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LIGHT.AS - Q3 2017 Philips Lighting NV Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, welcome to the Philips Lighting Earnings call Q3 2017. For the first part of this call, all participants will be in listen-only mode and afterwards there will be a question-and-answer session. (Operator Instructions) I would now like to give the floor to Robin Jansen, Head of Investor Relations. Mr. Jansen.

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

Good morning, everyone, and welcome to the Philips Lighting Earnings Call for the Third Quarter 2017. With me are Eric Rondolat, CEO of Philips Lighting and Stephane Rougeot, CFO. In a moment, Eric will provide an update about our business and operational performance, after which Stephane will take you through the third quarter financial performance. Eric will then tell you more about the outlook for 2017. 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 this conference call will be made available as soon as possible on our Investor Relations website.

With that, I would like now to 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. I propose that we go straight to Slide 4. In line with our objectives, we achieved positive comparable sales growth in the quarter, comparable sales increased by 1.3%. For the first time in our transformation, the growth of LED and connected lighting systems & services more than offset the decline of our conventional businesses. Total LED based sales increased by 22% and now represent 68% of total sales compared to 56% in the same period last year. Europe delivered robust growth with a continued solid performance except in the U.K. and Ireland. The Americas and Saudi Arabia continued to be impacted by challenging market conditions. Overall, our operational profitability continued to improve with LED and connected lighting systems & services substantially contributing to this performance. As a result, the adjusted EBITA margin increased by 50 basis points to 10.5% in the quarter. Net income more than doubled from EUR 51 million last year to EUR 110 million this quarter. Free cash flow was minus EUR 5 million in the quarter compared to EUR 164 million in the same period last year. Working capital increased as an improvement in our growth profile, and a build-up in Home, ahead of the high season in the fourth quarter, led to higher inventories. In addition, inventories increased in several geographies where sales were softer than initially anticipated. Free cash flow also included a contribution of EUR 42 million to the company's pension fund in the U.S., which was partly offset by proceeds related to the sale of real estate of EUR 21 million.

I propose that we go to Slide 5, where you can see an overview of the financial performance by business group. LED, Professional and Home significantly contributed to the overall comparable sales growth performance, 10 basis points for LED, 380 basis points for Professional and 220 basis points for Home. Overall, as already mentioned, the adjusted EBITA margin improved by 50 basis points and we are pleased to see that, once again, all business groups are delivering in line with their strategic objectives.

This becomes even more evident when we move to Slide 6. So this slide shows the contribution of each business group to the overall profitability improvement. As you can see, increasing profitability particularly for Professional and to a lesser extent for LED and Home, more than offset the decreasing profit contribution of Lamps as its size continues to shrink.

Let me now quickly walk you through our business groups starting on Slide 7. Comparable sales in Lamps declined by 20.2% partly reflecting a high base of comparison in the third quarter last year. We estimate that the conventional lighting market continued to decline faster than our Lamps business in the first 9 months of the year, which has resulted in continued market share gains. Despite the high decline in top line, Lamps has been able to sustain a high level of profitability, at 20%. This is 110 basis points lower than last year due to the sales decline, but this was partly offset by procurement and productivity savings.

Let me now move to LED on the next slide, comparable sales in LED increased by 14.3% driven by significant volume growth, which was partly offset by lower selling prices and stronger growth in more affordable products. Growth was primarily driven by LED lamps, while growth in LED electronics slowed down. All regions contributed to the growth although countries with high LED penetration rates again showed lower growth rates, of course. The adjusted EBITA margin improved by 10 basis points to 10.7% in Q3, driven by operational leverage and procurement savings, offsetting price reductions and mix impact.

Let's now move on to Professional on Slide 9. In Professional, comparable sales increased by 7%. This solid growth performance does not reflect any contribution from a large project we are working on in the US that we have talked about in previous occasions. While production of our products and systems for this project is progressing according to plan, the end customer has decided to change the installation schedule, which has delayed revenue recognition. Systems & Services was the fastest growth driver in the third quarter. Performance in Europe and the rest of the world remained strong, while market conditions in the United States continued to be soft, in particular for small- to medium-sized projects. Market conditions in Saudi Arabia continued to be challenging and negatively impacted comparable sales growth by 300 basis points in the quarter. The adjusted EBITA margin improved by 380 basis points to 10.1%, driven by operational leverage, mix improvement and also cost reductions. Restructuring costs amounted to EUR 9 million related to the ongoing rationalization of the manufacturing footprint and indirect cost reductions.

