

**PHILIPS**

# **Koninklijke Philips Q3 2022 Results**

Monday, 24<sup>th</sup> October 2022

**Operator:** Welcome to the Royal Philips Third Quarter 2022 Results Conference Call on Monday, October 24<sup>th</sup> 2022. During the call, hosted by Mr Roy Jakobs, CEO, and Mr Abhijit Bhattacharya, CFO, all participants will be in a listen-only mode. After the introduction, there'll be an opportunity to ask questions. Please note that this call will be recorded and the 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.

## **Introduction**

Leandro Mazzone

*Head of Investor Relations, Koninklijke Philips N.V.*

Hi everyone. Welcome to the Philips Third Quarter 2022 Results Call. I'm here with our new CEO, Roy Jakobs, who took charge recently on October 15<sup>th</sup> – that is nine days ago – and our CFO, Abhijit Bhattacharya. Roy and Abhijit will take you through the third quarter results and our performance improvement actions. After that, there will be an opportunity for Q&A.

The press release and Q3 slide deck were published at 7.00am CET on our Investor Relations website. We also published an updated deck and frequently asked questions on the Respironics recall this morning. The full transcript of this call will be made available on the website later today.

Before we start, I want to draw your attention to our Safe Harbour Statement on screen. With that, I'll hand over to Roy.

## **Company Overview**

Roy Jakobs

*Chief Executive Officer, Koninklijke Philips N.V.*

Thanks Leandro and thanks everyone for joining us this morning. As this is my first earnings call as CEO of the company, I would want to welcome you on this call and like to start by saying that I'm honoured to have been given the responsibility to lead Philips. I look forward and commit to a transparent and constructive engagement with our investors, analysts and other stakeholders about our ambition to create value for shareholders and all other stakeholders.

### **We Operate in a Large, Structurally Growing and Resilient HealthTech Market**

Philips is a great company with a strong brand, leading innovation and portfolio, strong customer base and talented employees, operating in an attractive HealthTech market. Our strategy and solutions resonate with our customers. But we do face multiple challenges and have not lived up to their, and your expectations, in recent years. The current macroeconomic environment and external and internal supply chain disruptions presented further challenges, and our disappointing Q3 and 2022 performance reflects this.

We are taking actions to turn things around urgently and realise our potential as a responsible leader in health technology solutions; we will be laser-focused on this. My immediate priority

is to improve execution. We will do that by, first, further strengthening our patient safety and quality management and continuing to address the Respironics recall and regulatory and legal processes connected to this. Second, urgently improving our supply chain operations so that we restore supply, deliver on our strong order book and deliver better results. And, third, simplifying our organisation and the way we work to drive clear accountability and improve productivity and agility.

Moreover, we're taking immediate steps to reduce the costs involved in running the company. This includes the difficult but necessary decision to immediately reduce our workforce by around 4,000 roles globally, subject to consultation with the relevant workers' councils and social partners; a decision we do not take lightly and which we will implement with respect towards impacted colleagues, but one that is needed to cope with our current challenges. We expect that we can recognise the expected associated costs and see the connected savings in the coming quarters.

### **Three Strategic Imperatives to Drive Growth & Profitability**

In addition, we will continue to review areas to further improve our supply operations; invest in quality and simplified way of working, and remove organisational complexity. This is expected to result in additional restructuring and associated costs in 2023. We will elaborate on progress on this, the 2023 plan and the detailed plans to further strengthen Philips' operations and drive shareholder value creation, at our fourth quarter and annual results publication in January 2023. Our strong order book shows the strength of our solutions and portfolio for our customers, and we're going to stop at nothing to regain our upward performance trajectory and drive sustainable value creation.

### **Continued Focus on Innovation and Customer Partnerships**

Our continued focus on innovation and customer partnerships will further strengthen our businesses and results. For example, in the third quarter we signed a 10-year agreement with a large university hospital in Japan for the expansion of its eICU programme. We expanded our leading ultrasound portfolio with the FDA's market clearance for our new Ultrasound 5000 Compact system, and in Connected Care we continued to successfully expand ambulatory care solutions, as supported by newly published research on the Philips Mobile Cardiac Outpatient Telemetry.

### **Respironics Recall Update**

Before I give the floor to Abhijit, I would like to provide an update on the Respironics recall. I want to emphasise again that patient safety is our absolute number-one priority. We know how important these sleep apnoea devices are to patients and how they improve their lives, and, as such, I do apologise for any inconvenience caused. We continue with a comprehensive outreach to engage with patients, clinicians and regulators. We know that patients are waiting and we're doing everything we can to get the devices to them as soon as possible.

#### *Increased Production Capacity*

We have significantly further increased our production capacity, reaching four times pre-recall levels. As of today, we have produced approximately four million devices and expect to produce and ship around 90% of the registered affected devices by end of 2022. Further

biocompatibility testing and assessment of PE-PUR foam is ongoing to fully assess potential patient risk and to complement earlier released test data showing encouraging results.

On the regulatory front, while we do understand that you would like to know more about the proposed consent decree, we are still in discussions with the DOJ and therefore cannot provide details related to the possible financial and operational impact at this time. In Q3, we recognised a non-cash charge for the impairment of goodwill of the Sleep and Respiratory Care business, which Abhijit will further elucidate. Philips Respiroics will continue to provide updates when and as appropriate.

