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PRESENTATION

Operator

Ladies and gentlemen, welcome to the Philips Lighting analyst conference call. (Operator Instructions)

I would now like to give the floor to Robin Jansen, Head of Investor Relations. Mr. Jansen, please begin your meeting.

Robin Jansen - *Philips Lighting N.V. - Head of Investor Relations*

Thank you, and good morning, everyone, and welcome to the Philips Lighting Analyst and Investor Conference Call for the Second Quarter 2017 Results. With me are Eric Rondolat, CEO of Philips Lighting; and Stephane Rougeot, CFO. In a moment, Eric will give you an update about our business and operational performance. After which, Stephane will take you through the second quarter financial performance. Eric will then tell you more about the outlook for 2017 and wrap up. After that, we will be happy to answer your questions.

Our press release and the related slide deck were published at 7:00 a.m. CET this morning. Both documents are now available for download from our Investor Relations website. A full transcript of the conference call will be made available as soon as possible on our Investor Relations website.

With that, I will now hand over to Eric.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Thank you, Robin. Good morning, everyone, and thank you for joining us today.

So let's go to Slide 3.

We delivered a solid performance, both on the top line as well as on profitability in the second quarter. Comparable sales declined by 1.8% due to the ongoing decline in the conventional lighting market, which was partly offset by robust growth in LED and connected lighting systems.

Business groups, LED and Home, achieved double-digit growth. Total LED-based sales grew by 14%. LED-based sales now represent 63% of total sales compared to 53% in Q2 last year. Europe delivered robust growth, with a continued solid performance in the Benelux, Germany and Iberia. The Americas and the Middle East & Turkey continued to be impacted by softer market conditions.

In Professional, we were impacted by a high comparison base in the second quarter of 2016 due to a large project in Asia Pacific.

In the quarter, the adjusted EBITA margin increased to 10.2%, including a one-off real estate gain of EUR 15 million in Home. Excluding this gain, the adjusted EBITA margin improved to 9.4%.

Net income improved from EUR 57 million to EUR 73 million. Free cash flow decreased from EUR 60 million to minus EUR 27 million, reflecting an increase in inventories in Home and LED specifically to support anticipated growth in the second half of the year.

On Slide 4, you can see an overview of the financial performance by business group.

Each business group contributed to the improvement of the adjusted EBITA margin. Total adjusted EBITA increased by EUR 13 million. And we are pleased to see that business group LED, Professional and Home compensated the absolute decline in profitability in Lamps.

This becomes even more evident when we move to Slide #5. So this slide shows the contribution to the profitability improvement of each business group.

As you can see, increasing profitability in LED, Professional and Home more than offset the decrease in profit contribution of Lamps as its size continues to shrink. Excluding the EUR 15 million real estate gain in Home, we increased our adjusted EBITA margin by 10 basis points in the second quarter.

Let me now quickly walk you through our business groups.

Starting on Slide 6 with Lamps. Comparable sales declined by 18.2% due to the ongoing transition to LED lighting. We estimate that the conventional lighting market continued to decline faster, in the range between 23% to 24%, which results in market share gains. Despite the high decline in top line, Lamps was able to sustain a high level of profitability, once again at 20.7%, and this clearly reflects the success of our last man standing strategy.

Let me now continue with LED on the next slide. So we were pleased with our performance in LED in the second quarter. LED volume grew significantly, and the margin continued to improve, which is clearly showing that the actions we implemented about a year ago are paying off.

In the second quarter, comparable sales increased by 20.9% driven by significant volume growth, which was partly offset by lower selling prices and stronger growth in affordable products. All regions contributed to the growth, although we noted that countries with low LED penetration rates showed higher growth.

The adjusted EBITA margin improved by 220 basis points to 10.6% in Q2, driven by operational leverage and procurement savings, offsetting price reductions and mix impact.

Let's now move on to Professional on Slide 8. In Professional, comparable sales declined by 2.7%. This decline reflects a high base of comparison due to a large project in Asia Pacific as well as the situation in Saudi Arabia that negatively impacted sales growth by 180 basis points in Q2 2017.

Systems and Services were the fastest growth driver in the first half of 2017 and continued to deliver solid double-digit growth. Performance in Europe and Greater China remained strong, while market conditions in the United States continued to be soft, in particular, for small to medium-sized projects. However, the backlog for larger projects in the United States specifically continues to be strong and is expected to positively impact comparable sales growth and the adjusted EBITA margin in the second half of the year.

The adjusted EBITA margin improved by 50 basis points to 7.2%, driven by procurement savings and mix improvements. Restructuring costs amounted to EUR 23 million, related to the ongoing rationalization of the manufacturing footprint and indirect cost reduction.

Let's now turn to Slide 9. Home delivered double-digit growth in the second quarter of the year and remains on track to become profitable for the full year 2017. The CSG of 15.5% was driven by Home System and Home Luminaires and by all the regions. Demand for Philips Hue increased significantly in the first half of 2017, partly because of our strong partnerships with the makers of the recently introduced voice-activated smart home devices. To support the growth of the Philips Hue offering, investments in innovation, investments in marketing and investments in supply chain was stepped up, as we expect to further drive growth in the second half of the year.

