

# **PHILIPS**

## **Royal Philips Third Quarter 2017 Results**

Monday, 23<sup>rd</sup> October 2017

## Introduction

Operator

Welcome to the Royal Philips Third Quarter 2017 Conference Call on Monday, 23<sup>rd</sup> October 2017. During the introduction, hosted by Mr Frans van Houten, CEO and Mr Abhijit Bhattacharya, CFO, all participants will be in a listen-only mode. After the introduction, there will be an opportunity to ask questions. If any participant has difficulty hearing the presentation, at any time, please press the \* followed by the 0 on your telephone for operator assistance. 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 Pim Preesman, Head of Investor Relations. Please go ahead, sir.

## Welcome and Agenda

Pim Preesman

*Head of IR, Royal Philips*

Thank you. Good morning ladies and gentlemen and welcome to Philips' third quarter 2017 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 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 07.00 a.m. CET this morning. Both documents are now available to download from our Investor Relations website. A full transcript of this conference call will be made available by end of today on our website. Before I turn over the call to Frans, I would like to remind you that Philips' shareholding in Philips Lighting is currently still at 41.27% of the issued and outstanding share capital at end of the third quarter and the results continue to be consolidated under IFRS. Our loss of control is highly probable within one year due to further sell downs. Philips Lighting is presented as a discontinued operation in the financial statements of Philips as of the second quarter of 2017. Discontinued operations treatment means that the profit and loss of the Lighting business is reported in the discontinued operations and for the balance sheet, the assets and liabilities of the business are reported on the line 'asset held for sale' and 'liabilities held for sale' respectively. Cash flows are reported in the line 'cash flow from discontinued operations'. 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.

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

## Company Overview and Strategy

Frans van Houten

*CEO, Royal Philips*

### Philips company overview

Thanks Pim and thank you all for joining us today in this call. Philips' performance in the third quarter demonstrates that we continue to deliver on our plan, with comparable sales growth of 4% driven by double-digit growth in our growth geographies, most notably in China and 8% growth in our Connected Care and Health Informatics businesses. We delivered an Adjusted EBITA improvement of 140 basis points, driven by higher volumes and the productivity programme savings that are well on track. Moreover, we had a solid 5% comparable order intake growth on the back of 8% order intake growth in the third quarter of last year, thus maintaining momentum.

Let me start with some key points regarding our financial performance in the quarter, after which I will share some business highlights as well.

Our third quarter results demonstrate our progress in creating value. Philips' comparable sales growth of 4% was led by our Connected Care and Health Informatics businesses, which delivered 8% comparable sales growth. Our Personal Health businesses delivered 5% comparable sales growth and our Diagnosis and Treatment businesses showed a 2% comparable sales growth. We were able to further expand our backlog, with a solid comparable order intake growth of 5%, mainly driven by a 7% increase in Diagnosis and Treatment.

**Frans van Houten:** Geographically, our 4% sales growth was driven by a 15% increase in growth geographies, most notably in China, Latin America and India and this more than offset a 1% decline in mature geographies. We observed some shifts from September into Q4, both related to orders and revenue, especially in mature markets.

Moving to profitability, adjusted EBITA was 12.8% of sales compared with an 11.4% last year, which is a strong 140 basis point improvement. All three segments contributed to this margin increase. The increase in margins was driven by higher volumes and productivity programmes. The Connected Care and Health Informatics businesses made a strong recovery this quarter, as margins improved by 440 basis points. The improvement in Diagnosis and Treatment continued as margins improved by 40 basis points. Personal Health delivered 130 basis points of margin improvement. This is a good moment to refer to the change in leadership in this segment. During the quarter, we activated our strong internal talent pipeline to promote Egbert van Acht to become the Chief Business Leader of our Personal Health business segment. Egbert's experience with the Personal Health businesses enabled a seamless leadership transition in a very short timeframe.

### Strategic journey to leadership in health technology

Let me expand now on our strategic journey to leadership in health technology.

Our self-help productivity programmes continue to be an important contributor to our margin improvement. In the period 2017–2019, we have committed to achieve a cumulative total net productivity saving of EUR 1.2 billion. We have made a good start, as our programmes are well on track to deliver the targeted savings of EUR 400 million for 2017, with

year-to-date savings already at EUR 350 million. We continue to strongly drive the digital transformation to serve our customers better and unlock value for them and Philips and we are pleased with the progress that we are making with our HealthSuite digital platform adoption. The benefits are brought to life through the following example.

#### *COPD case study*

COPD is the most common cause of hospital readmissions and a recent study showed that with Philips' Trilogy home ventilators providers can save millions in readmission cost. We have expanded our market-leading home ventilation offering with the launch of the connected Trilogy ventilator in North America, linking it to the Philips' Care Orchestrator. Care Orchestrator is a unique patient management service for people living with chronic respiratory and sleep conditions. This service effectively provides care coordination between patients, homecare workers, doctors, hospitals and payers, all enabled by our HealthSuite digital cloud platform. The combination of the connected Trilogy ventilator and the CareSage service provides a clinically-validated solution for COPD management which is expected to help providers lower care costs and reduce hospital admissions while improving the patient experience.