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

I realise that I've provided you with a lot of information in this first update from my side, on results and on the issues to address in quality, supply chain and organisation complexity. I do this so that you know what you can expect from Philips and from myself as CEO.

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

## **Financial Performance in the Quarter and Full-Year Outlook**

Abhijit Bhattacharya

*Chief Financial Officer, Koninklijke Philips N.V.*

### **Q3 2022 Performance Summary**

Thank you, Roy, and good morning everyone. Our performance in the third quarter was impacted by operational and supply challenges, inflationary pressures, the COVID situation in China and the Russia/Ukraine war. Comparable sales declined 5% in the quarter and adjusted EBITA was 4.8% as pre-announced on 12<sup>th</sup> October. We are seeing a gradual improvement in the supply chain situation and continue to take action to strengthen our supply chain resilience. However, the progress has been slower than expected. We have been able to mitigate most of the supply chain issues in our Personal Health businesses. In the health systems businesses, it takes longer to see the impact of our actions, given the regulated nature of the business and the installation-related risks from the customer side. All of this is expected to continue to gradually ease in the coming year.

It is important to note that these are not lost sales. The orders remain in our order book for future revenue recognition when we can fully deliver and install the equipment. Lower sales has an impact of 740 basis points in our adjusted EBITA margin compared to third quarter of 2021. Global inflation and cost headwinds also had significant impact, which was offset by the productivity and pricing actions we have taken and which will gradually contribute further.

Income from operations was impacted by the non-cash charge for the impairment of goodwill of the Sleep and Respiratory Care business reported earlier this month. This is due to revisions to the financial forecast of this business, resulting from the current assumptions regarding the estimated impact of the proposed consent decree and changes to the pre-tax discount rate. As disclosed, Philips Respiroics is subject to an investigation by the US

Department of Justice, is a defendant in several class action lawsuits and individual personal injury claims, and is in ongoing discussions with the FDA regarding the consent decree.

Given the uncertain nature and timing of the related events and of their potential impact and associated obligations, if any, the company has not made a provision in the accounts for these matters. Operating cash flow was an outflow of €180 million, mainly due to lower cash earnings, temporarily higher inventories and cash costs related to the Respiration field action.

## **Business Highlights Q3 2022**

### *Diagnosis & Treatment*

Let us now look at the performance per business. Diagnosis & Treatment comparable sales declined 2% on the back of 10% growth in Q3 2021. Low single-digit growth in image-guided therapy was more than offset by a decline in ultrasound and diagnostic imaging due to specific electronic component shortages. Adjusted EBITA margin was 9.1%, impacted by the decline in sales, the change in mix and cost inflation.

### *Connected Care*

The comparable sales for Connected Care declined 15% in the quarter, driven mainly by a substantial decline in the Sleep and Respiratory Care business due to the recall, the operational challenges and by supply chain headwinds in patient monitoring. Adjusted EBITA amounted to a loss of 9.5%, mainly due to the decline in sales and cost inflation.

### *Personal Health*

The Personal Health business's comparable sales grew by 4%, with high single-digit growth in Oral Healthcare and Mother & Child Care and low single-digit growth in Personal Care. North America grew 7%, while Western Europe grew double digits. The adjusted EBITA margin amounted to 14.1%.

## **Solid Order Growth and All-Time High Order Book**

Now on orders. On the back of a strong 47% comparable order intake growth last year, order intake declined approximately 6% in the third quarter. The book-to-bill ratio remained strong at around 1.2 and the equipment order book grew further in the quarter. These order book metrics are depicted on page 15 of our investor relations deck.

### *Diagnosis & Treatment*

In our Diagnosis & Treatment business, orders were up 3% on the back of a 15% increase in Q3 2021. Enterprise diagnostic informatics and image-guided therapy orders grew high single digit, diagnostic imaging grew mid-single digit, with another very strong quarter in magnetic resonance imaging.

### *Connected Care*

Connected Care orders declined 24% in the quarter, on the back of over 260% growth in Q3 last year; you will remember this was caused by the cancellation of the ventilator order for the US government. The average order growth over the last three years was 8% in Connected Care as we continue to experience good demand in the hospital patient monitoring business.

## Actions to Improve Performance

### *Pricing Actions to Address Inflation*

Now I would like to update you on some of the key actions we are taking to step up performance. First, on pricing. We have been raising pricing by mid-single digit since the beginning of the year. In the Personal Health businesses, this is expected to have an impact of around 4% this year. In the Diagnosis & Treatment and Connected Care businesses, due to the longer equipment order book cycles, the impact of price increases will take longer to be fully realised in the profit and loss account. We expect around 1% impact this year and we will continue to take further pricing measures as needed.

### *Stepping up productivity initiatives to €0.5 billion per year to deliver €2 billion in the 2022-2025 period*

We said we are implementing productivity actions. Many of these initiatives have been communicated to you before, but are being expanded or accelerated. In the supply chain, savings come from dual sourcing, supplier consolidation and the warehouse footprint rationalisation. In quality, we are announcing processes, increasing capabilities and product management. In R&D, we are shifting the focus to fewer high-impact projects in the innovation pipeline. In connection with this action, we recorded a non-cash charge of €168 million in the third quarter, as reported earlier this month.

Roy mentioned the difficult decision to immediately reduce our workforce by around 4,000 roles globally, which will have expected severance and termination-related cost of approximately €300 million in the coming quarters, of which about €150 million in the fourth quarter of this year. The associated cost savings are expected to amount to an annualised saving of €300 million.