The adjusted EBITA margin increased to 8.2% in the quarter. However, excluding the real estate gain of EUR 15 million, the adjusted EBITA margin improved by 6 percentage points to minus 2.1%. This was driven by operational leverage and procurement savings, and partly offset by the higher investment in Philips Hue that I already referred to. All in all, Home remains on track to become profitable on a full year basis in 2017, excluding the impact of the real estate gain.

Moving on to Slide 10 now. Solid progress was made overall and in each business groups despite difficult market condition in markets like the Americas and Middle East & Turkey. Sales performance in the first half of this year continued to show an improving trend compared to 2015 and also compared to 2016. Once again, excluding the EUR 15 million real estate gain, the adjusted EBITA margin increased to 8.9% in the first half, giving us confidence that we're on track to deliver on our margin target for the year. Free cash flow was minus EUR 26 million in the first half of 2017, reflecting an increase in inventories to support the growth in the second half.

Let's now look at Slide 11, where we provide a snapshot of our LED-based sales, which grew by 17% to EUR 2.1 billion in the first half of 2017.

In the left chart, you can see that our LED-based sales grew with the CAGR of 28% since 2013 and now represents 62% of total sales in H1 2017.

In the chart on the right, we see that 40% of our LED-based sales comes from business group LED, while 48% comes from Professional and 12% from Home. In each business, group we saw double-digit comparable sales growth in LED-based sales in the first half of 2017.

So this is what I wanted to cover regarding the business and its operational performance. I will now hand over to Stephane, who will tell us more about the financial performance for the second quarter of 2017.

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Yes, thank you, Eric.

Turning now to Page 13, you can see the adjusted EBITDA bridge.

With respect to gross margins, we were able again to improve productivity and also deliver procurement savings across each of our business groups. The adjusted gross margin as a percentage of sales improved by 30 basis point this quarter compared to last year. Our indirect costs improved by EUR 9 million, and that includes the additional investment that we've made to support our growth. We also benefited from a favorable currency effect and also from the real estate gain in Home.

On that last point, let me take a moment to explain how we treat incidentals, and most notably, the sale of real estate.

First, of course, we comply with the accounting policies of our main shareholder as we are still consolidated in their statements. As a consequence, our adjusted EBITDA includes restructuring cost, acquisition-related charges and also other charges and gains above EUR 20 million. Once our main shareholder will deconsolidate Philips Lighting's financials, we plan to review this policy.

Since our goal is to provide clear and accurate informations so that we can show our true operational performance, we therefore highlight material one-off. In Q1, you remember that the real estate gain of EUR 15 million was, by and large, equal to a one-off gain in Q1 2016, so the results in Q1 reflected our true underlying operational performance improvement, and we improved from 7.1% to 8.4%. In Q2, as we did not have a similar material one-off gain in Q2 last year, we also show our Q2 adjusted EBITDA excluding the EUR 15 million real estate gains in Q2, so that would present our true operational performance improvement from 9.3% to 9.4%.

When it comes to our outlook, it's totally consistent with that approach. The 50 to 100 basis point increase of the adjusted EBITA margin for the year will reflect our true operational performance improvement without the help of any material one-off. And this is why we have now excluded from the guidance the EUR 15 million gain that we have realized in Q2.

Finally, when we look at the year-to-date performance, our adjusted EBITDA is 120 basis points ahead of last year at the end of June. And as mentioned by Eric earlier, excluding the EUR 15 million real estate gain in Q2, our year-to-date adjusted EBITDA margin is 70 basis point ahead of the first half of 2016, and that's within the range of our outlook for the year.

Turning now to the next page, Page 14. We show the year-on-year development of our indirect cost base, which was 32.3% in the second quarter of 2017 compared to 32% a year ago. We had the negative impact of currency movements, which increased our cost base by EUR 3 million. We continued in parallel to implement all the cost reduction initiatives that we have launched. And we have achieved a EUR 9 million savings on indirect costs. This reduction is after the additional investment that we have made to support our growth, in particular in Home Systems. Finally as you know, we are executing a detailed plan to realize our cost savings, for example, in selling expenses in IT, in real estate, in finance and in HR.

If we look at the reported EBITDA. Just to give you an update on our restructuring charges, let's report our cost range from both above the gross margin and below the gross margin. In the first half of 2017, we recorded EUR 41 million of restructuring costs, which is comparable to the level of the first half 2016. For the remainder of the year, we expect restructuring costs to be in the range of EUR 20 million to EUR 25 million for the third quarter and probably EUR 60 million to EUR 70 million for the fourth quarter of 2017, which would take our overall restructuring costs in the range of EUR 140 million for the year. And this is in line with our guidance between 1.5% to 2% of annual savings.

Let me now take a closer look at our working capital position in the second quarter. I am on Page 15. And you can see that our working capital decreased by EUR 126 million year-on-year. At the end of June, it represents 10.9% of sales, and this is an improvement of 130 basis point compared to a year ago. This reflect the sustained improvement that we have achieved throughout the year 2016.

Compared to the end of the first quarter 2017, our working capital has increased. Although inventories have always been an impact on driver to decrease our working capital, we had higher inventories in LED and in Home in the second quarter to support the growth that is expected in the second half of the year.

