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PHIA.AS - Q4 2016 Koninklijke Philips NV Earnings Call

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OVERVIEW:

Co. reported 2016 YoverY comparable sales growth of 3% and 4Q16 YoverY comparable sales growth of 3%.



CORPORATE PARTICIPANTS

Pim Preesman *Koninklijke Philips NV - Head of IR*

Frans van Houten *Koninklijke Philips NV - CEO*

Abhijit Bhattacharya *Koninklijke Philips NV - CFO*

CONFERENCE CALL PARTICIPANTS

Ian Douglas-Pennant *UBS - Analyst*

Mark Troman *BofA Merrill Lynch - Analyst*

Ben Uglow *Morgan Stanley - Analyst*

James Moore *Redburn Partners - Analyst*

Andreas Willi *JPMorgan Cazenove - Analyst*

Gael De-Bray *Deutsche Bank Research - Analyst*

Max Yates *Credit Suisse - Analyst*

Daniel Cunliffe *Liberum - Analyst*

Jonathan Mounsey *Exane BNP Paribas - Analyst*

Peter Reilly *Jefferies - Analyst*

Alok Katre *Societe Generale - Analyst*

Veronika Dubajova *Goldman Sachs - Analyst*

Marc Scharz *Henderson Global Investors - Analyst*

PRESENTATION

Operator

Welcome to the Royal Philips' fourth-quarter and full-year 2016 results conference call on Tuesday, January 24, 2017. During the introduction hosted by Mr. Frans van Houten CEO and Mr. Abhijit Bhattacharya CFO all participants will be in a listen-only mode. (Operator Instructions). Please note that this call will be recorded and is available by webcast on the website of Royal Philips.

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

Pim Preesman - Koninklijke Philips NV - Head of IR

Thank you. Good morning, ladies and gentlemen. Welcome to Philips' fourth quarter and FY16 results conference call. I'm here with our CEO Frans van Houten and our CFO Abhijit Bhattacharya.

On today's call, Frans will take you through our strategic and financial highlights for the period. Abhijit will then provide more detail on financial performance and market dynamics. After that we will take your questions.

Our press release and related information slide deck were published at 7:00 AM CET this morning. Both documents are now available for download from our Investor Relations website. A full transcript of this conference call will be made available by tomorrow on our Investor Relations website.

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



First, as you know, Philips retains a 71.225% stake in Philips Lighting and, therefore, continues to consolidate Philips Lighting's results. However, since Philips Lighting reported its Q4 and full-year 2016 results on January 23, we will focus our commentary on today's call as much as possible on the performance of our HealthTech portfolio.

We encourage you to review Philips Lighting's fourth quarter and annual results materials, which are available on the Philips Lighting IR website.

Second, as a reminder, following the decision in 2014 to combine our Lumileds and Automotive Lighting businesses into a standalone company, the profit and loss of these combined businesses is reported under discontinued operations and the net assets for the business in the balance sheet underlying assets held for sale.

The cash flow of the combined Lumileds/Automotive businesses is reported under cash flow from discontinued operations.

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

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

Frans van Houten - *Koninklijke Philips NV* - CEO

Thanks, Pim. And thank you, everyone, for joining us today.

2016 was a defining year for Philips, in which we completed our transformation into an innovative health-tech leader, with key competitive differentiators and a solid platform for profitable growth.

During 2016, we executed on significant milestones of our strategic roadmap.

We successfully listed our Lighting business in May, after extensive preparations, where we executed on the separation project on time and below cost. This has given Philips Lighting the opportunity to further build on its leadership position in the exciting lighting industry.

Secondly, after battling difficult circumstances in a limited buyer universe, we are pleased that we have found a good home for our combined Lumileds and Automotive businesses and are on track to close the transaction.

It is important to note that the combined Lumileds and Automotive businesses had a very strong second half of the year, as we had expected, and have ended the year with good momentum, with an adjusted EBITA for the year of 20%.

We have successfully integrated the Volcano business, which had a stagnant top line at the time of the acquisition in 2015, and it has delivered double-digit growth in the last four quarters and also contributed to the double-digit sales growth in our Image-Guided Therapy business, overall, for the last two quarters of 2016.

Moreover, we have reduced over \$40 million in cost to drive the Volcano business to profitability.

We have successfully acquired and integrated PathXL, a Northern Ireland-based leader in digital pathology image analysis, workflow software and educational tools. PathXL's image analysis and tissue pathology software will complement Philips' digital pathology solutions offering and help expand our leadership in this fast-growing field.

Then we have acquired Wellcentive, a leading US-based provider of population health management software solutions. With this strategic acquisition, we strengthen our Population Health Management business and leadership, as health systems gradually shift from volume to value-based care and provide more preventative and chronic care services also outside of the hospital.

These moves, as I've described them, have positioned us well to capture the tremendous opportunities that we see in the health-tech domain.

We are pleased with the performance of our HealthTech portfolio in the fourth quarter. Growth and margin improvements across all of our HealthTech operating segments drove comparable sales growth of 5% for the fourth consecutive quarter and 190 basis point increase in adjusted EBITA margin to 15.3% for the quarter.

Overall, the Philips Group had 3% comparable sales growth and 190 basis point increase in adjusted EBITA margin in the fourth quarter, driven by higher volumes and cost productivity in each of the segments, partly offset by a higher level of investment in growth initiatives and innovation.

We achieved an adjusted EBITA of 10.5% for 2016, which is a year-on-year improvement of 130 basis points and at the low end of our guidance of an adjusted EBITA of around 11%.

During 2016 our three Accelerate! Cost-saving programs all delivered ahead of plan, with EUR269 million of gross savings in overhead cost, EUR418 million of gross savings in procurement and EUR204 million of productivity savings, driven by the End2End process improvement program.

There are significant opportunities ahead as a focused health-tech company and we are delivering on these opportunities through three key strategic initiatives going forward.

First, we will continue to improve margins by better serving customers and improving productivity.

More specifically, we are continuing the self-help journey that we began with our Accelerate! program in order to improve quality, operational excellence and productivity on an ongoing basis by lowering our cost of goods and non-manufacturing cost.

Along with these efficiency improvements, we will continue to lead the digital transformation in connected healthcare. We are unlocking value for both patients and providers by delivering more effective coordinated and personalized care. Our customers and partners know that they can turn to us and our HealthSuite platform to manage patient health by leveraging real-time patient data and clinical analytics.

This leads us to the second initiative. We are boosting growth in our core business by extending relationships to capture opportunities in all geographies and deepening partnerships through consultative customer partnerships and business models.

And, finally, we are able to do this because of our third initiative. We are developing and delivering winning innovative solutions across the health continuum.

Philips' integrated suite of systems, smart devices, software and services are improving outcomes and productivity, which is driving growth through portfolio extensions and through organic investments, partnerships and supplemented with focused M&A. The performance of our HealthTech portfolio in 2016 demonstrates that our strategic focus is paying off.

Order intake growth in the fourth quarter was flat, which is in line with our expectations and comes, actually, on the back of a strong double-digit order intake growth during the fourth quarter of 2015 as well as a 8% order intake growth in the third quarter of 2016.

We are particularly pleased with the strong order intake in China, Latin America in 2016, which, after a weak 2015, showed strong double-digit comparable order intake for the year.

Overall, order intake growth in the year was 1%, with the second half of the year gaining momentum with growth of 3%.

The Personal Health businesses grew by 7% on a comparable basis, aided by the sell-in for Chinese New Year, which is in January 2017 compared to February in 2016.



There was growth across the portfolio, led by double-digit growth in Health & Wellness and high-single-digit growth in Domestic Appliances, while the adjusted EBITA margin improved by 100 basis points in the fourth quarter.

