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EDITED TRANSCRIPT

PHIA.AS - Q3 2015 Koninklijke Philips NV Earnings Call

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OVERVIEW:

PHIA reported 3Q15 comparable sales of EUR5.8b and net income of EUR324m.
Expects modest comparable sales growth for 2015.



CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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Daniela Costa *Goldman Sachs & Co. - Analyst*

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PRESENTATION

Operator

Welcome to the Royal Philips third quarter 2015 results conference call on Monday, October 26, 2015.

During the introduction hosted by Mr. Frans van Houten, CEO and Mr. Abhijit Bhattacharya, CFO. (Operator Instructions).

Please note that this call will be recorded and is available by webcast on the website of Royal Philips.

I will now hand the conference over to Mr. Robin Jansen, Head of Investor Relations, please go ahead, sir.

Robin Jansen - Koninklijke Philips NV - Head of IR

Thank you, operator, and good morning, ladies and gentlemen. Welcome to Philips third quarter conference call.

I am here with Frans van Houten, CEO and Abhijit Bhattacharya, CFO who took over from Ron Wirahadiraksa exactly two weeks ago.

In a moment Frans will make his opening remarks and will take you through our main strategic and financial highlights for the period.

Abhijit will then provide more details on the financial performance during the quarter. After that both Frans and Abhijit will be happy to take your questions.

Our press release and the related information slide deck were published at 07:00 AM CET this morning.

Both documents are now available for download from our Investor Relations website.



A full transcript of this conference call will be made available by tomorrow on our Investor Relations website.

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

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

The cash flow of the combined Lumileds and Automotive businesses is reported on the cash flow from discontinued operations.

Therefore all commentary that will follow in terms of sales and earnings, at both the Group level, as well as at the Lighting sector level, excludes the performance related to the Lumileds and Automotive Lighting businesses.

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

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

Frans van Houten - *Koninklijke Philips NV* - CEO

Yes thanks, Robin. Good morning to everybody on the call.

Before I dig into the Q3 performance, I'd like to take the opportunity to welcome Abhijit to his new role as CFO, and provide you with a bit of background on the transition.

Ron informed us shortly before the official announcement two weeks ago that he had decided to take on a new career challenge at LafargeHolcim. This came unexpectedly but I'm glad that we were able to deal with this quickly.

I'm happy with Abhijit taking the role as Philips' CFO. Abhijit has built an impressive resume of delivering results in various financial and operational leadership roles at both Philips, as well as NXP.

This, together with his track record of successfully managing highly complex projects, will enable him to play a key role in advancing Philips' transformation.

I would also like to wish Ron all the best in his new role, and I'm grateful for his substantial contributions to Philips.

Now turning to the quarter. Our results continued to improve with good growth in Healthcare and Consumer Lifestyle, and a year-on-year improvement in the operational performance in all three sectors.

This was achieved despite continued foreign exchange headwinds, and difficult macroeconomic conditions in a number of emerging markets, especially China, which demonstrates the resilience of our business and the progress that we are making on our transformation journey.

And while we continue to make progress on our overall operational excellence, address underperformance in certain areas, and address our core structure, we are making targeted investments in innovation to enhance our leadership positions.

I will talk more about these investments in a moment when I discuss our third-quarter performance in each sector.

Let me now start with Healthcare, where we are very encouraged by continued sales growth, the return to a positive order intake growth, and the improvement in margins.



To ensure that this trend is sustainable, we will continue to make important investments in growth areas which we believe will substantially drive future returns.

There is a clear need to drive productivity in health systems, next to enabling the shift to value-based healthcare, aimed at improving clinical and financial outcomes for care providers.

In response to this need, we are offering integrated solutions to drive the industrialization and personalization of Healthcare.

These will enable preventative care, increase first time right diagnosis, decrease waste, and empower patients to be increasingly engaged in their own health.

One specific example is our portfolio of clinically proven speed care solutions.

The Dream Family, aptly named, is a fully-integrated solution featuring a connected positive airway pressure therapy device, with a novel mask line and interactive engagement tools to improve care for obstructive sleep apnea patients.

Engaging personalized coaching tools empowers users to embrace their care while seamlessly connecting patients and care teams for optimal therapy management.

For example, the Dream method which is a mobile and web-based patient support application that offers patients motivation alerts, troubleshooting advice and educational contact.

And in line with our strategic focus of partnerships with hospitals and health systems, we signed again, a multiyear, multivendor service agreement, this time with the King's Daughters Medical Center in Kentucky, United States, to become the imaging and biomedical service provider for the hospital, and the entire integrated delivery network that the hospital is part of.

The Multi-Vendor Services that we will provide include maintenance services, compliance management and equipment utilization optimization. The integrated approach is designed to manage the complexity of multiple manufacturers and third-party vendors, so that the integrated delivery network, or IDN, can focus on delivering high quality care.

In the third quarter, we also signed an agreement for the installation of our advanced image-guided therapy technologies at the Dutch Catharina Hospital's new cardiovascular center, which is currently under construction and due to open its doors mid-2016. This multiyear agreement comprises the interventional imaging equipment, clinical IT, upgrades and maintenance services for five interventional rooms and two hybrid operating rooms.

The rooms will be equipped with Philips technology that reduces the amount of X-ray radiation used during the procedures, without impacting image quality, benefiting both patients and staff. The clinical IT that will be installed includes the 3D navigation solution such as Philips EP navigator and EchoNavigator, to give doctors better insights during the different types of minimally invasive treatments of the heart.

