

PHILIPS

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Leandro Mazzoni - Head of Investor Relations

Good morning, ladies and gentlemen. Welcome to Philips' Third Quarter 2019 Results Conference call. I'm here with CEO, Frans van Houten, and CFO, Abhijit Bhattacharya. On today's call, Frans will take you through our strategic and financial highlights for the period. Abhijit will then provide more detail on the financial performance and market dynamics. After that, we will take your questions.

Our press release and the related information slide deck were published at 7:00 a.m. CET this morning. Both documents are available on our Investor Relations website. A full transcript of this conference call will be made available by end of today on the website.

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

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

Frans van Houten - CEO

Yes. Thanks, Leandro, and thank you all in the call for joining us today. In the third quarter, we delivered a mixed set of results. I am pleased with the strong 6% comparable sales growth in the quarter. All businesses were contributing. The adjusted EBITA margin for the group, however, was short of our expectations at 12.4% of sales compared to the 13.2% in the third quarter of 2018.

Our Diagnosis & Treatment businesses delivered a very strong 9% comparable sales growth. Connected Care businesses posted 5% revenue growth. And the Personal Health businesses delivered comparable sales growth of 6%. Comparable order intake was flat on the back of double-digit growth in the third quarter of 2018, reflecting the unevenness of the order intake dynamics and softness in North America. Over the last 12 months, the comparable order intake grew 5% for the group. I would like to mention the high single-digit comparable order intake in the growth geographies on the back of 20% growth last year as China delivered another quarter of double-digit growth.

As discussed during the update on our financial performance earlier this month, Diagnosis & Treatment and Personal Health delivered a good performance in adjusted EBITA margin improvements compared to last year despite increasing tariff headwinds. The improvements in those segments were more than offset by adjusted EBITA margin decline in Connected Care and a higher-than-expected decrease of license income in the segment Other.

Connected Care consists of strong businesses with good profit pools and leading market positions, notably in the attractive franchises of Patient Monitoring & Analytics and Sleep & Respiratory Care. These leading businesses represent almost 90% of the Connected Care revenue. In the near term, the impact of headwinds and several transformations underway, together with the investments to drive future growth in adjacent markets, affect profitability.

The fundamentals of the Connected Care businesses, however, remain very strong. I'm confident that this segment will contribute to Philips' overall performance improvement. We have made several interventions in the Connected Care businesses during 2019, and we expect that they will start gradually contributing to performance improvement in the coming quarters.

Overall for Philips, we are accelerating the current cost productivity initiatives. And we are working on actions to sustain order growth and sales growth of higher-margin products. Importantly, we have stepped up efforts and strengthened capabilities to increase the effectiveness of actions to mitigate tariff headwinds. Let me remind you that this includes supplier base adjustments and reconfiguring the supply chain. We will stay the course and continue with our strategic journey to leadership in health technology.

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

During the third quarter, we entered into new long-term strategic partnerships with leading hospitals. For example, we signed a comprehensive 10-year innovation partnership agreement with the German Klinikum Stuttgart hospital, the largest provider in that region. The agreement includes the demand-oriented replacement and procurement of state-of-the-art medical technology, including diagnostic imaging and intelligent informatics solutions, and a new development of workflows and Connected Care solutions.

As health care continues to transform from a volume to a value-based approach and the amount of data available for each clinical decision is growing, our customers are seeking seamless, integrated solutions to enable more precise diagnosis, treatment as well as optimized patient care pathways inside and outside the hospital. In the third quarter, we continued to roll out exciting new products and solutions.

In Diagnosis & Treatment, following a successful introduction in Europe and Asia, we introduced a new Incisive CT platform in North America. The new platform integrates innovations in imaging, workflow and life cycle management, including a industry-first Tube for Life guarantee, helping health care providers with smart clinical decision-making, increasing efficiency and improved experience for patients and staff.

On the informatics side, we further expanded the Enterprise Diagnostic Informatics portfolio with the completion of the acquisition of Carestream Health's Healthcare Information Systems business. Adding a state-of-the-art cloud-based imaging data platform, our offering now includes advanced Vendor Neutral Archive solutions, diagnostic and enterprise viewers, interactive multimedia reporting, AI-enabled clinical operational and business analytics tools as well as tele-radiology and diagnostic patient management services.

We are looking forward to the RSNA Annual Meeting in early December in Chicago, where we will present the aforementioned and other innovations. We will showcase how we apply our strong clinical

capabilities, simplify workflows and integrate artificial intelligence to help clinicians deliver a precision diagnosis leading to targeted therapies with predictable outcomes.

In the quarter, we continued to expand the reach and depth of our Image-Guided Therapy portfolio. Following the National Medical Products Administration clearance in China, and that is the new abbreviation for the China FDA, we launched the highly successful Azurion platform in China. Overall, the Image-Guided Therapy business delivered a robust high single-digit comparable sales growth globally with the devices business delivering double-digit growth, driven by the peripheral vascular portfolio. We made solid progress with the Stellarex drug-coated balloon range with the launch of the longer 150 millimeters and 200-millimeter balloon versions in the United States that will broaden the treatment options for peripheral artery disease patients.

Moreover, as the safety of patients is our highest priority, I'm really pleased that a third-party evaluation confirmed our confidence in the safety profile of Philip's Stellarex. The safety analysis demonstrated that there is no difference in mortality between patients treated with Stellarex DCB and uncoated PTA through 3 years. It has also identified -- it also identified no device-related deaths and no correlation of Stellarex DCB to late all-cause mortality. This analysis represented one of industry's most extensive and rigorous safety assessments over paclitaxel-based device. And we were published in *Circulation*, a peer-reviewed journal of the American Heart Association.