For the Personal Health businesses in mature geographies we had comparable sales growth in the high-single digits, driven by double-digit growth in Western Europe and high-single-digit growth in North America. This was partly offset by a low-single-digit decline in other mature geographies.

In growth geographies we had mid-single-digit growth, driven by double-digit growth in China, Central & Eastern Europe and Middle East & Turkey, partly offset by a double-digit decline in India, which was largely due to the effects of what is called demonetization.

We remain committed to sustaining a mid- to high-single-digit sales growth in Personal Health, enabled by our strong innovation pipeline.

Through our focus on locally relevant value propositions and ability to leverage our digital capabilities, the Personal Health businesses posted strong double-digit online sales growth in China. And that was driven by Oral Care and Air businesses, where Philips is the number 1 brand in China.

Building on the success of the Philips' integrated Dream Family solution in the United States, Europe and Japan, we recently introduced a Philips DreamStation Go portable CPAP solution. DreamStation Go is a compact and lightweight device designed to provide sleep therapy for travelers with obstructive sleep apnea.

Switching to our Diagnosis & Treatment business, which posted comparable sales growth of 3% and the adjusted EBITA margin improved by 280 basis points, driven by double-digit growth in Image-Guided Therapy, where we are benefiting from ongoing synergies from integrating Volcano in Image-Guided Therapy.

Our improvements in Cleveland continued and our investments to augment our quality standards remain on track. For the full year, Cleveland-related activities contributed improvements of approximately EUR76 million to the adjusted EBITA.

Our investments in innovations are paying off within Diagnosis & Treatment, where we are enabling first-time-right diagnosis, precision interventions and therapy; all foundational to precision medicine.

Our strong solutions capabilities resulted in significant expansion of our long-term strategic partnerships as we entered into 15 new multi-year contracts with an aggregate value of approximately EUR900 million. And I see many more opportunities for Philips to grow by leveraging our deep clinical and consumer insights to deliver innovative healthcare solutions to our customers.

In the fourth quarter we entered into a 10-year EUR74 million agreement with the Expert Group of Companies, one of Russia's leading network of healthcare centers and clinics, to modernize the regional healthcare infrastructures and make the delivery of patient care in Russia.

This partnership is very much in line with our strategy to forge multi-year strategic customer partnerships. They'll provide solutions combining advanced imaging systems with clinical informatics to improve cardiac care. And, as the network's technology partner, we will also provide deep clinical expertise, consulting services and technology planning for multi-disciplinary medical centers and specialized cardiac centers.

Building on the successful collaboration between Philips and the US health system Banner Health in the area of remote monitoring of acute patients in intensive care units and remote monitoring of high-risk chronic patients at home, we now have entered into a 15-year strategic partnership to provide insight into the needs of greater patient populations through the use of our Diagnostic Imaging solutions, which will be a major focus of the partnership.

Together, Banner Health and Philips will conduct an end-to-end analysis of Banner's extensive inpatient and outpatient imaging capabilities to drive operational efficiencies and create a connected clinical environment to support Population Health Management programs.

Further, we are continuing to deepen our market penetration in Image-Guided Therapy solutions, where we saw a strong growth of peripheral imaging and therapy categories in the United States. And we are expanding in new geographical markets, such as Asia Pacific.



In October we incorporated our Volcano catheter-based imaging and measurement solutions into our robust portfolio of interventional cardiology solutions in Canada, where we serve 85% of Canadian hospitals with cardiology solutions.

In Image-Guided Therapy systems we have developed an industry-first augmented reality navigation technology to guide minimally invasive spine surgery; a fast-growing new market for Philips.

Turning to the Connected Care & Health Informatics business, comparable sales increased 4%, driven by mid-single-digit growth in Patient Care & Monitoring Solutions and Population Health Management. And the adjusted EBITA margin improved by 50 basis points.

In the mature geographies we had mid-single-digit comparable sales growth, driven by double-digit growth in Western Europe and other mature geographies, while North America posted low-single-digit growth. Growth geographies showed a mid-single-digit decline with double-digit growth in Latin America offset by a double-digit decline in China and Middle East & Turkey.

In today's healthcare environment it is more important than ever to seamlessly connect consumers and care professionals to provide actionable insight and better health and economic outcomes.

In the fourth quarter, within Patient Care and Monitoring Solutions, we launched the latest version of our IntelliVue Guardian solution in Europe, which has expanded our global leadership in patient monitoring solutions beyond acute care settings.

Our solution comprises of smart devices, such as wearable biosensors, and clinical decision support software and services that help clinicians to recognize early subtle signs of patient deterioration in hospitals' general wards, allowing for timely intervention and improved patient outcomes.

In Healthcare Informatics, Solutions & Services we are the global leader in advanced clinical informatics. We have made great progress in turning the business model to a so-called platform as a service, or PaaS, and software as a service, SaaS, business model, which are higher margin models with recurring revenue streams and, therefore, we expect to continually improve the margins of the business.

At RSNA 2016, the largest radiology show in the world, we launched a high-performance universal data manager. Our new solution helps healthcare enterprises to organize large data sets, including millions of images and other data from multiple sources. This complements our Philips IntelliSpace Healthcare Informatics portfolio, which consists of our Illumeo Adaptive Intelligence and IntelliSpace Portal 9.0, advanced visualization and quantification platform.

At the RSNA we also launched PerformanceBridge; a new suite of operational performance improvement software and services for radiology departments.

Finally, as part of our focus on oncology, we extended our genomics analytics activity in the fourth quarter, driven by the strength of our Philips IntelliSpace genomics clinical informatics platform.

First of all, we are teaming up with Illumina, a leader in DNA sequencing technologies, to offer integrated solutions for genomics data in cancer research. Together we are acquiring, analyzing, annotating and interpreting genomics data in oncology cases.

In addition, we have launched a collaboration with the company, N-of-One, a molecular decision support leader, to accelerate innovation in the clinical interpretation of cancer genomics.

Both of these partnerships are significant steps forward for our oncology initiatives, where we are unlocking the value of genomics for a much wider group of laboratories and care providers and advancing genomics initiatives at a greater speed with the aim of better patient outcomes.

As you all know, our products and related services are subject to various regulations and standards. We are committed to quality and over the last years we have made investments enabling significant progress in this area. We are currently in discussions on a civil matter with the US Department

of Justice, representing the US Food and Drug Administration, arising from past inspections in and before 2015, focusing primarily on our external defibrillator business in the United States.

To give you some additional color, the size of this business globally is less than EUR290 million and the part under discussion is less than one-half of that business. That is not a proxy to estimate financial impact, which cannot be made until the discussions are concluded. However, we do anticipate a meaningful impact on the operations of this particular business. Since the matter is under discussion, we are unable to give any further details at this moment.

Ladies and gentlemen, looking back, we have made significant progress during 2016. We have made significant strides in executing on our strategic agenda and we have delivered strong improvements in our operational performance.

Our improvement in adjusted EBITA margin of 130 basis points during the year, combined with a 5% growth in our HealthTech portfolio, provides evidence that our strategy of focusing on the HealthTech domain is delivering results.

For 2017, despite elevated uncertainty in the markets in which we operate, we will continue to improve our underlying performance and target to deliver 4% to 6% comparable sales growth and, on average, a 100-basis-point improvement in the adjusted EBITA per year for the next three to four years for our HealthTech portfolio.

As mentioned earlier, our order book development had strong momentum in the second half of 2016 and, as a result, we expect 2017 to be a back-end loaded year as well.