#### **Global brand campaign**

We launched a global brand campaign to help us leverage the Philips brand as a key competitive differentiator and to strengthen our reputation as a leader in health technology. This new campaign builds on our belief that *'there is always a way to make life better'*, which supports our ambitions to improve the lives of 3 billion people a year by 2025. We are also using the campaign to deepen our engagement with consumers and customers in the C-suite, accelerating a shift from a transactional business model to a more sticky relationship-based model. This has already yielded encouraging results in the first wave of markets, including in the United States, where we are partnering with the *Washington Post* for the launch.

#### **Long-Term Strategic partnerships**

We create further value through deeper customer partnerships and increasing geographic spread. During the third quarter, we signed several multi-year agreements, including a five-year agreement with the Siloam Hospitals of Indonesia covering maintenance and operational services. As Indonesia's largest private hospital group, the Siloam Hospitals provide general and highly specialist care to more than 2 million patients a year. Siloam Hospitals use a broad range of Philips Healthcare technologies, such as suites for image-guided therapy, Diagnostic Imaging solutions, including MRI and ultrasound. The new agreement aims to ensure the high quality of healthcare services that Siloam is providing to its patients, while at the same time improving operational and cost efficiencies.

We also signed a six-year agreement with the San Giovanni Calibita Fatebenefratelli Hospital in Rome, which is specialised in providing mother and child care. The hospital supports the birth of 4,000 new-borns and provides critical care for 400 premature babies from across Italy each year. Philips will provide a full suite of medical technologies, clinical informatics and services. Philips will implement a centralised command system that works with advanced patient monitoring for the Neonatal Intensive Care Units to enable continuous monitoring of the neonates and applying predictive analytics of their condition.

In the United States, Philips expanded its relationship with Advocate Health Care, the largest health system in Illinois, to assist Advocate Health Care in standardising its clinical IT and patient monitoring solutions across the enterprise for improved patient outcomes and predictable cost.

We continued our strong growth momentum in China, driven by our innovative consumer health and professional healthcare portfolio, focused initiatives to step up market share and customer partnerships. This is illustrated by the double-digit growth in Diagnostic Imaging order intake, which was in part driven by the strong traction in the private hospital segment, such as the new strategic partnership with Health One Hundred, the largest health examination organisation in China. Moreover, an important milestone in the long-term partnership agreement with Phoenix Children's Hospital was achieved with the opening of a new emergency department and level-one paediatric trauma centre, which both feature connected solutions from Philips.

## **Innovations**

### *Lumify mobile ultrasound*

Philips also continues to reinforce its leadership in cardiac ultrasound with a strong performance in the United States and a continued drive to expand in adjacencies such as in the Obstetrics and Gynaecology and the point-of-care segments, resulting in strong double-digit order intake growth in each of these clinical segments in the third quarter. For example, Philips introduced Obstetrics and Gynaecology ultrasound innovations that are designed to support earlier, easier and more confident diagnosis. Philips introduced a Lumify mobile ultrasound in Europe and Asia with the first multi-million order secured in Germany. Lumify is Philips' first app-based mobile ultrasound solution that offers diagnostic capabilities for compatible smartphones and handheld devices, focused on the urgent care environment.

### *Digital pathology*

Highlighting Philips' leadership in digital pathology, the Pathology Institute in Hall and Pathology Institute in Tirol Kliniken in Innsbruck, both in Austria, fully digitized their diagnostic process with Philips' comprehensive IntelliSite Pathology Solution. Last quarter, we already announced that we received regulatory clearance from the FDA for the Philips IntelliSite Pathology solution, which is the first and currently only digital pathology solution for primary diagnostic use, enabling us to market the solution in the United States.

### *Sonicare DiamondClean Smart*

Moving on to oral healthcare, after a successful launch of the Sonicare DiamondClean Smart in Q3 to Dental Professionals and consumers in China and the United States, we are rolling out this innovative and superior Philips range to over 20 other markets in Q4. Most of the activation has started in October and first signs are promising. The DiamondClean Smart is the most technologically advanced toothbrush in the world, building on the success of DiamondClean iconic design range but adding sensors delivering a complete care experience. This innovation also comes with a coaching app to help guide consumers towards a more complete oral cleaning. Feedback from dental professionals and consumers has been encouraging, with strong ratings and reviews in China, for example TMall rated the proposition with 4.8 out of five and JD.com at 95%.

### *Airfryer*

During the quarter, we also launched the next-generation Airfryer, which features innovative technology to prepare tasty, healthier food with little to no oil. As a leader in this category, Philips has sold now more than 8 million Airfryers globally to date.

On a different note, we are looking forward to the RSNA, or in full the Radiology Society of North America, annual meeting at the end of next month in Chicago. This is one of the largest radiology trade shows globally and Philips will be unveiling some exciting innovations in diagnostic imaging systems, advanced clinical informatics and services, all designed to facilitate an efficient workflow and first-time-right diagnosis. This will lead to a significant further renewal of the portfolio offerings in the Diagnosis and Treatment businesses.

### **Spectranetics integration**

We are also making good progress with the integration of Spectranetics. The Spectranetics business reached an important milestone with the FDA approval of Stellarex, the next-generation drug-coated balloon, or DCB, to treat patients with peripheral arterial disease. Stellarex latest results from the ongoing ILLUMENATE European randomised clinical trial demonstrated that Stellarex is the first low-dose DCB to demonstrate a lasting treatment effect two years after the treatment compared to standard endovascular care in the United States.

The Stellarex launch in the US is going very well, it is fully on plan, whereby we also cross-trained our existing sales force to further expand the US market launch.