Reinforcing our leadership in patient monitoring solutions, we introduced the next-generation IntelliVue MX750 and MX850 bedside patient monitor platforms in Europe. They feature an extensive range of measurements and analytics as well as a host of cybersecurity capabilities, which I would like to elaborate on. These systems have certificate-based note authentication, which means unauthorized access to the network is immediately identified and blocked. It also has data encryption during transmission as well as at rest, which means in case of theft or repair, the patient data privacy is guaranteed. These systems have full remote service access, so any new security patches can be made available to customers immediately. Moreover, we signed multiyear enterprise patient monitoring agreement with the Kantonsspital Frauenfeld in Switzerland and the University Clinic of Bonn in Germany to improve workflow and clinical outcomes in these hospitals.

Switching now to our Personal Health businesses. We can look back at a very successful IFA, Internationale Funkausstellung 2019, the leading consumer technology trade show that took place in Berlin in September. We highlighted our gradual shift from single products to personalized consumer health solutions that seamlessly integrate into people's lives and lifestyles, empowering them to make healthier choices and fulfilling their personal needs. This resonated very well with consumers as well as our online and retail partners.

At the show, we introduced our newly developed Philips Airfryer XXL, featuring Smart Sensing technology that takes over the cooking process to ensure a perfectly cooked meal. At a touch of a button, the Philips Smart Sensing technology automatically adjusts the Airfryer's time and temperature settings, delivering superb, tasty meals. We also showcased our Sonicare oral care platform, including

the Sonicare teledentistry service, which we recently introduced in Germany. With the Philips Sonicare power toothbrush and the accompanying Sonicare app, people can manage their daily oral care. Adding the new teledentistry service, we now provide people with remote dental assessments from licensed dentists.

In the quarter, we further broadened the oral care portfolio with the global rollout of the connected Philips Sonicare ExpertClean, following the launch in the United States earlier this year. The smart power toothbrush delivers superior oral care results with its sonic technology and deep-cleaning brushing technology -- brushing mode.

Moving on to the third key driver of our strategic agenda: improving margins through customer and operational excellence. Our self-help initiatives to drive over EUR 1.8 billion in savings over the period 2017 to 2020 are on track. We delivered EUR 96 million savings during the third quarter, driven by 3 main programs: procurement savings, manufacturing productivity and cost reduction.

A progress update on regulatory matters now. We continue to address the follow-up request of the U.S. Food and Drug Administration, the FDA, as part of the efforts to fulfill our obligations under the Consent Decree. We remain in dialogue with the FDA. However, given the nature of the process, which includes further reviews of the improvements we have implemented to date by the agency, we still cannot provide a definitive time line for the expected lifting of the injunction.

Now please let me conclude. Since 2016, we have delivered 3 consecutive years of 4% to 6% comparable sales growth and over 100 basis points of annual adjusted EBITA improvements. For 2019, we expect growth to be within the 4% to 6% range. But given the overall significant headwinds and the performance trajectory of the Connected Care businesses, we now expect the adjusted EBITA margin for the group to improve around 10 to 20 basis points.

We have strong businesses and a strategy that clearly resonates with our customers. While 2019 is a more challenging year in terms of stepping up profitability, our strategic journey to leadership in health technology remains intact, and we are absolutely focused on continuing to drive improvement. For 2020, we target a 4% to 6% comparable sales growth and an adjusted EBITA margin improvement of around 100 basis points. This already takes into account that Connected Care starts from a lower adjusted EBITA margin base and we need to work on improvements from there. In that context, we now expect the Connected Care businesses to deliver an adjusted EBITA margin in the 13% to 15% range next year.

With that, ladies and gentlemen, I'll turn the call to Abhijit, who will provide more detail on financial performance and market dynamics.

Abhijit Bhattacharya - CFO

Thank you, Frans, and good morning to all of you on the call and the webcast. Let me start by providing some color on the third quarter comparable sales growth of 6%. Mature geographies delivered a 5% comparable sales growth, reflecting growth in Western Europe, North America and other mature

geographies. Growth geographies sales increased by 9% on a comparable basis, driven by double-digit growth in China, India, Russia and Central Asia.

The Diagnosis & Treatment businesses delivered a very good 9% comparable sales growth. Ultrasound continued on its strong performance spot and grew double digit. Image-Guided Therapy and Diagnostic Imaging both grew high single digits. The sales for Connected Care business in the third quarter grew by 5%. The Monitoring & Analytics business showed mid-single-digit growth. And our EMR business delivered strong double-digit growth. The Sleep & Respiratory Care business grew mid-single digit, driven by double-digit growth in sleep and the oxygen businesses, partly offset by a decline in home ventilation.

The Personal Health business delivered 6% comparable sales growth during the third quarter, led by new product introductions and double-digit growth of our Oral Healthcare business. Personal Care delivered low single-digit growth. And in the Domestic Appliance business, comparable sales grew by high single digits in the quarter. With the strong comparable sales growth in the third quarter, year-to-date comparable sales growth reached 5% for the group, which is well within our targeted range.

