

# PHILIPS

## **Royal Philips Q3 2021 Results**

Monday, 18<sup>th</sup> October 2021

**Operator:** Welcome to the Royal Philips Third Quarter 2021 Results Conference Call on Monday, 18<sup>th</sup> October 2021. During the call hosted by Mr Frans van Houten, CEO, and Mr Abhijit Bhattacharya, CFO, all participants will be in a listen-only mode. After the introductions, there will be an opportunity to ask questions. If any participant has difficulty during the conference at any time, please press the star followed by the zero on your telephone for operator assistance. Please note this call will be recorded and a replay will be available on the Investor Relations website of Royal Philips.

I will now hand the conference over to Mr Leandro Mazzone, Head of Investor Relations. Please go ahead, sir.

Leandro Mazzone

Head of IR, Koninklijke Philips

Good morning and welcome to Philip's third quarter 2021 results conference call. I'm here with our CEO, Frans van Houten, and our CFO, Abhijit Bhattacharya. Frans and Abhijit will take you through our strategic and financial highlights for the quarter. And after that, we will take your questions.

Our press release, the related information slide deck, as well as FAQs on the recall notification of certain Sleep & Respiratory Care products were published at 7.00 CET this morning on our Investor Relations website. The full transcript of this call will also be made available today on the website.

As mentioned in the press release, Adjusted EBITA is defined as income from operations, excluding amortisation of acquired intangible assets, impairment of goodwill and other intangible assets, restructuring charges, acquisition-related costs and significant one-off items. Comparable growth for sales and orders are adjusted for currency and portfolio changes. Over to you, Frans.

Frans van Houten

CEO, Koninklijke Philips

Yeah. Hello, everyone. Thank you for joining us today. As the COVID-19 pandemic continued in the third quarter, our teams remained focused on delivering what we call the triple duty of care: meeting customer needs, safeguarding the health and safety of our employees, and ensuring business continuity.

We remain extremely focused on implementing the necessary corrective actions for patients affected by the component quality issue that we announced earlier this year. We have mobilised all necessary resources across the company to address this, because patient well-being remains at the heart of everything we do at Philips, so this is a top priority for all of us.

Our strategy and portfolio continue to resonate very well with customers. In the third quarter, we were encouraged by strong comparable order intake growth of 15% in Diagnosis & Treatment and 21% in Connected Care, excluding the impact of the partial ventilator order cancellation in Q3 of last year.

The strong momentum was driven by a positive hospital CapEx environment, but also the strength of our portfolio, resulting in an all-time high order book for Philips, as shown on page 28 of our presentation. We also signed 19 additional long-term strategic partnerships across

the world, demonstrating the trust hospital leaders have in our ability to enhance health outcomes, lower the cost of care, and improve patient and staff experience.

Our comparable sales declined 7.6% in the quarter on the back of 10% growth in Q3 2020. As anticipated, this quarter's sales were impacted by approximately €150 million headwind as a consequence of the Sleep recall as we are prioritising the remediation of effective devices in use by patients.

In addition to that, we faced intensified global supply volatility and issues such as the shortage of electronic components and increased shipping times. This resulted in challenges to fully convert our opportunities to revenue, which set our sales back by around €150 million in the quarter with the bulk of the impact actually taking place in September.

Year-to-date, our comparable sales grew 3% and our adjusted EBITA margin improved 90 basis points. Excluding the Sleep & Respiratory Care business, year-to-date comparable sales growth was 10%, and the adjusted EBITA margin improved almost 500 basis points. Abhijit will provide a more detailed overview of the numbers shortly.

Now, I would like to provide some colour on some of our initiatives to respond to the needs of today's hospital leaders across the globe as they plan for the future. As a pioneer in spectral diagnostics, we have enabled our customers for many years to benefit from a reduction in follow-up scans, increased certainty in lesion characterisation and reduced time to diagnosis. Our new Spectral CT 7500, which we introduced earlier this year, is attracting very strong customer demand and contributed to another quarter of double-digit growth in the computer tomography business.

The University Medical Centre Utrecht in the Netherlands is among the customers who already installed these systems with the aim of enhancing outcomes in mainstream clinical diagnosis through image quality and detail for all patients and in all exams while speeding up scan time at the same time. Building on our leadership in Image-guided Therapy solutions in cardiology, we are further strengthening our position in fast growing adjacencies such as neurology and oncology. For example, the US-based Piedmont Health equipped its neurosurgical operating rooms with specialised Philips Azurion Solutions for the treatment of stroke.

And we also announced positive results of the clinical study aimed at setting a new standard of safety and accuracy in the diagnosis of small peripheral lung lesions using the Philips Lung suite in combination with Azurion.

In the quarter, we launched two new key health suite informatics solutions which are scalable across the enterprise to support customers to achieve the quadruple aim of care: the Patient Flow Capacity Suite, a solution that helps manage to complete patient journey, and the Acute Care Telehealth, which builds on our successful Tele-ICU solutions. Importantly, we continue to grow market share in our core businesses through deeper more comprehensive customer partnerships. For example, we provided the newly established Yili Chuanxin Oncology hospital in Xinjiang province, China, with a range of solutions to address the hospital clinical needs in screening, diagnosis, treating and rehabilitating cancer patients. The solution includes IntelliSpace Digital Pathology and the Ingenia 3.0 Tesla MR, IQon Spectral CT, Incisive CT and CT Big Bore imaging systems in combination with the IntelliSpace portal for advanced visualisation and analysis.

As part of a 10-year partnership with Rutherford Health in the UK to open multiple community diagnostic centres, the first centre was opened in Taunton, for which we provided innovative diagnostic imaging systems. This included our 1.5 Tesla Ambition MR for helium-free operations, which obviously drives lower cost of care while providing confident diagnosis.

The recently acquired Capsule business continued to add new device drivers to its medical device information platform, which is now a part of our HealthSuite informatics platform. With more than 1,000 unique types of medical devices capable of integrating with the platform, customers can connect more devices to advanced health systems' digital transformation with intelligent vendor-agnostic tools that turn complex data streams into actionable clinical insights.

