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PRESENTATION

Operator

Hello, and welcome to the Signify Third Quarter Results 2021. (Operator Instructions) Today, I am pleased to present Eric Rondolat, CEO; Javier van Engelen, CFO; and Thelke Gerdes, Head of IR. Please go ahead with your meeting.

Thelke Gerdes - *Signify N.V. - Head of IR*

Good morning, everyone, and welcome to Signify's Earnings Call for the Third Quarter 2021. With me are Eric Rondolat, CEO of Signify; and Javier van Engelen, CFO. During the call, Eric will touch on the key operational and financial takeaways for the third quarter '21. Javier will then follow with a review of the company's performance for the third quarter. To close, Eric will end today's presentation with the outlook for the remainder of the year and closing remarks. After that, we will be happy to take your questions.

Our press release and presentation were published at 7:00 this morning. Both documents are available for download from our Investor Relations website. The transcript of this earnings call will be made available as soon as possible on our IR website.

With that, I will now hand over to Eric.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

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

Let's start with some highlights of the third quarter on Slide 4. So the demand for connected lighting and the performance of our growth platforms remained solid in what has been a very disruptive external environment this quarter. The strong demand pickup across most segments and geographies is evidenced by our healthy order book, which increased by 90% in comparison to the third quarter of last year. This economic recovery further aggravated the challenging supply of our environment, which we had already discussed in the 3 previous quarters. These developments impair our ability to meet the high demand and resulted in a negative top line impact of more than EUR 100 million.

We have taken a comprehensive set of short-term and mid-term mitigating actions to reduce the impact on our customers while simultaneously increasing our prices to offset structural inflation. These actions have enabled us to deliver a strong double-digit adjusted EBITA margin of 11.1%, driven by an acceleration of price/mix and indirect cost savings. At the same time, we continue to invest in digital and marketing initiatives to further enhance our growth profile. Working capital remained structurally healthy in the third quarter, and our free cash flow generation remains on track, although delayed due to the current external challenges.

I would like now to discuss our third quarter performance in more detail, and I propose that we move to Slide 5. So we increased the installed base of connected light points from EUR 86 million in Q2 to EUR 92 million at the end of Q3, including 2 million connected light points from Telensa, the U.K.-based and street lighting company we recently acquired at the start of the third quarter. LED-based sales now represent 83% of total sales. Sales came in at EUR 1.6 billion, representing a comparable sales decline of 4.8%. Adjusted indirect costs decreased by EUR 37 million to 29.4% of sales, driven by structural cost savings and one-off effects in the previous year, namely the provisions for the partial reimbursement of solidarity contributions to employees.

Strategic investment in digitalization activities continued. The strong double-digit adjusted EBITA margin of 11.1% reflects the positive price and mix actions, offsetting the structural part of inflation and underabsorption of fixed costs. Net income increased by EUR 4 million to EUR 94 million. And finally, free cash flow was EUR 85 million as a result of a lower income from operations and an outflow from working capital.

So on the next 2 slides, I will give a bit more details on the demand supply and supply environment as well as the pricing development. So let's go to Slide 6. Our order book grew since Q3 2020 with order levels increasing sequentially over the last 4 quarters. Compared to last year, the order book value increased by 90% at the end of Q3, and this is due to a strengthening demand in component scarcity and logistic challenges. Indeed, we have been exposed to e-component shortages with a spike in the number of escalations in the second and third quarter.

The Q3 lockdowns that have been taking place in Malaysia and all the ASEAN countries lead to further e-component decommitments from our suppliers. We have also been exposed to global logistic challenges, including container shortages and port congestions, as 10% of the world shipping capacity was taken out during the quarter.

And during that same quarter, we experienced 5 cases where Chinese sports, which are important hubs within our supply chain, experienced a shutdown of congestion. And as widely reported, we are continuing to see congestion at U.S. sports such as L.A. and Long Beach impacting our deliveries to the U.S. Altogether, the disruptions negatively impacted our top line by more than EUR 100 million during the quarter, mainly affecting Digital Solutions and Digital Products divisions. This top line effect is, to a large extent, attributable to components around 75% and logistics around 25%.

Let's now talk to price development. Moving to Slide 7. This quarter, net price continued to improve and turn positive. More importantly, price and sales mix more than offset what we call the structural part of our COGS inflation. It is important to consider that sales mix is taken into account as it includes product replacements and new product launches that are mostly at higher gross margins. Overall, we see positive momentum on pricing and are planning regular and necessary price increases to compensate for the upcoming structural inflation.

Now let's move on to the discussion on our divisions, starting with Digital Solutions on Slide 8. Comparable sales decreased by 7.3% as the division was most exposed to the component shortages and logistic disruptions. Sales growth was still affected by lockdowns in some of our markets like ASEAN countries and Canada. Adjusted EBITA margin declined by 120 basis points versus last year to 10.5%, and this was mostly due to lower fixed cost absorption, but also due to increased input and logistic cost that were only partly offset by pricing and indirect cost savings.