Let's now move to our net debt position on Slide 16. Our net debt at the end of June was EUR 697 million. And this is an increase of EUR 281 million compared to the end of the first quarter. We had a cash outflow of EUR 27 million in the quarter, which was largely the results of higher inventories in LED and Home that I just talked about. In the quarter, as you know, we also paid a dividend of EUR 157 million to our shareholders, and we invested EUR 120 million in our own shares by participating to the second selldown by the main shareholder and also a few open market purchases to provide the obligations under our long-term incentive plan. That leaves our net debt to a level of EUR 697 million at the end of June.

Finally, let me give you a bit of an update on our capital allocation policy on Slide 17. Of course, we continue to have a very strict financial discipline in the way we generate and in the way we use cash. As you know, we are committed to managing our financial ratio and maintaining a financing structure that is compatible with an investment grade profile, and that includes the disciplined management of balance sheet liabilities. In the second quarter, we paid the dividend. We also will return up to EUR 300 million to our shareholders in the period 2017 to 2018 by participating to share disposal by our main shareholder. Up to now, we have already used EUR 183 million out of the EUR 300 million.

We have also looked at our pension situation, and we have an active pension de-risking strategy. And we always look for opportunities to reduce the cost and the risks associated with the defined benefit plans. As part of this strategy, like many other companies, we intend to reduce our deficit in the U.S. and to contribute approximately $150 million to our U.S. pension fund over the period 2017-2019, so that we further reduce the liabilities and lower the cost going forward. The first contribution of $50 million is planned for the third quarter of 2017.

Let me now turn to Eric for the outlook and the conclusion.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Thank you, Stephane.

So if we turn to Slide 20, you will see that we reiterate our outlook for 2017. We are on track to further improve the adjusted EBITA margin by 50 to 100 basis points in 2017. However, note that this is excluding the EUR 15 million real estate gain in Home in this quarter, as we have already said it. We will continue to deliver solid free cash flow, driven by profitability and working capital improvements. And while we are cautious given the global economic uncertainty, we remain on track to return to positive comparable sales growth in the course of the second half of this year.

Now that I have confirmed the outlook, I would also like to highlight 2 elements that will impact performance, but not our outlook for 2017.

First of all, we expect an additional gain on the sale of real estate in the third quarter of around EUR 20 million in Lamps, which will not affect our adjusted EBITA margin guidance. Secondly, as most of you probably know, a new tax regime came into effect in India on the 1st of July, which is known as the Goods and Services Tax or GST. We welcome this tax reform. But please keep in mind that it is estimated to have a negative impact of around EUR 15 million on our sales in the second half of the year, which, again, will not affect our growth outlook for 2017.

With that, I would like to open the call for questions, which Stephane here and myself are happy to answer.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the next question comes -- first question comes from the line of Andreas Willi, JPMorgan.

Andreas P. Willi - *JP Morgan Chase & Co, Research Division - Head of the European Capital Goods*

My question is on cash flow. You mentioned on the call and in the release the increase in inventory for growth in Home and LED in the second half. Should we expect this to be beyond the growth rates we have seen before? Because we -- these divisions have had good growth rates for a while, so why is there -- why the significant step-up in inventory now? Does it mean, basically, growth rates are expected to increase materially for the year? And should we still expect working capital in terms of the cash flow statement to be a positive contributor then for the full year as this working capital or the inventory gets shipped in the second half?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Let me take the question on the increase in inventory, and I will let Stephane take the question about the cash flow. So what we see so far, we see very clearly at the level of Home Systems a growth that is quite important for the year, and we expect to see it coming really to life in the 2 last quarters of the year. In that specific business, we ran out of capacity at the end of Q1 and during Q2, so we had to make investments in order to rebuild the capacity and to increase the capacity of that business for the rest of the year. And we have been building up inventories in order to make sure that we're going to capture all the opportunities in Q3 and Q4 for that business. We're also very much in line with the growth intake that we see on voice-activated devices of Amazon, Google, and now Apple is also coming in that game. Now when it comes to the growth rate, they also have to be compared to where we were last year because we also grew substantially in those quarters. But for Home Systems, we see a clear intake and a very, very big potential to grow further. When it comes to LED, we've seen also a high level of growth in those 2 quarters. It was around 16.6% or 16.7% in Q1 and 20.9% in Q2. We are fairly confident moving forward that we're going to be able to maintain a high level of growth for those businesses, and we need the inventory in order to be able to satisfy the demand. We need also to take into account that Q3 that -- the back end of Q3, but especially Q4, are very high quarters for us, especially for everything which is related to consumer businesses, so this is why we are building on these inventories.

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Yes. Andreas, on your question with respect to working cap and its contribution to free cash flow for the year, so I think we've always said that, since the end of last year that, in 2015 and in 2016, the reduction of working capital has been a significant contributor to the free cash flow, and that we should not expect that moving forward. It would be by the same order of magnitude by the simple effect of the company going back to growth. So from that standpoint, the contribution that was above EUR 100 million per year up to 2016, I don't think people should expect that it's going to be the same type of order of magnitude. Whether it's going to be a positive contribution, of course, we are working in order to be able to deliver this, but again, not as much as before. And then it's going to depend also very much on the level of growth in the fourth quarter. If we have a significant growth in the fourth quarter, of course, we won't be able to collect all our receivable by the end of December, and it would be collected partly in the first quarter of next year. So then in that case, that may impact the free cash flow, so that will also depend on the end of the year.