### *Actions to address supply chain headwinds*

Very importantly, we continue to drive significant actions to increase supply chain resilience and mitigate the impact of disruptions. We are engaging with senior government officials, strategic suppliers and foundries to prioritise on healthcare supplies; directly working on component issues across all tiers of suppliers; diversifying sourcing of high-risk components with almost 400 alternate components certified to date. Lastly, we are also redesigning our printed circuit boards to qualify alternate sources of supply.

## Outlook

Let me now provide guidance for certain areas of our business.

In the segment Other, we expect a net cost of around €30 million at the EBITA level in the fourth quarter, mainly due to the restructuring cost we mentioned. This means we expect an adjusted EBITA of around zero in Q4, in this segment. We currently expect an effective tax rate of mid-single digit in 2022, mainly due to the lower income.

We expect to deliver positive free cash flow of around €600 million in the fourth quarter, due to phasing of sales and working capital. In the full year 2022, we therefore expect a free cash outflow of around €700 million, due to the lower earnings, temporarily higher inventories, and the cash cost related to restructuring.

In addition to measures to manage cash, we are taking measures to further strengthen our near-term liquidity position until we deliver on our order book and consequently start to see

better cash flow from operating activities next year. In this context, it's important to clarify that we remain committed to dividend stability, which is an important part of our capital allocation policy.

We secured a €1 billion credit facility to be used if and as needed, and we will execute the settlement of forward contracts entered into as part of share repurchase programme announced in July 2021 at the original settlement date of 2023 and 2024, instead of in 2022, as previously announced. The forward contracts with settlement dates in Q4 2022 will be settled this quarter as planned.

### **Conclusion**

To wrap up, looking ahead, we see prolonged operational and supply chain challenges, a worsening macroeconomic environment, and continued uncertainty related to COVID-19 measures in China, which will be partly offset by our productivity and pricing actions. As announced on 12 October, we now expect a mid-single-digit comparable sales decline in the fourth quarter of 2022, with a high single to low double-digit adjusted EBITA margin.

We are actively monitoring the situation and our teams are working very hard on delivering on our order book and mitigating the impacts of headwinds. And we remain laser-focused on our improvement actions.

With that, I'd like to open the line for questions.

### **Q&A**

**Operator:** Thank you, sir. If any participant would like to ask a question, please press the star followed by two times one on your telephone. Due to the time, please limit yourself to one question. This will give more people the opportunity to ask questions. There will be a short pause while participants register for questions.

We will take our first question. Please stand by. And your first question comes from Hassan Al-Wakeel from Barclays. Please go ahead. Your line is open.

**Hassan Al-Wakeel (Barclays):** Thank you for taking my questions. I have two, please. Firstly, to start with a high-level question for Roy, could you give us some insight about how you look to improve execution and set realistic and achievable targets going forward? I know Adhijit has talked about stretch targets in the past, which were in the midst of a transformation. Your view on the extent of supply chain shortages easing may have been overly ambitious in hindsight, but how should we think about the base case into next year? More specifically, what could revenue growth look like if you were unconstrained by supply and what could it look like if supply does not improve, and would this impact the most profitable businesses?

And secondly, could you talk a bit about leverage and liquidity and how you think about the maintenance of the cash portion of the dividend? Given the deterioration in business performance and litigation, which albeit is likely a few years out in terms of potential payments, could it make more sense to invest this incrementally into the business? Thank you.

**Roy Jakobs:** Thank you, Hassan, for your question. Let me take the first one, and then I can ask Abhijit to address the second one.

So, in terms of my insights and as I've also shared, we have a very strong order book, but we have a serious challenge in conversion. And that challenge, indeed, is coming out of execution, where we need to focus more in addressing the supply chain issues that we have with external suppliers, meaning, we need to go to the next level of the second, third and fourth-tier suppliers to secure the components that we need to get to complete our products, so that we can bring them to installation. But also, we need to improve our internal supply chain agility, so we can deal better with the volatility that we see.

For example, in redesigning part of the boards, but also improving the information flow that needs to flow seamlessly and fast from what we get on the supply side up to what we get from the customer side. So that's also where, when you heard me talk about the focus on execution, I very much look at quality, supply and productivity to actually improve near-term our performance trajectory. And on that, indeed, I have also been talking about realism. Realism in terms of the situation we face, so that we can actually address the right areas to improve our performance trajectory; but also, secondly, in terms of being realistic in terms of what the trajectory will be.

Now, as you can imagine, I'm now on my 9<sup>th</sup> day into the job, and I will go looking into the structural trajectory and also interventions that we're going to do, and update you in January on the plan for 2023, and also the trajectory moving forward. Because we have a very strong product portfolio, we have an exciting trajectory ahead, but we need to get our execution in line with the order book and with the potential that we have.

**Adhijit Bhattacharya:** Thanks, Roy. Hassan, hi. Regarding leverage and liquidity, I think, look, our cash earnings this year have been lower, our inventories have been temporarily higher, so therefore, we have taken a term loan. So this is not a bond, multi-year bond. We've taken a term loan to help us go through this period because we will also have restructuring costs as part of the reduction in the people that we have spoken about. So as far as liquidity is concerned, we are not particularly concerned. We have adequate reserves and a strong balance sheet. And as I mentioned, our commitment to dividend remains. So there should be no kind of concern on that front.