While we are very encouraged by these positive innovations in Healthcare, we continue to manage the remediation process at our Cleveland facility.

Production levels are developing largely in line with our expectations, although the resumption of production of a limited number of smaller product lines require more work. This means that the Cleveland EBITA improvement in 2015 will now be in the range of EUR50 million to EUR60 million. And I would like to flag that we will continue to invest in remediation and quality optimization well into 2016.

Turning to Consumer Lifestyle, here we had strong performance with comparable sales increasing by 6% year on year. Health and Wellness and Personal Care both delivered double-digit growth, driving market share gains across a number of geographies.



Next to this strong growth performance, Consumer Lifestyle also delivered strong margin improvements on the back of higher volumes, favorable product mix and ongoing cost productivity.

Standing out this quarter was the Philips Oral Healthcare business, where we sustain our traction in the market, with innovative solutions like the Philips Sonicare, DiamondClean, Amethyst and the Philips Sonicare Airfloss Ultra. We also announced new and exciting Philips personal health programs at the Internationale Funkausstellung or the IFA in short, in Berlin earlier in the quarter, which empowered consumers to take greater control of their personal health.

Built on the Philips HealthSuite digital platform, these health programs mark a new era in the connected care for consumers, patients, and health providers. Each program comprises connected health measurement devices, an app-based personalized program with coaching, and secure cloud-based data analysis.

For example, the Philips Health Watch measures a wide range of health biometrics including heart rate activity and sleep patterns to help prevent or mitigate lifestyle-induced chronic conditions.

Let me now turn to Lighting. I am very pleased with the sustained strong growth and improving margin performance of our LED business. LED now represents close to half of lighting sales, which positions our total lighting business well for positive growth over time. Simultaneously, our ongoing proactive management of the conventional market decline is allowing us to deliver continued improvements to Lighting's EBITA margins.

LED Lighting comparable sales grew by 24%, while conventional Lamps declined by 15%, resulting in a comparable sales decline of 3% for Lighting overall. Later on this call, Abhijit will provide a bit more granularity on how to read the sales decline of the conventional business.

Overall, Lighting is an attractive market with a solid profit pool in which Philips is focused on meeting the increased lighting needs of a growing global population and embracing the digital opportunities. We do so by delivering highly energy efficient, cloud-connected, smart LED lighting solutions for homes, for offices, and municipalities alike.

On the other hand, we are running a highly attractive fast-growing LED luminaires, Systems and Services business, with above-sector margins leveraging our strong brand leadership, vast distribution network, and leading innovation that enables us to build long-term customer relationships which drive recurring revenue streams through innovative business models, such as selling light as a service, with maintenance contracts for smart cities and smart buildings.

We have a strong conventional lighting business that generates attractive cash flows and has a competitive cost advantage due to our operational improvements and economies of scale. And this cash profile and cost advantage will endure over the long term, as we continue to proactively manage the conventional lighting tail.

We are developing new innovative solutions every day. Lighting that reacts to its current environment and can help set a mood or tone in a room or outdoor setting, not just light it up. For example, in India, Philips will outfit 32 Accenture offices with more than 140,000 LED-based products. The upgrade will enable significant energy savings and create a more pleasant work environment.

We pitched in for conceptualization, design, and managed services beyond just the LED lighting products. As part of the End2End order, we will also be offering warranty on products and will commit to a certain level of light performance.

A common denominator driving significant improvements in each of our sectors is, of course, our ongoing multiyear Accelerate program. In Healthcare, for example, we reduced manufacturing cycle time by 45% at our image-guided therapy facility in the Netherlands.

In Consumer Lifestyle, we simplified the order fulfillment process in Spain, resulting in improved customer service levels and improved sales.

In Lighting, we implemented a new business model in Indonesia which resulted in enhanced business-to-government sales capabilities and important new customer wins.

Overall, our three productivity programs cover overhead cost reduction, Design for Excellence and End2End and they drive operational performance improvement.

In the quarter, we took out EUR33 million of overhead cost, achieved EUR107 million of cost of goods sold, and End2End productivity program achieved incremental savings of EUR63 million in the quarter. Pretty good.

With respect to the separation process, we remain on schedule to complete the separation of the Lighting business in the first half of 2016. As we have said, we are reviewing all strategic options for the Lighting business including an initial public offering and a private sale.

Turning now briefly to the full-year outlook. For full-year 2015 we continue to expect modest comparable sales growth and we remain focused on improving the adjusted EBITA margin, despite ongoing foreign exchange headwinds and challenging conditions in certain emerging markets.

Before handing over the call to Abhijit let me update you on the sale of a majority interest of our Lumileds business to a consortium led by GO Scale Capital.

In the course of seeking required regulatory approvals, the committee on foreign investments in the United States, or CFIUS for short, has expressed certain unforeseen concerns.

Needless to say, we will continue, together with GO Scale Capital, to actively engage with CFIUS and remain committed to taking all reasonable steps to address its concerns, but given these, the closing of the transaction is uncertain.

I will now hand over the call to Abhijit to discuss our financial performance and market dynamics in more detail. Go for it, Abhijit.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

Thank you, Frans.

Good morning and welcome to all of you on the call. I'm honored to join the top team at Philips at a very exciting time for the Company as we continue our transformation.

I'd like to thank Ron for his guidance as we work together to ensure a seamless transition.