In Personal Health, we continued to invest in new product introductions and launched several oral healthcare innovations targeting different price points in China. These included two new electric toothbrushes and our professional teeth whitening offering, Zoom, which was launched through a local partnership with LinkedCare, one of the largest dental solution providers in the Chinese market.

And in Latin America, in a co-branding partnership with Colgate, we see a strong takeoff of our oral care product range. In line with our plans, we successfully completed the sale of the Domestic Appliances business. This concludes our major divestments allowing us to fully focus on extending our leadership in health technology and accelerating our transformation into a solutions company.

We reported an after-tax gain of €2.5 billion in discontinued operations related to this divestment in the third quarter.

Let me now speak about the field actions in Sleep. We are doing everything we can to deliver a solution to patients and caregivers as fast as possible. The repair and replacement programme is well underway in the United States and several other countries. We have produced more than 750,000 units of repair kits and replacement devices to-date, of which more than 250,000 units have reached customers.

We have substantially increased our overall production volume in the third quarter to 50,000 – 55,000 units per week and are on track to reach 80,000 units per week in the fourth quarter. We expect to complete the repair and replacement programmes within 12 months. We have a strong programme management in place to see the corrective actions through as fast as possible.

As you know, several civil and personal injury claims related to this recall have been filed. It is too early to draw any conclusions or to talk about the merits and the timelines to handle claims at this stage. But I want you to know that we have competent legal team managing the litigation matters. And right now, we are focusing on the patients and the corrective actions required there first.

I would also like to remind you that when we announced the recall in June, we acted on the assumption of a worst case clinical impact scenario assessment related to the PE-PUR foam issue based on the test data and information available at that point of time. We continued with further research and testing to better scope any potential patient risk and are getting expert assessments on this. We aim to make this information available to the competent

authorities and healthcare providers as soon as possible, which is still anticipated in the fourth quarter.

As Leandro mentioned, we have published frequently asked questions, FAQs, on the recall to provide details and clarification on the progress. There are some areas, particularly related to litigation, where we will – where we are not able to provide further details at this time, and we will share additional information in a transparent and timely manner as the situation evolves.

Now looking ahead, we continue to see uncertainty related to COVID-19. Supply chain volatility has intensified globally, which already led to longer lead times to convert our strong order book to revenue in the third quarter, and we expect this headwind to continue in the fourth quarter. This makes more challenging to deliver on incremental demand, which we expected to compensate the shortfall in Sleep in the near-term. Therefore, we now expect to deliver low single-digit comparable sales growth with a modest adjusted EBITA margin improvement for the full-year 2021.

Based on our strong customer demand and growing order book, we expect to resume our growth and margin expansion trajectory in 2022 as we work through the headwinds.

Our journey to leadership in health technology continues, and I'm pleased with the significant progress that we are making on our strategic road map. We are executing on a clear strategy to help transform care along the health continuum and have a stronger than ever portfolio to serve our customers. I remain therefore very confident on the medium-term growth and margin opportunity of our company.

And with that, I'll turn the call to Abhijit.

Abhijit Bhattacharya

*CFO, Koninklijke Philips*

Thank you, Frans, and thank you all for joining us today. Let me provide some colour on the third quarter comparable order intake growth of 47%. You will remember in Q3 last year, we had the partial cancellation of the ventilator contract in the US, and that provides a favourable comparable base. When taking out this effect, order intake growth is still a strong 17%.

Diagnosis & Treatment order intake grew by 15% in the third quarter driven by double-digit growth in MR, in CT, in Ultrasound and in Image-guided Therapy. Order momentum was very strong in North America, Europe, Asia Pacific and most growth geographies. China delivered mid-single-digit order growth with short-term momentum affected by additional procedures required for importing healthcare products.

We have a strong position in China, including our R&D centres, our factories, local for local innovation and our fully Chinese management team and are further investing in local for local products and capabilities.

Order intake grew 270% in Connected Care and that is 21% when excluding the impact of the partial cancellation of the ventilator order last year. Patient monitoring orders grew 20%, building on a similar growth last year as a result of fundamental shift in adoption of our patient care management solutions in both high and low acuity care settings.

Comparable sales declined 7.6% in the quarter on the back of 10% growth in Q3 2020. As Frans mentioned, in addition to the high comparison base and the anticipated headwinds in our Sleep business, we also faced stronger than anticipated supply chain disruptions at the end of the quarter. I will elaborate further on that a bit later.

Coming back to the performance of our businesses. Diagnosis & Treatment comparable sales grew 10% in the quarter with double-digit growth in Image-guided Therapy and enterprise diagnostic informatics and high single-digit growth in Diagnostic Imaging and Ultrasound. We expect strong momentum in these businesses to continue in the fourth quarter.

The volume of elective procedures tracked above pre-COVID levels during Q3 even though they were below the levels seen in the second quarter due to the impact of the Delta variant in parts of the US and Asia Pacific early in the quarter. We expect hospitals to continue to normalise their operations and work through the backlog of patients in the coming quarters, although COVID remains a risk of course.

The comparable sales for Connected Care businesses declined by 39%, driven by a substantial decline in the Sleep & Respiratory Care on the back of a very strong Q3 last year as well as headwinds related to the recall. Patient monitoring comparable sales growth also declined on the back of a very strong Q3 last year and an increased in the lead time to convert the order book into sales.

Personal Health comparable sales were in line with Q3 2020. As anticipated, sales growth in the quarter was impacted by two phasing factors: the shift of Amazon Prime Day from Q3 last year to Q2 this year and pre-deliveries made in June due to the cut-off period related to the legal and financial disentanglement of Domestic Appliances as of 1<sup>st</sup> July 2021.

As mentioned during the Q2 earnings call, we estimated that these factors had a negative impact of 5 percentage points of growth of Personal Health in the third quarter. The year-to-date growth was 15% with double-digit growth across businesses. Underlying consumer demand for our strong portfolio in Personal Health remains very solid, but the current supply issues are expected to affect revenue in the fourth quarter as well. Consequently, we expect Personal Health sales in Q4 to be in line with last year compared to mid to high-single-digit growth if we were unconstrained by supplies.