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

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

Thank you, Frans. Good morning to all of you on the call and the webcast. Let me start by providing some color on the fourth-quarter growth of 5% for the HealthTech portfolio.

On a geographic basis, mature geographies delivered mid-single-digit comparable sales growth, with both Western Europe and North America growing mid-single digit, while other mature markets achieved double-digit growth.

Personal Health recorded high-single-digit growth; Connected Care & Health Informatics mid-single-digit growth; and Diagnosis & Treatment low-single-digit comparable sales growth.

In the growth geographies mid-single-digit comparable sales growth was largely driven by double-digit growth in countries like Argentina, Mexico, Chile, Turkey, Indonesia and Singapore and partly offset by double-digit decline in India.

In the growth geographies, Personal Health and Diagnosis & Treatment recorded mid-single-digit growth for the quarter.

In HealthTech Other, sales increased by EUR27 million, mainly due to higher royalty income and one-time patent license deals.

Turning to order intake, comparable currency order intake was flat year on year, as expected, on the back of a strong double-digit comparable sales growth in the fourth quarter of 2015.

Connected Care & Health Informatics grew in the low-single digits, while Diagnosis & Treatment recorded a low-single-digit decline.

In growth geographies order intake on a currency comparable basis showed high-single-digit growth, driven by Latin America. North America posted low-single-digit growth. Western Europe posted a double-digit decline compared to a strong double-digit growth in the fourth quarter of 2015.



Let me now turn to the EBITA development for the Group in the fourth quarter.

The adjusted EBITA margin of 13.8% in the quarter was 190 basis points higher than the year before. This strong margin increase was driven by an improvement of 100 basis points in Personal Health; 280 basis points in Diagnosis & Treatment; and 50 basis points in Connected Care & Health Informatics; and 180 basis points in Lighting.

Our underlying operational performance contributed 160 basis points to the adjusted margin in the fourth quarter as our Accelerate! program continues to improve operational performance and drive efficiencies.

More specifically, overhead and End2End productivity programs amounted to EUR152 million; partly offset by investments in new business areas, brand campaigns, cyber security, etc., which led to a net contribution of EUR34 million.

Design for Excellence, or DfX, delivered EUR163 million of additional bill of material savings year on year, which is on top of our normal run rate procurement savings of EUR96 million.

In addition to the operational improvement of 160 basis points, the improvement in the adjusted margin was supported by 50 basis points of positive financial contribution from Cleveland, which was partially offset by a negative impact of currency translation effects of 30 basis points.

In HealthTech Other the adjusted EBITA was in line with the fourth quarter of 2015 and reflected high royalty income from one-time patent license deals, partly offset by investments in innovation brand campaigns and cyber security.

In the fourth quarter the income tax expense was EUR198 million, which was an increase of EUR46 million compared to the fourth quarter of 2015. The increase was mainly due to higher earnings, partly offset by one-off tax benefits.

On December 20, 2016 we announced our intention to redeem the outstanding 5.75% notes due in 2018 with an aggregate principal amount of \$1.25 billion. The redemption resulted in a charge in the fourth quarter of EUR62 million, reflected in the financial income and expenses line. The cash outflow in the first quarter of 2017 will be approximately EUR1.2 billion, excluding accrued interest.

This transaction contributes to Philips' plan to reduce its annual interest expenses by approximately EUR100 million in 2017.

Despite this charge, overall net financial expenses decreased by EUR50 million in the quarter. This was driven by lower interest charges related to the Masimo agreement and the fourth quarter 2015 valuation allowances charges.

Net income from discontinued operations was EUR17 million higher than the fourth quarter of 2015, mainly due to the improved operational performance of the combined Lumileds and Automotive business.

The return on invested capital, which is calculated on a five-quarter MAT basis, was 13.6%, which is almost 5 percentage points above our WACC. ROIC on total Philips, excluding Lighting, amounted to 14.7%.

Our drive to increase working capital efficiencies continues to yield results, as inventories as a percentage of sales decreased to 13.8% year on year; an improvement of 50 basis points. On a currency comparable basis the improvement was 90 basis points.

As we discussed during our Capital Markets Day, our dividend policy is aimed at dividend stability. As such, a proposal will be submitted to the Annual General Meeting of Shareholders to be held on May 11, 2017 to declare a distribution of EUR0.80 per common share in cash or shares at the option of the shareholder. Further details can be found in our fourth-quarter press release.

The Philips Group delivered significant improvements in 2016, as we delivered 3% comparable sales growth and adjusted EBITA margin improvement of 130 basis points. And I'm pleased that our focus on cash and working capital efficiency resulted in a cash flow from operating activities of EUR1.9 billion.



Let me now provide you with some healthcare market perspectives for the US, Western Europe and China.

We see some uncertainty in the US market with regards to the Affordable Care Act. With the passage of the FY16 budget resolution in mid-January, the Republican-controlled Congress has begun the process to repeal and replace the Accountable Care Act.

The policy and political uncertainties around the ACA repeal and replacement effort center on a number of areas, including the lack of a single clear Republican alternative to the ACA. These uncertainties, which are likely to continue for some time, were underscored with the broad executive order stating that it is the policy of the new administration to seek the prompt repeal of the ACA.

Even with this recent development, several questions remain, including what will happen to those who participate in the ACA's expanded health insurance coverage and, of course, how long will this process take?

Nevertheless, fundamentally we believe that the imperatives that drove the adoption of the ACA in 2009, that is controlling healthcare cost, improving the quality of care, increasing the number of Americans with healthcare coverage, are still at work. These imperatives will compel political efforts in this arena, continue the focus on value-based care and resolve the current uncertainties in the US market.

Because Philips' solutions and strategies are aimed at addressing these imperatives and leveraging value-based care, we believe we continue to be well positioned in the US market.

In other areas of healthcare policies we regard Medicare reforms, including MACRA, which incentivizes physicians to transition from fee-for-service to value-based payment programs, and similar value-based models introduced by the center for Medicare and Medicaid innovation to remain in effect.

Given these dynamics, we expect the US market growth to be in the low-single digits while we closely monitor further developments.

Looking at Europe, a declining market in 2016 can be attributed to flat growth in the larger markets, such as Germany, Switzerland and Austria, combined with high-single-digit decline in smaller markets, such as Central & Eastern Europe, the UK and Ireland.

In Central & Eastern Europe transition from legacy healthcare funding programs is negatively impacting the market.

In the UK an NHS budget cut, combined with uncertainty associated with the Brexit, are primary contributors to a weaker market in 2016.

For 2017 we expect modest low-single-digit market growth in Europe.

In China a key growth driver is the Government's focus on improvement of the level of care provided in existing tier 2 and tier 1 hospitals. In tier 3 hospitals we continue to see a gradual shift in demand to more integrated enterprise-wide solutions and emerging contemplation of population health management.

Based on this we expect market growth to be in the mid-single digits for 2017.

Overall, we estimate the global healthcare market growth to be in the low-single-digit range for 2017.

Let me now turn to our 2017 guidance for HealthTech portfolio of businesses.

Overall, restructuring for 2017 is expected to be approximately 65 basis points, which is in line with our Capital Markets Day guidance. Acquisition-related costs are expected to be approximately 20 basis points.



In the Healthcare Other segment we expect net cost of approximately EUR40 million in the first quarter and approximately EUR100 million for the full-year 2017, both at EBITA level. Included in these numbers are negligible restructuring costs and other incidental items in the first quarter and approximately EUR40 million for the full year.

IP royalties are expected to be EUR25 million to EUR35 million lower compared to last year; in large part during the first half of the year.