Moving to the orders. Diagnosis & Treatment delivered flat order intake in the quarter. The demand for our innovative products and solutions remained strong in this segment. And despite the tough comparables, the equipment portfolio delivered mid-single-digit growth in order intake in the third quarter. This was offset by phasing of some orders in the Enterprise Diagnostic Informatics business. Comparable order intake in Connected Care was also in line with the third quarter of 2018, continuing on the uneven pattern of order intake that we witnessed during the last quarters. The funnel of opportunities in these businesses remained strong.

Overall, growth geographies continued to perform well with its high single-digit order intake growth in the quarter, driven by double-digit growth in China. Mature geographies' order intake declined mid-single digit, mainly driven by North America, which was impacted by tough comparables and phasing of orders in Enterprise Diagnostic Informatics business that I just mentioned. Western Europe order intake grew low single-digit in the quarter.

Let me now turn to the profitability development for the group in the third quarter. Adjusted EBITA increased by EUR 15 million and the margin decreased by 80 basis points compared to the third quarter of 2018. The Diagnosis & Treatment business delivered an adjusted EBITA margin improvement of 210 basis points compared to the third quarter of 2018. Personal Health delivered an adjusted EBITA margin increase of 30 basis points in the period. The improvement in Diagnosis & Treatment and Personal Health were driven by growth productivity, which more than offset the headwinds from tariffs.

The adjusted EBITA margin in the Connected Care business decreased to 11.3% in the quarter. Operating leverage from growth was more than offset by increasing headwinds from tariffs, a delay in the positive impact of the compensating measures, factory under-coverage and an adverse mix impact. I want to underline that we continue to address the performance trajectory of the Connected Care businesses, as highlighted by Frans. A number of measures have been deployed and will start to gradually contribute to

the performance improvement of this segment over the next quarters.

Adjusted EBITA for the group was also impacted by a higher-than-expected decrease of license income in the segment Other. Our productivity program delivered EUR 96 million net savings in the third quarter, more specifically procurement savings, in part driven by our Design for Excellence program, delivered EUR 41 million of bill of material savings year-on-year. The manufacturing productivity program contributed EUR 39 million to the gross margin. And net nonmanufacturing cost reduction amounted to EUR 16 million.

Overall adjusted EBITDA for -- in the third quarter increased EUR 66 million, resulting in a margin of 17.4% of sales, in line with the third quarter of 2018. This includes the impact from the implementation of IFRS 16 lease accounting as of January 1, 2019. The impact on adjusted EBITDA is approximately EUR 150 million increase for the full year 2019, reflecting the depreciation on the leases capitalized under the new standard.

Income tax expense decreased by EUR 39 million in the third quarter, mainly driven by lower income compared to Q3 2018. Net income amounted to EUR 208 million, including a charge of EUR 78 million related to goodwill impairment in the Connected Care business compared to EUR 292 million in Q3 2018. The adjusted diluted EPS from continuing operations increased by 10% in the third quarter, driven by growth and a lower number of common shares outstanding compared to the same period of 2018. Year-to-date, adjusted EPS grew 18% compared to last year.

Net cash flows from operating activities increased by EUR 91 million in the third quarter. Excluding an outflow of EUR 130 million related to pension liability de-risking in the U.S. in the third quarter of 2018, net cash flows from operating activities decreased by EUR 39 million in the third quarter, mainly driven by higher payment outflows to suppliers due to account payable phasing. Year-to-date, net cash flow from operating activities increased by EUR 272 million.

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

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

Let me now provide some additional guidance for certain areas of our business. The imposition of tariffs between the U.S. and China creates headwinds. Based on the announcements made so far, we estimate a negative net impact after compensating actions of around EUR 70 million in 2019. This is higher than our previous guidance due to the impact of tariffs announced during the third quarter as well as the delay in the positive impact of the compensating actions to offset those. We continue to invest in the necessary countermeasures and expect the results to gradually kick in. The overall gross impact of tariffs before compensating measures is expected to be more than EUR 100 million this year.

In the segment Other, on an adjusted EBITA level, we continue to expect full year cost at EUR 80 million, which is a decline of EUR 52 million versus last year, mainly due to lower expected royalties in 2019 and a positive movement in our environmental provisions in 2018. At EBITA level, we expect a net cost of around EUR 130 million for the full year 2019. For Q4, we expect on adjusted EBITA of around positive EUR 5 million and a net cost of around EUR 25 million at the EBITA level in this segment. The guidance on financial income and expenses for the full year 2019 is now reduced to a net cost of around EUR 120 million compared to our previous guidance of a net cost of around EUR 150 million.

On the topic of capital allocation, as of the end of the third quarter, we had completed around the 33% of our EUR 1.5 billion share buyback program for capital reduction purposes that was announced on January 2019. We also sold all of our remaining 14% shares in Signify for a total proceeds of EUR 477 million in the quarter.

In conclusion, let me make the following remarks. Despite increasing headwinds, the adjusted EBITA for the group increased by over EUR 100 million year-to-date, driven by growth and productivity measures, leading to an adjusted EBITA margin in line with the same period of 2018. While we continue to navigate global geopolitical challenges and market volatility, we expect profitability to improve in the fourth quarter due to the performance trajectory in the Diagnosis & Treatment and Personal Health businesses and a gradual recovery in Connected Care. As Frans mentioned, for 2020, we target a 4% to 6% comparable sales growth and an adjusted EBITA margin improvement of around 100 basis points for the group.