Other examples of the progress on the integration is that we already identified cross-selling opportunities for over 500 accounts and achieved some significant procurement savings by leveraging our existing Philips contracts.

### **Image-Guided Therapy**

Our Image-Guided Therapy Devices business continues its strong performance, with double-digit growth driven by the success of our smart catheters for peripheral imaging and therapy, as well as the sales growth of our iFR portfolio on the back of the strong clinical study results earlier this year.

iFR is the next-generation physiologic measurement to assess the blood flow across a suspected blockage. We are convinced that this proprietary technology is a clear differentiator in this market segment.

### **Sustainability**

Last month, I also attended the United Nations General Assembly meeting in New York and we made a commitment to improve the lives of 300 million people in under-served markets, thereby recognising the often critical needs of women and children in many communities already struggling without adequate access to healthcare.

Last year we announced our new five-year sustainability programme, Healthy People, Sustainable Planet, which includes the ambition to improve the lives of 3 billion people by 2025 by focusing on sustainable development goals, primarily 3 and 12 and we also aim to become carbon neutral in our operations by 2020.

So, ladies and gentlemen, sustainability is an integral part of the way we do business at Philips and we are pleased that this was also recognised as we were named industry leader by the Dow Jones Sustainability Index 2017 for the third year in a row.

### **Quality management regulation compliance**

As stated in the press release, this month we reached agreement with the US government on a consent decree focusing on our defibrillator manufacturing in the US. The decree is related to compliance with current good manufacturing practice requirements arising from past inspections in and before 2015. While this settlement, of course, is a disappointment for all of us, we are fully prepared to fulfil the terms of the decree and we hope to resume the suspended defibrillator production in the course of 2018. As a consequence of the decree, we anticipate an EBITA impact of approximately EUR 20 million in the fourth quarter of 2017 and approximately EUR 60 million in 2018. The combined sales of the external defibrillator product lines affected by the terms of the decree were approximately EUR 35 million per quarter in 2016. Let me stress that there is no concern on product quality. Our products are market-leading, also in the area of quality and reliability and are highly appreciated by our customers. Further, as expected, the FDA conducted an inspection of our Cleveland facility in the quarter. In accordance with normal practice, we submitted our response to inspection findings for review by the FDA. We are committed to delivering high-quality innovative products and solutions and over the last years, we have made significant progress in our quality management regulation compliance.

### **Management changes**

Last Friday, or 20<sup>th</sup> October, Philips held an Extraordinary General Meeting of Shareholders during which Marnix van Ginneken, Philips' Chief Legal Officer and member of Philips Executive Committee, was appointed as a member of the Board of Management, replacing Pieter Nota. Marnix has been playing an important role in the Executive Committee since 2014, providing valuable contributions on a wide area of subjects. His broad knowledge of Philips and his vast international corporate governance expertise makes him an excellent member to complement the board of management.

### **Reclassification of shares to Health Care sector**

I'm pleased to note that in September the MSCI acknowledged our transformation into a focused health technology leader by reclassifying Philips' stock to the healthcare sector from the industrials group. This follows the reclassification of our shares to healthcare by the FTSE Group's ICB and the change in sector classification for the STOXX Europe 600 Index to Health Care.

Despite ongoing global uncertainties, our outlook for 2017 remains unchanged, supported by our 5% year-to-date comparable order intake growth, we are on a good track to deliver the 4–6% comparable sales growth and an improvement in the adjusted EBITA margin of around 100 basis points this year.

And with that, ladies and gentlemen, let me turn the call to Abhijit, who will provide more detail on financial performance and market dynamics.

## Financial Performance

Abhijit Bhattacharya

*CFO, Royal Philips*

### Growth

Thank you Frans and good morning to all of you on the call, as well as on the webcast. Let me start by providing some colour on the third quarter growth of 4%. This was largely led by 15% comparable sales increase in the growth geographies, which was driven by strong double-digit growth in China, India, Turkey and Argentina. In the growth geographies, each of the three segments recorded double-digit growth in the third quarter and Diagnosis and Treatment grew in the twenties on the back of high-teens growth in Q3 2016.

North America sales were flat, year on year, while other mature markets posted a 4% comparable sales growth, driven mainly by Japan. Sales in Western Europe declined by 6% in the quarter, following a strong second quarter when comparable sales grew by 8%. Year to date, sales in Western Europe have grown low single-digit, which is in line with our expectations. In Health Tech Other net sales decreased by EUR 9 million, reflecting lower royalty income.

### Order intake

Turning to order intake, as Frans mentioned, comparable order intake overall grew by 5%. The Diagnosis and Treatment businesses grew for a second quarter in a row by 7%, driven by double-digit growth in ultrasound. The Connected Care and Health Informatics businesses grew by 1% on the back of strong mid-teens comparable growth last year.

In the growth geographies, order intake on a comparable basis grew high-single-digit compared to Q3 2016, mainly driven by China and India. We continued our strong growth momentum in China, driven by our innovative consumer health and professional healthcare portfolio and focused initiatives to step up market share and customer partnerships. This is also illustrated by the mid-teens growth in Diagnostic Imaging order intake, which was in part driven by the strong traction in the private hospital segment, such as a new agreement with one of the largest health examination organisations in China. Year to date, the Diagnostic Imaging order intake in China amounts to over 20%. Comparable order intake in North America posted a 2% growth, while Western Europe declined 3%.