On Slide 9, you will find some of the business highlights from our Digital Solutions division. And the first one, I would like to highlight shows our commitment to safety and security as we continue to support the emergence of smart cities around the globe through the acquisition of Telensa. Through this acquisition, we're adding a narrowband and TALQ-compliant solution to our already feature-rich open and secured systems. With

Telensa, we're able to make smart city infrastructure affordable to cities, utilizing the unlicensed radio space. Telensa will continue to sell its systems under its own brand name.

The second highlight shows our support to food availability, where our existing customers, Den Berk in Belgium, decided to go for a second hybrid lighting installation with LED top lighting. Den Berk, which is the largest tomato grower in Belgium is the first customer to have installed our Toplighting Force, which has a higher light output and is perfect for light loving crops such as tomatoes. This results in higher output for farmers. All the lights are connected to the GrowWise control system to provide our customer with the ability to dim light levels when necessary, improving the growth cycle and reducing energy use and costs.

Let me now move to Digital Products on Slide 10. During the quarter, dividend showed a resilient sales and adjusted EBITA performance. Comparable sales growth was 2.5%. Despite the impact of supply chain constraints, these had a particularly strong impact on connected home products. The adjusted EBITA margin was broadly in line with the previous year at 13%, driven by a positive effect of sales mix and price increases, which were offset by higher COGS. Given the continued demand, we implemented our commercial plans through additional marketing spend.

The next slide, Slide 11, shows a few business highlights from the Digital Products division, all illustrating our commitment to customer-driven innovation. Let me start with the latest addition to our Philips LED family, one that truly embodies how innovation and sustainability come together at Signify. In September, we launched in Europe our most energy-efficient LED bulb to date called the Philips A Class bulb. This is the first in the new Philips ultraefficient LED range. This bulb is 60% more energy efficient in comparison with standard Philips LED bulbs. Due to these energy efficiency gains, the product helps to save consumers money on their electricity bills, something that, with the rising energy prices, seems more important than ever.

Furthermore, we also have enriched our product offering for our consumers, both for Philips Hue as well as WiZ, as you can see. And more specifically, we announced the Philips Hue and Spotify partnership. So together, we developed an algorithm that analyzes the meta data of each song in real time. This algorithm creates a more advanced live script that, on top of matching the beat, matches mood, tempo and more. This provides consumers who use the Hue app with the most immersive music experience ever.

Moving on to Slide 12 and to talk about conventional products, which declined by 13.2% on a comparable basis while adjusted EBITA margin increased by 90 basis points to 18.8%, once again showing the resilience of that division.

Next, I would like to discuss the third quarter performance of our Brighter Lives, Better World 2025 program on Slide 13. In the third quarter, we celebrated 1 year of carbon neutrality in our operations, and we continued to progress on our Brighter Lives, Better World 2025 sustainability program commitments. First, we achieved a cumulative carbon reduction across our value chain of 48 million tonnes ahead of track. This reduction was mainly achieved by an accelerated shift to energy efficient and connected LED lighting in the first 3 quarters of 2021, which have decreased and signifies carbon emissions in the use phase.

Circular revenues increased to 24% compared with the 2019 baseline of 16%, and we are on track for the 2025 target of 32%. This is mainly driven by the strong portfolio of serviceable luminaires and further expansion of both the Home Luminaire and modular businesses.

Brighter Lives revenues were 26%, making good progress towards the 2025 target of 32%. And this positive trend can be explained by a strong contribution of the well-being portfolio, including quality of life, high comfort, Hue and WiZ products.

Finally, the percentage of women in leadership position was 25%, stable compared to last quarter, but slightly below our 2021 intermediary goal to reach the 2025 target of 34%. Also, this quarter, we signed the United Nations Women Empowerment Principles, which emphasizes our commitment to gender equality.

Let me now hand over the presentation over to Javier, who will discuss the third quarter financial performance.

Francisco Javier Van Engelen Sousa - *Signify N.V. - CFO & Member of Board of Management*

Thank you, Eric, and hello to everyone. Moving to Slide 15, where we visualize the adjusted EBITA bridge for Signify. Overall, adjusted EBITA margin remained strong as pricing and mix offset structural inflation while indirect cost savings partially offset the negative impact of volume and transitory inflation. Compared to Q3 2020, the quarter in which we hit an all-time record Q3 profit margin of 11.5%, the adjusted EBITA margin decreased by 40 points to 11.1%.

Let me explain the main variances on a more detailed bridge. First, lower sales driven by the supply constraints led to a negative volume impact of EUR 38 million. Mix effect now separated from volume as it includes the positive margin impact of new product launches had a positive effect of EUR 30 million. This mix, together with the EUR 12 million positive pricing impact, helped to more than offset what we call structural inflation in Q3, which was worth about EUR 35 million.

Transitory inflation, including the occasional spot buys and higher logistic costs, had a EUR 20 million -- EUR 22 million year-on-year impact. As we believe them to be more temporary of nature, we decided to not yet pass these costs on through further price increases. Indirect costs as a percentage of sales improved by 70 basis points or EUR 37 million. This was mainly driven by structural cost savings and onetime effects in the previous year, including provisions for the reimbursement of solidarity contribution to employees last year. Finally, FX had a small adverse impact of only EUR 4 million.