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

QUESTIONS AND ANSWERS

Veronika Dubajova - Goldman Sachs

I'd like to start with Connected Care, please. And both of you, Frans, Abhijit, have alluded to some comments -- some efforts that you are making or rather taking to improve the operational performance. Just would love to get a little bit more insights into what these are and how quickly you expect these to kick in. And I guess related to that, I think profitability historically in this division has been weighted down by a number of a longer-term investment projects that you've had ongoing. Any views on maybe

curbing those or sizing those down in light of the margin progression and development we've seen year-to-date?

Frans van Houten - CEO

Yes, in Connected Care, we have several measures to improve. Now let's first unpack a little bit the various drivers that set us back. So we spoke about the headwinds of tariffs. But besides that, we also saw some more price erosion in the quarter, which we relate to the need for stricter price management. We don't relate it to structural market trends. And we also saw an unfavorable product mix in Sleep & Respiratory Care basically due to the respiratory side of the house. And we think we can improve the mix going forward in the fourth quarter, therefore, having the benefit of a higher-margin product mix. We also saw some cost elements in the quarter that we do not think will continue and thereby expecting an improvement of profitability coming through quickly. And then finally, you know how we are keen to reduce inventories. And I think we had underestimated a little bit that the effort to reduce inventories would lead to an under-recovery of factory overhead costs. So that also hit us.

Now personally, I don't like it when I need to give you such a long list of stuff because we as management are accountable for that. Now we have sat down with the management of Connected Care, even personally I did that again last week. We feel confident about the measures that are underway. We will expect to see already an improvement in the fourth quarter. Then -- and we expect further improvement coming through next year. Nevertheless, we felt it was appropriate, prudent, you could maybe say, that we take the guidance of Connected Care somewhat down, recognizing that it will take longer before, let's say, the adjacencies and the investments in adjacencies will materialize and thereby lifting up the profitability structurally longer term.

Now you asked me about those investments in adjacencies. Frankly speaking, we strongly believe we are on the right path to bring Monitoring & Analytics into other care settings, to enable telehealth and ambulatory care, to connect patients outside of the hospital to caregivers. We have many pilots ongoing. We are being recognized as a thought leader in Connected Care. In fact, 2 industry analysts, among which IDC, recognized us for being leaders in the population health space. So I believe we need to stay the course, albeit with more careful cost management and stricter controls on, let's say, all the things that I've mentioned, price realization, mix and what have you. And we will be able to deliver better results. We continue to grow the business, and I think that speaks for itself.

Veronika Dubajova - Goldman Sachs

That's great. And if I can, just a quick follow-up on the North America orders. Abhijit, curious to know if the D&T order pattern, excluding the IT piece, what was the growth you saw on imaging versus in IGT? If you can give us any color on the breakdown between the 2 and Ultrasound, I guess, as well.

Abhijit Bhattacharya - CFO

Yes. I think for the remaining businesses, we remain very strong. So if you take out -- if you look at Diagnosis & Treatment and take out the informatics piece, then it's a 5% growth overall. And then strong momentum continues in Ultrasound, whereas I think for Image-Guided Therapy, we had a bit of tough

comps. But even then I think momentum is still pretty good in North America. But yes, overall, if you look, it's 3 quarters of decline in order intake. So I think that is something we need to acknowledge, which is why we called it a big soft. If you look at the, let's say, market share data for the last 12 months ending Q2 because we don't have the Q3 data, we are still holding on to share, which is very good because, as you know, we have been gaining share over the last couple of years. So I think that gives you a little more color that the segment still remains strong. And informatics, we had a really big order last year which skews it a little bit.

Patrick - Wood - BofA Merrill Lynch

I'll just ask my 2 upfront if I can. I guess the first one would be kind of a follow-on from Veronika's question really on the U.S. side because you're calling out a slightly slower growth rate for the market overall for the full year now. And if I look at the 2-year order book growth rate, it's kind of flattish. So I guess the underlying question is what are you hearing from the hospitals themselves in terms of demand? How do you think the radiology, I guess, demand in the end market is faring and have you noticed any particular change on that side?

And then the second question, more on sleep and respiratory. Just curious if you guys have any thoughts on the last competitive bidding round that, I think, has kind of wrapped up now. I think we'll hear about that next year. But we heard some sort of suggestions that there might be masked price concessions that are something like 15%, 20% if the bidding comes out the way people think. I'm just curious how you feel about the sleep and respiratory business on that side, that would be really helpful.

Frans van Houten - CEO

Yes. Patrick, well, in North America, we believe that hospital CapEx broadly speaking is in the low single digit. And also, new hospital build, I think, off the top of my head, down to 1%, right? So it all reflects a more neutral market situation where, in fact, you could even see a bifurcation between hospitals who have really very little to spend and then some successful hospitals with quite a bit to spend. I think, first, is 2018, the imaging market, is a touch less robust. I think I recall that last year, we spoke about a 3%, 4% growth in imaging. We would now see it more in low single-digit growth. As Abhijit said, we haven't seen market share numbers yet for the third quarter, so I want to be a bit careful there. But overall, the market seems to be a little bit more cautious than before.

On the Connected Care side, I think we've flagged this before. Patient monitoring market is flat and there is no growth there and that we are the market leader in intensive care patient monitoring. We really need to get this adjacency of introducing sensing and analytics for patient care outside of the intensive care into other care settings that we need to get going in order to grow the pie. All the pilots that we have been doing with hospitals reflected that is a strategy that they like. As hospitals are more exposed to value-based care, they need to start keeping patients out of hospital and not come back within the 30-day period but preferably longer. Medicare Advantage is something that incentivize hospitals to keep patients out of the hospital.