Andreas P. Willi - *JP Morgan Chase & Co, Research Division - Head of the European Capital Goods*

Just to clarify on the inventory build, was this mainly components? Or did you overproduce in Q2? But did it benefit profitability in Q2 or not, basically?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

It's both, Andreas. It's components and finished goods, yes.

Operator

And moving on to the line of Martin Wilkie with Citi.

Martin Wilkie - *Citigroup Inc, Research Division - Director*

It's Martin from Citi. Just on the LED growth and partly in relation to the inventory build. You mentioned, I think, last quarter, there was some change in relationships with certain distributors. And you'd also mentioned in the past that perhaps, white label could be a part of our new growth strategy. I just wanted to understand if any of these new distributor relationships were more onerous for you in terms of inventory build, in terms of whether you need to essentially hold more of it versus your distributors? Or is that pretty much neutral in terms of how the working capital works?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Thanks, Martin. It's pretty much neutral now. We are, and we've described last time that we're moving into the market of private labels. And we've seen that, especially on the consumer side of the business, that many of the retailers are moving also towards private label, and we've been very successful in securing some of those deals. So it would -- I would say marginally increase our inventory because these are standard products, but potentially different SKUs because the branding is different, but I would say it's marginal.

Martin Wilkie - *Citigroup Inc, Research Division - Director*

And if I can just follow up in that. In terms of those private label deals, you obviously are not going to disclose profitability and so forth. But does it have a meaningful impact in terms of your margin outlook in terms of that mix between Philips branding and private label? Or should we not think of any significant change there?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

So they have effectively from a gross margin standpoint a much lower level. But the drive business, they help also to dilute the cost base, and they are not that dilutive when you go to the operating margin.

Operator

And moving on to the line of David Vos, Barclays.

David Anton Vos - *Barclays PLC, Research Division - Analyst*

A question on the gross margin or the volume mix impact on that gross margin. There is quite a big step change between Q1 and Q2. Volume mix went from EUR 9 million positive to EUR 35 million negative. And I was just wondering if you could comment on where that exactly is coming from. Is this just the Lamps division declining in magnitude, or it is also partly contributed to the LED division, for example? And of course, if you could quantify that, that would be amazing.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Yes, sure. David, I'll take that one. So yes, indeed, when you look at our volume mix this quarter compared to last quarter, it's a different trend. You are right. It's essentially due to the Lamps business. We've seen higher unit decrease in Lamps year-on-year compared to what we'd seen in the first quarter. That has been largely offset in the Lamps business by gains, especially in terms of positivity. That's why, by the way, the total margin on Lamps is still high and slightly improved. But the volume effect is largely coming from Lamps versus Q1. Also, you notice that, in Home, our CSG this quarter is a bit below our CSG last quarter, so we had a bit of a higher volume in Home in Q1 this year compared to Q1 last year, and it's a bit lower in Q2 this year compared to Q2 last year. But the main driver is really Lamps. On LED, because you kind of hinted on that one, on LED, we haven't seen that much difference between Q1 and Q2, still a very high growth in terms of volume.

David Anton Vos - *Barclays PLC, Research Division - Analyst*

Perfect. And then actually staying on the same Page 13 as my follow-up. On the indirect costs side, so moving away from the gross margin, there is also a bit of a step change between Q1 and Q2. What are your ambitions for indirect costs going forward? Is kind of EUR 10 million a quarter of costs out, is that the run rate? Or can we achieve something materially different from that?

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

So when you look at the past performance, it's been actually higher than this. And you can't really do this on a quarterly basis because there is also comparison, there are some investments. So I mean, the true underlying number is, of course, better than that one. When you look on a full year basis, you probably remember last year, the improvement was closer to EUR 100 million for the year. And our goal is, of course, to continue to reduce our fixed cost structure, and we have taken quite a number of actions in order to deliver this. Q1 was limited, it was 0, although, of course, there were quite a number of additional investments. Q2 now, we start to see again some reduction, the EUR 9 million despite the additional investment. We plan to see more in Q3 and more in Q4. But yes, this is really on top of our agenda to make sure that we get our fixed cost structure reduced overall and also as a percentage of sales.

Operator

And moving on to the line of Lucie Carrier with Morgan Stanley.

Lucie Anne Lise Carrier - *Morgan Stanley, Research Division - VP*

My first question actually is around the Professional business. And you stated very clearly, you have high expectation for this business in the second half despite the market still being relatively soft in North America. So my question is, how -- what is the level of conviction or the evidence that you have that those project that you're expecting will take place in the second half? And how much of the, I would say, the top half of your guidance is linked to this conviction or to this expectation around the Professional business? That's question number 1.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Yes. As we said at the end of Q1, it's more than level of conviction because these are projects that we took in order intake in Q1. And these are projects that are going to be delivered in the course of Q3 and Q4 of 2017, so the backlog that we have already taken and that we need now to convert in revenue by delivering and installing the goods in Q3 and Q4.