On Slide 16, I would now like to zoom in on our working capital performance during the quarter. On an absolute basis, working capital decreased by EUR 127 million year-on-year to EUR 316 million. As a percentage of last 12-month sales, this is an improvement from 6.4% at the end of Q3 2020 to 4.7% at the end of this quarter. The lower year-on-year working capital was the result of higher payables, lower receivables and lower other working capital items, which more than offset temporary increases of goods in transit due to shipment delays.

On Slide 17, you can see our net debt evolution. At the end of September, our net debt position remained at around EUR 1.4 billion, translating into a slight increase in net leverage ratio to 1.8x. The slightly higher net debt and leverage was mainly due to our dividend tax payment, leases and M&A. This was partially offset by the third quarter free cash flow generation of EUR 85 million. Other includes cash used for new lease liabilities, acquisitions, purchase of treasury shares, derivatives, repayment of debt and FX impact on cash. Overall, we remain well on track to deliver on our commitment to reduce our leverage ratio back to 1x at the end of 2022.

And with this, I will now hand back to Eric for the outlook and some closing remarks.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Thank you, Javier. To wrap up, I would like to highlight again that we are encouraged by the continuously strong demand for our products as evidenced by our healthy order book. We are addressing the unprecedented yet transitory supply chain challenges. Looking ahead, we expect that they will continue to have an impact over the coming months. We're also planning price increases to offset structural inflation, and we'll maintain rigorous cost discipline.

As a result, and with no further deterioration of the supply chain, we are expecting to end at the lower end of our 2021 guidance ranges of 3% to 6% comparable sales growth and adjusted EBITA margin of 11.5% to 12.5% and free cash flow exceeding 8% of sales. The fundamentals of our business remain stronger than ever, driven by the ever-growing need for energy-efficient and digital lighting technologies.

Well, with that, we would like to open the call for questions, which both Javier and myself will be happy to answer.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of George Featherstone from Bank of America.

George Featherstone - *BofA Securities, Research Division - Research Analyst & Associate*

Firstly, on the order book, thanks to the additional information here. I wonder if you could tell us the mix within this in terms of connected and non-connected and also by division? And also, could you give us a sense of the margin quality in the order book compared to current levels?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. So it may give an indication on the order book. So effectively, it increased quite substantially quarter-to-quarter. Now you may recall that what we have said previously is that most of what we invoiced during the quarter are orders that we take also during the quarter. And when we enter in a new quarter, we have an order book to be involved during the quarter, which is about slightly below 20% of the quarter. We are slightly above 50% entering Q4. So this is a very important difference for us in the way we manage the business. So clearly, the orders are there.

They are a bit more skewed towards digital solution in terms of divisions and also projects for connected because what needs to be explained is that if you have missing products and especially missing connected products that are using a lot of e-components, then you cannot deliver a project. And these projects are being delayed. So we see quite a fair amount of those in our backlog at this point in time. So 50% of what we should normally invoice is already in the order book and the most touch divisions and business in Digital Solutions and the connected businesses.

George Featherstone - *BofA Securities, Research Division - Research Analyst & Associate*

Just a kind of follow-up on the component shortages as well. You put the charts in there. I just wanted to know what the kind of number was, what's the order of magnitude of the components in Q3 that you had on an escalation list?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

So we effectively didn't give a number. It's in the hundreds. We're not disclosing specifically that number, but you can see that the ramp-up has been dramatically high and slightly going down at the back end of Q3. So we see also an improvement of the situation. I would say, a gradual improvement, understanding that, at this point in time, we're also taking commitments with our suppliers on the volume that we need for '22 and some cases in 2023. But it's in the hundreds. So it's very, very substantial.

Operator

Our next question comes from the line of Lucie Carrier from Morgan Stanley.

Lucie Anne Lise Carrier - *Morgan Stanley, Research Division - Executive Director*

The first one is a follow-up on George's question regarding the backlog. So if I understand well, when you're talking about 50% of the quarter is already visible to you in the order backlog, that means you have about 6 weeks visibility kind of half of the quarter. But just on that backlog, what is your visibility around the potential risk for double ordering because we've heard that from several distributors and the cancellation policy you have around the order. And I think you maybe didn't answer the question from George around the margin in the backlog. That would be my first follow-up on the backlog.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. Lucie, you're right, I didn't answer to the question on the margins. Let me take it after answering to the first part of your question. So you're right on the visibility, that's the 6 weeks ahead. On the backlog of order that we have today, which is, of course, bigger than that because we have also orders in the backlog that we are going to be delivering in Q1 and also potentially in Q2 and they are in our overall backlog, we didn't have any cancellation of orders at this point in time. So that backlog has been very stable.

The way we are working, we are working on 2 sides. We are working on the sides of our customers to make sure that the demand is genuine. So we do not have customers that have ordered more today in order to make sure that they're getting something. We've been very precise. We went into the details in order to understand really the demand. And we do not have customer as we understand it today that are ordering over the normal levels. I mean we know also what the consumption is on a regular basis, especially for the make-to-stock item that go to distribution. So we don't have that situation.