So to make a long story short, I'm convinced that the strategy of Connected Care is resonating with the leading customers in North America. But from pilot to early adoption to mass market takes a whole lot longer than we had perhaps originally anticipated. On Sleep & Respiratory Care, the bidding, I think, is likely to have some downward pressure on prices as the earlier bidding rounds have also done. If you recall, we were able to recover from those earlier bidding rounds pretty well. And we have confidence that we can maintain a good margin profile for Sleep & Respiratory Care despite the CMA rounds. So I think it's early days, but that's what I would like to say about it right now.

David Adlington - JP Morgan

Just on the goodwill impairment, I just wondered if you can give us some further color on which businesses or business that related to specifically and what made you take the write-down at this point.

Abhijit Bhattacharya - CFO

Yes. It was related to an acquisition we made 3 or 4 years ago. It was in relation to Wellcentive, where we have seen that the business growth has been lower than we had initially anticipated. So as this whole segment grows, we see more and more hospitals running pilots before running into the bigger orders. And therefore, that affected valuation.

David Adlington - JP Morgan

Okay. And then maybe just one follow-up on the orders. A slight order growth has just rolled over a bit in all 3 of the kind of geographies compared to last quarter. You sort of pointed towards maybe a sort of a bit of a pickup in Q4 maybe and a decent funnel. Should we be thinking about a reacceleration in growth from here across all 3 quarters? Or I suppose how do you think order growth into Q4?

Abhijit Bhattacharya - CFO

Yes. David, we've always said to look at orders over a 12-month period because between quarters, if you could have occasional very strong quarter and then occasionally flat quarters. So if you look at the last 12 months, we are kind of around the 5%, as Frans mentioned. We expect to end this year similarly for the full year around the 5% with a slight uptick in Q4. So I think we are nicely in the middle of the range that we had planned to be.

Michael Jungling - Morgan Stanley

The first question I have is in relation to U.S. medical device tax. Hypothetically, if there was no extension in the moratorium in 2020, what do you think the EBITA impact would be for Philips as a total? And then secondly is a question about the tariff impact on organic sales growth. Was there an impact -- a positive impact on organic sales growth by you being able to raise price in categories such as Personal Health, shavers, coffee machines, toasters as well as in D&T and some sort of indication as to what the benefit to organic sales product may have been from those price increases passing on those tariffs?

Frans van Houten - CEO

Yes, thank you. Michael, Frans here. Yes. The U.S. medical device tax reimposition is at this time a hypothetical situation, where we really hope that the U.S. government can avoid that. And if it were to be reimposed and if we would need to digest that within our P&L, I think it would be a headwind of around EUR 45 million. But it would apply to the whole industry. And therefore, it will actually drive up prices in the market. So I would, in that hypothetical situation, certainly not expect us to absorb all of that in our own P&L.

Your second question, let's say, the footprint of the various competitors is different. And therefore, we have not seen a, let's say, unified move to pass on the tariffs into the prices. I would say that our comparable sales growth is hardly, if at all, influenced by price changes. We have raised -- we have issued a price raise that will effect on Q4. But that obviously it's not yet in the Q3 numbers. Overall, I think, especially on the health system side, we have not been able to pass on tariffs into the customer base yet.

Scott Bardo – Berenberg

I wonder if you could provide a little bit more as a granular breakdown of the Connected Care business for us. You mentioned a decline in home ventilation being one of the causes for negative mix this quarter. Can you share with us how big home ventilation is and more broadly how big the sleep apnea business is within the context of the division? And also then with reference to your revised mid-term or 2020 targets, it's always my feeling that sleep apnea was a higher-margin business as well as your ICU monitoring business, a higher margin than the group. So what is implicit or embedded within your 13% to 15% margin framework for both of those businesses? And in a sense then, how much are you expecting to invest from lossmaking activities, developmental activities which are burdening this margin?

Abhijit Bhattacharya - CFO

Yes. So let me give a couple of things. First, let me put the discussion on Sleep to bed, so to say. So Sleep is a good business for us, good double-digit growth with very good margin. So that's not the issue. We had good growth in the mass business. We good growth in the system. So that has gone very well. What has happened in Respiratory Care is we have our Home Ventilation business which has very, very high margins actually, which had after many quarters had a decline. Normally, this business was growing double digits. And this happened because of a change in reimbursement qualification criteria, which came into effect in July, where those who claim reimbursement have to undergo further tests, have to show better compliance. So it has increased the paperwork and therefore, in the short term, has caused the decline. This was compensated by stationary oxygen, which has lower margin. So that is what has had an impact on the mix.

With the studies that we have done, we believe that Home Ventilation, new cases will continue to increase double digits. So after maybe a quarter or 2 of this hiccup, we will see this growth coming back.

Asking on the -- so we don't, of course, for competitive reasons, don't give margins on all our businesses and a specific guidance on each and every component. But let me just give you a coloring of Connected Care in total. So Monitoring & Analytics and Sleep [& Respiratory Care] constitute just short of 90%, as Frans mentioned in his speech, right? So these are 2 strong businesses which are -- which have very good margins, accretive to the group. For the time being, let's say, with the reasons that we gave, Monitoring & Analytics had a poor quarter because of the tariffs, the factory loading, mix issues, et cetera.

