34% of total revenue as a recurring and sticky kind of customer base.

On China consumer side, we have enjoyed good demand. We track both sell-in data as well as selling-out data. Now last year, you remember that we said sell-out data are good. However, sell-in data, we see under pressure because inventory reductions in the pipeline. This year, that has more normalized. And therefore, sell-in and sell-out data are more in line. And therefore, you could say that our growth rate is a good indication of the traction that we are having in the marketplace, right? So consumer has stepped up over last year. Also on the back of innovations in shaving, in oral care, that has strong demand. Let's say the discussion around GDP growth slowing down has not yet translated in a reduction of consumer demand. We don't see that as of yet.

Scott Bardo - Berenberg

Frans, I wonder if you could flesh out a little bit the comments around the consent decree and how typical is it to get observations when you're under consent decree. And does this signal or flag any escalation of risk about

plans? And maybe you could talk a little bit around that. And second question, please. Nice to see you're confidently reiterating the 2020 targets, EUR 20 billion top line, 15% margin.

But as we go into next year, can you provide some high-level thoughts about the next guidance period? Is this sort of growth you see as sustainable going forward? Perhaps you can highlight some further opportunities that you identified to progress margins further from the 15%, maybe a little bit of discussion on how you see the next period, too.

Frans van Houten – CEO Philips

Okay, sure, Scott. Yes. Well, a consent decree typically stays with the company for several years. We have studied other companies being on the consent decree. And then we see that periods of 4 or 5 years of increased scrutiny are not abnormal. Now to make this story a little bit more complex, part of the consent decree is an injunction on the factory in Bothell for production and sales in the United States while we continue to export elsewhere. We had hoped that, that injunction would be lifted already some months ago. That has not yet happened. And it is being held up by additional increase of the FDA, basically testing whether our quality management system has improved enough as evidence to lift it. And of course, that is a dialogue. We have the independent auditors that have come in repeatedly. They have written favorable reports.

These reports have been handed over to the FDA. FDA then asks additional questions, right? Examples of these questions can be, "Okay, you have shown evidence for 1,000 examples, maybe you can provide evidence for 10,000 examples, okay?" That kind of back and forth is going on. So no new observations, no new bad things to discover or tell you. It is much more in, you could argue, the deepening of the evidence that we are in a good shape now. Then the next question is how long could that continue? This is something that we are -- had all hoped that it would go faster, right? Currently, we hope that, let's say, after this summer that we are in a much better space when it comes to lifting the manufacturing and sales injunction for the United States. Does that answer your question?

Scott Bardo - Berenberg

I think it does.

Frans van Houten – CEO Philips

Okay, thanks. Then if we go to your question on next year. Well, let's first deliver on our stated guidance before we get ahead of ourselves and talk about what's next. But people who have seen us act in conferences and roadshows know that we had to field this question that you asked many times, right? And then typically what we say is that the world does not end after meeting our 2020 targets. And of course, we expect to further improve afterwards. We have just not quantified how much that is. And frankly speaking, I don't think today is the moment to do that. But we are an ambitious bunch and we know exactly where we are in the competitor peer group. And we know that world-class looks different than where we are today. So I think we should leave it with that kind of positive sentiment.

Scott Bardo – Berenberg

Very good. And just with respect to growth or medium-term growth, does growth become more difficult the bigger you become as a company? Or is it that you're in this continued field innovation cycle such that these sorts of levels of growth are sustainable over the medium term. Can you perhaps touch upon that?

Frans van Houten – CEO Philips

It may differ by segment, of course. But what springs to mind immediately as you ask this question is let's demonstrate that our investments in Connected Care had a great return, right? I expect that the growth of Healthcare Informatics and Connected Care as such and telehealth and home care that are all great opportunities. And we have been investing in these things. And also we have been acquiring some of these, let's say, more startup-like companies that in their business cases all need to deliver as these products comes to market and therefore should also show a nice growth path. So look, there are plenty of things to be excited about. And therefore, I would continue to be positive about growth.