**Hassan Al-Wakeel:** Thanks. And if I can just follow-up on the question, just trying to understand potential upside and downside scenario into next year with regard to supply, i.e., given the order backlog that you have, and if you were indeed unconstrained by supply, what that would look like? And what the business could look like in terms of no real improvement in supply and would this impact the most profitable businesses?

**Adhijit Bhattacharya:** I think, Hassan, as Roy mentioned, those are things we are working through in the coming months. So, I think we best leave that in terms of projections for next year, to the update in January. We have a big Q4 to deliver. I think we need to deliver on that. And then we come back on how we see next year developing.

**Roy Jakobs:** Maybe one colour that we can give, if we would have unconstrained supply for MR, we could deliver over one year's of plan into the market. So, that's kind of giving you a bit of colour in terms of that actually, we have a real strong order book where for some of our

solutions, we have what we normally would sell in a year as part of order, but we need to unlock the supply to actually fully capitalise on that.

**Adhijit Bhattacharya:** Yes. And there's, of course, other modalities as well, including IGT, etc. So you will see that our coverage for next year remains pretty high.

**Hassan Al-Wakeel:** That's helpful, thank you.

**Operator:** Thank you. We will now go to our next question. Please stand by. Your next question comes from the line of Veronika Dubajova from Citi. Please state your question.

**Veronika Dubajova (Citi):** Hi, guys. Good morning and thank you for taking my questions. I have two, please. One, would love to understand how that 4,000 personnel reduction is spread across the various businesses and functions, if you can give us even just a rough outline – I appreciate some of this might be fairly sensitive, but a rough outline, that would be helpful.

And then my second question is related to this. I mean, I think, Roy, you already talked about the desire to increase efficiency of R&D, while reducing the absolute spend. And I'd just love to understand the logic and the rationale behind that, and how confident are you that you can get more for less, or at least the same amount of output for less. I think there's been some concerns around this by some of your large shareholders. It would be good to understand how you're thinking through that. Thank you.

**Roy Jakobs:** Thank you, Veronika. So let me address the first question. So in terms of the reduction in force, actually, it's a global measure we take. So actually, we will have and see impact across our operations globally. But, of course, you will see that the highest impact is in our top-four markets in terms of our employee base, which will be the US on top, then the Netherlands, and then India and China. So those is where we have the best absolute numbers, but that's also in line with the numbers of total workforce.

Next to that, of course, we also adopting, first and foremost, more Group and staff functions and we are protecting the operational [inaudible], so, of course, to ensure that we can deliver with quality and have all our manufacturing, operational supply, services and sales staff fully focused on that. So that's how we drive the efficiency.

And then on the second question, in terms of innovation, yes, I do believe that we have room to improve our efficiency and effectiveness of innovation. And, actually, the view that I hold, is actually by focusing more on where we have strong innovation potential, but also skill potential, actually, we've got better returns for the investments that we're making.

So you saw that we have cut some of the projects. Those are projects that would fit into that bucket where actually we see that they would generate maybe less scalable big impact. So, we are focusing now on fewer innovations that we can scale to a bigger size, but also ensure then that we do it at the right quality norm.

**Veronika Dubajova:** That's helpful. And if I can follow-up on the reductions. Are you – is there a specific business or area that you're targeting the most?

**Roy Jakobs:** No. You have seen – and maybe I must call out that we are going through our portfolio. So actually, we see that actually, we have this opportunity to start also with the tail end of smaller projects that we have across businesses. So, we also look at it across

countries in terms of where do we see the biggest potential. And, of course, this is also guided by what we get from our customers. So, actually, the customer pool and kind of where we see the orders coming in and demand being the strongest, of course, will fuel a lot more demand.

I am further working through also the structural measures. So as I said, I will come back to that in January, in terms of where we're going to focus more to double down to generate an acceleration of our growth trajectory.

**Veronika Dubajova:** Okay. That's very helpful, thanks so much.

**Operator:** Thank you. Your next question comes from the line of David Adlington from JP Morgan. Please go ahead and ask your question.

**David Adlington (JP Morgan):** Morning, guys. First one on Personal Healthcare. I just wondered if you can help us out with seeing in terms of end-market demand for your products with 4% pricing into the quarter. It looks like volumes are flat. Just wondered what the sort of trajectory is like in the quarter and into the fourth quarter?

And then second, just a very quick one. I think we were expecting at least the outcome of the compatibility study. Just wondered if there were any updates on that, please?

**Adhijit Bhattacharya:** Okay. Let me take the first one, David. And then, Roy, maybe you take the one on testing.

**Roy Jakobs:** Yes.

**Adhijit Bhattacharya:** So, overall, you have seen that the Personal Health demand in Q3 has held up pretty well. We had good growth in Western Europe. We had strong growth in North America. But going forward, with all the issues around energy pricing and lower customer confidence, we expect China to get softer in Q4, we expect Europe to get softer as well, whereas, North America continues to remain strong.

So, let's say going forward into Q4, we are a bit cautious about our Personal Health business, probably be in a kind of flat to slightly declining range. That is largely driven by consumer demand more than really any issue with our portfolio or supplies.

**Roy Jakobs:** And then maybe on the testing, as you know, we have been coming forward with our test results, that actually showed very encouraging results in December, based on the view you see that we're within standard; and then in June, where we reported back on the very low prevalence of foam degradation that we saw coming back from the devices that we tested.

We are further testing, as we also shared. We are working through those also in collaboration with the regulators. So we, unfortunately, cannot share further detail now. But I promise you that the moment we can, I will be – and we will be coming forth with those results immediately.