### Margins development

Let me now turn to the EBITA development for the group in the third quarter. Adjusted EBITA margin of 12.8% in the quarter was 140 basis points higher than the year before. This margin increase was driven by a very strong margin improvement of 440 basis points in Connected Care and Health Informatics. In Personal Health, the margin improved by 130 basis points. In both segments, this was mainly attributable to operational leverage from growth, procurement savings and cost productivity. In Diagnosis and Treatment, the margin improvement was 40 basis points, mainly due to procurement savings and cost productivity.

Our performance in the third quarter is driven by higher volumes, improved operational performance and delivering on our cost productivity targets. More specifically:

- Net overhead reduction amount to EUR 26 million in non-manufacturing cost;



- The productivity programme contributed EUR 43 million to the gross margin;
- Procurement savings, in part driven by Design for Excellence programme delivered EUR 77 million of bill-of-material savings year on year. Year on year, our productivity savings amount to EUR 350 million and as Frans also mentioned, we are on track to achieve our target of EUR 400 million for this year.

In Health Tech Other the Adjusted EBITA amounted to minus EUR 19 million; the decline of EUR 5 million compared to Q3 2016 was caused by the lower royalty income.

One-off significant items in the third quarter were approximately EUR 70 million above our previous guidance. Of this, around EUR 40 million related to acquisitions that were closed in the third quarter, mainly related to the acquisition charges of Spectranetics and an additional EUR 30 million due to acceleration of certain restructuring costs.

In the third quarter, the income tax expense was EUR 5 million, which was an increase of EUR 21 million compared to last year, mainly due to higher income. Both Q3 2016 and Q3 2017 included a release of tax provisions.

Overall net financial expenses declined by EUR 154 million year on year, mainly reflecting a EUR 98 million charge in Q3 2016 related to the redeemed notes in October 2016, higher dividend income related to the retained interest in the combined businesses of Lumileds and Automotive and lower interest expenses on net debt.

### **Return in Invested Capital**

Return on invested capital, which is calculated on a five-quarter MAT basis was 13.2%, which is five percentage points above our weighted average cost of capital and improved by 0.7% compared to Q3 2016. ROIC decreased by 2.2% compared to the previous quarter, mainly due to the impact of acquisitions.

### **Working capital**

Our drive to increase working capital continued to yield results as inventories, as a percentage of sales, decreased to 14.9% year on year an improvement of 120 basis points. Overall working capital improved by 80 basis points to reach 9.6% of sales.

### **Free cash flow**

Free cash flow was EUR 72 million in Q3 2017, including EUR 219 million of pension liability de-risking in the US. In Q3 2016, the free cash flow was EUR 65 million, including EUR 63 million of pension de-risking. Therefore, free cash flow excluding pension liability de-risking amounted to EUR 291 million in Q3 this year, compared to EUR 128 million in the same quarter last year.

### **Net debt**

The change in debt in Q3 mainly reflects the notes issued for a total amount of EUR 1 billion. We successfully placed EUR 500 million floating-rate notes due in 2019 and EUR 500 million fixed-rate notes due in 2023 at very competitive pricing levels. The net proceeds of the offerings were used for the repayment of the EUR 1 billion loan which was entered into for the purpose of financing the acquisition of Spectranetics and for general purposes.

**Market update**

Let me now provide you with an update on the US market and our outlook for Western European and China markets. Healthcare in the US is undergoing profound change; with our scope and scale in the US and wide range of digital innovations, we are well-positioned to support public and private healthcare organisations to reduce healthcare cost, improve the quality and outcomes of care and move from a volume-based to a value-based systems of reimbursement and service delivery. We continue to pursue and develop customer partnerships focused on these aims.

Market uncertainty continued in Q3 while legislative processes to repeal the ACA was deferred. Uncertainty around other policy topics, for example the ACA health insurance marketplace stabilisation remains. The market uncertainty continues to impact larger and longer term customer commitments. Additionally, it is possible that the current two year delay in the medical device tax will expire, and not be extended after 1<sup>st</sup> January 2018. We continue to monitor these events closely and stay focused on the needs of our customers.

We saw a moderate improvement in government spending during the quarter. Given these uncertainties, we continue to expect US market growth to be in the low single digit while we closely monitor further developments. In Western Europe, we continue to expect modest low single digit market growth and in China, we continue to expect mid to high single digit market growth for 2017. Overall, we estimate the global healthcare market growth to be in the low single digit range for 2017.

**Guidance**

Let me now turn our guidance for Health Tech Other, Legacy items and restructuring costs:

- In the Health Tech Other segment, we now expect approximately EUR 80 million net cost at Adjusted EBITA level for the full year. On an EBITA level, we now expect EUR 90 million of net cost for the year. Both the EBITA and the adjusted EBITA losses increased by EUR 20 million compared to the previous guidance reflecting lower expected royalty income.
- In Legacy Items, we expect lighting separation cost to remain EUR 30 million for the full year. We now expect EUR 105 million of net cost at reported EBITA level, an increase of EUR 10 million driven by the movement of environmental provisions and legal charges. At adjusted EBITA level, we now expect EUR 50 million net cost for the full year.
- Restructuring and acquisition-related cost in the fourth quarter are expected to amount to approximately EUR 150 million. We are taking additional restructuring and portfolio optimisation measures mainly focused at acceleration of productivity programmes in Diagnostic Imaging. Restructuring charges were on an average 80 basis points during the last three years, and we now expect a similar level for 2017 to 2019 with a decrease thereafter.