Max Yates - Crédit Suisse

Just my first question is on Personal Health. Could you talk a little bit around what you're seeing on the competitive landscape, particularly pricing, how you're seeing some of your key competitors in the market acting? That would be the first one.

Frans van Houten – CEO Philips

It differs by product category, Max. I think last year, we had quite a lot of dialogue on oral care, specifically in North America, which is the most advanced market when it comes to power toothbrushes with a population penetration of around 37% or so and where competitors are becoming more aggressive. Now then you recall that, first, our impression was that this was a temporary thing. I think in the meantime, we explain it more as being part of a market where we now are looking at the majority of the franchise of consumers coming into the franchise, which then also warrants to have power toothbrushes at multiple price points, recognizing and realizing that we have introduced in North America power toothbrushes at lower price points.

What we announced today that we had the entry-level power toothbrush in Americas in Q2 is a demonstration of that. And we are seeing good demand on that. I think it will also make us less vulnerable for, let's say, outright price competition. And there's also some new players in the North American market, very much in the low end of the market. We will continue to position ourselves as a premium brand. Internationally, in other markets, we don't see the same dynamic as in North America. Prices in China hold up well, prices in Europe hold up well. So as such, the reason why Personal Health profitability did not expand is much more in relation to the step-up in advertising as well as the currency headwinds that were visible in the second quarter than anything else.

Max Yates - Crédit Suisse

And just the second question would be on Connected Care. And is there any way you can give us a sense of when you look at the order backlog, how that looks compared to 12 months ago at Q2 '18? Just trying to get a sense of obviously the softer order growth that you've had in the first half of the year, how quickly that feeds through to second half revenues or actually whether the orders that you took in the end of last year will still support healthy mid-single-digit organic revenue growth as we go into the second half. So just trying to understand where the level of backlog is and how much the better orders we've seen.

Frans van Houten – CEO Philips

Yes. No, that's great. So you recall from last year that, in fact, the orders came in, in Q4. And as a consequence, we guided in January that it would be second half year-loaded when it comes to revenue growth. So you have some -- you've seen some of that come through in Q2. And we -- let's say the way we talk about it now is that the second half will be stronger than the first half. In other words, we expect for Connected Care a stronger second half year still, let's say, on the back of that order book. Now it remains a lumpy business with larger customer installations that also need to be accepted and then signed off and then revenue recognized. But yes, I reiterate a stronger second half year. I look to Abhijit, whether he has anything else to say?

Abhijit Bhattacharya - CFO Philips

No. I think it's fair because last year, we had 14% growth in orders, I think, in Q4 that got us 5% order intake growth for the year. And those orders will get fulfilled in the remaining part of the year. But yes, we also need the newer orders to come in. And the funnel is there, so we see clearly the funnel there. But we have to get that to signature and hopefully that comes in the coming 2 quarters as well.

Max Yates - Crédit Suisse

Sorry to be pedantic, but just when you talk about the better second half, are you referring to order momentum? Or are you referring to better second half growth rates in terms of revenues? I'm just trying to understand what those...

Abhijit Bhattacharya - CFO Philips

Both.

Frans van Houten – CEO Philips

Both. The revenue growth is on the back of orders we already have. And obviously, we need order momentum to also underpin next year. And that's where I have referred to the lumpiness. If I look in the funnel of opportunities that we track in our sales force, then the engagement with customers and their interest is substantial. It's just turned out to be much more work to get them from interest to orders and from orders to revenue.

We talked about that, if you recall, at the Capital Markets Day, where in fact, we lowered a bit the near-term guidance for Connected Care because of this kind of market development. It doesn't diminish my longer-term

expectations about the opportunity in Connected Care, also as I described in relation to the questions from Scott. But near term, it's a lumpy and an uneven market. I hope that, that answers your question.