**David Adlington:** Any thoughts in terms of when that might be, Roy?

**Roy Jakobs:** It's hard to predict, as I said, because it's not fully dependent on when we have completed but also when we then work through with the various parties that are looking at it from an external perspective. So, unfortunately, I cannot give you a date. I can only

promise you that we are as eager as you to, kind of, conclude this, and get this out. So the moment we can, we will inform you immediately.

**Operator:** Thank you. We will go to the next question. And the next question comes from Graham Doyle from UBS. Please go ahead and ask your question.

**Graham Doyle (UBS):** Good morning. Thank you for taking my question. Just first one, just around supply chain. And if you think of the issues you had over the last, I suppose over 12 months now, it doesn't feel like any of them are getting particularly better. But when we look at things like shipping availability or freight rates, they certainly have been improving. So what do you think is causing your particular issue? Is it maybe too much outsourcing or, sort of, lack of foresight in terms of systems telling you where and when you're having these problems?

And then a second question just around, sort of, a follow-up to David's question of the data. On biocompatibility, are you actually getting this data in-house on a regular basis and therefore have an absolute view on that? And then in relation to that, I know [inaudible] mentioned a number around 50,000 individuals who have contacted a lawyer in relation to the litigation. I'm just wondering, have you got an update on that number as well, please? Thank you.

**Roy Jakobs:** Okay. Thank you, Graham. Let me start with the supply chain. And so, I think there are two parts of your question, one, do we see it getting better. So, I think you heard Abhijit just talk about PH, where actually, we see that has significantly improved and actually, we're – we don't feel we're currently supply constrained to capture the demand. Unfortunately, we are in a moment where the market demand is dropping under the current inflationary pressures and the consumer confidence that is dropping.

In Health Systems, there, we are still facing significant challenges that is – and has to do both with prolonged challenges that we see in our supply market that we need to source from. So we still have shortage of components, whether it's chips, whether it's batteries, but unfortunately, also in second and third tier. We have improved quite significantly in the first tier suppliers. So actually, last year, around this time, we would be looking at around 200 first-tier suppliers that were very constrained. Currently, it's around 20.

But even if you have 20 constrained, that means that only one part missing and you cannot complete an installation and, therefore, cannot bring it to the customer and not recognise. So it takes longer.

Secondly, as I mentioned, there are also internal challenges that we need to address. The redesign of our products to more current components is something that we're working hard on. Also, there, we have made progress. But reality is also, in a regulatory market, that takes some time. Especially with our current strong focus on quality, we also want to do it first time right. And we have quite a significant amount of products to work through.

Secondly, the information flow, indeed, as I called out, is something that we are investing in to improve it, to just improve our agility to address the volatility in the market better across the different product lines that we have.

So whilst we see improvements – and also you call out, for example, freights, we expect to get better logistics towards next year – we still see that we need to work through quite significantly on that.

And on the second question on biocompatibility, yes, we have a lot of testing ongoing. Actually, it's internal, but also very much external, because we want to ensure that we have the external validation coming in. So that's actually continuously a dual programme. But it's, as I said, not yet at a stage that we can share the outcomes.

On the litigation side, we have currently around still a registered amount of 50,000-60,000 this time, so it has indeed increased a bit. We also have started now some of these processes in the market, where the science day is starting so you see the first kind of dialogues starting. But as we also shared before, it's too early to, kind of, predict any outcome of it. So we will come back when we have further news on that. But it's indeed true that we increased a bit in the number there.

**Graham Doyle:** That's great. Thank you. Maybe just one quick follow-up on biocompatibility. Could you just maybe explain or give some background in terms of the actual parameters and the testing that you have asked a third-party to do? So how much input has the FDA set[?]? Like has it been, here's a standardised test we expect you to do? Or did you design these protocols from scratch?

**Roy Jakobs:** So we have – of course, there are standards in the market that you have to comply with. So that's the first guidance that we put our testing towards. Secondly, you rightly say that, kind of, we are in constant dialogue with the FDA as well to, kind of, look at the testing protocols that we use. They also have actually a continuous input from our side on our testing data. So actually, we share the data that become available on a regular basis with them so they, in essence, have access to those data and then also give their views on it.

So this is a process that is in collaboration with the FDA but also with other regulators, because they're also very interested, of course, in this. So it's a combination of the standards that we test again, but also if you have additional testing that we do, we will share protocols that we use for feedback.

**Graham Doyle:** Great. Thank you very much.

**Operator:** Thank you. We will now go to our next question. And the next question comes from James Vane-Tempest from Jefferies. Please ask your question.

**James Vane-Tempest (Jefferies):** Hi, good morning. Thanks for taking my question. Just firstly on R&D. You mentioned shifting to fewer high-impact innovations, which, I guess, increases the R&D concentration risk and makes the timing of launches more lumpy. Just looking at the €120 million write-down in D&T, can you give us some examples of the types of innovation which have been shelved and what you'd consider higher impact and how this impacts the timing of launching new innovations?

And then my second question is just on cash flow. You talked in Q3 about the consumption of provisions impacting operating cash flow. Just wondering what we can expect on that in Q4? And given your restructuring plans, can you give us a sense of where leverage is expected to land at the end of the year? Thank you.