Finally, the fourth quarter results will include the financials of the businesses acquired in Q3, and we'll have a dilutive effect of 20 to 30 basis points on the adjusted EBITA for the quarter. During the third quarter, we also started the EUR 1.5 share buyback programme which was announced on 28<sup>th</sup> June and intend to complete it in two years the programme will more than

offset the share dilution income connection which Phillips long term incentive programmes and dividend in shares.

We execute part of the programme through a series of individual forward transactions unevenly distributed over the two year period. Details of the transactions can be found on the Philips Investor Relations website.

In summary, we are pleased with another solid quarter with mid-single digit order intake and comparable sales growth, earnings improvement, free cash flow improvement and further progress on working capital management.

On a year-to-date basis, we have delivered an improvement of 100 basis points in adjusted EBITA. We continue to target a performance trajectory to deliver 4 to 6% comparable sales growth and around 100 basis points improvement in Adjusted EBITA per year.

Before we open the line for questions, I'd like to remind you that we will host our Capital Markets Day in New York next week on 2<sup>nd</sup> November where we will provide an update of our strategy and deeper insights on the path to value towards 2020.

We look forward to meeting many of you in New York while a live webcast will available for the plenary presentations as well. With that, we'll now open the lines for your questions. Thank you.

## Q&A

**Operator:** The first question comes from Miss Veronika Dubajova from Goldman Sachs. Please go ahead.

**Veronika Dubajova (Goldman Sachs):** Good morning gentlemen and thank you for taking my question. I'll keep it to two to start off. First, can you talk about what drove the slowdown in the Personal Health growth? In the third quarter, it seems to me that both the momentum in Health and Wellness and Grooming decelerated pretty meaningfully in the third quarter. So, maybe you can talk about what happened there and how we should be thinking about the growth trajectory for the rest of the year? So that's my first question.

And then my second question is more a financial one. Abhijit, looking at your execution versus the 1.2 billion saving programme, it seems to me that you are running slightly ahead of where you had expected to be. Is this a function of timing only or are you also realising that the savings target that you had communicated is maybe there are pockets above and beyond what was included in the 1.2 billion, which is allowing you to be progressing so well so far?

**Frans van Houten:** Yeah hi, good morning Veronika. Thanks for your questions. Let me start with the first one. My advice is let's not look for any trends in the Personal Health. I rate the Health and Wellness and Personal Care entirely to phasing and timing of campaigns and product introductions. We expect a strong year-end, so we don't read anything significant into it. I'm pleased with the handover to Egbert van Acht and I'm absolutely confident in the momentum that we're having in these businesses.

**Abhijit Bhattacharya:** Veronika, on the savings, yes you're right we are slightly ahead. I think in general, the 1.2 billion will still remain the 1.2 billion. But we will try to of course

see how quickly we can get the savings in, but for the time being the 1.2 billion remains and I would take maybe a slight over delivery for this year as a starting point.

**Veronika Dubajova:** Understood. And I noticed that you mentioned in the charges where the quarter that you were looking at some portfolio optimisation measures and D&T. Is there anything we need to be aware of and that will be my last question? Thank you.

**Abhijit Bhattacharya:** No, not in particular. We are taking some significant measures to improve profitability in Diagnosis and Treatment. We're behind our peer group there, and therefore let's say some of the less profit making businesses where we don't see a path forward to value. We are taking some actions to stop those, but it's nothing major.

**Veronika Dubajova:** Terrific, thank you both.

**Operator:** Thank you. As a reminder if you would like to ask a question please press the \* followed by the 1 on your telephone. If you wish to cancel this request please press the \* followed by the 2. Please limit yourself to one question with a maximum of one follow-up. We can now take our next question from Ian Douglas-Pennant from UBS. Please go ahead.

**Ian Douglas-Pennant (UBS):** Hi. Thanks very much. This is Ian Douglas-Pennant from UBS. So, my one question I guess would be on healthcare order so we've had very strong order growth first nine months of the year, but that hasn't translated into meaningful revenue growth. How should we think about it? Should we think about a very strong Q4? Is there a sustainable increase in that kind of order fulfilment time or how should we think about that?

**Frans van Houten:** Yeah hi, Ian. Yeah, some of what you say is right. Orders become a little bit bigger. It takes some more time to make it over the finish line. I think we talked about it in July as well on the back of the second quarter. At that time, it was some patient monitoring deals that moved into from a revenue recognition into the third quarter. By the way, that did happen. You saw subsequently a very strong CCHI quarter with patient monitoring performing very well.

Again also in Q3, we saw some deals that didn't make it into the end of September revenue recognition. Otherwise, the quarter could have been even stronger. So now we're looking at a significantly backend loaded Q4, where we intend to finish the year well. The order intake also bodes well for the underpinning of next year because some of these orders actually will only make it into revenue during 2018.

**Ian Douglas-Pennant:** Could you also talk about – is there any change in the criteria that would make you book something as in order, which maybe you're booking them slightly earlier than you might have done previously either intentionally or unintentionally?

**Frans van Houten:** No, no. We have no change. In fact, we are quite strict in order recognition, but I look to Abhijit to elaborate.

**Abhijit Bhattacharya:** No, absolutely Ian, to your question, we have intentionally not changed anything. So in order intake nothing happens unintentionally. It's just good to remember that for the large scale projects, we don't recognise the entire project as order intake. So we – for imaging equipment, for example we go out the next 15 months depending on the lead time. So, actually for the larger scale projects, we recognise only that portion of the order which is in the delivery horizon, which is probably different from what our competitors do.