I'm also looking forward to reconnect with the financial markets as I take on my role as Philips' CFO and I'm sure I'll meet with most of you in the coming months.

Let me start by providing you some more detail on our financial performance for the third quarter and some market developments.

Comparable sales in the third quarter increased by 2% to EUR5.8 billion compared to last year. On a nominal basis, total sales increased by 12%, mainly driven by 9 percentage points of positive currency translation effects.

On mature market, comparable sales increased by 3% driven by 5% in Western Europe, 1% in North America and 3% in other mature markets.

Sector-wise, in the mature markets, Healthcare and Consumer Lifestyle grew mid-single digit while Lighting declined low single digit.

In our growth geographies comparable sales remained stable in the third quarter with double-digit growth in countries like Poland, Indonesia, India and Mexico, being offset by sales declines in countries like China, Russia and Brazil.

Sector-wise, in the growth geographies, sales growth was driven by mid-single digit sales growth in Consumer Lifestyle, which was offset by mid-single digit sales decline in Lighting and a low single digit sales decline in Healthcare.

Let's take a closer look at order intake now. Currency comparable order intake increased by 2% year on year as a result of high single digit order intake growth in Western Europe and mid-single digit order intake growth in North America which was partly offset by double-digit order intake decline in China.

In Lighting specifically, as Frans mentioned, we are focused on capitalizing on the shift from conventional to LED lighting. Let me provide you with a bit of color on how we look at our Lighting business.

With 44% of our lighting sales now in LED we have established ourselves as the global leader in LED lighting. As you are aware, we have been growing this business strongly over the last few years to achieve this position. The LED business is competitive, and by driving operational excellence and building scale, our overall gross margin in LED lighting are above gross margins in conventional lighting, which is the reason for the improvement trajectory you see in the Lighting results in the last four quarters.

Our conventional lighting declined by 20%, mainly because the Professional [Conventional] (corrected by company after the call) lighting business declined by 30%, which is something we are driving ourselves, as more customers buy our innovative offerings in LED systems and services which deliver higher margins than our conventional Professional lighting-based products.

Our conventional Lamps business declined in line with the industry trend and we manage our cost structure extremely well to keep generating strong cash and margins.

So to summarize, we have a high growth and profitable LED business coupled with a cash and profit accretive conventional business which has a declining top line.

With this I hope to have been able to provide some clarity on how we are driving performance improvement in our Lighting business.

Moving over to the EBITA developments in the quarter, in the third quarter, slide 16 of the presentation material that we posted on our website provides an overview of the main drivers of adjusted EBITA when compared to the same period of last year.

As you see, the adjusted EBITA margin of 9.8% this quarter was 70 basis points higher than in Q3 last year, despite negative currency translation effects of 160 basis points.

This margin increase was driven by margin improvement of 190 basis points in Consumer Lifestyle, 40 basis points in Lighting and 30 basis points in Healthcare.

Our underlying operational performance therefore contributed 210 basis points to the EBITA margin in the third quarter, as our Accelerate program continues to improve operational performance and drive efficiencies.

Specifically, in the fifth bar, you see a net contribution of EUR90 million from our overhead and End2End productivity programs. Year-on-year incremental gross overhead cost savings amounted to EUR121 million in the quarter, and our End2End productivity program generated EUR63 million of additional savings year on year.

These gross savings were partly offset by an increase in non-manufacturing cost as a result of investments in Healthcare Informatics, Personal Health Solutions, Healthcare Incubator and quality and regulatory improvements.

Design for Excellence, our DfX program, which is aimed at reducing costs of goods sold, delivered EUR107 million saving year on year.

These cost savings, as well as the positive impact of volume and mix, more than offset the 100 basis points of wage inflation and a negative price effect of 220 basis points.



As I mentioned, the 210 basis points operational improvement was to a large extent offset by a currency headwind of EUR53 million, or 160 basis points, mainly due to adverse swings in various emerging market currencies, most notably the Chinese one.

Our total annualized overhead cost savings through the end of the third quarter amounted to EUR322 million. However, we expect overhead cost savings for the full year to be close to the full-year target of EUR265 million as the anticipated savings for the fourth quarter are likely to be more than offset by increase in IT spend due to phasing as well as our rollout of the Philips integrated landscape.

Bottom line, we generated a net income of EUR324 million in the quarter compared to a net loss of EUR103 million a year ago. This increase is mainly driven by higher operational earnings as a result of higher volumes, the ongoing cost saving initiatives I talked about earlier, and lower incidental items.

The return on invested capital, which is calculated on a five quarter MAT basis, was 8.3%, excluding the CRT antitrust litigation provision which we took in Q4, 2014, the ROIC was 9.7%.

Inventory, as a percentage of sales, decreased by 30 basis points to 16.8% year on year. Excluding the negative translation effects and changes in scope of consolidation, inventories as a percentage of sales were up 40 basis points, mainly in Healthcare.

In the third quarter we recorded a free cash flow of EUR58 million compared to EUR155 million in the same period last year. The delta was caused by a higher CapEx related to certain refurbishment investments we are making in a couple of our existing offices to enable us to reduce the amount of office space that we use as well as the purchase of certain IP licenses and higher working capital requirements due to ramp-up of inventories for Q4 sales.

By the end of the third quarter we've completed 66% of our EUR1.5 billion share buyback program. We continue to take a disciplined approach to capital allocation that allows us to fund growth while maintaining a solid capital structure.