Then we have the investments in Population Health Management and we have the issues around the Therapeutic Care businesses, which are basically currently lossmaking and therefore detracting the margins. So as we look for 2020 improvements, we do expect Monitoring & Analytics to improve. We do expect the Sleep & Respiratory Care business to improve because, let's say, the shorter-term margin impacts we hope to correct. And then the cost actions that we have put in place will also start giving results from this year and next year. So a combination of these 3 will get us to the 13% to 15% range that we have guided for, for next year.

Scott Bardo – Berenberg

That's very helpful. Do you have a sense of the proportion of the division which relates to Home Ventilation? That would be helpful. And perhaps best guess on when you expect to resume AED shipments into North America.

Abhijit Bhattacharya - CFO

Yes. The AED shipments into North America, as Frans mentioned, is difficult to quantify at this stage so that depends on...

Frans van Houten - CEO

We are shipping the HeartStart. So let's say the portable device has never been exempted from -- because it's the best AED in its category and the FDA has given us an exemption sort of from the injunctions so that we can actually deliver the HeartStart one. The injunction lifting will give us benefits on margin and costs as well as allowing us to also then start selling the more hospital-oriented defibrillator products in North America. And so from a revenue point of view, the impact and relevance is less. From a bottom line point of view, lifting the injunction will have a very good positive effect.

Abhijit Bhattacharya - CFO

Yes. And then on the Home Ventilation, yes, we don't give specific numbers on each business. But this is in the few hundreds of millions, so it's not a very small business. It's a good medium-sized...

Scott Bardo – Berenberg

Very good. And perhaps lastly from me, just with respect to group gross margin, I note this quarter, your gross margins were down 240 basis points year-on-year, which is higher than your adjusted EBITA margin contraction this quarter. So I wondered if you could help pull out what the particular impacts this quarter

were for gross margin and perhaps give us some future thoughts about the progression of the gross margin.

Abhijit Bhattacharya - CFO

Yes. I think, Scott, the margin impact largely happened in Connected Care, right? So the reasons that we gave for Connected Care are largely the same reasons that are valid for the group. So I think the steep decline in Connected Care actually impacted the group as strongly as you saw. In terms of cost, of course, you saw the contrary. So with the 6% growth, we got good operating leverage, and therefore, that helped to mitigate some of that. But there are no new reasons, let's say, for gross margins at the group level other than what we have given for Connected Care and then you could expand that more for the group now.

Frans van Houten - CEO

In general, of course, all the duties that we pay are in the gross margin. And that applies to all the divisions. And then the operating leverage makes up for that.

Max Yates - *Crédit Suisse*

I just had a question on Personal Health. So just firstly, could you give us a little bit of color whether there was any difference between the growth rates in Europe and U.S.? I think you sort of cited low single digits for mature geographies. But I just wanted to understand whether there were any diverging trends between those 2 regions.

Abhijit Bhattacharya - CFO

Yes. I think Europe was still a bit stronger than U.S. in the quarter. But it's a 6% growth overall, so we've seen good growth. But Europe is still stronger, and we expect momentum to pick up in North America in the coming quarters.

Max Yates - *Crédit Suisse*

Okay. And just when you look at -- because I think it was this time last year where we had the online retailers destocking around the sort of large sales days in China. And I just wanted to understand whether there was any way you could track the current inventories of online retailers. And I think particularly given you mentioned that consumer confidence in China was a little bit more mixed, and obviously we're coming into some of those more important sales days in Q4. So is there any kind of [comforts] or any tracking you're doing currently around inventory levels among your online retailers?

Abhijit Bhattacharya - CFO

Yes. Currently, it is all -- normally, as we mentioned last year, Max, the sales on the dates are huge. And it becomes almost very difficult to predict the exact mix that will sell through. So we have to see how those days go. But currently, there is no overstocking in the channel and we have also been working through the year to see that our supply chains are better aligned. So nothing to call out yet on that.

Max Yates - *Crédit Suisse*

Okay. And just a final one on Personal Health. Obviously, I mean the growth is coming through the margins. You've talked about kind of getting further margin expansion in this division is maybe going less easy than the other 2. So I just wanted to understand, are there any sort of pockets within the different subsegments within Personal Health where there are still sort of meaningful opportunities, where you look at kind of potentially what you're earning versus peers is meaningfully different? Or is it -- are we now at kind of margin levels where you're really very comfortable in all the segments and the focus is now really on growth?

Frans van Houten - CEO

Well, Personal Health has further margin expansion possibilities. Let's also remind ourselves that both Personal Care and Oral Care have margins already today that are above the average of Personal Health. And we see strong pickup of Oral Care, thanks to the new product introductions at multiple price points. The strong growth in brush heads, that had very nice margins. We spoke a bit about the opportunity to further have pickup in North America. So overall, I think we are sitting with a couple of very strong margin drivers in Personal Health. In fact, the weight of Domestic Appliances in the third quarter was significant. Despite that, we had a margin expansion. So expect further margin expansion going forward.

Abhijit Bhattacharya - CFO

In fact, Domestic Appliance also increased their margins in the fourth quarter -- in the third quarter, so across the board. And the target for Personal Health is 16% to 18%. On a last 12-month basis, we are just shy of the 15.5%. So clearly, more expansion is what is planned for in the coming year.