On the margin, well, we see a margin that is going to be pretty much in line with what we've seen. So far, understanding also that the way we see the margin, it's a moving target because as costs are increasing on a regular basis, we need to increase price on a regular basis. So we are entering in a situation where it's not about there is an increase of the cost of commodities and we need to make a price increase. I think we need to enter in a different setup where we have to make regular price increases when we see new commodities being increased at the level of their cost in what we call and -- we've been thinking a lot about that with Javier and the team. We talked about the structural part of the inflation, meaning the inflation that we believe is going to stick in the long run. And there's one part of the inflation that we believe is fundamentally structural. We're pricing up against that. and that's working.

Now there's less a structural part of the inflation. And on that one, for also commercial reasons, we're not pricing it up. We're buying component from the spot market, sometimes 20x, 30x, what is the normal cost. We believe that this is not a longer-term trend. You know the story on containers that have increased by 4x the price that we could pay them for previously. And if you go on the spot market for containers, it's probably 10x where they used to be. I think that's not going to last. It's not going to stick.

Now we're doing also some adjustments that are going to benefit the margin. For instance, we're going to put an add-on cost for transportation. So it will not be facial on our prices, but it will be an additional element for inflation of -- linked directly to transportation. We're putting that in place in the coming days. But it's going to be a permanent adaptation, I believe, in the quarters to come, and we have to be ready for that. And we are ready for that.

Lucie Anne Lise Carrier - *Morgan Stanley, Research Division - Executive Director*

I guess that brings me to my second question. I was hoping maybe you could give us some indication around the percentage of sales and procurement that you have coming from Asia and going into North America and Europe? And when you think about your freight kind of contract or your logistic arrangement, can you maybe help us understand, usually, if you have kind of longer-term contract or if they roll over after 1 year or if you usually have spot-based type of contract.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Okay. So let me take that question in a broad way, and then I will come and we'll zoom a bit more on the specific points that you're asking. So we have -- we don't have long-term contracts in many years, but we have contracts on period that can be 6 months to a year, depending on the freight forwarders that we're using. Now we have to understand that given the situation at this point in time, all this notion of longer term has, to a given extent, vanished. And there is a lot of adjustment that is being done on a daily basis, also on the side of the freight forwarders that have their own issues to find containers and make sure the overall supply chain is balanced.

We, nevertheless, have contractual agreements. And the way it works is that we try to book a given capacity at a given price. If ever we need more, then we have to go on what we call the spot market, which is substantially higher in terms of costs, especially at this point in time. So there's no contractual terms over the very long term. It can be 6 months to a year. We are blocking capacity at a given rate. And if we go above that, we have to go at higher spot rates. What we also have done during the crisis, we've moved to more airfreight, which we don't like to do, not only for cost perspective, but also because of the fact that it's very much CO2 emitting. So we don't like to do that. But I think delivering our customer was the absolute priority, so we had also to move to this.

So very disruptive situation. If I take a bit of distance, we realized that managing a demand crisis probably much simpler than managing a supply crisis, which is what we're doing at this point in time. But we've done a lot of action also on the site of freight forwarders to make sure that we could adapt to the situation. And we were well inspired to do a lot of the actions that we have done. Otherwise, the situation would have been even more critical.

Now it's true that our supply chain is very global, and it's internationalized. And in a situation like that one where we need to move, I would tell you, it's several hundreds of containers on a weekly basis from one part of the world to another one. In a situation like that one, we were particularly impacted. Now moving forward, that doesn't tell anything about the positioning and the strategic positioning of the company, but punctually from an operational standpoint, yes, it impairs quite a bit our capacity to deliver.

Operator

Our next question comes from the line of Rajesh Singla of Societe Generale.

Rajesh Kumar Singla - *Societe Generale Cross Asset Research - Equity Analyst*

First question would be on your comment earlier. You mentioned that because of a significantly higher energy prices, we could see an increase in demand for LED. So are you seeing any early signs of pickup in -- or acceleration in demand for LED? I think your order book suggests the demand is likely to remain strong in the near term.

And the second question would be on supply chain. So are you seeing a gradual improvement? So what kind of improvement we can expect in Q4 or maybe in the first half of next year? So are you seeing any kind of commitment level from your suppliers, which can guarantee you timely supply of your components?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Thanks, Rajesh, for the questions. Look, acceleration in demand, the major issue we have today is we're facing a crisis of supply. So it's very complicated in a situation where you have a crisis of supply to be also able to measure an increase in demand because you have a difficulty just to simply deliver. What we believe is that the increase in energy prices, and I'm not talking about gas, I'm not talking about electricity, is favorable to us because we are bringing a very high level of energy efficiency with the solutions that we bring to the market with a very, very fast return on investment.

So if the price of energy goes up, it will make our solution even more interesting from an ROI standpoint. You may have seen I would just comment on that one because it's a very, very important one. We have released to the market and we have launched what we call our ultraefficient LED bulb. So you have to picture that LED bulb, which is going to retail around EUR 99, is a completely new design where we see basically a good illustration of innovation and sustainability coming together because that bulb will be saving 60% of the energy consumption of already available LED bulb.