Following the successful IPO of Philips Lighting in May last year, we expect remaining separation costs for the first quarter to be EUR20 million and approximately EUR30 million for the full-year 2017. Other legacy items are expected to be EUR15 million in the first quarter and approximately EUR35 million for the full-year 2017.

For 2017 we expect the effective tax rate to be around 30%.

Given our order book development as well as the potential one-off margin impact related to our external defibrillator business, we expect improvements in 2017 to be at the back end of the year.

As laid out during our Capital Markets Day in November, and as mentioned by Frans earlier, we continue to target a performance trajectory to deliver 4% to 6% comparable sales growth and, on average, 100 basis points improvement in adjusted EBITA per year for the next three to four years.

With that, we'll open the line for your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ian Douglas-Pennant, UBS.

Ian Douglas-Pennant - UBS - Analyst

So my question is on the defibrillator DOJ issue and, if it's okay, I've got one question with three what I hope are short subparts.

So how -- the key thing is how can we be comfortable this is not indicative of systemic quality controls issue at Philips? Obviously Cleveland's taken longer to resolve than we hoped. I appreciate this is small in the direct impact, but how can we get comfort that this is not wider problems? Perhaps you could talk about the changes you made after Cleveland across the Group rather than just in that one division.

The two shorter follow ups would be, did this impact Q4 results?

And, secondly, will you include the cost of resolving this issue in EBITA adjusted? Or will you exclude them as one-off issues going forward? Thank you.

Frans van Houten - Koninklijke Philips NV - CEO

Let me answer the first question and the other two I'll ask Abhijit to elucidate.

So, as I said, the discussion with DOJ FDA relates to findings of past inspections two years and more in the past, and relate primarily to compliance, to Quality Management System regulations. As such, there is no concern on product quality. In fact, our products are market leading; also, in the area of quality, are highly appreciated by our customers.



Over the last two and a half years, basically, since the major interventions in our Healthcare division, we have invested all across our sites and made significant impact on quality and quality compliance everywhere. I feel confident about that.

Nevertheless, the impact of the past inspections and the subsequent dialog with DOJ means that we will have now the consequences of these past issues and will relate to, let's say, some impact in the business during 2017 as well as expenses on that business.

That is as much as I can say about it. It is unfortunate. Nevertheless, it is certainly not comparable to a Cleveland. It's a much smaller business, which the global business in the defibrillators is around EUR290 million; less than half of that is in the United States. So we need to see it in that context and we will work diligently to get through this discussion.

When the discussion with DOJ ends, we will, of course, immediately inform the market but, at this time, we cannot give further detail. You need to appreciate that, as we are in negotiations, that that is a sensitive matter. But, rest assured, we take it very seriously.

And now I'd like to ask Abhijit to talk about the financial side.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

So building on what Frans said, there is no impact in the Q4 results since we are unable to estimate at this point of time what the potential impact could be.

As far as "adjusted or not," I think we will continue to use our standard definition. If there are impacts which are larger than EUR20 million we take that out of adjusted EBITA, which are one-time impacts. And for the rest, it will be so. Once we know exactly what the conclusion is, then we will give you those further details here.

Frans van Houten - Koninklijke Philips NV - CEO

Maybe one more addition to everybody in the call. So we have now given quite extensive discussion on this. We are not able to give more information at this time about this matter. So, with that, I also hope that you appreciate that there is not a lot of point in going back to this point. Thank you.

Ian Douglas-Pennant - UBS - Analyst

Could I just violate your request that you've literally just made, really quickly? And just confirm that you -- have you stopped selling products that you were selling before? So is the impact entirely a cost issue? Or are we looking at an opportunity cost in terms of lost revenues as well? And then I promise to stop talking after that.

Frans van Houten - Koninklijke Philips NV - CEO

No, no, I fully understand, Ian. After all, it's your job to enquire so I appreciate that. At this time, it's business as usual. We have not concluded with DOJ and we can, at this time, not give you an estimate of the impact on the business. So I have to leave it at that.

Ian Douglas-Pennant - UBS - Analyst

So, as things stand today, there is no impact on revenues? But that might change in the future depending on what DOJ say.



Frans van Houten - *Koninklijke Philips NV - CEO*

Correct. That's correct.

Operator

Mark Troman, BofA Merrill Lynch.

Mark Troman - *BofA Merrill Lynch - Analyst*

Just sticking with the defibrillator subject for a second, Frans, could you say -- I know we don't know the impact but could you say that the issues that are being addressed, are they similar to what we saw in Cleveland, i.e., this is all about procedures? And is it that the remedies that you need to implement, is it a similar sort of process to Cleveland, albeit it seems like the business is a lot smaller? That's question number one.

And then question number two, more one on demand. In terms of your order pipeline, I know you gave your outlook for the regions, in terms of your order pipeline, have you seen any changes, I guess, post the presidential change in the US, any uncertainties coming through in terms of the US demand profile in the near term? Or is it business as usual? Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

All right, Mark. I'm violating my own statement now. It is not similar to Cleveland. We have made tremendous progress over the last two years through our investments in quality improvement and Quality Management Systems improvement. And, in that context, we are in much better shape than what we were in 2014.

We have made investments in all Healthcare sites across the world and we believe we can stand up to any scrutiny that will come our way; also scrutiny as part of, let's say, this discussion with the DOJ.

And, on top of that, as you said, it's a smaller business. And we believe that the quality of our defibrillators is actually market leading and we measure that, in a sense through, let's say, what we see as field call rates and what have you. Our customers are very happy with these products.

So it is different. Nevertheless, it is a little bump in the road here that we need to deal with.

Now to your second question. There's a lot of uncertainty in the market related to potential policy changes in the United States. But, to your question, we have not seen changes in order behavior in the US market so far. In fact, we are proud that we have gained market share all across the world, and also in the US; outgrowing, on average, competition.

We also feel very encouraged with 15 large-scaled [use] last year through the year and that underlines that our strategy is very well received and that our innovations are spot on.

So, at this moment, the sentiment is okay.

Now I did speak with several hospital CEOs last week in Davos and the week before at the conference in San Francisco. I think everybody talks about it. Hospital CEOs are concerned what effect this may have on their Medicare/Medicaid patients and, depending on the hospital, that the proportion of their business differs between anywhere between 20% and 50%, depending on which region they operate in.

So I think caution is necessary. And if we really see impacts then, of course, we will flag that to the market. At this time I think we just need to be cautious.

Mark Troman - *BofA Merrill Lynch - Analyst*

Okay. Thank you very much, Frans.

Operator

Ben Uglow, Morgan Stanley.

Ben Uglow - *Morgan Stanley - Analyst*

I'm sorry to labor the same point as I have been for a little while but I wanted to understand the order trajectory, what is happening on the ground, if you like, in Diagnosis & Treatment. And the reason why I look at this particularly, it's a EUR7 billion business so it is the most material part, or a very material part, I should say, of HealthTech.

If we look through 2016, over the course of the year, if the math is right and obviously we don't have the absolute numbers, you're ending the year low-single digit down in orders.

What I just want to understand is, given the resumption at Cleveland and given the pickup we saw in China in the market generally, why have we not yet seen a stronger reactivation in your Diagnosis & Treatment business? Why do you think that you're not posting the same level of order growth in Imaging that we see at peers and that we see in the market overall? So that was question number one.

Question number two, and fairly obviously it relates to this, is your order book conversion is typically around 70%, something like that. Are there other factors that you see in the Diagnosis & Treatment division this year that would bridge you towards 4% to 6% growth? I.e., if we put to one side this order book issue, what other factors would allow you to have better growth, i.e., mid-single-digit growth plus, during 2017?