Looking ahead, we remain concerned about the global macroeconomic environment and in particular China, Russia and Latin America.

In the US year-to-date Healthcare market, growth has been driven by procedure growth, a relatively strong economy and new enrollees through the Affordable Care Act. These drivers have outweighed continued reimbursement pressure, peer mix changes and adjustment to new payment models replacing traditional fee-for-service payment.

Healthcare CapEx in the US is forecast to remain flat in 2015 versus last year, although new hospital construction is expected to grow by high single digit.

Despite the expectation that the US healthcare market growth in the second half will be lower than in the first half, we expect overall US healthcare market growth for the full-year 2015 to be low to mid-single digit.

After an exceptionally strong 2014, expectations for the European healthcare market have been tempered to low single digit declines in 2015 overall, with low single digit growth expected in the second half of 2015.

Following a challenging second half of 2014, the Asia Pacific region is expected to show moderate low to mid-single digit healthcare growth in 2015 driven by a rebound in Japan.

In China, headwinds related to a slower GDP growth, the government's anti-corruption measures and efforts to encourage domestic innovation are expected to continue to impact Chinese healthcare market in 2015. Overall, we continue to estimate the global healthcare market growth to be in the low single digit range for 2015.

Moving to Lighting indicators, the overall US construction market is expected to grow high single digit in 2015, of which residential -- of which non-residential construction is now forecast to grow in the high teens.

The Architecture Billings Index or the ABI, however, slipped in August 2015 with a score of 49.1, down from a mark of 54.7 in July. The construction market in Western Europe is expected to show slight growth in 2015 following its return to positive growth in 2014. This growth is largely driven by a slight pick-up in non-residential construction.

Nevertheless, overall sentiments and market expectations in Europe remain quite uncertain and vulnerable, so we remain cautious.

We continue to expect IG&S to show a net cost of around EUR450 million at the adjusted EBITA level for the full-year 2015. At the reported EBITA level we now expect a net cost of around EUR700 million in IG&S for the full-year 2015 compared to the previous guidance of EUR750 million.

This includes the separation costs for the Lighting business which is expected to come in at the lower end of the range of EUR200 million to EUR300 million for 2015 and to remain within that range in 2016.

The EUR50 million lower reported EBITA guidance for IG&S reflects lower separation and restructuring costs that are partly offset by EUR40 million of costs related to the de-risking of the US pension plan that we announced earlier this month.

Let me briefly summarize our financial performance before opening the line for questions.

Our third quarter results were driven by solid growth in Healthcare and Consumer Lifestyle and operational results improvements in all three sectors, most notably in Consumer Lifestyle.

Looking ahead, however, we remain concerned at the macroeconomic environment, market volatility and uncertainty in various regions of the world. Based on prevailing rates, we expect currency movements to have a slightly positive impact in the absolute EBITA for Q4 and a neutral impact on the margin in Q4.

Taking all this into account, we continue to expect modest sales growth for 2015 as well as improved operational results. While we are concerned about the impact of -- that the more challenging global macroeconomic environment is having on the results, we expect further operational performance improvement in 2016, reinforcing the underlying strength of our business.

I'd also like to take this opportunity to inform you that we have appointed Rene van Schooten as the interim CFO for Lighting. Rene has built an impressive career in finance over 22 years, culminating in being the CFO of Lighting from 2001 to 2004.

Thereafter Rene has held general management positions across almost all Lighting businesses, excluding the Automotive business. The appointment of Rene will ensure continuity focus on performance needed in the near future.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Gael De Bray, Societe Generale.

Gael De Bray - Societe Generale - Analyst

Two quick questions, please. Could you elaborate a bit more on the -- what's going on exactly with the Lumileds' transaction, what are the issues there? And maybe in relation to that, with the closing of the Lumileds' transaction now uncertain, how does it affect the timing of your M&A strategy? So, that's the first question.

And the second question relates to the Consumer Lifestyle division. How do you explain the strong increase in working capital at CL. Is there an issue in terms of collecting payments or have you changed somewhat the business model for the division? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Hi there, Gael, Frans here. Let me take the first and then look to Abhijit to answer the question around the increase in working capital at Consumer Lifestyle.

It is customary in the United States to request for regulatory approval. The CFIUS Committee looks at all foreign investments in the United States. Together with GO Scale Capital we have applied for that approval. This is taking longer with some unforeseen concerns that we are working on in a collaborative fashion.

As you will appreciate, the CFIUS process is confidential and we are not at liberty to give you a peek inside of the dossier, so let me not do that. We continue to work together on this towards a closing and that's what our focus is on. So, whereas we do flag some uncertainty, the main news here is also one of delay.

There is no relationship at all with regard to the separation of Philips Lighting. I just wanted to underline that.

And on your question on how this affects our M&A strategy, basically it does not change our M&A strategy. In any case, we were cautious in our M&A approach and not in a hurry.

We're making great progress in the implementation of Volcano where we are fully on schedule with our assumptions with regard to the benefits and integration. We have quite a lot on our plate with the separation of Philips Lighting and therefore we will not do anything unexpected on the M&A front. Strategically we remain interested in bolt-on acquisitions as also elucidated at our Capital Markets Day and in the near-term there's no change in that outlook.