Let's now turn to Slide 10 and Home. So Home showed an acceleration in sales growth and an improvement in profitability in the third quarter. Comparable sales growth of 28.1% was driven by significant growth in Home Systems and by solid growth in all regions. Demand for Philips Hue Home lighting system continued to increase significantly, because of our continued market penetration and our strong partnerships with the makers of recently introduced voice-activated smart home devices. To support the growth of the Philips Hue offering, investments in innovation, marketing and the supply chain continued and are expected to drive growth in the fourth quarter and beyond. The adjusted EBITA margin increased by 220 basis points to 1.4% in the quarter. This was driven by operational leverage and a continued focus on product cost innovation. All in all, Home remains on track to become profitable on a full-year basis in 2017, excluding the EUR 15 million real estate gain in the second quarter. So this is what I wanted to cover regarding the business and our operational performance, I will now hand over to Stephane who will tell us more about the financial performance for the third quarter of 2017.

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

Yes, thank you, Eric. Let me now turn to Page 12, and look at the adjusted EBITA bridge. So when you look at the gross margin, we saw a positive impact of volume and mix, and we also continued to deliver significant productivity and procurement savings as you can see, which helped the overall gross margin as a percentage of sales to further improve by 30 basis point compared to the third quarter of 2016. We also continued to work on our indirect costs, which decreased by EUR 12 million while we made additional investments to support our growth. And finally, we benefited slightly from the favorable currency effect on our adjusted EBITA.

Turning to our cost base on Page 13, you can see here the year-on-year evolution of our adjusted indirect cost base, which was 31% in the third quarter of 2017, which is 40 basis points lower than the same period last year. As you know, we have designed a detailed multi-year plan to significantly lower our indirect cost in particular on selling expenses, on IT, on the real estate, finance, HR. We continue to implement these plans and all the cost reduction initiatives that we have launched. We achieved during this quarter compared to last year a EUR 12 million reduction and this reduction again is after some additional investments that we are making in order to support our growth, in particular in Home Systems. In addition, as mentioned earlier, we benefited from the favorable impact of currency evolution also on our cost base, which reduced the indirect cost by EUR 14 million. If we look at the reported EBITA, we have a real estate gain of EUR 21 million related to Lamps. Furthermore, like I did also last quarter, I'd like to give you an update on our restructuring charges that support our cost reduction actions both above and below our gross margin. In the first 9 months of 2017, we recorded EUR 49 million of restructuring charges. For the remainder of the year, like we said at the end of July, we expect restructuring charges to be in the range of EUR 80 million to EUR 90 million and that brings for the full-year the restructuring charges to be in the range of EUR 130 million to EUR 140 million and that's in line with the guidance we gave, which is between 1.5% and 2% of sales. So these restructuring charges are expected to be booked in the fourth quarter, and are mainly related to the further optimization of our manufacturing footprint especially in Lamps and also the continued reduction of our cost base across our businesses and across our functions.

Let me now take a closer look at the working capital evolution in the third quarter. So overall, in absolute value, the working capital at the end of September increased by EUR 28 million compared to a year ago. It represents 11.9% of sales, which is an increase of 70 basis points compared to a year ago. We ended the quarter with higher inventories compared to the end of June and as mentioned by Eric earlier, that reflects the improvement of our growth profile overall as a company and also the build-up of inventories, especially in Home ahead of the high season in the fourth quarter. In addition, our inventories increased in certain geographies where we had anticipated higher sales in the third quarter. And finally, when you look at this trend in working capital and the impact of free cash flow, this is a very different trend, of course, compared to last year when working capital was lowered in the third quarter as the company was still experiencing negative growth. In the fourth quarter, we do expect a substantial reduction in inventories and more generally in working capital as this is the highest quarter in terms of sales.

Let's look now on Slide 15 at the net debt evolution. At the end of the quarter, our net debt is EUR 12 million above the end of June. If you look at the free cash flow, in addition to the profit that we generated in the quarter and the impact of the increased working capital that I just talked about, you can see some other elements that impacted our cash and therefore our debt position. Net CapEx was EUR 3 million positive because it includes the favorable impact of the real estate transaction for EUR 21 million. The change in provision of EUR 76 million mainly relates to the contribution to the U.S. pension fund that we did for EUR 42 million i.e. $50 million. In the quarter, we also paid EUR 33 million for both taxes and interest, and then outside of the free cash flow, you can see here the share we purchased, the buyback for about EUR 15 million to cover the obligations that we have in our LTI performance share plan. And that leaves us with a net debt position at the end of September of EUR 709 million, which includes ourincluding a cash position of EUR 605 million at the end of September. Let me now turn to Eric for the last part of the presentation.