And in order to do that, there are 5 patents that we had to develop and file on the filament or in structure, its positioning, the electronics that regulates current and voltage. So it is -- an energy bulb that comes on the market with a very high level of added technology and innovation to it. But to your direct question, do we see an accelerated demand at this point in time? It's very complicated to say. What I just can tell you is the focus that we have on connected lighting in consumer space and professional space as well as our growth platforms are really getting a strong traction, but that was the case also before the crisis. I think that the more we go, the more we find that the market is well educated to understand what these technologies are bringing.

Improvements in the supply chain. So I strongly believe that we should see an improvement, but that's not the way we've even built our Q4. We built our Q4 on the basis of no further degradation, and that's something very important to understand. Back in Q1, we didn't expect what would be happening in Q2. And Q2, we were also not expecting what's really happened in Q3, where the prices on the component and the logistics side clearly worsened.

At the end of the day, if there's no further COVID-related closure of factories, like the closure of factory in Malaysia that took for some of our key suppliers 2 to 3 weeks, if we do not have ports and harbors being congested or being shut down like it was the case for a few of the key hubs that we are using in China, if we do not have these COVID-related issues, we believe that we should see a sequential improvement in Q4, but probably even more so in Q1 on the e-component side, on the foundry side and probably on the next level of transformation of the semiconductor industry in Q2. And if you look at what some of the probably more knowledgeable analysts are saying at this point in time is that we should go back to a more normal situation in the second part of 2022.

Look, this is where we are. So if there is no further COVID-related issues affecting the supply chain, we see continuous improvement in Q4 and probably coming back to a situation that would be close to being normalized in the second half of next year. I would like to say more, but at this point in time, the situation is so fluid and so unpredictable like it was the case in Q3. We never thought that what happened in Q3 will happen. Now we need to adapt, and that's what we're doing.

Rajesh Kumar Singla - *Societe Generale Cross Asset Research - Equity Analyst*

Maybe a follow-up question on the LED penetration in the U.S. So can you share your information or insights into the percentage of LED penetration in the U.S. and Europe currently?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Well, I think we have an LED penetration. It's complicated because it depends on the segments and so on, but it should be on 40% at this point in time, 40% to 50%, and connected is probably below 10%.

Operator

Our next question comes from the line of Sven Weier from UBS.

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

My questions, they are both on the EBIT bridge. And the first one is on pricing side of the bridge. I was just wondering which quarter should we see actually the full impact of your price increases? Because I would assume Q3 doesn't really show it yet and the same probably for the structural COGS increase. Is that already showing the maximum here? And yes, that's the first one.

Francisco Javier Van Engelen Sousa - *Signify N.V. - CFO & Member of Board of Management*

I'll take this one. Look, on the pricing, I go back to what Eric said before. The important thing is what we said, we see now a change really getting the pricing to the bottom line compared to previous quarters. And if you go back a little bit longer, you see that the change is material from EUR 60 million, EUR 70 million erosion per quarter to now being positive. And the important thing is that, that together with mix is compensating the increase in the bill of material and what we call the most structural cost increase.

Now specific to your question on where will it end, I go back to what Eric said. I don't think this has got a short-term ending point. We will see quarter-by-quarter an increase in inflation, which means that what we are clearly doing at this point in time, we have regular price increases that we have been implementing since early this year and believe that will continue. So I would expect that from a cost point of view, we'll still see those kind of amounts that we have on this slide probably to proportionally go up or with the objective that we have of stabilizing gross margin, and that's how we balance the equation.

So do I expect for Q4 a further impact on pricing? Yes, but same in Q1, Q2 next year as we continue pricing in an inflationary environment. So I don't think this is going to be a 1 quarter, 2 quarter phenomenon. It is going to go further, and we are prepared for taking those pricing quarter-by-quarter as we see input costs coming up.

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

Okay. And the second question I had was on the logistic costs. I was just wondering, I mean, how much of your logistics cost is shipping? And that's maybe a more structural question. I mean what are your plans? Because you talked about CO2 reduction. When do you plan to go to zero carbon shipping? And I think we've seen an announcement from Amazon, they want to do it by 2040. Are you more ambitious than that? And what does -- and I guess that will probably take up the logistic cost structurally. So what are your plans on that side?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. Sven, I think the proportion of shipping and the repartition of the logistic costs, you can imagine in the past few weeks or few months has radically changed. So it's very difficult to give an average today because this is moving on a daily basis. And when we decided to go airfreight or if we are above the reservation that we had in terms of capacity, we need to go to the spot market, which is far higher. And it's very complicated today to have a clear average, and I don't think we should take that into account to mobilize the business moving forward because, once again, this is very transitory.

Now the question that you asked is a very important one because -- and it's not only because we are in a crisis today, which is basically impacting the supply chain that are fairly globalized, which is the case of ours. But I think that we should effectively try to limit more. And the shipments in general, especially across continents, we should have supply chain that are more continentally independent. And that's a decision that we had strategically decided to take, and we're building the plans in order to make that happen. So that's a lesson that we had already taken.