Abhijit, the working capital question.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, hi, Gael. On working capital in CL, it's really an issue on the Gregorian calendar. We have moved this year to the Gregorian calendar. Last year we were not on it, so certain payment runs happened before the 31st of the month, so it's -- our receivables and our inventories are fine, it's actually paid timing on payables and that basically evens out through the year.

So, it's not just for CL, it runs across all businesses but that's the main reason why you see that happening.

Gael De Bray - *Societe Generale - Analyst*

Okay, thank you. Can I have a quick follow-up on the Lumileds' transaction? I can see the underlying performance for Lumileds is sharply down this quarter compared to a year earlier. Do you confirm that GO Scale is still very committed to the transaction?

Frans van Houten - *Koninklijke Philips NV - CEO*

Both parties work together towards a closing, so no change.

Gael De Bray - *Societe Generale - Analyst*

Okay, thank you very much.

Operator

Daniela Costa, Goldman Sachs.

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

So, two points. The first one, just can you comment on the Imaging orders having turned into growth? How much of that is recovering maybe market share that was lost throughout the Cleveland closure versus underlying market getting better?

And then the second thing just on margin and on the operational improvement that you guide for 2015. I believe earlier in the year you had commented a while back off 100 basis points, then at the Capital Markets Day you've commented that that was maybe tougher, given the situation in the markets and FX. Can you just give a little bit more of detail, if possible? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Hi, Daniela. Yes, good question on the order side. Clearly we are very, very pleased with the order intake in the United States at 5% and Europe even higher than that. After all, these are our core markets and the high order intake is a clear sign of strength of our portfolio.

Now, if you dig a little bit deeper in that, then I can tell you that the order recovery is pretty much across the board. Our ultrasound is doing great, our patient monitoring is doing well. We see several of the so-called large iron image modalities doing good. We see MR having strong traction, new orders on CT coming in.

So, overall I see the Europe and United States strengths as a very nice recovery. Without wanting to cry victory, because I think that would be the wrong message, we still have more work to do, but I find it very encouraging.

Now, the negative piece is, of course, China where we saw a negative order intake growth, for instance, versus last year and there we hope in the future to be -- to also -- to get back into positive territory.

Then on the question of margin improvement, we basically stick by the entire explanation we gave at Capital Markets Day and I see the third quarter improvement as a nice underlying proof point of the trajectory that we are on. And now we will diligently work into the fourth quarter, which, of course, is an important quarter for us, seasonally always big, and we remain on the trajectory that we set.

Now, talking about foreign exchange, we warned for that in London and it did come in quite negatively with 160 basis points negative, yet we were able to overcome it and I think that's the strength of the improvement program with Accelerate that we are on, which came in at 210 basis points, outpacing the currency issue all together, and that we aim to -- on that part we aim to continue.

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

Thank you.

Operator

Andreas Willi, JPMorgan.

Andreas Willi - *JPMorgan - Analyst*

My question is on Healthcare. You mentioned the slightly slower recovery at Cleveland. Is the aim still to recover EUR175 million over the two years? So is this a move from 2015 into 2016 for the remaining margin or profit recovery?

And maybe you could also give some indication on pricing of these new orders. Overall the pricing and the earnings bridge this quarter wasn't bad, but what do you see in the order intake in your effort to regain the share? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, good question. We remain committed to the overall profitability improvement in Cleveland, the EUR175 million that you mention but clearly it has slipped somewhat. We are now expecting EUR50 million to EUR60 million this year, which means that the step up needs to be bigger next year.

We have no reasons to backtrack from that ambition, on the contrary, we feel that we are making good progress in the marketplace, also with customers, also with new order intake.

The cost of stepping up and improving the quality management system is at an elevated level and, that elevated level is expected to continue into 2016, thereby putting some counter pressure on the profit improvement.

With regard to price erosion, overall, and I think you already alluded to it Andreas, we see the customary equipment price erosion, which overall for Healthcare then results in the 1% to 2%. I said in the past that for selected modalities and selected customers, we can go a little bit more aggressive, as we want to repair some of the pain that we have caused to those individual customers and their price erosion can be a little bit higher. But not to the degree that it impacts the overall average of the Healthcare margin evolution. So I think that's in the end that's what we need to keep in mind.

Andreas Willi - *JPMorgan - Analyst*

And the follow-up on pricing, if you have these strong effect headwinds because of importing into some of these emerging markets, other companies, maybe not directly related to Philips, but other companies, seem to be reasonably successful in compensating that by price increases because competition has the same issues when they have to import, for example, into Brazil or other markets. Is that pricing benefit there at Philips as well, but kind of then offset with the overall negative pricing on the bridge? Or why are you not able to offset more of that FX headwind?

Frans van Houten - *Koninklijke Philips NV - CEO*

I think what you see overall in the FX situation, is that we have sizeable dollar cost, even though in the United States, of course, we see also the benefit in the top line. But globally, we have sizable dollar cost and especially versus emerging markets, there we see the negative.

What you now see coming through is the existing sales being under pressure and it's hard to hedge for that in emerging markets because it's very costly. Of course, as you point out, that for future orders we will adjust our prices. But that's in the order intake, that's not yet in the sales.

So there's a time lag when it comes to adjusting for currency effects. We will, of course, do everything you said. In fact, we will do more, because we overall feel that our cost structure should be brought more in line with a natural currency basket and this is something that Abhijit has jumped immediately on, in his role as CFO. And maybe at one of the future events we can elucidate a little bit on how we will evolve our industrial footprint and cost base to get more to a natural hedging situation.