Lucie Anne Lise Carrier - *Morgan Stanley, Research Division - VP*

Sorry. Just to my question on how much the top half of your guidance depend on this project?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

We're not going to give numbers. But we're not only depending on this project in the Americas. If that's the sense of your question, we see that we have -- potentially had in Professional in lots of the geographies which is quite good.

Lucie Anne Lise Carrier - *Morgan Stanley, Research Division - VP*

Okay. And my follow-up question was around regarding the pricing. It seems that the price pressure has stepped up as percentage of sales sequentially between the first and the second quarter, which was a little bit of a surprise because considering increase in raw materials across the board that we see, I was more expecting actually that the price pressure potentially would come down. So can you maybe comment on the dynamic on pricing here, please?

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Yes, sure. I'll do this. So when you look at the price effect, it was minus EUR 100 million. Q1 was minus EUR 87 million. So I mean, we don't really see any material trend on that standpoint. Now of course, it depends on the mix of the businesses and the pressure we've seen in one business group versus the other business group. In LED, which is usually where most of the questions are because that's where we see the highest price pressure, we haven't seen any material change in trend in price pressure in Q2 compared to Q1. And then for the other businesses, it's remained also relatively similar with fewer puts and takes here and there. But I would say, overall, no major change or trend evolution here with respect to price.

Operator

And moving on to the line of Alok Katre with Societe Generale.

Alok Katre - *Societe Generale Cross Asset Research - Equity Analyst*

Alok Katre from SocGen. Could I have a little bit of a follow-up on the Professional side? In the U.S., clearly, you have those, let's say, a few large projects that come in, and I can understand that you have a pretty sizable conviction on those. But can I sort of take it, or can we sort of take it as a message that you've already started progress on those projects, and therefore, that is what is driving the conviction that those projects will get delivered? Or is it where the projects are still, let's say, not even in the work in progress stage, and therefore, there are some risks attached to it? That's my follow-up.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Yes, sure. We have, at the back end of Q2, already invoiced a part of this project, but we could not recognize them as revenue yet because it depends on the actual installation of the goods by contractors. So as you can see, it's a reality. We have not only started to produce, we have also started to invoice according to the contract that was signed. So it's a reality.

Alok Katre - *Societe Generale Cross Asset Research - Equity Analyst*

Okay, fair enough. And then my question around the nonmanufacturing costs, could you just elaborate a little bit on where do you stand in terms of the process, particularly in terms of HR, finance and selling costs? I guess, you started some of these actions over the past 6 months, but any details or granularity on where you stand over there? And by when should we start to see a bit more meaningful impact on the savings and also feeding through into the P&L? And the associate sort of question over there. You talked about the GST changes in India. Should we -- I can understand the sort of sales effect over there, but should we then also see that, let's say, the bunch of red dots that you have on the distribution footprint over there also then start to sort of help you? And are you sort of doing any specific steps over there for the second half of this year or over the next sort of 12 months or so?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Sure. So Stephane can take the cost reduction action, and I will talk about India.

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Sure. So Alok, on the NMCs, so IT is probably the area where we started earlier, which has contributed already to a reduction of what we spend in terms of NMCs. There is more that we can do here, but that's the one that is the most in advance. Real estate also to a large extent. And here, I am talking in terms of spend, I put aside the gains, of course. Then when it comes to HR, that function is also -- has started its reduction plan probably about 6 to 9 month ago. And we start to see the impact in terms of reduction, and we will see more by the end of the year and especially in 2018. And finally, finance, the reduction and streamlining when it comes to finance has started. We've done the design in the first part of the year and that started at the end of the second quarter. Of course, implementation takes a bit of time because we have still a lot of thing that we need to do and to provide the finance function. And so here, we would expect to see the material effect in the course of 2018 and then with full effect in 2019. Finally, when it comes to sell-ex, which is the last part also of our spend in NMCs, in many regions, there has been a lot of actions taken to optimize our sell-ex, which we've been doing. In parallel, as you know and we highlighted some of the investment we've made also to support growth in some very specific areas and very specific businesses. But overall, we expect the end of the year and also in 2018 to also have a reduction of our sell-ex as a percentage of sales. So that's where we are on the overall confirmation and reduction of cost initiatives.

Alok Katre - *Societe Generale Cross Asset Research - Equity Analyst*

So but just to understand it clearly, it's more advanced in that sense I mean, for 2017, really, it's HR that you should see most of these savings and sort of come through. And then finance and sell-ex really look 2018, 2019 topic, right?

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Yes, yes. And also, as a percentage of sales, the impact of higher sales in Q3 and Q4 are also contributing to the dilute our NMC as a percentage of sales.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

So if we go back to the question about GST in India. Directionally, and for the medium term, we believe that that's a great measure, because at this point in time, the Indian territory is quite complex when it comes to the tax regime in between provinces. So it's a great measure, but it will need after it's being implemented a moment of adaptation. And we believe that, that would have an impact on our top line, as we have described, but that's for the short term. That will not modify the efficiency and the wide network that we have in India in terms of point of sales. They are based in the geographies where they operate, and they're extremely efficient, and we're going to continue to support them after that measure has taken place. But that GST measure will help greatly the way are gonna manage logistics in India, because at this point in time, we need to have warehouses in all the different provinces, and totally, we're going to be able to further optimize and streamline the cost of our logistic over there.

Operator

And moving on to the line of Daniela Costa with Goldman Sachs.