Now what we need to understand is that the CO2 emission of shipments is not the most important one in the world. I would say it's only a fragment of the emission of CO2. But nevertheless, I believe this is something that we need to do because it has other positive elements. I think it's -- if we are more continentally based, it will be probably more in line with the geopolitical attentions that we see at this point in time, and it will help us at the level of our working capital probably to alleviate some of the working capital that we have in some regions. If we source more locally, we are much, much faster in terms of delivery, which has a lot of added collateral benefits.

So sorry not to be more profound on shipping, but I'd tell you, at this point in time, it's very complicated to say there's no number that could serve as an important number to mobilize those costs because things are very fluid at this point in time.

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

And I take it that you haven't made a decision yet whether you're going to join some of these alliances like I said on Amazon committing to the zero carbon shipping that's still pending.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. No, Sven, we've -- look, I do not know to tell you the absolute truth. So I'm going to ask Javier where we stand there. But we've made commitments that I think are bigger than that. So the -- so we're carbon neutral, Scope 1, Scope 2 and a bit of Scope 3 already since a year. And we've made the commitment on our new program enlarging our scope to Scope 3, to the full scope 3 that we will do the reductions that are the objective of the Paris agreement, but we would achieve these reductions in line with the Paris agreement, not in 2030 but in 2025. So we want to go 2x faster than the Paris agreement on an enlarged scope, which is saving huge amounts of tons of CO2. And I would say, in doing so and in working on this, we're going to save much more than what we can save on transportation. It doesn't mean that we should not look at it, but I think the stakes that we're looking at are far bigger for us.

Operator

Our next question comes from the line of Andreas Willi from JPMorgan.

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

Eric, Javier and Thelke, I have a question on the ultraefficient LEDs. If you look at the improvement in energy consumption, is this something you would expect to trigger a bit of a replacement wave now after maybe some of the first-generation LEDs being replaced again? Is there enough of an incentive, both for consumer or professional users to do that from here if you compare it maybe to the relatively straightforward payback calculations that were there to go to LEDs in the first instance.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. That's a very important point, Andreas, and we're looking at that strategically. And we believe so because of the added energy efficiency that some customers are going to go for. But also and maybe even more importantly, Europe has been a first mover, revising what were the energy class definition. So if you have the LED of the old times, which is classified A class in terms of energy efficiency with a new classification, it will be F or G. And the new ultraefficient LED bulb that we are now bringing to the market will be A. So we're also matching the evolution of the standard and the higher requirements in terms of energy efficiency. And if at one stage, in some instances, people want -- only want to have A class, then this type of technology will effectively replace existing one and there could be an earlier replacement cycle on existing LED bulbs, absolutely.

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

And my follow-up question on the component shortages. Maybe specifically talking about connected home lighting. Is that a meaningful part of the EUR 100 million you called out? And how should we assess end-market demand there? Would it be coming up also against some relatively tough comparables, but I guess it's going to remain an issue of supply and not demand there for the coming quarters?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. So here, once again, because of all the different things happening in opposite direction is sometimes complicated to have a clear view. But let me try to give highlights on the different elements. So first of all, in brief, what happened in Q3 on Components. We were supposed to receive a lot of components in July. And they were delayed, and they arrived at the back end of September. So even trying to manufacture very quickly, we could not be able to deliver on time. So that's one thing.

On the sales that we have not realized, we're not giving the information. I would not say that the majority of it is smart home lighting. But at the level of the smart home lighting business, it is clearly a few points of growth. But that business continues to behave well during the quarter.

Now to the second part of your question, we see also with consumers spending more money now going back to restaurants, going back to different type of entertainment traveling again. We see a demand which is going slightly down compared to what it used to be during the crisis. This is a question that we had very often between you guys and us. We see that happening. We're also comparing the performance of that business against a higher base. So that business is growing. There's still demand, probably because of the higher base and the change of behavior. There's a bit more growth than what we have seen at the time.

Nevertheless, what is gained is gained, which is the accelerated education of the consumer on connected offers and especially connected lighting. Also revitalized by the fact that we bring systematically new innovation to the market, you can imagine, and I'm talking about that one, it's not anecdotal. It's really a cool one. I'm using it myself at home. You connect your to Spotify and your app, and you get a very immersive experience on your music listening. So that's a reality. But yes, it's probably a demand, which is going down slightly, but which is still growing and healthy.

Operator

Our next question comes from the line of Philippe Lauwerys from Goldman Sachs.

Philippe Lauwerys - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

My first one is on your calling out UVC as having a high comparison base. But previously, you mentioned this was going to be a multiyear structural opportunity. Could you just give some more color on that?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes. Surely, Philippe. I think that becomes truer every day with the extension of the crisis also. What we have seen, we have seen a complete change in what we sell in UVC from in 2020, the burner, the part which is emitting light. So the components and 2 finished products, both on the consumer side but also on the professional side. What we have seen, we have seen very interesting wins in schools, for instance, where we have a device which is completely closed that we also use here, by the way, which is ensuring that the room is clean. A lot of countries are looking at how they can have the people to go back and to stay at school in a safer environment, and we get a fairly good traction there. So our profile in terms of growth and in terms of sales, growth is really changing from the component back then to the finished product at this point in time.