Let me now turn to the profitability development in the third quarter. Adjusted EBITA for the Group was €512 million, which is 12.3% of sales. In Diagnosis & Treatment, the adjusted EBITA increased by 450 basis points to 14.2% of sales, mainly driven by sales growth and productivity. In Personal Health, adjusted EBITA was 15.9%, up 100 basis points from last year, mainly driven by productivity measures.

Connected Care delivered an adjusted EBITA margin of 6.2% of sales impacted by the sales decline in the high margin Sleep business, which was partially offset by our productivity programmes. It's important to note that Connected Care, excluding Sleep & Respiratory Care, was up 600 basis points between 2019 and 2020 and we expect to hold on to that gain despite the decline in sales this year.

Adjusted EBITA in the – for the Group was also impacted by higher-than-expected license income in the segment Other, mainly due to phasing of royalty settlements. We continue to focus on driving productivity initiatives that delivered €73 million savings in the quarter, more

specifically €34 million through procurement programmes, €16 million supply chain productivity and €23 million overhead cost reductions. These initiatives helped partly mitigate the impact of the increase of components and broader supply chain costs that we are experiencing.

Adjusting items were €53 million lower than guidance in the quarter due to lower restructuring and acquisition-related costs and lower costs for the separation of Domestic Appliances. Financial income and expenses included the positive impact from the increase in value of our minority participations. Income tax expense was a gain in the quarter mainly due to the positive impact of the recognition of some tax assets relating to business transfers.

The adjusted diluted EPS from continuing operations was €0.40 in Q3 this year. Year-to-date, adjusted EPS grew by 19% and free cash inflow was €45 million in the quarter, mainly due to phasing as the inflow for the first half of the year was €140 million higher than last year.

Let me provide some additional guidance for certain areas of our business. In the segment Other, we expect an adjusted EBITA loss of around €80 million for the full-year 2021. This is €30 million better than our prior guidance due to higher cost savings year-to-date. For Q4, we expect a net loss of around €20 million at the adjusted EBITA level for segment Other. Restructuring charges are expected to be 60 basis points in 2021, which is lower than our prior guidance of 70 basis points to 80 basis points due to lower costs year-to-date.

Acquisition-related costs are expected to be around 30 basis points lower this year compared to our prior guidance of 70 basis points. This is also due to lower costs year-to-date as we have optimised some of our integration processes. In the fourth quarter, we expect restructuring, acquisition-related and other charges of approximately €105 million.

Financial income and expenses are expected to be a net cost of around €70 million in 2021. This is lower than our prior guidance of €115 million, largely due to the increase in value of our minority stakes. We expect the effective tax rate to be between low to mid-single digit in 2021. This is due to the impact of the recognition of tax assets relating to business transfers that I just mentioned earlier. Our mid-term guidance of 24% to 26% effective tax rate, excluding incidentals remains valid.

On capital allocation, we are currently executing two share buyback programmes for capital reduction purposes of €1.5 billion each. The programme, which was initiated in the first quarter of 2019, will be completed this year as more than 20 million shares purchased through forwards are expected to be delivered and cancelled by 31<sup>st</sup> December. This will result in a reduction of 2% of the outstanding shares. Under the programme announced in July 2021, we entered into a number of forward transactions in the course of Q3, covering approximately half of the programme and totalling 19.6 million shares with settlement dates in 2022, 2023 and 2024.

The remainder of the programme will be executed through open market purchases by an intermediary, with a significant part taking place during this quarter. More details on the share buyback programmes are available on our Investor Relations website.

To conclude, I'd like to take you through how the year has progressed so far and our outlook. As Frans mentioned, our end markets remain very healthy and competitive momentum of our solutions is very strong, as evidenced by the record order book. In the first nine months of

the year, our comparable sales grew 3% and our adjusted EBITA margins improved 90 basis points.

Excluding the Sleep and Respiratory Care business, comparable sales growth was 10% and the adjusted EBITA margin improved by almost 500 basis points year-to-date. We are delivering on our transformation initiatives and as well as our productivity programmes.

We have been working through the global supply chain headwinds for some time now. But in the earlier part of the year, our ability to mitigate supply chain risk was higher, especially during Q3, as supply – as supplier inventories started depleting and the global supply chain challenges intensified, lead times to convert our strong order book to revenue increased, impacting our ability to deliver on part of the revenue upsides we had planned in Q3 and Q4 to mitigate the shortfall from Sleep.

The impact is particularly strong on businesses like patient monitoring, oral healthcare and Image-guided Therapy, which, as you know, are our high margin businesses and also the businesses which have been showing high growth. For Q4, for example, we are challenged with suppliers that are unable to give full visibility on e-component availability and shipping times, and incremental short-term demand remains difficult to fulfil.

We remain focused on driving necessary actions to deliver on our strategic performance road map. Due to the intensified supply chain volatility that we are working through, we now expect to deliver low-single-digit comparable sales growth and a modest adjusted EBITA margin improvement in the full year. I want to reiterate that based on our strong customer demand and growing order book, we expect to resume our growth and margin expansion trajectory in the course of 2022 as we work our way through the recall and that we remain very confident on our medium-term financial trajectory.

With that, Frans and I are happy to take your questions. Thank you.

## Q&A

**Operator:** Thank you, sir. If you would like to ask a question – if any participants would like to ask a question, please press the star followed by the one on your telephone. If you wish to cancel this request, please press the star followed by the two. Please limit yourself to one question with a maximum of one follow up. This will give people the opportunity to ask questions. If you're using speaker equipment today, please lift the handset before making your selections. There will be a short pause while participants register for a question. The first question comes from Veronika Dubajova from Goldman Sachs. Please state your question.