Andreas Willi - JPMorgan - Analyst

Thank you very much.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - Morgan Stanley - Analyst

I had a couple of questions, again, on Healthcare. One was more specific and I guess one general.

On the margin bridge the Cleveland impact is minus 1. There are a lot of numbers flying around about what Cleveland was actually going to contribute this year. But my understanding, or what I thought it was going to do this year, was ballpark EUR80 million, something like that, EUR80 million to EUR100 million. I don't know if that's correct? Maybe it's more for Abhijit.

But can you just tell us, what is leading to the negative impact in EBITA bridge this quarter? Is it simply quality investments, quality control, or are there other factors at play? So can we have sort of specific understanding of that number in the margin bridge?

The second issue, that I guess may be for Frans, is more general. When we look into the fourth quarter, it's normally your big quarter in Healthcare. If we go back historically, we're normally looking at roughly a 3 percentage point margin step-up between the third quarter and the fourth quarter. When we look at 2015 and everything that's happened, what are the puts and takes on that step-up? What would make this a better or a worse year in terms of delivery in the fourth quarter?

Frans van Houten - Koninklijke Philips NV - CEO

Well since you direct the question so smartly to Abhijit, Ben, let's start with Abhijit.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

On Cleveland, the number I think which we have given out is EUR100 million improvement that we had planned on this year, will be, I would say, it's going to be EUR50 million to EUR60 million.

So the EUR40 million gap largely comes -- Frans mentioned earlier that the ramp-up in Cleveland is going well, however there are the smaller product lines which are delayed into next year, the remediation is delayed into next year. So we will have some loss of sales which, of course, then impacts the margin.

And the second one, as you rightly pointed out, is we have stepped up the remediation effort that we have put in there and that results in slightly higher cost as well.

So these are the two big ticket items that affect the EUR100 million coming down to the range of EUR60 million, let's say.

Ben Uglow - Morgan Stanley - Analyst

Thank you. Just to be specific on that, Abhijit, there is no significant negative price impact in that number. This isn't an issue of you having to discount much more aggressively than you thought in order to relaunch Cleveland?

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

No, this is not linked, and I think Frans mentioned it, for specific customers who have been negatively impacted, we may do something here or there but that's not a big impact on the overall numbers, bringing the number down from where we said over EUR100 million to now the EUR60 million or so.

Ben Uglow - Morgan Stanley - Analyst

Thank you.

Operator

We will now take our second question --

Frans van Houten - Koninklijke Philips NV - CEO

Ben had a second question, operator, and I'm sure he wants an answer on that.

Well Ben, without trying to specifically guide for the quarter which we don't do, I don't mind giving you a bit of color on it. We saw, of course, in the third quarter a significant positive impact from our Accelerate program and operational improvements, that will expectedly continue. We also expect a positive volume impact in the fourth quarter whilst seeing similar headwinds to a degree.

Overall we should expect a strong fourth quarter -- what do you want to say about FX, Robin?

Robin Jansen - Koninklijke Philips NV - Head of IR

We expect additional tailwind from FX in the fourth quarter as well.

Frans van Houten - Koninklijke Philips NV - CEO

Okay. A tailwind from FX?

Robin Jansen - Koninklijke Philips NV - Head of IR

A small tailwind so that -- because the US revenue side in the fourth quarter is, due to seasonality, very big. And so whereas we earlier in the call talked about being long on dollar cost, your long on dollar revenue, and that brings that currency negative which was sizeable in a small currency positive.

Ben Uglow - Morgan Stanley - Analyst

And again the same question, Frans, that I asked Abhijit. We're not going to have to be absolutely crazy on price discounts to build up that order book in 4Q?

Frans van Houten - *Koninklijke Philips NV - CEO*

We don't do anything crazy, Ben, you know us (laughter)

Operator

Daniel Cunliffe, Liberum.

Daniel Cunliffe - *Liberum - Analyst*

Just a quick follow-up on the pricing. You talk about 2.2% or EUR140 million, similar to Q2. Just really wanted a bit more color on that. So you talked about no real aggressive price pressure in Healthcare. It just seems -- do we have any color on the Lighting portion of that, given the increased proportion of LED within that? I'm assuming that the overall consumer is flat and moderately up, just a bit of color on the pricing?

And then just a quick follow-up, perhaps, on the Healthcare Informatics, double-digit order decline given mid to low single digit growth in elsewhere within Healthcare. I just wanted to understand a bit more of what's behind that double-digit pressure? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Thanks. Well let's first indeed confirm that on the consumer side we generally do not see price pressure because the rate of introduction of new products is so good that we are compensating and therefore we only see margin expense in Consumer, really well done there.

Then in Lighting, let's make a distinction first between the LED lamps and the LED luminaires. Overall, in LED lamps price erosion must happen because LED lamps need to come into a price range where also consumers will see it as a staple and start adopting it on a mass scale. We are getting very close to that but price erosion on LED lamps has been double digit for most of last year.

In LED luminaires it's actually the opposite. There we see margin expansion due to the functionality that gets into LED luminaires. Increasingly you see controls being embedded creating smartness in LED luminaires and we see prices typically being higher than in conventional lighting. This is also why in Abhijit's part of the speech, we elucidated that the conventional decline in the Professional Lighting Solutions side of the business is actually a good thing because it leads to margin improvement.

If you add it all up then we see a price erosion of around mid-single digit which is a stable situation all around.