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

Sure. Thank you, Stephane. Let's now move to Slide 17 and let's move to the outlook. Achieving comparable sales growth in the quarter is an important step in the improvement of our growth profile. We are also on track to improve the overall adjusted EBITA margin by 50 basis points to 100 basis points and for Home to be profitable for the full year in 2017. Please note that this is excluding the EUR 15 million real estate gain in Home in the second quarter of this year. In addition, we expect to deliver a strong free cash flow in the fourth quarter based on a substantial reduction in inventories. So with that, I would like to open the call for questions, which Stephane and myself are very happy to answer.

QUESTIONS AND ANSWERS

Operator

Thank you. Ladies and gentlemen, we are now ready to take your questions. (Operator Instructions) And the first question comes from the line of Andreas Willi with JPMorgan.

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

Good morning, gentlemen. My main question is on the inventories that you discussed on the call as well as the increase, if you could break that down, how much is in that sense good inventory because you see the strong demand in Q4 in Home and then what's the amount of excess inventory in LED where you couldn't sell as many as you had expected? And what's the impact on Q4 in terms of selling out these excess bulbs, should we expect a negative impact on margins in terms of price reductions or discounts or can that just be sold instead of --basically by new ones during Q4?

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

So let me try to take it by piece. As you know, we do not give exact [proportions], but I will tell you what is in the inventory build-up. So first of all, there is an increase in the Home business as we had targeted not only an increase in Q3, which has materialized but we also have anticipated a strong increase in Q4 for that business and in general for the consumer business of Philips Lighting, Q4 is a strong quarter. So I would say that this inventory is built up to prepare for future higher sales. So this is also the translation that when you have the big change in the growth profile with the business, overall, Home was growing at 28% in Q3, it does consume working capital and we need to be able to build the inventory to tackle the demand, which if you remember well, we were not doing so well last year and I think that we missed opportunities. So we didn't want that to happen in 2017. Now let's move to other businesses, and let's move to LED, when you look at the performance of LED in Q3, the performance in LED lamps is pretty much in line with expectations, maybe a bit lower as we were very aggressive also on that business and we had started to build-up inventories as we said previously at the end of Q2, for the demand that we were forecasting in Q3 and now also coming up in Q4. Where we were surprised is with the lower demand that we experienced in the LED electronics part of the business. And this is where we had built up inventory and not only in finished goods, but also in components because this is a business where we are not totally outsourced and the demand there was lower than what we had anticipated. Let me give you a very specific example. In the U.S., selling to OEMs or to linear manufacturers, we've seen that demand was much lower than we had anticipated and a market that was far softer, especially when we're selling to big OEMs, there's still more dynamic selling to smaller size customers, so this is what we experienced on that business. There is no real impact on margin that we see on this inventory build-up, most of it, I would say, is outsourced, what is not outsourced is not so much in finished goods but also a fairly sizable amount in components. So, I hope that this answers your question on that.

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

Yes, that's very clear. The follow-up question, if I look at your Professional business, which had an excellent quarter, Europe probably needs to grow somewhere in the mid-teens, which is maybe 5 times market growth, you maybe give some more comments around where you are gaining share, are there some larger projects, is this kind of double-digit growth in Europe sustainable? Thank you.

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

So let me give an overall comment not only about Europe. What we are very pleased to see, is the 2 steps transformation really happening. So the first step is about converting the business to LED. And the second step is moving to connected lighting. What we've said previously in the calls is that we had been investing ahead of the curve on the consumer business, but also on the Professional business in order to build the right weapons that would help us to be also a leading player in the connected lighting space. Namely what we've done on the Professional part of the business, we have invested in technology, because when we sell connected lighting systems, all the technology is ours. We have been investing in new technologies, new capabilities in all the markets where we operate in order to be able to sell directly to end users our connected lighting systems. We have also invested in entities, 8 around the world, that we call system centers that do not only do quotation, but also the delivery of the project. When we reviewed in the last week the performance in the different markets, we realized that these investments are starting to pay off, they come to a level of maturity that is satisfactory and this is bringing the sales of connected lighting systems & services up. This has been particularly the case in Europe, where we have been strong on products, but also very strong on connected lighting systems & services. We are touching 3 major end user segments. So historically, we've always been good in what we would call the outdoor applications, probably still the case, but also now with the newly announced InterAct Office offer, we see that we are also successful in offices and industry, but also in retail and hospitality. So we see that this trend is really coming to completion and as I was saying, I think we only scratched the surface, the potential in connected lighting is really, really strong moving forward.

Operator

And moving on to the line David Vos with Barclays.