**Veronika Dubajova (Goldman Sachs):** Hi. Good morning, Frans, Abhijit and Leandro. Thanks for taking my questions. I have two, please. My first one is, I mean, I appreciate you've not yet given us 2022 guidance. But I'm just trying to kind of get your impressions and thoughts on the pulls and pushes as you head into next year, on one hand, looking at the order backlog. I think this is the highest I remember seeing it and I followed your stock for a while. So clearly, there are some real revenue opportunities as we move into next year. At the same time, I think, Frans, you were quoted on Bloomberg this morning talking about wage inflation, and I suspect some of the inflationary cost pressures on the supply chain side



also continue to bite into next year. So my first question is really kind of your degree of confidence both on the revenue and the mid-term margin outlook as it translates into 2022, and maybe what are the incremental upside and downside risks that you see at this stage? And my follow-up I'm going to ask it now, so we don't have to go back and forth. But just a quick word on the failure rate that you're observing at the moment with the DreamStation as you go through the repair and replace process? How far is it off the initial figures you had given us? And then any timeline for the VOC studies, if you can give us an update on that? Thank you.

**Frans van Houten:** Yeah, hi. Good morning, Veronika. 2022 guidance, right, it's – where shall I start? Order book indeed very promising, underpins already a significant part of revenue for next year. Innovation line up very strong, I would argue, strongest in a long time. That also bodes well. And we expect to continue to rack up good orders. Also on the consumer side, we think we are well positioned.

Then I think we need to take into account comparables, right? I mean, year-on-year comparison. First half of this year strong comparable revenue growth, right? That makes the year-on-year comparison a bit more challenging. Then we need to take into account that the Sleep business will only resume with revenue coming through in the second half as we complete the field action on the recall. So therefore, you have quite a few puts and takes in constructing the revenue forecast.

And we said in the press release that as we work through these headwinds, we resume our upward trajectory on growth, right? We have not been more precise. I think we should do that only at the end of the year. But clearly at the second half of the year, we want to be there, right, on that trajectory; detailing out the first half of the year we'd like to – to keep that in our pocket for a moment as we do more calculations as we get closer to it.

The – then we also said we will have margin expansion next year. And despite inflationary pressures, we feel confident that we can derive margin expansion. Abhijit referred to, you know, if you would exclude the Sleep impact, that actually, we saw a 500 basis points profit expansion. So we feel that seeing the forest for the trees has been a little bit difficult this year, but that there is good underlying margin expansion possible and that we will see that come through next year, even when taking into account some of these inflationary pressures.

Now, let's unpack that a bit. We think that the shipping issues are not going to be structural. We think that labour increases are probably a tad higher than this year and therefore something to be reckoned with. We think that the semiconductor shortages will abate by second quarter. So, we need to be quite tactical on how we make our longer term contracts. And we are doing that.

We have already started increasing prices, especially also on the consumer side and passing on some of the temporary cost adders such as all shipping to our customers where possible. Now to make a long story short, I hope that your takeaway of this story is that we are confident our ability to offset pressures, productivity gains will continue and that we will get back on – finally we get back on our path, as I should say that we communicated to capital markets day in – in 2019.

Okay, then, question related to the Sleep – sleep apnoea devices. You know, the complaint ratio has gone up, post the announcement; that is not unusual, as people are made aware of

the recall and put in their – their own complaint. The – the nature and the severity of the complaints has not materially changed from before the field safety notice, which reassures us that there's not suddenly, you know, very bad situations coming out of the woodwork; no deaths has been reported as we said that earlier.

The failure rate as a percentage has not materially gone up, but as we previously reported the failure rate as a percentage of units shipped, that doesn't make any sense now because we have stopped shipping devices since – in May as we prioritise the production capacity for the remediation. Right, so therefore, it's better to look at the complaints versus the units shipped in a cumulative manner, cumulatively over the last years. And we are still in very, very low failure rates. Yeah, hundreds of – what's the expression there? Beyond the – far below the decimal point. Let's take an action point to see what we can report to you guys in a written manner.

Then on the studies, we've always said that we want to create a body of evidence by further testing. When we went out in April, and May, it was on a relatively narrow set of data, taking a worst-case scenario as to potential patient risk. That is what you are required to do from a regulatory point of view. In the meantime, we have many more units out for test and we have involved more test houses and also third-party specialist experts who can give their opinion about the compounds whether they are toxic or not. So characterising the risk in a much more sophisticated manner.

In July, we said that that would probably take at least three months. So August, September, October. So you know, we are getting beyond – at the end of the three months forecast. It may be having some delay, but we still expect it to be the course of the fourth quarter. And then we aim to share that as transparently as we can; of course, we first need to go to the regulators before we can go to public markets, but we see advantage in being open and transparent to this.

Also, as it influences the assessment of litigation; I mean, we fully realise that investors and analysts find it difficult to – to assess the litigation risk but we don't want to add to speculation, and therefore we think waiting for these test results will be the best way to go forward to help you assess the risk that we – we believe will be there. I hope Veronika that answers your questions.

**Veronika Dubajova:** That was very comprehensive Frans. Thanks. Can I just confirm as you think about 2022? I mean, I guess you have the midterm guidance out there, right? Which is the 5% to 6% sales growth of the 60 to 80 bps adjusted EBITA margin improvement. Would you expect 2022 to be in that range already?

**Frans van Houten:** Well, I've tried to say that we need to grow into that range, rather than be there on 1<sup>st</sup> January.

**Veronika Dubajova :** Understood. Okay. That's great. Thank you, guys.

**Operator:** The next question comes from Hudson Al wakeel from Barclays, please state your question.

**Hudson Al wakeel (Barclays):** Thank you for taking my questions. I have two, please. So firstly, following up on your commentary on 2022, and more specifically on Connected Care, we've seen a more meaningful impact in margins this year in Connected Care. And I wonder

how you think about this evolving into next year. Do you think the business can grow the top line, or demonstrate margin expansion, albeit from a low base, as the recall continues to weigh for a significant chunk of 2022?

And then secondly, in D&T, do you expect a sequential acceleration of growth into Q4, based on the current phasing of orders? Or could the supply constraints mean that this is now unlikely? And then also, what about 2022? And are you confident about 5% to 6% growth in D&T? Thank you.