**Ian Douglas-Pennant:** Great, thanks and sorry, what I hope is a one word answer question. I can't find the size of the tax provision reversal. I'm sorry if it's obvious.

**Abhijit Bhattacharya:** We don't give that amount out because of for the obvious sensitivity, but it was slightly lower than last year, this is what I can tell you.

**Ian Douglas-Pennant:** Okay thanks.

**Operator:** Thank you. We can now take our next question from Andreas Willi from JPMorgan. Please state your question.

**Andreas Willi (JPMorgan):** Yeah good morning everybody. My first question on Connected Care, you had a great margin performance there this quarter, a big step-up, been a bit erratic last few year so. Are you confident you've reached the kind of a higher level of performance there or is this still going to be quite volatile in terms of the quarterly margin performance beyond the seasonality? And my follow-up, the second question will be on restructuring. You made some comments earlier maybe you could elaborate a bit more in terms of where the increased spending is going and why is it needed? Is it – are you more ambitious now or is something else in the market going against you that you need more spending within the same kind of operating plan to get your targets? Thank you.

**Frans van Houten:** Hi Andreas, good morning. Well the CCHI market margin improvement certainly was helped by a very strong Patient Monitoring business in the quarter. The way I would look at it, it is a combination of structural improvements across the entire CCHI segment as well as an over delivery thanks to great factory loading and a quarterly high in the Patient Monitoring revenue. So the seasonal peak may not be the same every quarter, but the structural improvements will of course continue as we see CCHI as a – in the near term trending towards in mid-teen EBITA performance.

**Abhijit Bhattacharya:** Yeah Andreas, regarding the restructuring, there's not something specific going against us in the market. You know, we have a pretty ambitious programme which we classified as self-help over the next three years and whatever we can pull in – because from the time you actually start the process you restructure, you have the cost-out and you improve the profitability is a reasonable length of time. So the earlier we can get these done the better we are in terms of delivering our year-on-year improvement. So, nothing out of the ordinary, but yes, as we take deeper actions with global business services and as we move along on our footprint rationalisation, these costs are coming in now and a bit accelerated to your point.

**Andreas Willi:** Thank you.

**Operator:** Thank you. We can now take our next question from Mark Troman from Bank of America. Please state your question.

**Mark Troman (Bank of America):** Yes, thank you very much. Good morning Frans. Good morning Abhijit. I got a question on Diagnosis and Treatment. The margin up 40 basis points; looks like ultrasound doing very well, but could you provide a bit more colour on the margin performance of how IGT and Diagnostic Imaging is performing? Thanks very much.

**Abhijit Bhattacharya:** Yeah, hi Mark. I think overall all our businesses are doing well. You're right that DI has of course improved but so as IGT. And IGT is continually improving. In Diagnostic Imaging, we didn't have so much growth this quarter so the operational

leverage was a bit limited, and that's also partly with, as Frans mentioned, some of the revenue recognition issues in the quarter. But I think overall for the year, we will make a good improvement there as well. So with the revenues moving into Q4, the operating leverage impact will come in Q4 as well.

**Mark Troman (Bank of America):** Okay, thanks for that Abhijit. And then one follow-up on pricing, I mean so far this year, you looked to have been a 100 basis points on your group. Profit bridge negative 100 basis points or a bit less in fact earlier in the year. And I think your longer term average is about 130. How are you feeling you're doing on pricing? Do you think you can keep slightly ahead of that 130 basis points for your benchmark?

**Frans van Houten:** Yeah, Mark, I would think we should be able to maintain this for the time being. We also see that as we are emphasising the solutions aspect more and we go to more partnership deals that and we sign-up for let's say helping hospitals drive productivity that the business becomes less of a price game and much more of a performance game. So I – we are hoping that we can continue down that path and thereby mitigate and even reduce price pressures.

**Mark Troman:** Very helpful, thanks very much.

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

**Operator:** Thank you. We can now take our next question from Patrick Wood from Citi. Please state your question.

**Patrick Wood (Citi):** Thank you very much. I have two please, if I may. The first is obviously a very strong performance in PCMS. I'm trying to get a sense for there, how much of that is, let's say the deferred orders that are coming through and a sort of one quarter bump versus going forward. Should we expect for example Q4 to look a bit more like Q1 or 2 from an organic growth perspective? That will be the first one. And then the second one is so the deferred revenues that you expect to fall into something like DI in Q4 of this year. Do you have a rough sense of roughly how much we should expect from that? Should we expect within the overall D&T business, a step-up at organic sales growth in Q4 or was similar to Q3? Thanks.

**Frans van Houten:** Yeah, well Patrick, we're not going into specific guidance for Q4, so it is a bit tricky, you know, how shall I answer you. I mean Andreas, of course, asked a similar question what is attributable to a seasonable peak and what is the structural improvement? And I answered that CCHI is trending towards the mid-teens EBITA performance on a structural basis. We had a very strong sales performance for PCMS in the quarter. Therefore, you need to even it out a little bit and get to a kind of a more normalised incline of the performance improvement. You know where one quarter, you can be a little bit ahead and in the next quarter you even it out again.