Frans van Houten - *Koninklijke Philips NV - CEO*

Let's, let's talk about it because -- so maybe let me start with taking you all the way to fourth quarter 2015, where Diagnosis & Treatment had an order intake of 21%. So the end of 2015 very strong.

Then the beginning of 2016 was much weaker because, maybe related to that very strong order intake in the fourth quarter of 2015, we had a positive order intake growth in the third quarter and close to flat in the fourth quarter.

We continue to sit on a healthy order book for D&T for the year 2017.

Now a bit more color. We saw that the ultrasound market actually shrunk in 2016. So that was not an easy market. We saw strong traction in Image-Guided Therapy. And in the Diagnostic Imaging we actually expect further traction in 2017, with a couple of new products coming on the market. We also have an important product launch expected later this year for Image-Guided Therapy and we expect stronger traction for ultrasound in 2017.

So there are several positive drivers that give us the confidence that we can, across the Philips' portfolio, support, let's say, the growth target.

I'm looking at Abhijit, whether I missed anything.



Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No. I think the last thing is, Ben, as you know, the order book is 30% of revenues, right. So 70% is still outside the order book, which comprises of the service business, Personal Health, etc. So, with those growing also pretty good, we are pretty confident that we will still be within the guidance.

Ben Uglow - *Morgan Stanley - Analyst*

Okay. So that's very helpful, thanks. And the color does help. So I'm right that we can comfortably assume for Diagnosis & Treatment that we should be within the guidance band for the current year.

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, the guidance band is for Philips in Health Technology, so --

Ben Uglow - *Morgan Stanley - Analyst*

So if you take out Personal Health, I guess -- because the growth rate, to be clear, in the last couple of quarters we're down to 3% now. So that's why I'm asking the question.

Frans van Houten - *Koninklijke Philips NV - CEO*

Well there's nothing shameful of 3%. But let's say the overall growth rate of 4% to 6% is for Philips in Health Technology. Personal Health, slightly ahead of that, the other two slightly below that but, overall, we will stick to our guidance range.

And maybe there is one more comment to make and that is that some of these larger scale deals do not show up in the order intake numbers because we typically only take a 15-month window in recognizing orders. Now, as time progresses, then we will, of course, look back at these large-scale deals and bring it to orders.

Also, the more managed equipment services deals that come as a recurring revenue stream may skew the picture here a little bit.

Ben Uglow - *Morgan Stanley - Analyst*

That's really helpful. Thank you very much.

Operator

James Moore, Redburn.

James Moore - *Redburn Partners - Analyst*

My first question surrounds the margin guidance for this year; the 100 basis points on average you've talked about over the years. And I know you wanted to get away from individual year-based guidance but, at the same time, with the FDA issue today I sense that you're trying to say that guidance remains applicable.

Can we be very clear and say that that guidance remains applicable for 2017, given the FDA issue? That's the first question.

Secondly, I wondered if I could talk about your Lighting stake and any reductions planned and the timing on that.



And then, finally, could you give us a little color on the Diagnosis & Treatment business? The margin's progressing. I see it's up in the year and the quarter. You've obviously had, in the past, the big iron issues. But there are movements in there for service margin, ultrasound and other pieces; IGT, etc. I wonder if you could just give us a bit of a feel for how much big iron has improved and how much it has to go?

Frans van Houten - *Koninklijke Philips NV - CEO*

Let's give it a try, James. In fact, in the past we had the habit of giving a far-out target, three years away, and then we typically had to do a sprint towards the end of the three years to get there. So at the Capital Markets Day Abhijit and I said, look we want to become a more predictive company and provide an annual improvement in the results. So, in fact, we are not stepping away from guidance that relates to a year improvement.

We have, however, said that it is, on average, 100 bps per year, right, which could mean that in one year you're a little bit over that number and in another year you are a little bit below. So I don't want to be stuck on exactly 100 bps within a given year. It could be around that number; either above or below. But then it should average out on 100 bps on average for a three- to four-year period.

So I hope that that helps. And we remain committed to that statement also for 2017. That means that we will compensate for the impact that the potential agreement with DOJ FDA will have within our business. We feel that we have enough levers to pull -- productivity, new product introductions, margin expansion, growth -- that we are able to absorb that.

We think that it's -- even though it's a disappointment, I want to reassure you that this relates to past inspection issues related to Quality Management Systems, there is nothing wrong with our products and that we will continue to push the envelope.

We have momentum, right, and that's how we talk about it in 2016. It's working and we will just continue with that momentum.

The second question, if I may, go to the Lighting stake. I spoke with a lot of medtech investors and I'm really encouraged by what they have to tell us. They believe that our strategy is very interesting, that we are operating in various market niches that are highly relevant, the way we embrace digital, which is very relevant for hospitals and consumers in the future. And, actually, many medtech investors say they can't wait to see us as a pure health-tech company and which means a deconsolidation of Lighting is important to them.

So that is imprinted on my mind. It's what we keep in mind. Today, however, I cannot give you a precise timeline as to when we will sell down but we are committed to sell down and when we have news to tell you, we will tell you.

And it is certainly going to be helpful that Lighting yesterday told the market that if we sell down that they will participate through their share buyback, which could mean, therefore, that the rate in which we go down can actually accelerate a bit.

So I'd like to leave that point at that statement.

Then the third point about D&T margins, as I'm running out of steam here I'm going to ask Abhijit to take that one.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No, I think, even though you've seen from last year to this year (inaudible) improvement in the D&T margins, in the overall plan that we have made we are also looking at 100 bps improvement next year across the Group. But that would mean that it comes pretty much evenly across the businesses. So it's not that there is one outperformer and there is a lagging business.

So if you look at the productivity savings that D&T has lined up, the procurement savings that are lined up, the cost initiatives that they have lined up, I think we expect the momentum that we have gained on margin improvement to continue into next year, although not as steep as it has been this year, which is -- and then you've seen in the fourth quarter, I think it's well above the 200 bps. It's about 280 bps.

So that trend should continue next year.

Frans van Houten - *Koninklijke Philips NV - CEO*

I could add to that, Abhijit and James, that the product portfolio is strong. Diagnosis has, for example, strong MRI range, radiology solutions, performance bridges, productivity for radiologists. Ultrasound, we are moving beyond cardiology and ultrasound into OB/GYN and general imaging. And then I think we are really on a roll with Image-Guided Therapy. Volcano is working out fine. It's really very good with double-digit growth.

So I think there are several growth levers that also will improve the margin through mix and in growth.

Okay, James? Does that answer your question?

James Moore - *Redburn Partners - Analyst*

Yes, that's very helpful. Could I just circle back to your comment about the compensating in 2017 for the FDA? Is that really to say that if there is an impact it would be contained within a single fiscal year as opposed to, say, two or three, as we saw with Cleveland?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, I would like to postpone, let's say, the discussion of impact until the moment when the discussions with the DOJ are finalized and leave it for now at a meaningful impact.

I know I'm going against my own word again. I want to reiterate that this is not a product issue. This is related to the past findings on the Quality Management System and we need to demonstrate that that is all in order. So that causes, potentially, disruption.

I would like to leave it at that and we'll get back to you if and when we conclude with the DOJ.

James Moore - *Redburn Partners - Analyst*

Thanks, Frans.

Operator

Andreas Willi, JPMorgan Cazenove.

Andreas Willi - *JPMorgan Cazenove - Analyst*

First question I have is on Connected Care & Health Informatics. You had some negative sales growth in the Informatics business in Q4. Maybe you can comment a bit around that. It's certainly an area where we would have expected to see some more growth, given the product launches and what you talked about in the past.