**Frans van Houten:** Yeah, let's start with Connected Care. There, we will have the complexity of comparables as the Sleep business was affected from the second quarter onwards. So obviously, as the Sleep business resumes, we should see a very strong growth in the second half of the year. I'm looking at Abhijit, whether you want to say anything more to that.

**Abhijit Bhattacharya:** No, I think I mentioned it earlier as well. Overall, if you look at the Connected Care margins, excluding the Sleep and Respiratory Care business, they are holding despite the lower sales on the back of tough comparables last year, and the whole supply chain situation. So I think we've made a good step in margin and we will return to growth and Q4 margins will be good as well, given that it's a big quarter. So similar to what you said Frans. And on the D&T Q4, Q3 was, as we said, already double-digit growth, we expect it to be in the similar range, maybe slightly up, but again, depends a bit on the supply chain volatility. Current outlook is it will be a bit stronger than Q3.

**Hudson Alverkeel:** And 2022 for D&T? Based on the current order book?

**Abhijit Bhattacharya:** 2022 will also be a strong year. So the 5% to 6% is very doable, given where we are in our order book at this point.

**Hudson Alverkeel:** That's helpful. And if I can just ask a follow up on – on Sleep. Can you talk about the impact that you're seeing on the mask side of the business? I remember this wasn't a significant impact in Q2. And I wonder if that changed in Q3.

**Frans van Houten:** The – we have focused our sales force more on masks now and of course, the other products that we still have. And whereas you would expect the decline in masks commensurate with the decline in systems, actually, that decline has been much less, suggesting that we were able to sell masks on a standalone basis into the installed base. And I think that's – that's great. We didn't call it out in our report here, because it's not that significant. But still, we are pleased that we have been able to ship more masks than you would normally assume.

**Hudson Alverkeel:** Perfect, thanks a lot.

**Operator:** The next question comes from Lisa Clive from Bernstein. Please state your question.

**Lisa Clive (Bernstein):** Hi, two questions, both on the recall. You got FDA approval for repairing the devices and also I – also other international approval – regulatory approval. Was that in line with your expectations in terms of the timing when it happened in September? I'm just trying to understand why you're still estimating that two thirds of the devices will be replaced. Is this just the most cost-effective approach? And then from a business perspective, could you just give us an estimate of what% of your sleep apnoea

machine sales are generally replacement devices? Because I imagine if you are sending out a lot of DS2s, that the replacement cycle will be a bit lower in the next few years.

And then just last question on the VOC testing. What sort of information will you be disclosing? Is it things like how long the foam may release VOCs when it's breaking down? You know, is it three days? Is it three weeks? Is it three months? I'm just trying to get a bit of a better understanding in terms of what kind of information we are likely to see next month.

**Frans van Houten:** Okay; hi, Lisa. The approvals were, by and large in line with expectations; maybe a tad slower in coming. There were a tonne of questions that we had to work through. And also the paperwork, to – to document all these processes was enormous and to a degree still is. But we are out of the gate now and I think that's – that's what matters. And you have seen some of the numbers coming through already.

So maybe it could have been a few weeks faster, but you know, it is what it is. And the repair or replace cycle, or repair or replace proportion is still roughly in line with what we've signalled earlier. We felt it was a bit too early to count on a benefit there; it could happen. But the – for a repair process, you need the return flow of units affected; that return flow takes time to organise. And once we are fully underway with the circular – circular model there, we will be in a better position to tell you the quality of the units that are returned, whether they are in fact worthwhile to repair.

You could argue that, hey, you know if a patient has a unit in bad shape, you should give back a unit of equal status. But that's not how it works, right; you need to – as we touch the unit and the repair protocol is classified as a remanufacturing process, as opposed to a field repair. That also means that high quality standards apply to the repair process and therefore not all units can be reworked, so to speak. That's taken as an assumption already into the provision so I'm not flagging you a new risk. Right? But that is why we are cautious to already cry victory over a better repair replace ratio as perhaps you would have hoped for.

Moreover, as we don't want patients to wait, and we are able to produce DS2s – DreamStation 2s – we are basically shipping DreamStation 2 units into the field to get underway with this whole cycle, right? And therefore you should assume that in the early months of the repair/replace programme, you will see an overweight of new, whereas later on when that return path is well underway, we will see a more beneficial ratio of repair, right; hence, we cannot give you more information at this time.

Then the test: priority number one is to characterise the compounds and try to determine the level of toxicity. Obviously, that's very important to the patients and to the doctors and to the regulators. So that is where we are putting a lot of effort in. Furthermore, we'd like to understand, you know, how does the degradation process take place over time? How does ozone effectuate that, et cetera, et cetera. I think that is what you can expect. As I mentioned earlier, we will prioritise of course communication to regulators and doctors but we are fully cognisant of the importance for you to be able to assess the health risks and therefore the litigation scope. And I hope that we are in a much better place to help you assess that in a more reasonable manner later this quarter.

**Lisa Clive:** That's very helpful; thank you.

**Operator:** The next question comes from Scott Bardo from Berenberg. Please state your question.

**Scott Bardo (Berenberg):** Yeah, thank you very much for taking my questions. The first one, please, just on, again, the Sleep and Respiratory franchise. I think last quarter, you provided an update that there were some 2.2 million active device registrations for DreamStation for your field action. Forgive me if I've missed an update this quarter but I wonder if you can help us understand whether that's trended up or down just to get a sense of continuity?

And furthermore, linked to this question, please: again, on your broader study set that you are conducting currently, can you help us understand the potential ramifications for this update? Could it indeed be enough to change the FDA's current recommendations on DreamStation? Is that the sort of magnitude, the data package we should expect? Some comments there would be appreciated.

And second question, please, if I may. So thank you for the comments about sort of returning to your communicated trajectory. Of course, this year, we're not seeing much in the way of growth or margin expansion, I think, for obvious reasons. But what I'd like to understand is, do you envisage any catch-up effects for the margin growth lost this year? Or are we actually going to be growing Philips from a lower base now? Thank you.