Daniela Costa - *Goldman Sachs Group Inc., Research Division - MD*

I have 3 questions. First, can you let us know if you closed any plants in conventional? And what's the plan in there? Obviously, you've done very well on the margins, so just have a little bit of more of a visibility on plant closures. And the second thing, on market share and following on some on the questions on LED, sort of the good levels of growth in LED. Do you think you're gaining market share? And maybe you can expand on market share more in general. And the third point, just wanted to ask you about pricing in Lamps. And obviously, as you said in the beginning, you are gaining some market share in Lamps. Is there a point where you can actually take advantage of this in pricing as well?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

So let me answer to the first quick question concerning the plants in conventional. So nothing that we have really commented and communicated in Q2. Once again, you know the way we work on that business. We're looking at all our industrial setup. And we are looking at how to move forward the factory utilization of the different plants that we have. And whenever that goes beyond a given threshold, I mean, we take the measure that we have to take. More may come in the distant future, but for obvious reasons, we will only comment on those whenever they happen. Market share, so it's true that on LED, we are growing at this point in time at a very good level. We believe that we are effectively taking market share. And what is also extremely important, if you remember, when in Q2 last year, that business, that was running at high double-digits started to grow between 11% to 13% starting in Q2 last year and for the full remaining of the year. So we implemented actions, very clearly dedicated actions, and in some countries where we wanted to expand on our go-to-markets and try new go-to-market that were also linked to the availability of different prices for LED lamps. We also tried to take advantage in the United States specifically about of -- from utility rebate, so that is happening. And we also decided to expand our reach to private label, while at the same time, we did a much more pull towards LED Lamps than what we did in the past. And all that is paying off. So it's market share increase, but which is also directly related to concrete actions. What is good to see also in that business continues to improve on its operating margin because we again increased it by 220 basis points for the quarter. So what we had said at the time was implemented. It took a little bit of time, 2 to 3 quarters to get the impact of these actions. But the actions are in place, they are continuing, and we see the results, which is good.

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

Yes. To your question on pricing for Lamps, Daniela. Yes, we still see a very limited price erosion. There is still a little bit of price erosion, but it's very limited across the various product lines. Then we are still able to extract savings from commodities and from purchasing, so overall, of course, that helps and that allows us to still be able to adjust a little bit the price in order to continue to gain market share, but again, it's limited. And we haven't seen any material change in Q2 versus Q1.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

And maybe just to complement. At this point in time, we continue to have a very rigorous, a very stable strategy when it comes to pricing in Lamps. As it has happened over the past 3 to 4 years, the market price, we're respecting the market price, and a very -- as Stephane has said, a very limited level of price erosion. Are we taking advantage of our position to increase prices? No, we're not doing that at this point in time.

Operator

And moving on to the line of Victor O'Reilly with Jefferies.

Peter Reilly - *Jefferies LLC, Research Division - Head of Capital Goods, Equity Research*

It's Peter Reilly from Jefferies. My question, please, is a bit more color what's happening in the U.S. LED market. There's been a shift away from premium to value and private label, which is very dramatic last year. Can you talk about whether that trend is continuing into this year? So in effect, you're seeing ASP's still coming down quite rapidly. And whether you see any sign of that trend starting in other places, for example, Europe?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

As I've said it previously, we see the trend in private labels for consumer LED lamps a trend that is taking place worldwide online and off-line. And we are participating to that market, which was probably more difficult for us to participate to that market when price erosion was extremely steep. Now it's a bit less steep than what it used to be, we are participating to that market. So it's not only a phenomenon that we see in the states, which is -- it has actually happened, but it's also a sentiment that we see in other regions. Now if we look at it from a different angle, this is not something totally new. Also, in the past with conventional lighting, we had that phenomenon of private labels by some big and small retailers, and we participated to it at that point in time. So it's still something that we know how to do. Now this trend is very good for us. It's very good for our volumes. It's very good for our bill of material. And as a consequence, it's also good for the operating margin.

Peter Reilly - *Jefferies LLC, Research Division - Head of Capital Goods, Equity Research*

And if can sort of follow up, please, on pricing for Hue. You've obviously got very high growth ambitions. It's getting very good reviews. But is this priced at a significant premium to some of the new entrants that are coming to that market place. So do you think you can keep Hue pricing where it is? Or do you think you're going to have to be more competitive on pricing, given all the other people that are targeting that space?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

That's a very good question. We are looking at the situation at this point in time. And when we look at our offer, we look at it more globally. So it's not only about connected lamps. And we could be compared with other entrants that offer connected wide lamps. But what you get when you buy a Hue lamp, it's not only the lamp itself. It's the connectivity with the full ecosystem that we have been developing and which we're investing a lot. So let me give you examples. One Hue lamp can be connected to motion sensors. It can be connected to battery-less switches, behind which, you can register all different types of SIMs. We invested a lot in the app. So part of the experience in the Hue offer, it's not only the lamp itself, it's everything which is around it. Now we also -- we also been working extensively with the smart home integrators that are at this point in time launching on the market voice activated devices, which is boosting the market of connected lamps. And here, the name of the game is not only to provide a lamp that can react to a command given to a voice activated device. You have to make sure that when the command is given, it goes very quickly to the cloud of the smart integrator, then goes to our cloud and comes back very fast to command the lamp. And there's a huge investment to be done there. So when we look at our offer Hue, it's not only about a lamp, it's about the whole ecosystem that comes with it. Now we're looking at it at this point in time, because it's true that the traction of that business is also bringing a lot of competitors. At least at one stage, we need to review our policy in terms of pricing, we'll do that. We're looking at that quite actively.