And what should we expect from this business? In the past you also mentioned that you see the growth accelerating there. So is that Q4 just a one-off? Or is there something in the business in terms of that's holding back the growth at this time?

And my second question on capital allocation and dividend. You kept the dividend flat but you offer it again as a stock dividend with the potential of the dilution in terms of the number of shares. If Philips is an attractively valued health-tech player with a good balance sheet, should it really

issue shares over time? And why are you not buying back shares that are issued through this dividend scheme, which I appreciate has tax advantages for the shareholders that can participate but a dilution risk for the others?

Frans van Houten - *Koninklijke Philips NV - CEO*

Well, Connected Care & Health Informatics we saw strong sales growth in Patient Monitoring and a bit more lumpiness in Health Informatics.

Health Informatics is much more a project business. Moreover, as we move forward to SaaS and PaaS business models you build up a revenue stream that is coming in over time.

We did see very good order intake growth in the fourth quarter for Connected Care & Health Informatics and, therefore, we are confident about our ability to grow this business in the future.

Now my team here is scribbling next to me. So, Abhijit, why don't you --?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

If you look at Q4 we had a 4% growth in Connected Care & Health Informatics. PCMS grew nicely; well above the 5%. So I think overall growth this year was around the 5% compared to a 2% growth in Q4. But for the full year last year it was actually flat and this year we are up close to 5%.

So I think we are actually pretty happy with the return to growth in CC & HI. And we had good mid-single-digit growth in PCMS as well for the year, which was flat last year.

Frans van Houten - *Koninklijke Philips NV - CEO*

So maybe that gives a different perspective than what you had in mind, Andreas. It's an exciting business for us.

Your second question, and I'm sure that Abhijit would also like to contribute to that, we have, of course, over the last years done sizeable share buybacks. And, in that sense, we are ahead of the game in shrinking the share count. And over a longer period of time there is no dilution, especially if you then include this year's upcoming dividend payment as a combination of cash and scrip.

So just to reinforce that we are cognizant about the importance of not diluting, but we have looked carefully at it and we are not diluting.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No I think that's fairly plain. If you look at the buybacks we have done over the past two years, we have been actually accretive. So a couple of years if we do this. And it's actually a choice dividend, fortunately, so the shareholders make a choice on what they want to do.

We've made a small change so the default setting that we had earlier we used to actually put to scrip and we have put that to cash now. So that's in line with market practice. And then there are shareholders who gain tax advantages by taking on the scrip dividend and we give them that opportunity.

But, as Frans mentioned, the long-term plan is, of course, not to be dilutive.

Andreas Willi - *JPMorgan Cazenove - Analyst*

Thank you.

Operator

Gael De-Bray, Deutsche Bank.

Gael De-Bray - *Deutsche Bank Research - Analyst*

My first question is on the defibrillator business, or actually it's on the investigation process. Clearly I'm not familiar with the process here but could you explain why the DOJ is involved and not just the FDA this time? So that's question number one.

And question number two is on the contribution from Cleveland, which was probably EUR10 million or EUR15 million below expectations in Q4. So that would be great if you could comment about that. In particular, why the Cleveland contribution was the same in Q4 as in Q3, despite the higher revenue number? And if you could comment about what we should expect for 2017 that would be obviously very good. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

The FDA is not an enforcement agency in their own right. They do inspections. But when they want to enforce something then they go to their colleagues of the DOJ. So that's like if you would hire a law firm. So I hope that that answers the involvement of the DOJ. So that's normal. It's not exceptional. When the FDA wants to enforce they go to the DOJ.

The contributions of Cleveland, the way we report on them, of course, is related to the improvement actions, not necessarily to the sales progress. It has to do, for example, with cost containment, lesser expense on remediation actions and so on. It is not an exact science, I'm afraid.

We had originally, indeed, targeted a slightly higher amount. I think we came in around EUR80 million.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

It was about EUR10 million short.

Frans van Houten - *Koninklijke Philips NV - CEO*

So it was about EUR10 million short but the direction is that we are absolutely on track and we also expect to continue to improve in 2017.

Gael De-Bray - *Deutsche Bank Research - Analyst*

And would you expect to fully catch up on the last EUR175 million also you had over the past couple of years on Cleveland? What do you see the timing for that?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

We have said that will be over the next couple of years. So I think we are on track for that.

The way we look at Cleveland is production is back to where it should be. We are now making sales so it's not something that -- it's part of the overall improvement that we will drive next year, so it's not something that I think we'll need to call out any more because the operations are back on, let's say, where they should be.

And now we need to build back market share and the more volumes we drive the higher will be the contributions for the CTMI business, because it's now not restricted to just the Cleveland site because we are also manufacturing from other sites.

So I think we should -- at the end of the fourth quarter we think the Cleveland issue was closed on this.

Operator

Max Yates, Credit Suisse.

Max Yates - Credit Suisse - Analyst

Just my first question would be on the overhead cost savings and gross margin savings for next year. You gave in that bridge, where you showed the 100 basis points of margin expansion per year, 1.9% from gross margin and 0.5% from overhead.

I just wanted to understand the phasing of that through the three or four years and whether we should expect that to be evenly split over the next four years or whether any of that was front loaded because you'd already started closing some of the smaller manufacturing footprint. So just a little bit of color around that.

Abhijit Bhattacharya - Koninklijke Philips NV - CFO

I think Max, you should look at that as something that would be evenly spread because, even on manufacturing footprint, by the time you'd finished with the whole consolidation and get the savings into your P&L it takes a while, whereas the overhead savings and gross margin improvements comes a bit earlier.

So if you look at the entire package I think an even phasing throughout the three years is a fair way to look at it.

Max Yates - Credit Suisse - Analyst

Okay. And maybe just a quick follow up. I just wanted to understand the historic timeline around this defibrillator issue. So is it that there was an inspection in 2015? Since then you've been working with the FDA going back and forward and this word compliance was used because the FDA ultimately didn't get what they wanted and then bought in the DOJ? Or is it more a case of it was inspected in 2015, you've heard very little and now the DOJ's been bought in. I just want to understand a bit about that sort of historic timeline.

Frans van Houten - Koninklijke Philips NV - CEO

It's even a bit earlier than that where most of the past inspections were well before 2015. And the way you describe it, it's the latter. So, in fact, it's only recently that we were contacted and engaged in dialog with the DOJ.

Max Yates - Credit Suisse - Analyst

And is there any way you can give us any confidence that inspections, even before through 2015 that -- are there any more of these ongoing where you've had contact from the FDA regarding something that happened maybe back in 2014 or 2015?



Frans van Houten - *Koninklijke Philips NV - CEO*

Well, if I take a wider perspective. So I told you that we have made investments and we have made a lot of progress on quality across the board. We have ongoing inspections from regulatory bodies, including the FDA, all the time. And, in fact, we are quite pleased that in the last two years we have had no warning letters anywhere, which demonstrate the statement of progress.

So we can actually demonstrate to ourselves that the findings of, let's say, habitual inspections as they may occur from time to time, they are showing the progress that we have made.

As I said, or as you inferred, then we didn't hear for a while and then there is an enforcement action on past inspections and that the consequence is now, even though we have made a lot of progress.

Max Yates - *Credit Suisse - Analyst*

Okay, I understand. Thank you very much.

Operator

Daniel Cunliffe, Liberum.

Daniel Cunliffe - *Liberum - Analyst*

Two questions. Firstly, just on PH, the 7 points of very strong top-line growth. Just could you give us a sense of how much of that is due to the earlier sell-in from the change in the Chinese New Year timing? That's the first question.