Then you have a question around Healthcare Informatics. I would like to bring to recollection that we have a double-digit order intake trend in the first half of the year and then in the third quarter it was negative. It reflects the lumpiness of that business and we actually believe that the business is on an upward trajectory overall and very much benefitting from the leadership that Jeroen Tas is giving to that business where we are moving it quickly into cloud-based environments and we see a lot of customer interest in our Healthcare Informatics solutions.

Daniel Cunliffe - *Liberum - Analyst*

Very clear, thank you.

Operator

Philip Wilson, Redburn.



Philip Wilson - *Redburn Partners - Analyst*

Thank you for taking the questions. The first one is just coming back to your IG&S guidance of EUR450 million adjusted EBITA for the full year which I think is still implied. That implies a very high fourth quarter cost above the seasonal norm. Can you comment on what the drivers are of this increase? And is that EUR450 million a level we should expect in 2016? That's the first question.

And then just secondly, on your R&D. You saw a year-on-year increase of almost a point as a share of sales, can you quantify what's driving this, is it mix or are you seeing specific R&D increases in divisions? And should we expect this increase to continue? Thank you.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Let me take the one on IG&S guidance. You are right, it's a bit heavily backend loaded. A couple of reasons, one is of course the seasonality you know from the past, it's between 40% and 45% in the first half and between 55% and 60% in the second half.

This year it's a little more backend loaded for a couple of issues. One is, the license revenue that we expect in Q4 is slightly lower than what we had in Q4 last year, so that creates a bit of the gap. The normal seasonality, as I mentioned.

And then there are a couple of investments that we will kick in in IT. You already saw part of that in Q3. You will see a little more of that in Q4 as we get ready to launch out the Philips integrated landscape, which is the entire IT infrastructure that we are renewing. So that is primarily the reason why it goes a bit higher in Q4.

Regarding 2016, let me come back to you a bit later, because we are going through our budgeting process, etc., and we will look at, of course, these costs very closely in the coming weeks. So I don't want to guide at this stage, but we will come back to you at a later stage.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right. Then let's try to give a bit of commentary on the R&D. I think we have consistently flagged that in certain areas of the business, we have increased R&D investments. This is related to Healthcare Informatics, Personal Health Solutions and Pathology.

What is also at play here is that we have quite a bit of R&D in dollars and the currency effect, of course, plays through in the R&D totals. Part of our revenues is also in dollars, but as earlier explained, doesn't come at the same pace of increase as the cost base. That will reverse in the fourth quarter with the seasonality of sales more in dollars.

So bottom line is, yes, R&D goes up a little bit, but certainly not the only reason for the percentage spike which is partly also currency related.

Philip Wilson - *Redburn Partners - Analyst*

Okay. Thank you very much.

Operator

David Vos, Barclays.

David Vos - *Barclays - Analyst*

Two questions from my side, please. One on Lighting. With the LED business now getting close to 50% of that business, I was wondering if you could give a rough split of how much of that business is Professional and how much is Consumer?

And at the same time, could you mention what the outlook for the EBIT trajectory is on the Consumer side? I acknowledge Professional is doing much better there already. But I'm really wondering with the size and the scale that Philips should have in that business already, where do you see margins end up over time? So that's question one.

And then question two is on Respironics really. It's a business we don't speak too much about. But I was just wondering if you could give us a quick update on how you see the competitive landscape there developing? I think you mentioned something about new project launches there. And it would be interesting to hear if we're in a similar gross margin range as your US competitor there and how you think about growth going forward in that business. Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

We need to do a little bit of work to have the consolidated split between Consumer and Professional of the LED business. While that is being looked up, operational performance was strong in LED lamps; it was also strong in LED Professional Solutions; and was still the weakest in the whole part of the business where we still have more work to do.

Looking at --

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes, so I think the Consumer business would be about one-quarter of the Lighting business and about 75% of it would be Professional, which is the B2B part of the Lighting business.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, but that doesn't yet answer how much of the Consumer business is LED.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

[Close to 40%] (corrected by company after the call).

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, all right. That was the missing piece of the puzzle. Now with joint effort here in the team. So summarizing; 26% of Philips Lighting is Consumer; and [40% of that is LED and 60%] (corrected by company after the call) is still conventional. Reflects -- basically is in line with what we've talked about in general.

And then the profitability of the business is higher on the Professional side than on the Consumer side.

Then Respironics, I think we had a good run for the last year with increasing market share, a recovery on the mask side. You will recall that our competitor was stronger in masks for many years and we have brought out several new products in the market with masks that have a very nice patient facial fit and also, breakthrough form factors.

As a consequence, we are very excited about market share gains in that business. In the speech, we were referring to sleep and respiratory care, Respironics, with the Dream product range which is a breakthrough product range for patients with sleep apnea challenges.

This is a connected product, so besides the physical patient interface, there is also a coaching app and remote assistance through the cloud. It's one of the businesses that has moved first towards the HealthSuite Digital Platform.

Overall, we are very enthusiastic about our Respiroics business, even as the industry landscape, especially in the United States, is changing with regards to some reimbursement changes. Nevertheless, we continue to see good growth, good profitability expansion and market share gains.

David Vos - *Barclays - Analyst*

Okay, thank you. And a glance on the gross margin there? Is that possible to share?

Frans van Houten - *Koninklijke Philips NV - CEO*

No, we usually do not break that out by business. Sorry about that.