**Frans van Houten:** Yeah, hi, Scott. On the Sleep registered units, we are currently at 3.3 million registered devices. That does not mean that all registered devices are qualified devices for repair and replace, right, because we basically, after they are registered, need to determine whether they actually have been in used – in use or whether they have just been taken out of the cupboard and put on the registration list but were not in active use.

Then the study – the study said – and you asked that in conjunction with – you know, will it be enough for the FDA to change their view? I need to understand a bit better what your question is, because if you read the FDA advisory on their website, they actually say, 'Continue to use, contact your physician, consult your physician and then decide what to do.' So in fact, the FDA is not on the same page as Philips field safety notice where we said basically, stop use, then consult your doctor, and then decide what to do.

And there's this – this discrepancy between the FDA advisory and our own advisory is something that doctors and patients have flagged as something that they would like to see aligned. Let's say we were of course the ones that put the advisory out in the first place, and then – we are not doctors, we cannot do the risk benefit analysis as doctors and regulators can do. And so, the FDA came to a slightly different conclusion as to continued use, whereas we said worst case scenario was a stop use scenario.

So there's that discrepancy out there already – already for actually quite some months actually. The new data set that we are getting, you cannot, you know, anticipate what is going to be the outcome of that, right. I mean, if – otherwise I would publish it today. So we will need to get all the expert opinions in as to the nature of the compounds, potential toxicity of the compounds. And therefore, what potentially the health hazard is, if you move away from that kind of initial worst-case scenario. I'm afraid we'll still have to wait for that study to be published before we can expect also the FDA to do their evaluation of that. So it will take a little bit of time.

Then on your question on the trajectory, we flagged that we resumed the trajectory, we did not indicate a catch-up benefit. Obviously, I'm ambitious and I would love to do that, but with the inflationary pressures that we talked about earlier at this time, the signal that we would like to come back to the 60 to 80 basis points. We are not signalling any catch-up effect.

**Scott Bardo:** Okay, thank you Frans.

**Operator:** Next question comes from Julian Durmar, from Exane BNP Paribas. Please state your question.

**Julian Durmar (Exane BNP Paribas):** Hi, good morning, Frans, Abhijit and Leandro. Thanks all for taking my questions. The first one would relate to the supply chain volatility. I think you have stressed that you experienced 150 million headwinds at the sales level in Q3. I was just curious whether you could elaborate on which division is the most impacted by this. So if you could detail that for each and every of your three divisions, that would be that would be very helpful.

And the second question relates to a comment you made also about the positive CapEx changes from hospitals; I would be raking to get any sort of visibility on whether you believe this is just a recovery to a pre-COVID situation, or whether there is really something structural happening at the hospital level, and whether we should expect a stronger market for equipment going forward at least for over a couple of years.

**Frans van Houten:** Okay, Abhijit will take the first and I will take the second

**Abhijit Bhattacharya:** Yeah, maybe Frans you start with the second question and then I get the later. I have it but not here.

**Frans van Houten:** Sure, sure. Sure. The, you know, the positive CapEx trend actually came on the back of quite some slowness in the markets in the years before. I think on the – on the capital equipment on imaging, we know that the installed base is quite aged and old. I have heard many hospital systems wanting to build diagnostic centres in the community outside of the main premises of the hospital. And that would coincide with an investment cycle that will take a few years rather than only a few months.

Probably the older equipment units will stay in place in hospital, but these more efficient and more patient-friendly diagnostic centres that can operate at a lower cost and would potentially also not be affected by a COVID break out seem to be a trend going forward that we recognise in multiple parts of the world. So that I think is good news.

Same with ambulatory surgical centres, ASCs, where elective procedures can go in a patient friendly and safer manner for just the main hospital campus. So, we also see quite a few plans there that I would imagine is there for at least the next few years. Also the backlog of elective procedures points to building more capacity.

The CapEx trend in China, always a bit higher than the western world, will continue. There, we see a strengthening of local for local rules, which basically say that your product needs to be registered with the NMPA as a locally produced product. So it does not mean that it has to be a local brand; it has to be a company like us who produces it completely local and the NMPA say it is a local product.

Then on Monitoring and Connected Care related areas, I think we all remember 2019, when we were saying, you know, it was flat, you guys challenged us, you know, 'When is it not going to be flat anymore?' Well, COVID was a big accelerator for the insight; that monitoring at other care settings is appropriate, discharging patients – patients faster with wearable sensors. And then using command centres to oversee cohorts of patients remotely, leveraging telehealth – all of that has come to an acceleration.

And so basically, we see, finally, this whole vision of Connected Care coming to – coming to fruition. If we look at acquisitions like Biotel and Capsule, both of which are bellwethers for these kinds of trends, then I can tell you that strong double-digit growth is continuing there across the board. So we think that Connected Care will structurally have a higher growth rate going forward. And, of course, in 2022, initially, still, with some puts and takes due to year-on-year comparisons, but structurally should be at a higher growth rate. I look to Abhijit, whether you have the data...?

**Abhijit Bhattacharya:** Yeah. So Julian, just to be clear, the 150 million we talked about is the – let's say the higher impact on the supply chain volatility, right? So out of that, about 20 million was Personal Health, because some of it was already factored into the plan; the unfactored element was about 20. And the rest was roughly evenly split between Connected Care and Diagnosis and Treatment with maybe Connected Care slightly higher than the Diagnosis and Treatment.

**Frans van Houten:** Patient monitoring and IGT. In fact, all three businesses are high profit businesses that were affected, which is unfortunate. Go ahead operator.

**Operator:** The next question comes from Patrick Ward from Bank of America, please state your question.

**Patrick Ward (Bank of America):** Perfect. Thank you very much. I've got two please. One just more top down, I guess on China overall: you know, we got a lot on the news about different macroeconomic things happening. We obviously saw the GDP data. I'm just curious, what you guys are seeing given you have a huge business there from the Chinese consumer: you obviously have a lot of data and insight as to how the consumers look in our market. I'm just curious for your views there.