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

I have 1 please on connected lighting solutions. Acuity in its recent report mentioned that it's now installed 90 million square feet, around 8 million square meters in its connected lighting solution offering. I was wondering if you could give us sort of a similar number as to where Philips is at this moment in time? And then the second question would be just on the U.S. professional business also, if you could give an update on how the margin improvement in that particular bit of the business is going, it strikes me that perhaps we've made a bit more progress there too so, but confirming that would be helpful?

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

Yes, David, we are not always using the same metrics, for us the metric that we use, which is very specific and I think it is an unequaled number in the lighting industry at this point in time, is to measure the number of light points that we have connected across all the sectors and all the end-user segments including consumer and professional. And at the end of September 2017, we had connected 26 million light points worldwide in all the different segments. When you know that 26 billion is the existing number of light points today on the planet, it gives you an idea of the potential that we have moving ahead.

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

Sorry, Eric. The line just broke up a little bit, so that's 26 million as of the end of Q3 versus 26 billion of total light points globally?

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

Yes, absolutely.

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

Would you be able to give us a sense of how that's moved between Q2 and Q3, that 26 million number?

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

Yes, I can tell you how it moved between the end of last year, where we were at 22 million and at the end of this quarter, where we are at 26 million, so you see that there's been a big, big increase in the course of 2017. On the U.S. Professional business, we are continuing to see, as we have said it repeatedly in the previous quarters, in the construction nonresidential market for small to medium sized projects, the market being soft with renewed intensity, competitive intensity. So this is a market, which is pretty much backward at this point in time and the signs of weakness are continuing. We don't see that this will [rebound] anytime soon. This is a situation that we are facing since a few quarters. At the same time, we are continuing in that environment, in achieving the plans that we have in terms of improvement on many different forms. So that is not deterring in any way our resilience to carry the plans that we had ahead. But that's the situation of that market, specifically in the U.S. Now there is another side of bigger project dynamic. There is another side now, maybe less on the Professional side but on the consumer side, which is also moving up quite fast. I just wanted to highlight because we said that when we did the introduction, that we also on specifically the U.S. professional market starting in Q1, we continued in Q2 talking to you about a major project that we had taken and that we would be invoicing in Q3/Q4 and potentially also Q1 next year. I just want to make sure and highlight that in the performance of Professional that you have in front of you, there is no contribution of that project. So we have not been able to recognize revenue in Q3. And this has nothing to do with the project itself or our contribution to it. On the contrary, we are totally in line with whatever we had to deliver in terms of production. So we are absolutely ready and on time. It's just that the end-user customer has decided to postpone installation and then as a consequence to this, the revenue recognition is also postponed. So I just wanted to make that clear because we were pretty much telling you that this would be recognized in Q3, it hasn't been so far.

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

Yes, that's very clear. Thank you for that. Where is the client now in terms of the delays? Have they now made up their mind, and do they want it in Q4 or in Q1 next year? Can you shed some light on that?

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

Yes, I would, we are in daily contact. At this point in time we don't know exactly, because we have a contractor in between us and the end users. So we are discussing. But we don't know yet. We have also now a period in the U.S., it's going to be winter, so installing in the winter is not always easy. So we don't know what is in the mind of the customer at this point in time. So I cannot really comment. But we are invoicing and we are being paid. But we don't recognize revenues at this point in time.

Operator

And the next one in line is Alexander Virgo from Bank of America Merrill Lynch.

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

So the first question, I guess, I wondered if you could just break down the margin improvement in Professional for us? Maybe just give us a sense for how much of it is related to the structural cost reduction, particularly, how much of it from operational leverage, pricing headwinds presumably is an offset. Any indication on the granularity of that breakdown you could give will be very helpful.

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

Yes. So, Alex, Stephane here. Let me give you a little bit of direction here without, of course, being specific because we won't provide those breakdown by business. One of the large drivers, of course, has been the revenue increase and the operational leverage and, yes, for sure in the past few weeks, we've seen a higher than usual or higher than before volume effect, that is very positive. So that is driving overall the operational leverage. That is loading off factories and that has a positive effect on the P&L, that's one element. The second one is that, as mentioned by Eric, we've seen in Q3 again a significant level of activity in systems and therefore growth and as you will know, Systems carry a higher margin, so from that standpoint, the mix effect offsetting more Systems than products has also contributed to the margin improvement. It's not something new. It was the case already before but also in Q3 it has helped and that's the strategy that we are pursuing. Then 3, cost reduction, yes, for sure across our various geographies for now several quarters, we've taken actions to reduce our cost, manufacturing cost. You saw, for example, in Q3 last year, the significant restructuring charge we took in the P&L that was for manufacturing sites in Professional and for the last 4 quarters, we have actually closed those sites. And then also on indirect cost and across the P&L, of course, we are also bringing down the cost. So it's really those 3 elements that are driving the improvement in the margin.