**Roy Jakobs:** Thank you, James. So maybe starting off with the R&D question, and Abhijit can take the second one. So if we look at concentration risk that you mentioned, I would say that we have been more looking at innovation that was in the pipeline that actually was more fragmented, is further out and, indeed, doesn't generate the impact on scale that we expect from some of the innovations that we have currently in the market and that is working. So it's something that we have been looking at as part of our – keeping our innovation funnel healthy, making it stronger, and actually choosing the ones that have a better productivity and a better return rate.

Examples of great innovations that we are further, kind of, doubling down on are, for example, the MR helium-free next generation informatics as part of our IGT solutions, but also our monitoring solutions, where we see actually even more in the current markets, where demand is going and stepping also much more across and outside of hospitals to ambulatory and home situations. We see a significant opportunity there that we are further rallying around.

So we're making choices that are connected to what we see as the demand and where the opportunities are in market, as well as that we look at the productivity and business case profile internally. So actually, this should give us a stronger pipeline for the future with a better return. That is the aim of the exercise that we're going through.

**Abhijit Bhattacharya:** Yeah, regarding the cash out, we will expect about a couple of hundred million. And this is when you say out of the provision, they have two parts. One is the – on the recall action. The other is on restructuring. So if you take both of them, that would be maybe close to between €300-350 million in the third quarter – in the fourth quarter.

In terms of leverage, we will not be significantly higher than where we are now. And that's why I said we've taken this more as caution to see that we have enough liquidity because the cash conversion of our inventories has pushed to next year. And that's why I said fourth quarter will have a positive free cash flow of €600 million because it is normally a much bigger quarter. But this time, we will have – let's say, we've take lower sales in our outlook and, therefore, slightly lower cash flow.

**James Vane-Tempest:** Thank you. And just to clarify one of the earlier points. So on the R&D, then it sounds as if it's more about focusing resources on what can deliver innovation in the short term, and, sort of, the medium to longer term initiatives are perhaps on the back burner for now until the business recovers. Is that a fair way to summarise that?

**Roy Jakobs:** No, I think we are improving. We're looking at the funnel. And I think we have room to, kind of, strengthen the funnel in terms of where we believe the biggest impact will be in the leadership position with exciting outlook. I think there is also a common practice in terms of what you do in pruning your funnel continuously. And let's not forget that actually, our R&D spend still is actually very significant with a 9-10% across the company. So it's not that we are straightaway cutting to the bone. Actually, [inaudible]. We're not slowing down. We want to accelerate the ones that we have in the pipeline where we see the better prospects and a better return profile.

**Abhijit Bhattacharya:** Yeah, so it's not about short-term versus long-term. It's really investing and resourcing our bigger wins more than we've done in the past.

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

**Operator:** Thank you. We'll now go to our next question. Please stand by. Your next question comes from the line of Falko Friedrichs from Deutsche Bank. Please go ahead and ask your question.

**Falko Friedrichs (Deutsche Bank):** Yes. Thank you very much. Good morning. My first question is on the targeted annualised savings of €300 million. So when do you expect to reach that level? And related to that, what is the expected net impact next year, considering wage inflation and all of the other inflationary pressure?

And then my second one is a quick follow-up on these conclusive test results. Understandable that you don't want to commit to a specific date, but is it fair to assume that we should get these test results this year still? Thank you.

**Abhijit Bhattacharya:** Hi, Falko, let me take first the targeted saving. That is the annualised savings, right? We plan to have most of the restructuring action completed by the end of the first quarter so then you would probably get something like €200-225 million in the savings for next year. So that would be the impact for next year as I see it.

Regarding the testing, maybe I give that to Roy.

**Roy Jakobs:** Yeah. Falko, we have, of course, all intend to do it as soon as possible. We need to do it right. We need to have it aligned. So therefore, I cannot commit to a date. Of course, I would love to see this year happening. But yeah, we will have to keep you informed from the moment that we, kind of, can share the results.

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

**Operator:** Thank you. Your next question comes from the line of Sezgi Oezener from HSBC. Please go ahead. Your line is open.

**Sezgi Oezener (HSBC):** Good morning. Thanks for taking my questions. I have three please. First of all, the €1.2 billion goodwill impairment, can you help us deconstruct that in terms of what – how much of that is coming from the estimated impact of the consent decree and how much is coming from the change in the discount rate?

Second question is, as seen, the settlement dates for the forward share purchase transactions have been pushed into 2023 and 2024 from 2022, while dividend is – commitment is maintained. And also couldn't help but notice that the cash figure declined somewhat by third quarter. So I also appreciate that you have the €1 billion additional credit facility. But what are your plans and how much of the recall costs are completed? I see 4 million out of 5 million, 5.5 million devices were produced but how much per the costs do you estimate from that?

And a final one as a follow-up, please. Do you expect the 4,000 full FTE reduction to fully come from the existing businesses, or does it include any exits or divestments? Do you have that on the plan?

**Abhijit Bhattacharya:** Yeah. So maybe going to the first one, about a fifth – so about 20% of the impairment comes because of the change in the weighted average cost of capital. The rest comes from assumptions that we have made in terms of lower cash flow from the business going forward with potential actions that could be required by the FDA, as part of

the consent decree. Now, those are our best estimates at this point of time. And since we are in discussions with the FDA, it becomes very difficult to make those public at this time. So once we have that signed, we will of course make it public.

Now, regarding the settlement dates of the forwards, most of them – so I think about 80 million or so comes in Q4, which we will settle and then most of it comes next year. So about 75% of the balance comes next year. And then the remaining part, the 25% is in 2023. So it's not pushed out. It is just we – earlier we had planned to pull it into this year and that was in the first quarter. We're just going back to the original dates that were committed. So we are not pushing it out.