Max Yates - *Crédit Suisse*

Okay. And maybe just a final housekeeping one. Just in Connected Care, when you look at your fourth quarter '18 margin, they were obviously down sort of around 300 bps year-over-year. So I just wanted to understand, was there anything one-off in the margin towards the end of last year that you would expect to reverse in Q4 '19 that gives you maybe some greater visibility on the turnaround in this division? Or is it just primarily from all of the things you talked about around less -- an effect from destocking and greater cost savings?

Abhijit Bhattacharya - CFO

I think it's more of the latter, Max. So not really one-offs of last year that will contribute this year.

Sebastian Walker - *UBS Investment Bank*

Just 2, if I could. So on the Connected Care margin decline, could you just help us understand the size of each of the different impacts? So how much was driven by the tariffs, how much inventory management and then the negative mix? And then I'll ask my second question later.

Abhijit Bhattacharya - CFO

Yes. I think we mentioned that also in the original press release or at least in the call that we had, that is about evenly spread in the 3 categories. So I think that's how you should look at it.

Sebastian Walker - UBS Investment Bank

That's very clear. And then on D&T, so the strength in revenue growth, are there any kind of timing elements that you want to flag there? What should we expect going into Q4 on growth?

Abhijit Bhattacharya - CFO

Yes. I think we don't guide now for every quarter. But you have seen a strong order intake coming in the last couple of years. And based on that, we said, yes, we would continue to expect strong growth. Last year, we grew 7% in this business, so -- and that's at the higher end of the guided range. I think we have guided for 5% to 7% growth. So we will be in that range going forward as well.

Daniel Wendorff - Commerzbank

Two, if I may. And the first one is also on Personal Health. When you look at growth rates of this division over the last 3 quarters, can you potentially quantify what was really coming from new product introductions? And what was the underlying growth, let's say so, if you had not brought new product to the market? Because I think you had a few negative items there as well last year. And my second question is when you look at the revised margin expectation for Connected Care and for the group overall for next year, has this any impact on your free cash flow targets?

Frans van Houten - CEO

Yes. Daniel, I was smiling a little bit with your first question on Personal Health. Let's unwrap it a bit. So last year, we had destocking and we had issues on supply of brush heads and so our execution was just not good enough, right? We have corrected all of that and we are now in a much better space. So execution is no longer really a big issue. We could still improve a little bit the supply situation in North America. But by and large, we are firing on all cylinders. And we have extended the product ranges. Now so this goes to your point, we have introduced a lot of new products. And that is causing us to grow more rapidly. And the reason for the smile was in Personal Health, if you do not introduce new products, then you will quickly feel that, right? So basically, every 12 months, you get innovations across the whole range. And you do that just to keep everybody excited, to offset price erosion, to make sure that the margins are up.

And so this is something that, in fact, works quite well. And I'm pleased with the work that Roy Jakobs has done to get that whole organization to perform more assertively. I think we are seeing the benefit of that and like to see the growth -- the margin expansion still to be a bit higher. We still have also some headwinds from tariffs there that we were able to compensate. I think going forward, with good mix management and further good execution on the supply chain, we should be able to see a nice benefit coming through. Now on your second question, the revised guidance of Connected Care will not have a material impact on free cash flow realization. We have many drivers that can benefit cash flow, among

which the cash conversion ratio. And we are very keen to do that and to get into the guidance of at least EUR 1.5 billion. So we will not change our cash forecast.

Wim Gille - ABN AMRO Bank

My first question would be on -- to the one-offs that you reported. So you had a minor -- so you had an impact of EUR 23 million related to a value adjustment on capitalized R&D in the Diagnostic & Treatment business. So can you give us a bit of a feeling what portion of R&D or basically what you adjusted there? And in line with that, in the Personal Health business, you had a EUR 20 million provision related to legal matters. Can you give me a bit more clarity on what kind of legal matters you're, let's say, provisioning for in this area? And my follow-up question will be on the acquisition of Carestream. How is that progressing so far?

Abhijit Bhattacharya - CFO

Do you want take the Carestream one first, Frans, then I'll take the...

Frans van Houten - CEO

Yes, sure. Let me talk about Carestream first. So Carestream has a very good technology stack that, let's say, addresses some of the demands in the market, for example, around Vendor Neutral Archive and in cloud-based hosting of tax systems. It fits hand in glove with our own product portfolio. We have been going to all the key customers that originate either from the Philips side or the Carestream side. And we have been explaining our road map of integration and the value propositions that will emerge, thanks to the integration. Generally, the customer response is very positive. Of course, customers would like to see the proof points. In relation to that, I think we should near term expect some caution before the orders will come through, but I'm very enthusiastic about the initial response from the customer base. Also, the staff integration and the technical integration of the PMI is going well. So then I'll look to Abhijit for the other questions.

Abhijit Bhattacharya - CFO

Yes. So I think on the R&D value adjustment that is in Diagnosis & Treatment, look, we spend EUR 800 million a year on R&D in Diagnosis & Treatment. And this is one specific product where we had made some investments and we find, let's say, that the future business case does not support the amount capitalized. So it's a small correction to the value adjustment. On the legal cases, we -- those are things which are currently sub judice, so we don't, let's say, give more color because, then also tells us a little bit or gives the other side an idea of what we are thinking. So unfortunately, at this stage, I would not like to give more details. When we have a settlement, of course, we will let you know.