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

Okay, that's very clear. Thank you. And then just as a follow-up question, if I just take a quick look at the LED growth for the group, you quoted a 22% LED growth, divisional growth, obviously, is only 14% but because LED as a division is much, much smaller relative to the rest of the group, it implies pretty meaningful growth for Professional again given Home is small in relative terms, with respect to growth in LED and Professional. Would it be right to assume that your growth in LED and Professional and I guess related to the Systems comment you just made, must be north of 25%, 30% year-on-year. Is that the right sort of number to think about?

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

We are not indicating those types of numbers now. Where you are right is that the growth of Home LED is substantial and probably higher than the growth of Professional LED, which is also above the average.

Operator

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

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

I just had 1 follow up regrading connected lighting systems, just to give us a sense of how much growth you are getting out of that and also parallelly, if you could just remind me of the connected light points at the end of 2016, I didn't catch that number. Those are just the follow-ups and then I will come to my question.

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

We had communicated a long time ago at the time of the IPO that connected lighting systems and services was 10% of the overall Professional business. It has grown since then, as that part of the business has grown much higher than the average. We estimate [the year] at this point in time around 18% to 20% of the Professional business.

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

And number of connected light points at the end of 2016?

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

At the end of 2016, we had connected, and that's not only on the Professional side, the professional and consumer side, 22 million light points. And at the end of September this year, it's 26 million.

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

And just on how are you positioned on the input cost side. I'm just thinking about the input costs and then the cost savings within the bridge, obviously, the decline in non-manufacturing cost is quite modest yet. So obviously, one is when should we expect an acceleration over here, is it still on track for 2018? And then how are we positioned on the input cost side where we are hearing about rises in chip prices coming out of China? So, it would be great if you would clarify on that? Thanks.

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

Yes, so let me take the first part on the non-manufacturing costs. So, yes, you saw in the first 2 quarters of the year, because of the sales decline as a percentage of sales, we are still above the same quarter of the previous year. Now Q3 is a much better trend. We are below the third quarter of 2016 investment base by 40 basis point, EUR 12 million is, of course, a significant amount. Now as I mentioned, it includes also the fact that we have increased our spend in a number of areas to support the growth especially in Home Systems. So I hope you can see that overall R&D cost in absolute value is higher in Q3 this year than in Q3 last year. So we are also investing to support the growth, now we expect more cost reduction [per quarter] than the EUR 12 million but it doesn't come always exactly in a linear way every quarter, but, overall, yes, the programs that are in place are tailored and designed to deliver more than that, because, as you know, the goal is that we reduce our non-manufacturing cost as a percentage of sales and we go to a range, which is anywhere between 25% to 29% over the next 2 years. So there is more to come. And part of the restructuring charges that we are picking also address those items. Now on your other part of the question on components and bill of materials, we're still being able to extract quite a large amount of savings in that area across our various business groups. We've seen, of course, a bit of tension on some of the components side in terms of pricing, but nothing that is changing the trend of the bill of materials [savings] that we've had over the last few quarters.

Operator

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

Lucie Carrier - *Morgan Stanley, Research Division - Analyst*

The first 1 is actually on the LED division. It looks like maybe the growth, you had spoken about the price being a bit of a headwind, but when we look at the overall bridge for EBITA, it doesn't seem that the price pressure, overall, at least for the group was significantly higher than the previous quarter, but the operating leverage, of course, on the margin in LED seems to have been quite weak, so I'm just trying to understand how we should think about the development of the earnings profile in this division going forward as it seems that the margin is a little bit stalling here?

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

Yes, I think you're right in your analysis, so the price pressure has not been drastically higher than before. I think we're capable in that business still to hold on the gross margin and if we connect that to the previous question of Alok, I think that now we see higher operational leverage, it will also come from our capacity to reduce our overall non-manufacturing cost, because each business depending on their share of our revenue is also allocated some cuts from the overall Philips Lighting base cost. So this is something that we have in mind and that we are working hard on. The cost of the company as a whole is a subject that we are tracking at this point in time with the highest level of authority to bring it down.