And then the second one, just, again, on the supply chain situation, I think it was 150 million primarily in September I think that was. And thank you very much Abhijit for giving a sense of Personal Health and the implication for Q4. I mean, should that mean that we should take that overall outside of just the Personal Health about 150 and say, you know, the Q4 impact could be double that or something like that, i.e., 300? I'm just trying to decide if it was just September that did the 150. Is it getting – you know, is that a larger impact in Q4? Or is there a functional situation where the supply chains are getting a little bit easier, actually, as you guys manage to work through some of the blockages there. Thanks.

**Frans van Houten:** Yeah, let's not keep that hanging because Q4 issue is about 200 million estimated, correct. So let's not have anybody think that it is going to get out of hand. 200 million is bad enough, of course, but we have mitigation actions in place to avoid, you know, a much bigger number. There is some volatility around it. So you could say 200 million was for us a kind of midpoint of some scenarios. But shipping should get better gradually.

**Abhijit Bhattacharya:** And the 150 is not all in September; bulk of it was in September. So you can say two thirds was in September and a third in July, August. So you saw it accelerating in September.

**Frans van Houten:** Then on the China question. Consumer demand is actually good. We see a lot of interest in the consumer devices. Of course, we have to tackle local brands that have become stronger. We also have seen a reduction of inventory in the channel. So sell out has been strong. We were hampered by supply constraints due to let's say the issue on components already flagged. I think for the fourth quarter we are expecting – Abhijit, are we able to share anything about fourth quarter China?

**Abhijit Bhattacharya:** Yeah, it's – I mean, like you mentioned order intake was good and I think that will continue. Also this sales momentum is slightly slower. But for PH, we continue to have growth. So I think that the trend of Q3 will continue into Q4.

**Patrick Ward:** Very clear. Thanks guys, thanks for the colour.

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

**Operator:** The next question comes from Falko Friedrichs from Deutsche Bank. Please state your question.

**Falko Friedrichs (Deutsche Bank):** Thanks very much. Good morning. I also have two questions. The first one on the product recall and would you be able to provide some feedback from doctors that you're getting, doctors that used to prescribe your, or still prescribe your sleep apnoea products? And with them, do you sense that there is still a big appetite to definitely stick with Philips post the recall, or do you rather sense that it can be quite tricky to gain back some of the share you're probably currently losing to your big competitor? So some qualitative info would be helpful here.

And then the second question on your free cash flow. We notice that part of the decline was driven by the consumption of provisions, most likely for the recall. Are you able to quantify that for us, so how much of the provision you released in the third quarter now? Thank you.

**Frans van Houten:** Yeah. Hi Falko. You know, we've heard from both doctors as well from the DMEs, the distributors, that they are judging us more on how we handle the situation, rather than that it happened in the first place, and we hear that doctors appreciate on how we do the communication and support them with intense information. They also told us that – why they like us. They – for example, the informatics applications around sleep devices and the ability to observe trend lines, they like that very much. They've also said that they don't want to end up with a situation where there's only one big supplier, right?

So, on the basis of all the feedback, we expect to be able to recoup our market share, maybe not immediately but over time, and we are also planning, already, in parallel to the remediation, you know, a comeback plan where we will go out, of course, with all energy to fight back and to regain and recoup our share.

Then on the free cash flow, Abhijit?

**Abhijit Bhattacharya:** Yeah. For Q3 I think we consumed around €60 million out of that – out of the provision, so that, of course, kept the cash flow down a bit in the quarter. But, like we said, year-to-date, you know, for the first half we were well ahead, so we remain in line to



get to the target for the year, excluding, of course, the cash impact of what we have to spend on you know – on the recall.

**Falko Friedrichs:** Okay, thank you.

**Operator:** The next question comes from James Van-Tempest from Jefferies. Please state your question.

**James Van-Tempest (Jefferies):** Hi, good morning. Thanks for taking my questions. Firstly, you've lowered the restructuring cost guidance and I think you said expected to be even lower next year. Just wondering if you can provide any more colour around this? Is this because restructuring charges have been pushed back or is it you expect fewer changes are required in the underlying business?

And my second question is you mentioned, sort of, growing into the 60 to 80 bps margin expansion next year. Given the first half comparison, which you highlighted on the call, is it fair to say you're more likely to see that more in the second half of next year? Thank you.

**Abhijit Bhattacharya:** Yeah. So on the restructuring, we have not pushed out any restructuring because, of course, that would impact the productivity programmes going forward. In the – at the start of the year, given the pandemic and the – let's say the longer term horizon, we have probably thought we may have go deeper, but with the resumed demand, et cetera, and the strong order book we don't need some of that restructuring, so therefore it's good that we also bring that – the adjusting items down a bit earlier than planned.

**Frans van Houten:** Yeah. And then on the phasing, when Veronika asked a question in the beginning I said we have to grow into that trajectory, we will not be immediately on that trajectory on January 1, right? So the second half of the year will be stronger than the first half of the year. I hope that that answers your second question, James.

**James Van-Tempest:** Thank you.

**Operator:** The next question comes from Wim Gille from ABN AMRO-ODDO. Please state your question.

**Wim Gille (ABN AMRO-ODDO):** Yes, very good morning. Wim Gille, ABN AMRO-ODDO. A pretty simple one I think. The other segment was quite well this quarter, in particular related to the phasing of royalty settlements. Taking also into account the disentanglement of Domestic Appliances this quarter, can you give us a bit of feeling where we should pitch our adjusted EBITA numbers for other going forward, so moving more into 2022. Is it fair to assume that we will have structurally better adjusted EBITA results in Other on the back of this? Thank you.

**Abhijit Bhattacharya:** Yeah, Wim. So what I said about the royalty was it's a phasing between Q3 and Q4. So overall we have kept costs lower this year and therefore we've reduced our guidance by €30 million lower going forward. Typically, what I do is in Q1 I give a very explicit guidance for the year, so I just request you to be a bit more patient and then we will do all our puts and takes and come back with a view as we start next year.

**Wim Gille:** Okay. Maybe to put it differently then. Can you remind us just what the impact is going to be of the royalty income from Domestic Appliances on an annualised basis? Thanks.