Order growth for CCHI in the second quarter was strong. So we also are sitting on a good order book for CCHI. I have strong confidence in the future sales traction there. D&T, if you'll recall we had good order growth in the second quarter, a little bit less in the third quarter but on a 12-months moving average, we are actually in the range completely supporting the growth plan that we have. I think Abhijit just now already said that we had some business slip into Q4 that also applies to Diagnostic Imaging and D&T at large. So we

are heading towards a good strong finish of the year. And again also for 2018, we already are having an order book that is well filled.

**Patrick Wood:** That's helpful colour. Thank you.

**Operator:** Thank you. We can now take our next question from James Moore from Redburn. Please state your question.

**James Moore (Redburn):** Yeah, good morning everybody. My first question is on the strong PCMS growth in the quarter. Can I assume that that's just sensible inventory channel management into the defib ruling. And so will it all reverse in the fourth quarter? I'm just really trying to understand how much is sustainable and how much we should think about a switch into the fourth quarter? And my second question is on Western Europe. I see you've had a couple of quarters in negative orders and I thought organic sales growth went from sort of +8 to -6. And Abhijit, you mentioned the comp and you mentioned year-to-date, your low single and that's in line. But just on the -6, can you talk a bit about whether any one business or any one country is driving that?

**Frans van Houten:** Yeah, well James, let me first of all strongly deny the implication of the inventory management in the third quarter. We did not. So this is not defib related at all. It's a strong performance on the side of patient motoring specifically. I mean, if I pivot to some of these customer examples you know Advocate Health, Lakeland, of course, those are new orders. They are not yet in revenue. But it just underlines the strong traction that we are having on patient motoring. Then the second question will be taken by Abhijit.

**Abhijit Bhattacharya:** Yeah, I think on Western Europe, it's largely from the Benelux and in the Benelux, in the last quarter, we had fantastic growth close to 30%. So therefore, it was very lumpy and then of course we had a big decline in this quarter. So I would not read too much into that James. If you look for the first half of this year we've had a 7% growth, so I think we're pretty okay because we had said all along Western Europe would be a low single digit market and we're trending in that direction.

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

**Operator:** Thank you. We can now take our next question from Ben Uglow from Morgan Stanley. Please go ahead.

**Ben Uglow (Morgan Stanley):** Yeah, good morning Frans. Good morning Abhijit. And I had a couple. On the orders, you very kindly gave quite a lot of detail around Ultrasound and the overall trend. How it would have been – without wanting to sort of sound pernicky is it correct or is it fair for me to assume that when we look at the North American market in terms of diagnostic imaging, i.e. advanced imaging, CT, MR etc, that the orders there are still trending down. Is – the sort of triangulating it backing it out, is that a fair assumption? If so, is there any connection at all between that current trend and what we're seeing on the North American revenues which are down mid-single digit so that was question number one.

Question number two and it's for Abhijit. Very briefly or very quickly on slide 31 of the presentation, can you just give us some colour on the incidentals. There's a 22 million incidental in Diagnosis and Treatment and then 18 million in Connected Care. I just want to really understand what those are about.

**Frans van Houten:** Yeah, hi Ben, good morning. So I'm going to disagree with your assumption because if I look at the whole year then DI Diagnostic Imaging in North America is on a very good trend. We saw mid to high single digit order intake growth in the first half year, and it's our belief that we are increasing some market share in particular in for example MR. So no worries for me in North America. Also when I look at the funnel, actually the customers that we're engaged with where we hope to win orders there is a lot of activity in the funnel with relation to DI.

Q3 just happens to be a little bit lumpy towards DI and I just get a very helpful message from Abhijit that year-to-date, for DI in North America, we are mid-teens in order intake growth. So it's even a bit stronger than I was just representing to you that's probably why I get that sign post. So anyway, it's going well. Just the third quarter happens to be a little bit softer, but nothing to worry about.

**Abhijit Bhattacharya:** Ben, on the incidental, there are couple of things. So we had actually guided to most of it, but in Diagnosis and Treatment like I said we took a couple of portfolio decisions which led to the additional charge of 22 million. And in CCHI as well, we did some portfolio rationalisation which led to a slightly higher than what we guided for, and that it was more a phasing between the quarters and we were able to pull it in earlier.

**Ben Uglow:** Just roughly, what are the charges?

**Abhijit Bhattacharya:** These are related to restructuring, inventory write-offs and any other balance sheet write-offs that we need to take when you stop a product line or a product.

**Ben Uglow:** All right, thank you very much.

**Operator:** Thank you. We can now take our next question from Max Yates from Credit Suisse. Please go ahead and state your question.

**Max Yates (Credit Suisse):** Thank you. Just my first question is around the comments on Cleveland. So you said, kind of as expected, the FDA's done their investigation and you've submitted your response. Is there any colour you could give on whether the issues that the FDA raised were kind of in line or less or more than perhaps you would have expected? That's my first question.

**Frans van Houten:** Yeah, the physical investigation onsite was completed in the course of August. And then as it's customary, you get the draft 483 findings that you can then react to and then you go into dialogue on the outcome. It's current expectations that we will have that dialogue only in the next coming months, so there's no immediate urgency behind the situation. So that is, I think, where I would need to leave it at. I mean obviously, there are some findings. Otherwise, I would have said it's a completely clean investigation, but I feel that this situation is very well in hand and that we will continue to improve. Also, the whole Diagnostic Imaging setup is very much a global setup with factories in three locations and all products being manufactured from those locations, so we feel comfortable about where we are.