Operator

And moving on to the line of David Olofsen, Kepler Cheuvreux.

Peter Olofsen - *Kepler Cheuvreux, Research Division - Analyst*

Two question left from my side. First, on the restructuring in Professional, the manufacturing footprint adjustment there, and the chart you took in Q2, is that in a particular region, or are you taking measures there on a worldwide basis? And then a question for Eric. I saw a headline on Bloomberg which seems to be quoting you that you might be interested in GE's lightbulb business. Did you indeed made the such a comment? And if so, don't you think there will be potential antitrust issues when you would buy that business?

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

So let me take the one on restructuring for Professional. Yes, so the charges for actions that we are taking, more in Europe. I won't be too specific, but more in Europe. And so it's not something that's global. It's dedicated to some very specific and timetable initiatives to adjust the footprint, which it can be either manufacturing or, of course, more general costs. It could be development cost. It could be cost for the business group itself. So we're looking at the overall cost structure of our various business groups, so this is what the EUR 22 million is covering.

Peter Olofsen - *Kepler Cheuvreux, Research Division - Analyst*

Maybe a quick follow-up on that. Because if I look at Professional, it's probably still been the North American business, which is on the lower end in terms of margins. So is there any meaningful restructuring in that region? Or is it mainly the top line which has to drag the margin improvement there?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

It's mainly the top line that we expect to grow in the U.S. So let me now take your second question about lightbulbs and GE. So we've commented, and maybe I was not clear enough this morning, but I think I've said that quite clearly. We're not interested to acquire lightbulb companies. This is not where our M&A strategy goes. We've stated and I reinforced this morning that we're interested in luminaire companies that potentially would come for consolidation and technological bricks for systems or a platform and capabilities for services. So this is where our M&A strategy will play. And we've said from the beginning, small to medium-sized bolt-on acquisitions. So this is where we are, this is where we stay. So no interest to buy a lightbulb company and not interested to buy GE.

Operator

Moving on to the line of Nigel van Putten, ING.

Nigel van Putten - *ING Groep N.V., Research Division - Research Analyst*

I have a follow-up on the earlier discussions around the larger projects in Professional. So if I understand it, the U.S. project for the second half is also a street lighting project. Could you just give us a hint how this compares to Jakarta? I think that was about 90,000 luminaires. And then also, more broadly, I mean, should we see this as a trend strengthening into the next year, or is this more of a one-off for the U.S. today?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

It's not a street lighting project. It's more architectural lighting in that specific case. So we will only be able to comment whenever it happens. Yes, well, it's a big project, so it's a one-off, but it could generate further sales moving forward. But when we look at the project at its boundary, at this point in time, we could consider it a one-off.

Nigel van Putten - *ING Groep N.V., Research Division - Research Analyst*

Clear, yes. And then on sort of how should we see these bigger projects going forward? I mean to what extent will you continue to flag these? Or are they, at some point, over the course of business? And how will it compare to sort of the second or at least the first half next year?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

We will keep the same custom in what we have done previously where we believe that there are some projects that can be substantially impacting the numbers, we will comment. We did the same for a big project in Asia Pacific last year in the second quarter of 2016, so we will continue to highlight whenever the size is sufficiently material and so that we inform you. Now we are managing a pipeline of projects. We're reviewing them on a regular basis. Also, big projects take time in terms of a commercial process before we take in orders. So we have all these ones ongoing at this point in time. And whenever there is something sufficiently substantial and material, we'll inform you.

Operator

And moving on to the line of David Vagman, KBC Securities.

David Vagman - *KBC Securities NV, Research Division - Financial Analyst - Brussels*

A lot of my question has actually been asked actually. But first, on FX, could you clarify please what has been impact the FX on your cost of goods sold, and in particular the renminbi, so in Q2? And then maybe a question on the Philips Hue. Could you explain the investments you're now making, the strategy you have and the objectives you set yourself in term of profitability?

Stephane Rougeot - *Philips Lighting N.V. - CFO and Member of the Board of Management*

For David, on FX, as you know, and we provide this in the appendix in terms of the breakdown of sales. FX effect -- FX had a positive impact on sales, which is largely due to the U.S. dollar. Now when we look at our cost structure and specific cost of goods sold, even though we still have a large amount of costs that are in dollar, there is, of course, a large amount that is in renminbi. And with the devaluation of the renminbi, that had a positive impact. We don't provide the specific details of those impact, but that's what explains why the gross margin and also at the adjusted EBITDA level, we had the mix of that positive impact on sales. And then suddenly get the impact, but to a lesser extent because of the favorable impact of renminbi on the cost of goods sold, and that led to that positive impact on the adjusted EBITDA for the second quarter. We also had one by the way in the first quarter, as you noticed. So we had, from that standpoint, it's been a positive impact.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

When it comes to Philips Hue the investments that we are doing, we do 3 types of investments. So the first one, in innovation. So I've talked previously about what we do in terms of cloud-to-cloud connection as well as delivering new offers to the market. So that's one. We do also a substantial investment in terms of marketing campaigns and pool. So we have been able to see over the past quarters that activation for the business is extremely important. And we have a set of actions that are going to be put in the market in Q3 and Q4. And the last level of investment that we are doing on that business relates directly to logistics, supply chain and capacity. So we realize that in order to be able to cater for the volumes that we expect in Q3 and Q4, we also had to step up in terms of logistics and operations. And this is where a part of the investment that we've done on that business has gone. From a profitability standpoint, we still aim at the profitability level which is high. We're not commenting specifically, but the level of profitability of that business is very good.