Julien Dormois - Exane BNP Paribas

I have two to finish with. It's on Diagnosis & Treatment. And I would like to get into a bit more details on two of the divisions, namely imaging and IGT. Quite opposite trend because in IGT, I think you've been in the double digits for 5 of the past 6 quarters. So I was just wondering whether you could elaborate a little bit on where this strength is coming from. Is it across the board? Or is it coming from specific products and how long you think this can last?

And in an opposite manner, in imaging, you are now out from your third quarter of flat or declining sales in the business. So I'm just curious as to what you think is the trajectory for this business going forward and especially where you think you stand in terms of the innovation cycle in that division. Are there seems to be some meaningful product innovation and launches to be expected here?

Frans van Houten – CEO Philips

Okay, Julien. The IGT is a success story. And I think it best represents the strategy that we have to move into solutions. Ever since the Volcano acquisition, the innovation strategy is around innovating the procedure rather than just providing hardware. So we can go into a hospital or an office-based lab and demonstrate that said hospital or the interventionist can treat more patients in a day in the same room while having less staff and therefore being more productive with better patient outcomes. And that is a very compelling story. And the Azurion platform, which is a systems platform and a software that guides to doctors, has proven to be very, very strong, even so that we could raise prices and have more demand.

And then we link in the devices business and get strong traction at the same time. So this strategy, I think, is a nice demonstration of applying the quadruple aim thinking into our innovation road map. We aim to do that everywhere. It's just that in IGT, we see the most strong benefit from that. Then talking about imaging, we have been growing nicely in Diagnostic Imaging. And in the earlier question, Abhijit already gave as a response that in the second quarter, the order intake for DI was also in the teens. So in other words, we are enjoying strong interest on the innovations of Diagnostic Imaging. Notably, the MR system is doing very well. But also the other systems enjoy a good interest. So I am optimistic that the growth momentum in DI also in revenue terms can step up as we move forward.

Julien Dormois - Exane BNP Paribas

Okay. That's very helpful. And just as a quick follow-up, regarding the closing of Carestream, is it still on track for an H2 closing?

Frans van Houten – CEO Philips

Yes. Carestream is on track. I don't know whether we give any specifics as to when. But I think it's a Q3 event. Julien, we get positive customer reactions on the Carestream acquisition. So it's very much welcomed by all.

Sebastian Walker - UBS

I've got two on Personal Health, if I could. So first, just thinking about the investments. Do you think that investments, particularly in advertising, are going to continue at the current levels for the remainder of the year? Or should we expect those to fall off? And then just thinking about those advertising investments, I mean, are those exclusively kind of short-term payoff investments and therefore we've seen the benefits of those in Q2? Or were there some longer-term investments that we should expect to have a positive impact on growth in Q3 and Q4?

Frans van Houten – CEO Philips

Yes. The way to answer this, Sebastian, is that the investments in advertising in the first half were kind of on top of. As we move into the second half, we will see the benefits of our marketing transformation kicking in, where we have a longer-term conviction that we need to shift internal expense or agency expense into working advertising share of voice, right? That enables us to maintain a higher advertising spend while not increasing overall marketing spend, right? So in other words, we will compensate the step-up in advertising over time. We couldn't fully achieve that in the first half of this year. But it is our intent to mitigate the extra advertising. I think it will be the new normal to have more advertising. But of course, we maintain our commitments to improve margins as well, so thereby lowering some of our other cost buckets accordingly.

Abhijit Bhattacharya - CFO Philips

And just to clarify, it's not a Q2-only impact. So the growth impact, we expect the growth trajectory for the remaining part of the year to be similar to the first half of the year. So it's not that it's just 5% in Q2 and then it goes down.

Frans van Houten – CEO Philips

Okay. Well, I appreciate very much everybody attending the call. I wish you good vacations, if you have them, while we will continue to run the ship into the third and fourth quarter. And I appreciate very much your support. Have a great day.