**Max Yates:** Okay and just the follow-up was just around the acquisition pipeline. Obviously, you've done quite a few deals sort of Spectranetics and some smaller ones. I'm just wondering how you think about the next six months and the pipeline that you see in front of you. I mean, are we more in integration mode over the next six months given the deals that



have been done or are you still very much sort of on the hunt for deals and you see a very healthy, sort of, and full pipeline in front of you?

**Frans van Houten:** I think we already flagged in the second quarter that it was accidental that they all seem to have come in the same period. So there's certainly not going to be that kind of intensity in a single period in the coming year. M&A does play an active role in our strategy, but only when a deal really passes our internal scrutiny will we do it. Most of our strategy is organic. Most of the improvement for our strategic goals is based on the self-help and the organic growth of the core business. Therefore, M&A is the icing on the cake rather than a necessity, right. So we will carefully look at those deals that can really strengthen the portfolio but we will not go into deals that get us distracted.

**Max Yates:** Okay, perhaps just one very quick follow-up on Healthcare Other. Is there any reason or any kind of clarity you can give us on 2018 in Healthcare Other and anything you can point us to that would suggest it will be better – it will be less negative than the 80 million this year in 2018.

**Abhijit Bhattacharya:** Yeah, I think, Max, you have to hold your horses till next week we would normally do that in the CMD. So we will do that in our Capital Markets Day.

**Max Yates:** Okay thank you.

**Abhijit Bhattacharya:** Yeah okay.

**Operator:** Once again if you would like to ask a question please press the \* followed by the 1 on your telephone. To cancel this request please press \*2. We can now take our next question from Scott Bardo from Berenberg. Please go ahead. Your line is open.

**Scott Bardo (Berenberg):** Yeah, thank you very much for taking my questions. Just the first question just following on from Max's question on Cleveland. Can you give us a feeling for where we are in the recovery from Cleveland as compared to his historic output so we are back at normal historic levels at Cleveland or is there still some way to go in that recovery? And perhaps you can just comment actually on well following on from your comments in the last update and you mentioned there's quite a lot of product redesign recertification. Have all of those activities now occurred at Cleveland or is there still some more activities to be done there? So that's the first question. I have a follow-up. Thank you.

**Frans van Houten:** Yeah, Scott. Frans here.

**Scott Bardo:** Thanks Frans.

**Frans van Houten:** In speech language, Cleveland has become synonymous with diagnostic imaging. And that's a little bit of an oversimplification. I mean we have several other sites in diagnostic imaging like Haifa, Suzhou and Best here in the Netherlands that all play an important role in the future of diagnostic imaging. And on the question of Max, I already said that we feel that it has much more de-risked the industrial footprint versus the past with virtually all products being produced in other locations as well. So that's my first statement. And the second point is that with regard to production volumes, if I add up the sum of all the factory locations across the world, yes, we are very much at normal levels now and we have completely recovered from a volume basis okay.

Then on the third – the third comment is on the famous cost side you know where we have seen of course heavy investments in improvements in the quality management system for compliance including the redesign of supplier base because some of the products problems were not our own doing, but actually part of the supplier base. There's still some work ongoing to rationalise the supplier base. Moreover, if I pivot to the profitability of DI from a kind of a mid-single digit EBITA, we have pledged to go in the near term, in the next three years to low teens. Now, obviously that can only be done if we tackle the cost of organisation also in debt or in the Diagnostic Imaging global footprint.

So we have more work to do. Abhijit already said that we have taken some restructuring in order to, let's say, put the business on continued improvement path and this is typically also a topic that I think would come back at the Capital Markets Day where we have both Rob Cascella as well as Kees Wesdorp, who is the Diagnostic Imaging Business Group Leader, present. And of course, they are completely prepared to be grilled by all of you. So I think we can give more colour during that conference on good track record and a good path that we're on in order to get to decent profitability in that business.

**Scott Bardo:** Thanks, that's a very helpful answer. And maybe just a quick follow-up please for Abhijit to answer some specific financials. So for the full-year Abhijit, I'd like to understand that the current range of growth is 4 to 6% growth range that both of those growth boundaries are still possible or do you feel more comfortable with one or the other end of that growth guidance. Perhaps also you could just give us a bit of a flavour on where you expect free cash flow for the full-year. I understand that that's they had some one-time impacts, but it would be useful if you could quantify that and just give us a feeling obviously for tax rate as well. How you see that this year and going forwards? Thanks very much.

**Abhijit Bhattacharya:** Yeah, I think I'm not going to get more specific on the growth rate. Frans mentioned earlier as well that we're going to be in the range of 4 to 6%. Year-to-date, we are close to the 4. We are rounded at 4, but just shy of it if you look at the decimal place. If we're based on Q4, we'd probably – we are comfortable that we will be in the 4 to 6 range. Free cash flow, again guidance doesn't change. We said 1 to 1.5 billion we maintain that guidance and the tax rate would probably be in the mid-20s. We had earlier guided to the high 20s. We would probably be in the mid-20s for the year based on where we are now.

**Scott Bardo:** Thanks Abhijit.

**Abhijit Bhattacharya:** Thanks.

**Operator:** Thank you Mr van Houten and Mr Bhattacharya. There are no further questions. Please continue.

**Frans van Houten:** Okay, well I think we had our share of questions this morning and it was good. I appreciate very much your attendance. I hope to see everybody during the Capital Markets conference that we'll be having in New York very soon. And for now thanks very much for attending and have a great day.

[END OF TRANSCRIPT]