Second question, again coming back to the defibrillator unit, now I think you -- I recall that Cleveland was round about EUR700 million to EUR800 million and that saw 340 basis points margin decline. The defibrillator unit's probably about 20% the size of Cleveland. Is it fair to assume 20% the size of the impact, i.e., 60 basis points margin pressure?

Now I appreciate you can't help on this, you said you wouldn't; that's clearly our job. But I'm more looking for the color of how this compares to Cleveland in terms of if you could give us a sense of the nature of the remediation actions that would be required. Are they in line with what you saw with Cleveland and not as harsh? Just some kind of a bit more detail on that so we can make our assumptions on the likely impact? Thanks very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

Daniel, I'm smiling because clearly I'm not very successful in stopping the flow of questions here.

Let's first talk about Personal Health. The team is doing a fantastic job. I really want to compliment the Personal Health folks because the growth is driven across the board. We saw strong growth in the United States, strong growth in Europe, strong growth in China. So you cannot infer that there was big impact of the Chinese New Year timing. If anything, it was relatively small.

The takeaway is that Personal Health has great innovations, very strong execution and we expect just continuation of growth.

Of course, not every quarter can be the same and that is why we wanted to flag the Chinese New Year timing. If Chinese New Year is later in the quarter, then you have, relatively speaking, a stronger first quarter. Now Chinese New Year is early it may mean that the first quarter is a little bit weaker. That is why we wanted to talk about it. Does that answer your first question, Daniel?



Daniel Cunliffe - *Liberum - Analyst*

Absolutely. Thank you very much.

Frans van Houten - *Koninklijke Philips NV - CEO*

Then the Computed Tomography and Advanced Molecular Imaging business actually was over EUR1 billion in size, so a little bigger than what you had in mind. But it would be wrong to associate, let's say, a percentage impact to the business in proportion to the sales. Unfortunately, it may not work like that.

We have not yet been able to estimate the impact for the defibrillator business. That we can only do when it is clear what the final outcome of the discussions with the DOJ are.

What we did want to say is that the defib business is, of course, a much smaller business and only about one-half or less than one-half of that business is in the United States. And for the rest, I'm afraid we'll have to be patient until the conclusion of the discussions.

Daniel Cunliffe - *Liberum - Analyst*

Yes, thanks.

Operator

Jonathan Mounsey, Exane BNP Paribas.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

A couple of questions. First of all on capital allocation, obviously you've been asked about the timing of selling down the stake in Lighting, commented that you were quite keen to get that moving. Once you do get the money in could you say something about maybe acquisitions, thoughts about how to deploy the money?

And just secondly on HealthTech Other, just looking through that business, or that division, it looks like it was central costs that drove the high level of the cost in that division this quarter relative to consensus expectations. Is that something we should model going forward? Will central costs be higher than maybe the Street currently thinks in HealthTech Other?

Frans van Houten - *Koninklijke Philips NV - CEO*

I will start and then Abhijit will finish.

If I first may take you to 2016, we have, in fact, used quite a bit of the cash generation to strengthen balance sheet, with taking the expensive bonds out. And in 2017, with the redemption of the 2018 bond, actually we continue on that policy.

We are, of course, cognizant that we will become a very cash-generative business. Actually my compliments to Abhijit for how he's driving working capital improvement and we probably can expect further improvement in that area.



So, in terms of capital allocation, M&A will potentially play a role going forward. And I've often referred to Volcano as a good indication of a deal. We have executed very well on that deal and it could be a direction to look at these kind of sizes of deals. But, at the same time, it needs to be actionable, it needs to have a good payback. We have high hurdles to apply, so I don't want to get ahead of ourselves.

And for the rest, I'd ask Abhijit to complement my introduction.

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

So I think if you look at HT Others, the central costs look high, because we actually have centralized a lot of costs this year, let's say, for finance and other functions, so that we manage those at Group level. That is actually part of our program to get our enabling functions costs to benchmark levels.

So I think I've guided for next year overall at a number of EUR100 million, with around EUR40 million of restructuring. So you have clear guidance there. And that will give you a net in the adjusted EBITA of around EUR60 million, which is a combination of lower license revenue of EUR25 million to EUR35 million, which we will offset with further cost reductions that we will drive.

So that's how you should look at HealthTech Other for this year.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Just one small follow up. So on the capital allocation, should we be thinking that pretty much all of the money that's returned from Lighting is potentially there to reinvest in acquisitions? Or that there's actual potential for capital return excess of that?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

I think we have said that a number of times. There are a few things that we are doing. One is cleaning up the debt portfolio. We have paid back also the loan we had taken for Lumileds, so that is done.

And, yes, part of that money will be reinvested in M&A if opportunities arise. And if the opportunities don't arise then we will look in the next years what we should do. But I think, at this stage, currently we are going to hold a stronger balance sheet for a while.

Jonathan Mounsey - *Exane BNP Paribas - Analyst*

Understood. Thank you.

Operator

Peter Reilly, Jefferies.

Peter Reilly - *Jefferies - Analyst*

I've just got one question, please. You've had another very good quarter from Personal Health. It continues to grow faster with higher margins than the rest of the Group. Can you give any tangible examples of any synergies between Personal Health and the rest of the Group? I know it's obviously part of your whole HealthTech strategy, but are there any tangible things you can highlight which show why that business benefits by being part of the Group?



Frans van Houten - Koninklijke Philips NV - CEO

Yes, Peter, as you already indicate yourself, it's part of our strategy.

If you look at the overall healthcare expenditure in the United States, it's shifting towards more ambulatory spending. So where originally 40% will spend in hospitals and 60% will spend outside of hospitals, actually now that moves to 30%/70%. So there is a quite significant shift of healthcare spending in ambulatory settings.

We expect that, with digital and cloud, consumer health activities at home will actually become larger and larger. We see that we are quite unique in positioning ourselves along the health continuum with regards to the ability to do preventative care and also support for chronic disease for consumers at home.

We have a lot of interest from hospital systems to understand how you actually influence consumer behavior. And we believe that our trusted brand for the consumers will give us opportunities in the future.

At the same time, Personal Health benefits from the connection to deep clinical insights and professional endorsement. The fact that we are growing Oral Care so well is because of our efforts on clinical evidence that our products actually have a better impact for health than consumers.

Our Air business is now starting to tackle allergens. We see down the road more and more propositions coming that are going to be a hybrid. So we are definitely going to stick with this business. We think it's great.

We also, by the way, are applying skills from consumer to professional. We have built up quite a sizable knowledge base on digital marketing that we are now going to apply towards health professionals; reaching more decision makers for our professional business.

Peter Reilly - Jefferies - Analyst

And, as you say, you're unique in your positioning. And, if it does give you a lot of tangible benefits, do you think other people are going to follow your example? Or do you expect to remain uniquely positioned in that space, because it is an unusual combination?

Frans van Houten - Koninklijke Philips NV - CEO

Yes, it may be unusual from a medtech traditional point of view, where medtech companies are focused on devices. But I can tell you that, in my discussion with medtech companies, they all struggle with what outcome-based care is going to do to them because in a volume market you sell lots of devices but, once you have to prove outcomes, you need to understand what an individual patient has as benefits of your devices.

The same with pharma companies. Pharma companies need to demonstrate impact, need to demonstrate compliance and results. They are actually talking to us with regards to our HealthSuite digital platform whether we can help them deliver the evidence of patient outcomes.

So, if anything, I would say more healthcare companies are going to seek for ways to become consumer-centric in their efforts. So I predict that over the next years we will see this rationale stronger.