We're looking also at integrating UVC also with Honeywell in what we call healthier workplaces, and we have interesting wins. But I think the level of education is still to be done and meeting myself many potential customers. And when I talk about this, a lot of them are surprised. And when I talk to them about what it does and how it works, I mean they want to go for it. So I think it's a pending assignment on our side to educate the market more, but we see a good traction on that business despite all the situation that we've mentioned about supply chain, we see a good traction on that business even with a different profile.

Philippe Lauwerys - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Got it. And then just secondly, you've obviously made very strong improvement in your working capital over the past year. Do you think that could be part of the reason why you're also having component shortages? Do you think actually maybe inventories could go higher again in the future to deal with that?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

No, not really. I think the working capital is well managed. What we've done, we structurally worked on it in the past 5 to 6 years to go from double digit to low single digit at this point in time. Not really -- but it's true that we do not have plethora of inventory. So the people who are managing their inventory maybe not as rigorously as we do. Maybe it would have benefited during the crisis, but only during a time. So no, I don't think that the way we manage inventory and working capital is a consequence of what happens today.

Operator

Our next question comes from the line of Andre Kukhnin from Crédit Suisse.

Andre Kukhnin - *Crédit Suisse AG, Research Division - Mechanical Engineering Capital Goods Analyst*

Can I just start with a follow-up on what you said? I think you're looking to introduce logistics-related surcharges. That won't be the core pricing, but will be specifically directed at high logistics cost. Could you share with us any order of magnitude? Or maybe more simply, would you expect these to offset all or a part of that headwind component of profit bridge of EUR 22 million in Q3?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

So I just simply don't know, Andre. So I don't have the number, the absolute value. The only thing that I can tell you, yes, it is there to offset part of what we have experienced in logistic cost increase. What also needs to be understood, we do that in order not to have an increase of our facial tariff price, but we should see that situation as very, very much evolving because the logistic costs have changed all the way through. Now we have an increase of the energy costs, which are going to impact once again those costs. So we can imagine that whatever we charge for can also evolve in the future, up or down and depending on what we see coming.

The most complicated thing to do at this point in time is to try to forecast where things are going. So you have a permanent catch-up game where we increase prices when we understand where things are going, but things are not stable. So they're moving again, and we need to adapt permanently. So that's what we have developed in the company, especially in Q3. And more than ever, adaptation is part of the game. And we've seen that during the quarter because our situation in Q3 has also evolved positively from a gross margin standpoint if we look at where we were at the beginning of the quarter in July versus where we were at the end of the quarter in September.

So it's really a game of permanently adapting and adjusting in order to adapt to what we see coming and also remain -- I would not say, it's not only remaining competitive. Of course, we have to remain competitive, but we also have engagement with our customers for the long run. And we want to be as transparent as we can with them to make sure that they understand what we are transmitting in terms of price and for the longer-term relationships that we are building. There are also some activities where, for instance, we didn't increase price not only talking about logistics. If you take a range like the Hue range, it's not only because people may believe that it's priced high. But given its growth and the capacity that, that business has to generate more gross margin with the growth that it provides, we didn't feel the need to increase prices. So it's really dedicated by businesses, and it's really dedicated by market. But the main idea, Andre, behind all that is that it's very fluid, and it's a matter of adapting.

Andre Kukhnin - *Crédit Suisse AG, Research Division - Mechanical Engineering Capital Goods Analyst*

That's helpful. And the main question I had really on mix given the substantial contribution, is this all about the new ultraefficient A class LED bulb? Or are there other products that are contributing to this? And maybe you could give us some details of contracting a bit closer.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Well, the new bulb has no impact on the numbers in Q3. And I would tell you, I think, Javier, if we look at the mix in Q3, we did not have a mix effect coming from the divisions.

Francisco Javier Van Engelen Sousa - *Signify N.V. - CFO & Member of Board of Management*

The biggest impact is more -- the reason why we separated it out is because you have new product introductions that indeed come, as we know, pricing more clear to come at higher price and higher margin. The biggest mix impact was, I think, on the digital products category where also with new introductions, especially also in the home lighting, you have new things coming in at higher margin. So it's not between the divisions. It's really the new product introductions that we are pricing up already for the inflation. The LED will be an example for the future, obviously. That will also have an impact with the pricing and the margin it has. But it's those introductions within the categories that we look at.

When we look at pricing, that's a bit dreadful. When we look at the pricing, we qualify our users pricing. And that's why we broke it out in more detail this time. Pricing is purely SKUs, which are 100% comparable with last year. And with the rotation of the portfolio when we introduce new products at higher prices, higher margin, that's still an important part of on us. Also with innovation, we drive margin back to the original levels. That's why we kind of -- this time, we're more specific on breaking out pricing/mix and then transitory and structural inflation.