Lucie Carrier - *Morgan Stanley, Research Division - Analyst*

The second question I had, was regarding the comment you made around the LED electronics business, which had come much softer than you were expecting. I just wanted to understand that in the bigger context of the demand for this type of product, which are typically led by Luminaires manufacturers and kind of bigger lighting system, should we read -- I mean, do you think it was more of a one-off, maybe something seasonal or should we read a little bit more into it, because typically customers are not buying control of the electronics, it means they probably don't plan to actually manufacture the luminaire. So how should we think about that case?

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

It's directly linked to the sectors, if people don't buy drivers it means that they probably are not going to sell luminaires, now just to correct one of the things that you have said, it's not only linked to big lighting system offers. You know it's luminaires in general including also luminaires that would go into systems. But you're right, the fact that less drivers or less LED modules are being sold by us, it means that our customers are selling less luminaires. Now it depends on the geographies. We see at this point in time trends specifically in Northern America that we don't think is going to be only a quarter issue, it may last a bit longer.

Lucie Carrier - *Morgan Stanley, Research Division - Analyst*

Just to follow up on that, so you are kind of implying here that you expect potentially the North American luminaire business as a market to continue to be a little bit weaker, considering the trends we're seeing in electronics for bit of a longer-term?

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

This is pretty much consistent to what we've said on and on that we were seeing the non-residential small to medium-sized project market being soft in the U.S. that's a confirmation of it.

Operator

And moving on to the line of Peter Olofsen with Kepler Cheuvreux.

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

I had a question about the Home Systems business. So basically the growth that you are showing is what you are selling into the channel. What are you seeing in terms of retail sellout, are you seeing similar growth there or have your retail partners been building up inventory as well ahead of the Q4 demand? And then I have a follow up on the LED segment.

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

Yes, actually the numbers that you see are the selling in numbers, the sellout has been extremely fluid, at this point in time given the growth of that business also at our customers, there is very little time to have in between inventory to be built, but this is an extremely, extremely dynamic environment, and the sellout is very strong, too.

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

Okay, that's helpful. And then on the LED segment, how big is the electronics part within that segment?

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

Electronics is slightly below 50% for that business.

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

So it's pretty sizable within the total?

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

Yes, absolutely.

Operator

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

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

I wanted to go back to the free cash flow point. Can you comment whether you think you will be positive in 2017 on free cash, and also, what do you think is a normalized working capital to sales level for this business, let's say, under flat growth? And then I have a follow-up, a quick one.

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

So I will take the first part of the question, which is the easiest one and I will leave the other one to Stephane. Yes, we will be positive in free cash flow through 2017.

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

So, Daniela, to your comment on whether we see any material evolution in our working capital percentage and should it change on that what it was before, the fundamentals you know, of course when you are in a period of time where you go from decline to growth, the whole percentage on a quarterly basis can become a little bit different. Also as you understand it, when you have accelerating growth especially in some businesses, and yes I am referring to Home Systems, when you measure inventory as a percentage of last 12-month sales, it doesn't really show what's coming, so it increases a little bit the percentage, but fundamentally our working capital as a percentage of sales as a company, even when we return to growth, shouldn't be fundamentally different from what it used to be. And we are not going to go backwards compared to the improvements and reductions that we have talked about the last 2 years.

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

And following up on the positive free cash in 2017, shall we look at Q4 from the prior year as an indication or given growth is potentially much better now, it should be substantially lower than that. And pension contributions, can you comment whether those are going to continue?

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

So let me take at least the pension part. So we said we would contribute $150 million over three years. So for this year, we're not going to making additional contributions, but we will make further contributions in 2018 and 2019 and as a consequence we reduce, of course, our liability by the same amount, and also improve some of the P&L and premium costs that we are seeing. And then on the fourth quarter where we are expecting a strong free cash flow and then a strong reduction of working capital in the fourth quarter -- and in inventories, of course.

Operator

And moving on to the line of Peter Reilly with Jefferies.

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

I've got 2 questions please on trends in LED and Lamps. Firstly on LED, I'm interested in the mix, you told earlier this year about -- and also last year about the U.S. market moving more towards value and requires a rapid rate in 2016. I get the impression that's now happening in other parts of the world so maybe you can talk about the overall mix and whether you see parts of the world. So maybe you can talk about the overall mix and whether you see this trend continuing for quite some time? And then secondly on Lamps, I think if my memory is correct, in 2016 the market fell more slowly than you anticipated, which is one of the reasons for the margin being so strong, in 2017 looks like the market is starting to fall faster than you anticipate, and you've got the strong growth coming through. Looking slightly further ahead, I mean, is the risk here to the Lamps business actually starts to decline at a faster rate because it's been cannibalized more rapidly by LED. So what can you tell us about the trends developing in the Lamps business please?