David Vagman - *KBC Securities NV, Research Division - Financial Analyst - Brussels*

And then, if I may, just if you could follow-up on the operating leverage you expect to have on your logistical supply chain investment. When should we expect to, let's say, to see like the payoff -- these paying off in term of margin?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

So to explain also so the way we manage the supply chain, we are not manufacturing. We are using strategic suppliers to manufacture, so we fully design ourselves. So we will see an immediate impact on our performance whenever we step up together with our suppliers their capacity.

Operator

And moving on to the line of Alexander Virgo at Bank of America Merrill Lynch.

Alexander Stuart Virgo - *BofA Merrill Lynch, Research Division - Director*

So a couple of questions, if I may. One on Professional. Can you talk a little bit about what you are doing underlying in North America? I mean, obviously, I understand that you've got project work that underpins margin improvement in the second half. But I'm just wondering, from a sort of manufacturing footprint or a cost structure, fixed cost structure perspective, what you're doing there, and particularly in light of the indirect costs commentary earlier on? And then the second question, just around the second half. Obviously, your growth numbers in the second half of last year provides you with some relatively easy comps. I think they cross most of the business, actually. So I can understand that confidence in the growth accelerating, which is good. Can you just talk quickly about the impact of KSA on Professional? And how we should think about that in the back half?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

So in Professional, in the U.S. first, so we have been permanently adapting our cost structure to the business and that we have in that territory. I mean, we continue do that on a regular basis. So it's not only about the big project that we are talking a lot about here. It's also the rest of the business we currently adapt whenever need be our structure to the business we have there. Now we have also dedicated actions towards distributors, agents and also end-users in order to develop the business in the U.S. And we see in many different forms that business growing after a few quarters that we commented in the previous years of decline. So there are a lot of actions that are ongoing, and despite the big project that we're focusing a lot on during this call, so a lot of things are happening in the U.S. and we are permanently adapting there. When it comes to H2, you're right, the basis of comparison will be slightly easier because we declined 3%, maybe a bit below 3% last year, both in Q3 and also in Q4. But it's not only about the base of comparison, I think we expect genuine growth also to come during those 2 quarters. Now what about KSA? So we still are registering in Q2 an impact of KSA on the Prof business of 180 basis points of growth. So it is still important, but it is much less than what we experienced last year. So that's exactly in line with what we had anticipated. So we were very impacted last year. We had a bit less impact in this year, but it's still a market that is not rebounding at this point in time. And we have limitations in doing business since we have decided not to do any more business with customers that have not paid us. And when it comes to being paid, after the provisions for bad debt that we did take last year, this is coming in, but slowly. And I would tell you, probably a bit slower than what we had expected, but that's the reality of the situation. So yes, we don't expect the KSA to be rebounding for the rest of the year.

Operator

We now take our last question from the line of Sven Weier, UBS.

Sven Weier - *UBS Investment Bank, Research Division - Executive Director and Analyst*

Just quickly following up on your U.S. comments and what you just said on the question before that you are quite confident on what you're seeing in your more of the base business. So would you be confident to start outgrowing the underlying market again more like Acuity at the moment? We all know the market is kind of flattish, only slightly up. So would you be confident that in the next couple of quarters, you start outperforming the market growth again? That would be the first question.

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Well, if we take into account the big project that we have talked about and that we're going to be invoicing in those quarters, probably.

Sven Weier - *UBS Investment Bank, Research Division - Executive Director and Analyst*

Okay. But not excluding those projects?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

Well, difficult to say. Then we're going to go into a lot of details. What we are saying is that we have said, as other competitors, that the market was softer starting from August last year, and it has continued in Q4 and Q1 and also in Q2. So but we are active in the market, and we are taking all the possible opportunities.

Sven Weier - *UBS Investment Bank, Research Division - Executive Director and Analyst*

Okay. And then just as a follow-up question on what you said on India, that you said this is going to have an impact of EUR 15 million on the top line or EUR 50 million?

Eric Rondolat - *Philips Lighting N.V. - Chairman of the Board of Management and CEO*

No, EUR 15 million, 1 5.

Operator

Thank you very much. And I would like to return the conference call to the speaker.

Robin Jansen - *Philips Lighting N.V. - Head of Investor Relations*

All right. Thank you, ladies and gentlemen. And thank you very much for attending the call and for taking part in discussion about our results. If you have any additional questions, please don't hesitate to contact Investor Relations, and we are happy to answer your questions. And again, thank you very much, and have a nice day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for attending. You may now disconnect your lines.