David Vos - *Barclays - Analyst*

Thank you.

Operator

Fredric Stahl, UBS.

Fredric Stahl - *UBS - Analyst*

Looking at Healthcare and the difference between orders and your revenue growth over the last few years and quarters, is it fair to assume that your order backlog is lower today than it has been post-crisis and that hence you're more dependent on order wins over the next few quarters to deliver revenue growth? Is that correct?

Frans van Houten - *Koninklijke Philips NV - CEO*

I think generally, that is correct. It has been stable, actually, over the last five quarters. Abhijit, do you want to say anything about it?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

Yes. Actually, if you see Fredric, in our booklet on page 57, we give the position of the development of the order book and you clearly see that when the order intake was a little bit lower in Q4 and Q1, it went slightly down but we are now building up pretty nicely. So if you compare Q3 this year to Q3 next year, we are at similar levels now.

Fredric Stahl - *UBS - Analyst*

Thank you very much.

Operator

Alfred Glaser, Oddo Securities.



Alfred Glaser - *Oddo Securities - Analyst*

I wanted to get back to Cleveland. Could you give us a bit more color on how the Cleveland ramp-up has influenced order intake in Healthcare, in Q3?

And then, I had a second question on Lighting. Could you comment a bit on the margin improvement or evolution in the LED space overall? And maybe give us some color on whether the Lamps or the other parts of the LED business are even making better progress in terms of profitability.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, sure. Let's start with the order intake on the Imaging side, which was a strong positive, certainly above the average for Healthcare. And that is very much related to the recovery in diagnostic imaging. So basically, underlining the fact that we are on the right path in repairing and restoring our position.

Much of that order intake also came out of the United States which, of course, makes us happy, because it says that the confidence in the market where Cleveland was the most visible, is coming back.

With regard to your second question. Margin evolution comes across the board in LED. This is good news. I already elucidated that, in Professional, we see -- we are, in fact, very happy with the move from conventional to LED, because in LED, we can build in all sorts of smart controls and features that make the overall price points higher, and also the sales levels higher. The gross margin in Professional LED are already above average for the totality of Lighting.

Now, in LED lamps, which was arguably more the battlefield for the last few years, we saw significant price erosion. But also, in LED lamps, the margins are improving already for the last five quarters or so, and start to contribute to the overall result.

So, we are now at a stage where we can say comfortably that we believe that the profit pool in LED will be attractive, and that we should be seeing a sustainable profitability level above from where Philips Lighting is today, also when we make a complete move over to LED. So Philips Lighting is not only having the leadership in conventional, but clearly demonstrates also margin leadership in LED.

Alfred Glaser - *Oddo Securities - Analyst*

Thanks a lot.

Operator

Max Yates, Credit Suisse.

Max Yates - *Credit Suisse - Analyst*

Just on the competitive landscape in Healthcare and I think across a number of players, we've heard various reports of some being more aggressive and competition stabilizing in China, and also some Japanese players being more aggressive at times. Could you give just an idea of how you're seeing your competitors in Asia behaving at the moment? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, I think everything that you said is true. We see the Chinese trying to establish themselves, although that's mostly in China itself, at this moment. We flagged that. That's also through some local preference that gives these guys a little bit of wind in their -- a little bit of tailwind.

Our response, of course, is to continue to innovate, for example, our ultrasound with anatomical intelligence built in, that's the kind of clinical decision support that our competitors don't have, and it sets us apart.

I can also confirm the aggressiveness on the Japanese side, it's very much helped by the Japanese yen devaluing versus the US dollar. And that gives an impetus of more export from Japan into the United States. Whereas most of our production happens in the United States itself, and therefore we don't have any currency benefit in -- with regard to our industrial footprint.

So this is a -- I guess, a new reality where we see some more activity on the Japanese side. Again there, our response is innovation next to the largescale deals, because many of the Japanese competitors only have single products, can only compete on single modality deals. Whereas, as you know, we have a strategy around systems integration and winning largescale deals where, for some of these competitors, more difficult to follow.

Max Yates - *Credit Suisse - Analyst*

Okay. And just a follow-up on the Volcano business. Obviously, within image-guided therapy, there's a 17% margin target, I think, by 2017. How's Volcano's margin specifically expected to evolve within this? And should this business be profitable this year, having come from, obviously, a loss in 2013?

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, that margin goal that stands, and of course is the blend between the equipment business and the catheter business coming from Volcano. I can report to you that Volcano is nicely on schedule. We do have, this year, the -- what we call the post-merger integration cost, as well as we have the depreciation of intangible -- of the acquisition assets, or at least part of that.

Operationally, Volcano is doing very well, and is improving its profitability as we speak. Also, on the sales synergy side, we see nice synergies in cross selling between the two salesforces. And that, basically, underlines our working assumptions when we did the deal.

So we are on track, and we don't break out Volcano's profitability specifically, but with this color, I hope that you can form a picture that we are quite pleased with this acquisition.

Max Yates - *Credit Suisse - Analyst*

Great. Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

You're welcome.

Operator

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

Frans van Houten - *Koninklijke Philips NV - CEO*

All right. Well, thanks, everybody, for dialing into this call. I hope that we have given you a good insight on how we are progressing. We are very pleased with the operational results improvement and will continue on that path forward. Thanks.

Operator

This concludes the Royal Philips third quarter 2015 results conference call on Monday, October 26, 2015. Thank you for participating. You may now disconnect.

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