And then maybe finally, and I don't want to belabor it, but you start seeing Apple and Google and other Silicon Valley companies getting into this space. I don't see that as a threat to Philips because we are, so-called, in the last yard of patient engagement and patient care and supporting doctors. But I do see it as an evidence that the consumer angle is going to play a bigger role in cloud-based healthcare delivery.

Peter Reilly - *Jefferies - Analyst*

That's very helpful. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

I'm sure we can continue this dialog at some point in time. That's fine.

Operator

Alok Katre, Societe Generale.

Alok Katre - *Societe Generale - Analyst*

I just have one, really. On Diagnostics & Treatment you mentioned that in 2017 you don't expect a similar level of margin improvement as in 2016. I would just like to understand what's driving that comment, given you should still get a bit of a bump-up from Cleveland and that actually should make life a bit easier for the margin expansion.

So what are the factors that should then hold back the margins, if you know that Cleveland's still going to contribute in 2017 at D&T?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

For 2016 we had a pretty significant increase. I think it was well over 100 basis points; close to 150 basis points or 160 basis points. And, basically, that's what we said we will not be able to repeat for 2017 because we will go into, let's say, more the -- I think for DI for 2016 to 2017 we had over a 240 basis points improvement and that's not what is going to happen for 2017. That's all.

So there is still a big improvement but the amount of improvement is just huge between 2016 and 2017.

Alok Katre - *Societe Generale - Analyst*

Yes. If I may just phrase it differently, 2016 you had roughly about EUR80 million or EUR75 million from Cleveland. You've still got about EUR100 million to be recouped over the next couple of years. Even if you assume it's EUR50 million, EUR60 million or a bit more on Cleveland coming in, that's still close to about 80 basis points to 100 basis points for the D&T margins.

So are you intending to say that the underlying improvement ex-Cleveland and D&T cannot be more than 50 basis points? Is that how we should be thinking about it?

Abhijit Bhattacharya - *Koninklijke Philips NV - CFO*

No. I think you make it a little bit too complex. So the year-on-year improvement for D&T was 150 basis points, right, 2015 to 2016. With the current plans, we don't see that high a level of improvement. It would be closer to the 100 basis points than 150 basis points, is what I'm saying.

Alok Katre - *Societe Generale - Analyst*

Okay. Fair enough.



Operator

Veronika Dubajova, Goldman Sachs.

Veronika Dubajova - Goldman Sachs - Analyst

I want to return to the D&T growth in the US because -- I appreciate that orders are not necessarily a big part of the book but, even if I look at what you disclosed in your press release this morning, it seems like the US D&T business was effectively flat year on year in 2016. And I'm just surprised by that comment, given some of the statements you've made about Volcano doing really well and also Cleveland coming back on track.

So is this a sign that the ultrasound business is really struggling in the US? And, if so, what can you do to address that? That's my first question and then I have a quick follow up.

Frans van Houten - Koninklijke Philips NV - CEO

We finished the year stronger than that we started it and that resulted in the overall flat situation.

We do believe we have the opportunity to grow the business in 2017. We expect an uptick from ultrasound. We expect IGT to do well. The big iron business market in the United States is flat overall. So that gives you the picture. China actually performs well. Europe, we expect, again, a lower growth.

Veronika Dubajova - Goldman Sachs - Analyst

So, Frans, you would think the US business as a whole and D&T accelerates in 2017. That would be your expectation irrespective of some of the concerns around ACA repeal.

Frans van Houten - Koninklijke Philips NV - CEO

Well, as I said in an earlier discussion, we don't see the effect of that yet. I've said we need to be cautious with a potential repeal and replace. I don't want to take an advance in hedging the traction that we are having.

So if the market is flattish in the United States and we are gaining share, then we should be growing at a low-single-digit rate in the United States for this part of the business. We expect to also outgrow the other markets. So, across the board, I think we are confident about the ability of D&T to grow.

D&T versus the rest of Philips, I've said, I think, in an earlier question, that PH is a little bit above the overall guidance of the Group; CCHI is probably on the guidance of the Group; and D&T is slightly below the overall guidance of the Group.

So I hope, with that, that I've given you a bit more color.

Veronika Dubajova - Goldman Sachs - Analyst

Yes, that's very helpful. My second question is very quickly on the M&A priorities. I know you've said size wise Volcano is of interest. But if you look at the portfolio that you have, which particular areas or categories would you be most interested in making acquisitions? And that will be it from me in terms of questions. Thank you.



Frans van Houten - *Koninklijke Philips NV - CEO*

Well, you can have two rationales for M&A. One is you can scale up and, therefore, you get cost synergies. Or you can have adjacencies in your portfolio and you get growth opportunities. Volcano was an example of growth.

If I look across the portfolio, I can certainly identify businesses where we are not yet number 1, and, therefore, a scale play could be interesting. And I can also identify opportunities for further adjacencies; for example, in the area of Image-Guided Therapy and Health Informatics.

But all of that is under the umbrella of, well, what is actionable, does it give you a return on investment and, therefore, it is very difficult to have a narrow guidance on where M&A will go.

We have done two acquisitions in 2016 that were both related to informatics: Wellcentive and PathXL. Clearly, there is going to be a lot of activity around digital artificial intelligence, machine learning that is very applicable to our business.

Much of these areas we can also do through organic growth. We have a keen eye on the market but we will not, let's say, do anything stupid when it comes to engaging on M&A if it doesn't return a good financial success.

Veronika Dubajova - *Goldman Sachs - Analyst*

Okay. Thank you.

Frans van Houten - *Koninklijke Philips NV - CEO*

I realize I'm not completely answering your question, Veronica, but I cannot be more precise than that. I hope you understand.

Operator

Marc Schartz, Henderson.

Marc Schartz - *Henderson Global Investors - Analyst*

Just a brief question with regard to your US business, well, the medical equipment which you sell in the US. To what extent is this all produced in the US? Or, put it differently, what proportion are you importing from Europe or from elsewhere?

Frans van Houten - *Koninklijke Philips NV - CEO*

Yes, a good question. Also came up this morning with some of the wires. Philips has always had a balanced approach to employment. So if you look at our geographical footprint, and let's make rough statements and we say that about one-third of revenue is in US, one-third in Europe, one-third in growth markets, our employment base mirrors that.

So, actually, we have more employees in the United States than we have in Europe. And sometimes I joke that we are as much an American company as we are a European company. And, of course, I say the same in China, where we have a sizable workforce.

So back to the US. Approximately one-third of our employees are there. That applies both to manufacturing and to R&D. Nevertheless, supply chains are complicated. So take ultrasound. We make the majority of our ultrasound equipment in the United States but we also export to other countries. Some other products we may not make in the United States but import.

So, of course, you're referring to the risks of border tax. I hope it will not come to that, because I don't think it's good for the world, but if something like that would happen, then we would point to the fact that we produce a fair share of everything we make in the world in the United States. It's about one-third and that is in balance with the one-third of revenues that we have in the US. And then we'll take it from there.

Marc Schartz - *Henderson Global Investors - Analyst*

Okay. Thank you.

Operator

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

Frans van Houten - *Koninklijke Philips NV - CEO*

I'd like to thank everybody for a good 1.5 hours of questioning and like to point to the fact that 2016 was a pivotal year for us, a defining year. We end the year with strong momentum. We have every intention to continue that momentum throughout 2017 on the basis of strong innovation, lots more productivity opportunities and an enormous enthusiasm and commitment in our employee base. And that's also what I hear from our customers; that they believe we are on the right path.

So thank you for your attention and talk to you soon.

Operator

This concludes the Royal Philips' fourth-quarter and full-year 2016 results conference call on Tuesday, January 24, 2017. Thank you for participating. You may now disconnect.

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