Hassan Al-Wakeel - Barclays Bank

I have two, please. So firstly, I'd like expand on the previous Personal Health question. Could you talk about the Oral Healthcare business in the U.S.? Nielsen data points to a deterioration over the course of the year to negative territory. And I'm just wondering whether the U.S. is contributing meaningfully to

the double-digit business growth that you reported in Oral Healthcare in Q3. And secondly, could you please talk a bit around the comfort that you have around full year guidance and the requirement for achieving 70 bps year-over-year in Q4 and how this pans out sequentially across the segments? Any color here would be helpful. Should we expect margin expansion to accelerate in Personal Health and for Connected Care to be close to flat or indeed up year-over-year?

Frans van Houten - CEO

Yes. Hassan, Frans here. The Oral Healthcare in North America is, let's say, on average, a little bit below the global growth rate. So it's not in double-digit territory. Nevertheless, we are growing. And moreover, I'm particularly excited about the sell-out data that we see in our online platforms, which encourage us that we are on an increased traction with the new product introductions. If you recall, we have extended into lower price points already over the summer. We have now just launched the mid-end product. The sell-out data demonstrated consumers are liking these products. And I also referred briefly to some supply chain improvements that we can further make. I think a couple of those, we will see stronger growth in North America going forward. Abhijit?

Abhijit Bhattacharya - CFO

Yes. On the 70 bps, yes, we have not guided specifically whether it is 70 or 60 bps. At 10 to 20 bps for the year, yes, you can back-calculate that and that will come to an improved performance in Q4. So that is what we are planning. I think what we are saying is that, across the 3 segments, we expect profitability to improve. So there will be an improvement in Connected Care, there will be an improvement in oral health care -- sorry, in Personal Health, and there will be an improvement in Diagnosis & Treatment, which tells us that since we are flat year-to-date with a bit of improvement in Q4, we should see a slight improvement in the profitability for this year compared to last year.

Falko Friedrichs - Deutsche Bank

It's Falko from Deutsche Bank. Two quick questions. Firstly, on the Azurion platform, how is the feedback from China after the recent launch? And do you expect this to be a meaningful driver to growth next year already? And then secondly, besides Ultrasound, which other equipment items really stood out in Q3 in terms of growth for the segment?

Frans van Houten - CEO

Yes. The Azurion launch went very, very well. Of course, customers in China were already aware of the platform and the success that we are having in the United States and in Europe. So they were -- well, I can't say they were dying to get it because that sounds a little bit exaggerated. But I think they have very high expectations. Now Philips is already the market leader in China. So we are not going to compete against ourselves, of course. So we do expect a further pickup in China with orders coming from Q4 and then revenue recognition somewhere in end of 2020. Because typically, the order to revenue recognition cycle is 9 to 12 months but positive effect to be expected.

Yes. On the D&T reporting segment, we already expressed our enthusiasm about Ultrasound, which is really growing very, very well. But I'm also pleased that Diagnostic Imaging continues to do well. On MR and CT, we see really good traction. In fact, we need to expand the production capacity for MR. The Incisive CT is being well received. So altogether, a strong -- a high single-digit growth in that area as well.

Michael Jungling - Morgan Stanley

I only have one question left. And that's in relation to Connected Care. Can you please talk about the staff turnover at patient monitoring specifically and also whether your product portfolio is currently being impacted around some of the concerns on security WiFi for some of your personal or remote monitoring products?

Frans van Houten - CEO

And Michael, staff turnover, in which geographies specifically? Or is it a general question? Or is it a question on measures?

Michael Jungling - Morgan Stanley

It's a general question about Connected Care in terms of sort of staff turnover. Is it increasing? Has it increased? And if so, why? And in terms of your product, you can sort of read on some of the blogs that you may -- there may be some security issues on your WiFi portfolio. I'm not sure if they're true. So therefore, I'm getting just some clarity on that product portfolio, the WiFi element of it.

Frans van Houten - CEO

Yes. So there's no particular concern around staff turnover in patient monitoring. We have made an intervention around the leadership of Monitoring & Analytics. So maybe I thought for a moment that you were referring to that. But I don't see a general concern around staff turnover. Yes, the security of the WiFi topic, of course, that's very interesting because hospitals in general struggle with their IT infrastructure and their WiFi infrastructure. And as there is more load on these hospital networks, we see a heightened interest to come with better solutions. In my speech, I referred to the security features of the MX750 and 850. And we have done and introduced those security features specifically because of concern around hospital network safety.

I would not see that as being the reason of impacting orders. The monitoring in intensive care settings is a mature market. And that correlates to the flatness in North America. The growth will need to come out of the new care settings, where, by the way, having the WiFi solved, let's say, is very important. I think that our performance in network capabilities is actually above industry average versus the competitors in monitoring, so I don't see this as a big issue for us. But it is a topic for the CIOs of hospitals and they have a little scrutiny of medical devices in general.

Operator

Mr. Van Houten, that was the last question. Please continue.

Frans van Houten - CEO

Yes. And maybe if you permit, audience, I would like to say a few words in wrapping up this call. I mean we have a very good business that is growing. We have a strategy that is very well received by our customers. We have a setback on profitability in only one segment of our portfolio while despite headwinds, we were able to expand margins in a significant way in the other businesses. So what we tell you now is that we have full confidence in our ability to resume an upward path in profit expansion, starting with Q4 and then all of next year. The whole team is focused on that and committed to that. And of course, it's us -- up to us to demonstrate that. I just wanted to finish this call on that upbeat sense that we will not allow this distraction to happen again. Thank you.

Operator

This concludes the Royal Philips Third Quarter 2019 Results Conference Call on Monday, the 28th of October 2019. Thank you for participating. You may now disconnect.