As far as the recall provision is concerned, currently, we don't see the need to increase the provision. We have been utilising it. And by the end of the year, yeah, we would have, as Roy mentioned, completed 90% of the recall. And the use of the provision may be a bit lower than 90%. But as the last pieces of the remediation is done next year, we will complete the use. But right now, we don't see any need for, let's say, increasing that provision.

Regarding the people, they largely come from existing businesses. They are not related to any divestments. So let me make that clear. There could be some smaller, really smaller businesses which we stop, but it's not a divestment. It's a very, very small – I'm talking about the €10 million or €20 million annual revenue kind of thing. So that's how you should look at it. It comes primarily from existing setup that we have today.

**Sezgi Oezener:** Thanks a lot. And if I may follow-up, the reduced revenue expectation – reduced cash flow expectation, which is related to the goodwill impairment in the Sleep segment, does that have to do also with the R&D projects that are being rationalised right now or –?

**Abhijit Bhattacharya:** No.

**Sezgi Oezener:** Okay.

**Abhijit Bhattacharya:** Not at all. This is completely separate.

**Sezgi Oezener:** Thanks.

**Abhijit Bhattacharya:** Thank you.

**Operator:** Thank you. We'll go to our next question. And the question comes from Wim Gille from ABN AMRO-ODDO. Please ask your question.

**Wim Gille (ABN AMRO-ODDO):** Yes. Good morning. I have a question on the headcount reduction. In the Dutch press, you mentioned that you will see, in the Netherlands, 400 forced reductions on a total employee base of 11,000. And on top of that, you will see 400, let's say, natural attrition. So, in total, 800 reduction in the Netherlands in terms of headcount. How should I compare the number here? Is it the 800 comparable to the 4,000, or is the 4,000, the, kind of, global force reduction and on top of that, you will have a bit of natural attrition as well?

And maybe as a follow-up in relation to that, your natural attrition is slightly more than 10% in a normal year. So that means that in a normal year, you have about 7,500-8,000 natural attrition, people leaving the firm. How should we look at, let's say, hiring at Philips at the

moment? Or how should we look at the total employee base in the coming, whatever, one, two years, given the structural headwinds that we're facing? Thanks.

**Roy Jakobs:** Thank you, Wim. Maybe let me take it. In terms of the 400 forced layoffs, that's indeed true. You mentioned the other 400 coming out of attrition, I think that's too small of a definition. We will look also at temporary force to actually take into that account so that's also where you see the difference with the 10% of attrition. So attrition, of course, will be looked at and used for outflow, but also we will reduce temporary workers.

So if you compare the 800, that's indeed a comparable number 4,000. And then we look at a global base, kind of, how we exactly populate that. We also work through the different countries structures and the local regulations and the workers councils, etc., that will be involved. So this will be done in a proper manner. But the compare we need to make is 800 to 4,000. And then there's also temporary labour in that.

Secondly, we will, of course, also make sure that we have a hiring, kind of, reduction, and therefore we'll be very careful in hiring when we also exit people. At the same time, we will continue to upgrade and where we need to have capability injection or where we need to have specific expertise, of course, we will hire that into the market. So I think we will be cautious, but we will not go into full stop because we will continue to support the business with the needs in specific expertise areas.

**Wim Gille:** So, to be, let's say, clear there, in the last three year, your headcount increased every single year, whereas your top line did not increase accordingly. So will we have a better balance in the coming, let's say, one, two years, with, let's say, the total headcount of the company compared to the top line development?

**Roy Jakobs:** Yeah, I think we – so if you look to the headcount development, I think it was not a full like-for-like compare because we also have acquired companies, as you know, so I think we need to look at like-for-like. But at the same time, I think it's obvious that now with several quarters of decline in revenue, sales, profitability, we also need to decline the amount of people in line with that.

We also signalled that this is an immediate initial action. I will be looking at the further plans and come back to you in January in terms of how we fully capture the potential of Philips, based on what we see outside as, kind of, the market and demand for our solutions, but also what is then the appropriate structure for that. And I will continue to simplify and increase agility, but also productivity.

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

**Operator:** Thank you. We'll take our next question. And the question comes from Ed Ridley-Day from Redburn. Please go ahead and ask your question.

**Ed Ridley-Day (Redburn):** Good morning. Thank you. Firstly, thanks for the clarity on your restructuring initiatives. If we look at the safety and quality control process, and then the investment and restructuring you're looking at, the focus you would like to bring there, Roy, could just give us a little bit more detail about how you envision improving that process, where particularly you might invest? Are you looking to bring in also senior hires, perhaps, from other med-tech companies? Because clearly, that is an area where, for many reasons, over the years, Philips has struggled, and then clearly addressing that will create a very

strong basis going forward. So if you could give us a little bit more colour on that process, that'd be very helpful.

And secondly, we talked a lot about focus obviously around R&D this morning. But just bigger picture for you, as you've arrived, if you could, sort of, sum up where you would like to see Philips in two or three years' time? Also related to focus, is there or are there parts of the portfolio, which perhaps, as part of your ongoing review, that you might look to change? If you could speak to that, that'd be helpful.