**Abhijit Bhattacharya:** It's going to be +/- €60 million or so.

**Wim Gille:** Thank you very much.

**Operator:** Once again, if you would like to ask a question please press the star followed by the one on your telephone. To cancel this request, please press the start followed by the two. We have a follow-up question from Lisa Clive of Bernstein. Please state your question.

**Lisa Clive (Bernstein):** Hi. One follow up on the recall. Am I correct that every device that's returned for either replacement or repair will actually have its foam tested and, if you, would you be able to disclose to us at some point the proportion that show any sign of breakdown once those results are available to you?

**Frans van Houten:** Hi Lisa. Every unit that comes back will be photographed and inventorised. Tested is a big word because you're not necessarily putting millions of devices through a comprehensive test, but they will be inspected.

**Lisa Clive:** Okay, that's clear. Thanks.

**Operator:** The next question comes from Kate Kalashnikova from Citi. Please state your question.

**Kate Kalashnikova (Citigroup):** Hi Frans, Abhijit, this is Kate Kalashnikova. For imaging diagnostics, on one hand hospitals are under pressure due to COVID, on another hand your costs are increasing due to supply chain challenges, high logistics costs. So how do you think about the net impact of these changes, and could you also comment on competitive dynamics when it comes to pricing?

**Frans van Houten:** Yeah. Hospitals are under pressure, but there is also a lot of government money going into shoring up hospitals and expanding the capacity of health care, right? So we should not take this pressure thing too much, right? I spoke earlier about diagnostic imaging change being built, I spoke about, you know, strong CapEx environment. A lot of the cost of radiology is actually not equipment but labour and there is a lot of efficiency to be gained in that whole workflow, and this is also why the Philips informatics solution is so appropriate. I mean our Radiology Command Center, ROCC, and the radiology solutions suite can drive productivity in radiology centres by over 30%, which is fantastic if you think about having more patient that need to be diagnosed, et cetera.

So overall, I look with optimism towards the market; there's enough to be done. What you will see is that many hospitals will buy good enough rather than the most super-duper machine. It's all about diagnostic confidence and efficiency, rather than only features. What we observe with the Spectral CT 7500 is that it gives a confident diagnosis in record time, right? This is very important. Reconstruction time is very fast, and given that you get spectral information without having to predetermine whether you want conventional or spectral imaging is a huge benefit. The fact that our MRI is helium-free and doesn't need expensive quench pipes in the real estate, right, is great, especially when, now, new diagnostic imaging centres are going to be built that you can build, basically, structurally with lower real estate costs, right? And so some of our competitors continue to emphasise the

academic centres as the only determining factor, but I can tell you that most C-suites are very focused on productivity instead.

So, overall, we think that we can hold our own in terms of competitive position and, yeah, I think on pricing health economics play more and more a role, and then it's important about lifetime cost and rather than only initial price. So I think we can maintain our position there.

**Kate Kalashnikova:** Thank you for this. And as a follow up, what proportion of your D&T sales in China is produced in China currently?

**Frans van Houten:** Quite a lot already. I mentioned that the criterion is registered as a local product with the NMPA. So it's not just, you know, are you, let's say, making it locally, but is it also correctly labelled as a local product? We are in line, more or less in line, with our competitors.

**Kate Kalashnikova:** I think you constantly disclose the percentage?

**Frans van Houten:** Yeah. Somewhere around the 40% or so on a formal basis. Goes up rapidly, as we understood that this was important, so we have been a path already to localise manufacturing and increase the local labelling. The NMPA takes quite some time to process these requests, so we are a bit dependent on the regulator there, but otherwise I think we are on a good path forward.

**Kate Kalashnikova:** Perfect, thank you.

**Operator:** The last question is a follow-up question from Veronika Dubajova from Goldman Sachs. Please go ahead, ma'am.

**Veronika Dubajova (Goldman Sachs):** Hi guys. Just a quick one, follow up, actually, on the China topic. I know you've mentioned some softness in order momentum in Q3. Just curious if you've seen improvements in that as you've moved through the third quarter, and if you can give us, sort of, a first look on how the China order momentum's progressing in the fourth quarter, and your best guess for when you might see a return to normalised order growth in this market? Thank you.

**Frans van Houten:** Well, we actually, I think, flagged that we have mid-single digit order growth in China. We flagged some revenue delays, also in China, partly also by the processing of all these IPPA regulations. That's, I think, where we stand. So it was more the revenue recognition that was a bit slowed for this, the order momentum, as such. Anything else, Abhijit?

**Abhijit Bhattacharya:** No. I think – last year I think the comparables in Q4, we had 17% order intake growth, so that will have some impact, but –

**Frans van Houten:** Yeah.

**Abhijit Bhattacharya:** – in general I think China is slower than it used to be, but as soon as the – part guidelines get clearer you will see momentum picking up there.

**Veronika Dubajova:** And any timeline for that, is that a 20 – you know, Q1 2022 is a realistic expectation for that?

**Abhijit Bhattacharya:** Very difficult to say, very difficult to say Veronika. It's a thing that the government is working through, and of course they see also the impact of things that are stuck in the pipeline, so we'll have to wait and see.

**Veronika Dubajova:** Okay, understood. Thank you, guys.

**Operator:** Thank you, Mr van Houten and Mr Bhattacharya. That was the last question, please continue.

**Frans van Houten:** Okay. Well, thank you for all your questions. Let me summarise by expressing my conviction that we are going to be on a path upwards and work through the challenges that you have asked numerous questions about. I do believe that the end goal of high-teens profitability by 2025 remains intact. We have a competitive set of innovations, we are going to resume our growth and margin expansion, and we hope that we will have, let's say, these sessions with you to go deeper on those questions as soon as possible.

In the meantime, thank you very much for today and stay tuned.

**Operator:** This concludes the Royal Philips Third Quarter 2021 Results Conference Call on Monday, October 18, 2021. Thank you for participating, you may now disconnect.

[END OF TRANSCRIPT]