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

On the first question regarding LED. So our LED business growth is -- which are repeatedly integrating 2 different businesses, the LED lamps and the LED electronics. So we've talked about LED electronics, giving it a bit of flavor of what we see happening in the world with a market that has softened and we gave the specific example in the U.S., which is our biggest market for that business. When it comes to LED lamps, what we see, we see that in the markets where LED have already penetrated above 50%, we see that the growth of LED lamps is smaller and this business is growing slower than in other geographies where the penetration is not as much. So let me give you an example, there are countries in Europe at this point in time where we are already selling more for than 2 quarters more LED than we sell conventional lamps, in which case we see the growth of the LED lamps being slower than in other countries, like probably growth countries where the penetration of LED lamps in the overall lamps market is much more reduced. So that has to be taken into account when we look at the overall growth pattern of that business. Of course, we continue to innovate to bring new products to the market and new features, but that's a reality that we also have to face. When it comes to Lamps, I would say it in the same way as you did, probably that towards 2016 we were expecting a faster decline than what actually happened. In 2017, it's true that we believe that the market is declining faster. We estimate that we have between 23% to 25%. So with our decline, which is around between 18% to 20%, we are doing better than the market decline. And this is the prime objective of that business. It is to gain market share and to be the last standing man. So this is actually happening and we are making this happen. Could we see the lamps decline faster in the future, was there clearly some technologies that are going to be banned at least in Europe to start with in 2018, which is halogen and what we also see, we also see that the cannibalization especially on the consumer business for the technology that is compact fluorescent lamps is at this point in time happening quite fast because the prices of LED are reaching also the price points of compact fluorescent lamps. So all these are factors that we need to take into account, we still believe that we should be around the same level of decline, maybe on the higher end of the range, we said 15% to 20%, but this is something that we monitor and once again in the Lamps business group, the main objective for us has always being to reduce cost before the volume come down. And as you can imagine we're looking at that on a very regular basis to see how we need to adapt our cost base depending on how we see the volumes going down. So these are very, very dynamic exercises that we have to make in a declining environment.

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

And if I can just come back on the LED lamps business, I think you said in the prospectus, you thought the market would peak in volume terms at about 2020 and then go into decline because you have longer lifetime, therefore a lower replacement rate. Is that still your view that 2020 is the volume peak or given that a -- [actually] more rapid shift towards LED, may be volume peak is earlier than that?

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

Yes, we are keeping the same view. It was between 2019 to 2020, but this is when you look at the market of non-connected LED lamps. If you were looking at that market in a different way and saying, okay, it's not only about non-connected lamps, it's also about the simple connected lamps, so the white connected lamps and if you add to the market of Lamps, the connected lamps and if you add also to that market perhaps what is going to cannibalize the non-connectivity lamps, which is what we call the LED luminaire, the ledinaire, the functional ones, then we believe that that market has the potential to grow beyond that point. But otherwise, if you are strictly talking about non-connected LED lamps, we are pretty much always on the same time horizon in terms of market peak.

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

And the LED lamps in the LED business, they are all non-connected because they get reported in Home and in Professional or I am missing something there?

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

Yes, you're right, at this point in time they are all non-connected.

Operator

And moving on to the line of Marc Hesselink, ABN AMRO.

Marc Hesselink - *ABN AMRO Bank N.V., Research Division - Analyst*

My first question is also on the free cash flow, on the provisions you talked about, the pension one, there are also some other provisions that change, then you will have the restructuring charges in the final quarter, it also cashed out in the same quarter. Can you talk about what are you going to see in provisions in the coming quarters but also in the coming years. And my second question is on Saudi Arabia, still a very big impact if I'm correct, it started like a bit over a year ago. So I was actually expecting that it would ease off a little bit in the year-on-year comparison. So can you talk about what's still further deteriorating in that market and what's the outlook there?

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

Yes, Marc, let me take the one on the free cash flow and the provision. So first, when you look at Q3, the comparison to last year is quite different, as you said, this year there is the impact of pension, which was not last year and also the other thing is that last year as you saw the net provision movement was positive EUR 7 million and this is because we took last year a large restructuring charge during the quarter, which, of course, was not cashed out during the quarter, hence the positive impact on the provision. This wasn't the case this year. Now in the fourth quarter, we expect to take a significant amount in restructuring as a charge, we will not spend the cash on that charge during the quarter. This is cash that we'll be spending in 2018 and probably also for some of those initiatives in 2019. But it will hit the P&L, but not the free cash flow in the fourth quarter. Moving forward, again, we said that overall and again in 2018 and 2019, we expect to book P&L charges in the range of 1.5% to 2% of sales so that we tackle the optimization of our manufacturing footprint, especially in the Lamps area and then later on that amount will go down and we are still on track for that.