**Roy Jakobs:** Thank you, Ed. Let me start with patient safety and quality. And, indeed, as I outlined, we have and I have put a lot of focus on improving execution, because execution will help us to convert our order book and therefore realise better results. And doing that firstly starts with, indeed, the right focus on patient safety and quality. What we are doing there and where we will be also further deepening the effort is, as you rightly call out, of course, there is a capability and culture question that we are addressing, which means that we have been actually hiring and upgrading the quality regulatory team.

But it goes further, because if you want to address quality, you need to actually inject quality across your innovation process, across your delivery process. And that's the next level that we're taking. So how can we actually also fully embed that end to end in our organisation beyond the function?

Secondly, we're looking very strongly at the product portfolio that is in strong demand for the future and how we actually make that the best quality portfolio that we have. So that's something that we will also come back to in the January plan, which are the focus areas and how are we going to address that.

If you look to the current quality and regulatory team, just as a data point, at the Group level, we have actually 70% new executives, all coming from med-tech. So if you look at the team of Francis Kim, who's leading that for us currently, he has assembled a team that comes from Stryker, Medtronic, Abbott, Pfizer, Boston Sci. So we're really assembling a very experienced team of quality and regulatory professionals that actually will help us to actually step up in this area. So that's a big area of focus that we will continue to double down on.

Then, on the bigger picture asset, I will come back in January on my exact view on that, including which are the areas that we see the biggest growth and potential in the market; which are the segments where we see the demand going and how are we lined up with our leadership positions to actually capture that potential; which are the focus areas that we will go after.

So then I will come back to that question and will then look at the products, the portfolio, the full set of, kind of, how we intend to win in the market moving forward because we have a great potential. As I said, we have a great order book, and we want to create even more impact so that will be part of the plan that I will present in January to all of you.

**Ed Ridley-Day:** Great. Thank you.

**Operator:** Thank you. The last question comes from Robert Davis from Morgan Stanley. Please state your question.

**Robert Davis (Morgan Stanley):** Good morning. Thank you for taking my questions. I had a couple. One was on just the Diagnostic & Treatment business. Could you give us a little bit

more colour in terms of where you're seeing the relative strengths and weaknesses within that? I know you've had, sort of, three quarters now of negative organic sales growth, but I think it was up 3% in the quarter in terms of orders. So, just would be interested in the relative moving parts there.

And the other one was just in the Connected Care business. You've obviously seen a margin deterioration in the fourth quarter. And I think the previous comments, you said you're expecting a pickup in the back half of the year underpinned by an improvement in the patient monitoring business. Are you still comfortable, confident with that kind of inflection in for 4Q? And yeah, if you could just, kind of, walk us through the moving parts on the margins in that division as well, given the deterioration. Thank you.

**Abhijit Bhattacharya:** Yeah. Robert, let me take that. I think, overall, in Diagnosis & Treatment, we are – as I also mentioned earlier, we are doing extremely strongly in MR. Roy mentioned that as well, that the order book is so long that we will even not be able to supply it all next year. I think in Image-Guided Therapy, that is our forte, and there also we have been continuing to grow market share and size.

The other one we talked about was Informatics. I think there also we are growing extremely strongly. Actually, our ultrasound business order intake remains extremely strong. It's very unfortunate that due to a couple of components that we are not able to deliver, but as we start next year, our backlog for ultrasound is probably 2.5 times what it is normally at the start of the year.

So I think across these modalities, we see strong growth, and probably in the area of CT, we remain flattish. So that's how I would complete the whole look.

On the CC margin decline, unfortunately, there are too – it's a strong decline. So it's important to explain it. There are two big factors. One is the decline in hospital patient monitoring. And I think there, you will see a good recovery in Q4, as we, kind of, are able to deliver more. It's a high gross margin business. And if you don't deliver, unfortunately, you have all your fixed costs, which hit the P&L.

And secondly, in the Sleep and Respiratory business, we have had lower sales in masks in this quarter. That's a high margin part of our portfolio. So that hits us a bit. And there were a couple of supply stops that we had for quality related issues, which we have spoken about earlier, that also hits us a bit in this quarter.

So you will see Connected Care margins improving in the fourth quarter, but this quarter was, yeah, hit heavily because of the reasons I just gave.

**Robert Davis:** That's great. Thanks both.

**Roy Jakobs:** If no further questions, shall we check?

**Abhijit Bhattacharya:** Yeah.

**Operator:** Thank you.

**Roy Jakobs:** Operator, do we have any further questions?

**Operator:** Thank you. There are no further questions. I will hand back to you.

**Roy Jakobs:** Okay. Thank you, operator. So, thank you all for dialling in. We appreciate the opportunity to engage. As we started, we have a disappointing Q3 behind us and a challenging outlook but a very strong order book. We're taking immediate and decisive measures to improve quality, improve supply chain and improve productivity. We will stay on that to actually go back to a delivery[?] profile of quarter-over-quarter improvement. And I look forward to come back to you with a more comprehensive plan at the Q4 results.

Also a big thank you, of course, for all our employees for putting all their effort in this and also for going through a difficult moment, because we did announce head restructuring which is impactful as you can imagine. It's a very necessary measure we need to take, but, of course, it hurts every single affected employee and all of us.

So, thank you for your attendance. Any further questions, you will know how to find us also through our IR channel. Look forward to continue to engage with you. Thank you all.

**Operator:** Thank you. [Inaudible] quarter 2022 results conference call on Monday, 24<sup>th</sup> October 2022. Thank you for participating. You may now disconnect.

[END OF TRANSCRIPT]