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

To answer your question on KSA, I would echo what you have said, the impact has been worsening in Q3. We should expect, and we should have expected also in Q3 an impact closer to what we have seen in Q1 and Q2. There's a very specific thing that has happened in Q3, where we have

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really continued to apply our rules of prudence on that market, especially when it comes to credit management. So there's a very specific issue that I cannot comment on in Q3, but the normal trend should be what we have experienced in Q1 and Q2.

Marc Hesselink - *ABN AMRO Bank N.V., Research Division - Analyst*

Okay, that's clear, maybe as a short follow up on the provision, on the year-on-year comparison, is the change in provision except for the pension, is that a net inflow or outflow?

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

When you see year-on-year?

Marc Hesselink - *ABN AMRO Bank N.V., Research Division - Analyst*

Yes, for the full year.

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

For the full year, based on what we will take in the fourth quarter, that should be an inflow meaning we got to book more provision that we are going to cash out.

Operator

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

David Vagman - *KBC Securities, Research Division - Analyst*

First question on the LED business and particularly on the LED electronics. So you've been saying that the LED electronics were lower, could you kind of tell us -- I think I didn't hear it correctly like the breakdown in sales in the LED division between LED lamps and LED electronics and maybe then give us some indication on the impact of the weaker LED electronics on the margin for the division because I guess the LED electronics is higher margin and then actually, second question on the Professional margin, could you give us a very rough indication of the trend, not maybe the absolute levels, but the trend in margin between Europe and U.S. and maybe the KSA, Saudi Arabia impact on margin?

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

So let's start with the LED part. So as I have said previously, when you look at the overall LED business groups, slightly less than half of that business group is LED electronics, there is no substantial impact in terms of mix between the 2 businesses when you re-consolidate the global at the global business group level. The margin in Europe is above average and the margin in U.S. is below average. The impact of KSA on the margin has been quite substantial. We don't disclose it but it has been quite substantial also in Q3.

David Vagman - *KBC Securities, Research Division - Analyst*

And then to come back on Europe and U.S. maybe the trends I understand that Europe is above average, but as for instance, Europe's been improving faster than U.S. given the difference in the market conditions?

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

Well, we see a positive trend in that business in terms of margin due to 2 factors. And this is valid in Europe as much as it also valid in the Americas, which is that when we said in luminaires, we said it is at a higher margin than a conventional luminaire and when we said systems, which is the part which is growing the fastest in that business, it also trends at a higher margin than LED luminaires. So the combination of the growth of LED luminaires as well as connecting lighting systems and services is having a positive impact on the margin. And this is valid in Americas as much as it is valid in Europe.

Operator

We now take the last question from the line of Timm Schulze-Melander with JPMorgan.

Timm Schulze-Melander - *JP Morgan Chase & Co.*

It was really just a clarification, Eric, I think you talked about this large U.S. project where you said that you are invoicing and you are being paid. But you're not recognizing revenue so the question is really 2 parts, just a) that seems a slightly strange situation, if you could just provide a bit of clarification. And #2, that would suggest that project has not been a material influence on your working capital and cash flow metrics in Q3. Could you just confirm that?

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

Yes, it has an impact on our cash flow and it stays since we have produced the goods in inventory. So it has a material impact on the cash flow, so that's one. Second, the way the contract is basically done in the following fashion, so we have to produce against some given schedules whenever we need those schedules we are invoicing and then there is after the invoicing a delay in order for us to be paid, and all that is happening exactly according to plan. Now the revenue recognition for the transfer of the title of the product was linked to the start of the installation and the product being taken by the installers to start the installation and as this is not happening, according to the accounting rules that we have to follow-up, we cannot recognize.

Timm Schulze-Melander - *JP Morgan Chase & Co.*

And could you give us some scaling of how significant a contribution that was into the Q3 working capital please?

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

We cannot do this for obvious reasons, I am sorry Timm but if we highlighted starting in Q1 continuing in Q3, that we had been able to get a substantial project, [the substantial size] was also to be able to guide you towards the fact that this is something which is quite sizable [for future thinking].

Operator

And with that, I would like to return the conference call back to the speakers.

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

All right, ladies and gentlemen, thank you very much for attending the call and for taking part in the discussion about our results. If you have any additional questions, please do not hesitate to contact Investor Relations and we're happy to answer your questions. And again, thank you very much and enjoy the rest of your day.

Operator

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