Operator

Our next question comes from the line of Peter Olofsen from Kepler Cheuvreux.

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

My question is actually a clarification question on the amount of more than EUR 100 million that you mentioned. I recall that at the half year stage, you mentioned a number of EUR 85 million. So the more than EUR 100 million that you mentioned for Q3, is that a net figure? Because I assume that some of the revenues that you missed in the first half were actually booked in Q3. So whether or not, have you accounted for that in that number of EUR 100 million?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Yes, Peter. Look, let me take a bit of distance and explain something additional. What we realized in Q3 is that we had to take another element into consideration, which is about the orders that we could not confirm. So what is our problem? And it's already -- it's still a bit the case in Q4. Today, at the end of the first month, I don't have a complete visibility on some of the components I'm expecting for Q4. So the problem is that it's difficult for us to confirm an order to a customer when we don't have a confirmation of the components. And these orders would be genuinely normally taken during the quarter and invoiced during the quarter. So we added that dimension that was small in Q2, but started to be bigger in Q3.

And if you were trying now to make a comparison between the EUR 55 million or the EUR 85 million that we mentioned in Q1 and Q2, what you need to know is that the degradation quarter-to-quarter is around EUR 71 million between the end of Q2 and the end of Q3. So it's an additional degradation, which is around EUR 71 million. Now we're not starting from the same base because in the EUR 85 million, we didn't have the unconfirmed orders. But if we were adding the unconfirmed orders that we had at the end of Q2 like we did at the end of Q3, the difference and the increase is EUR 71 million, which is quite substantial.

Operator

Our next question comes from the line of Marc Hesselink from ING.

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

I would like to come back on the order book to better understand what exactly is that increase in 90%. How much of that is the EUR 100 million of lost revenue? And maybe also to get the larger picture, how much of your normal revenue is order book business?

And the second question is a follow-up on the consumer connected lighting, given that the fourth quarter is so key for this business. How many inventory do you have? And do you still need some of those key components, like you just explained the one that went from July to September? Is that sort of shipment that you still need coming in for the fourth quarter?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Marc, so the EUR 100 million that we could not invoice in Q3 are part of the order book that we have at the beginning of Q4. I have said that in normal business situation, we have at the beginning of the quarter a visibility on less than 20% in terms of orders of what needs to be invoiced during the quarter. And today, for Q4, it is more than 50%. So that's just to summarize the numbers in a succinct way.

Q4 is key for the consumer part of the business and especially on the consumer side. So yes, we're working very hard to be able to get the components. We have also to allocate components when we receive them to what we believe are the priority businesses and customers.

Now I have to also admit that at this point in time, we cannot, for that business, fulfill all our customer needs. We have shortages on some parts of the business, but we're building inventory on the other hand. We still believe that we can do a good Q4, but we're going to do probably a Q4 that is going to be a bit limited compared to what we would have been able to do normally. But that's taken into account in the indication we have given at the level of the guidance. So yes, we're prepared. We're going to do a good Q4, but it's going to be probably a bit impaired compared to what we would have been able to do if we had received all the components.

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Okay. Clear. Then maybe for the order book to be 100% clear that what you just explained in the previous question, that orders that you could not confirm, those are not in there yet.

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

No. The orders, the EUR 100 million, it's over EUR 100 million that we could not invoice in Q3, will be invoiced in Q4, and they are part of the order book that we have at the beginning of Q4.

Operator

Our last question comes from the line of Joseph Zhou from Redburn.

Joseph Zhou - *Redburn (Europe) Limited, Research Division - Research Analyst*

I'll go one at a time. And firstly, on your lower end of the guidance, that implies a Q4 organic sales growth of 1%. That sounds fairly ambitious to me given the existing run rate. And what gives you the confidence to achieve that? I know you talked about now you have visibility on more than 50% of the Q4 sales, but then the rest is still a big proportion. And yes, I just wonder where does that come from, maybe some arrangement with your suppliers, et cetera, et cetera, that gives you the confidence?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

Joseph, what gives us the confidence is that we have spent a huge amount of time with the teams reviewing the backlog of orders, reviewing the status of the inventories, reviewing good in transit. And look, we're not starting Q4 as a normal quarter. Once again, starting Q4, we have a much higher visibility on orders than ever before. And we're taking that into account, and we're matching the orders with the inventory we have already and with the inventory, which is coming, whether it is finished goods or industrial inventory. And we've done that in a very, very detailed way.

I would say that even at this point in time, we have made a forecast with the team, which is constrained. And with all these measures taken into account, we believe that we can achieve the lower end of the guidance. I don't think it's ambitious, frankly speaking, with what I see today, I think something, which is completely as rich. Now I've just -- there's just one caveat. If we have new harbor closures, if we have new plant closures, it's a different game. But if the situation doesn't deteriorate compared to what it is now, I think we have more than the capability to say what -- to do what we have said we could do because our forecast is even constrained.

Joseph Zhou - *Redburn (Europe) Limited, Research Division - Research Analyst*

Yes. That's very clear. And then my next and final question is about the supply chain situation. And do you think we will be at a worst point of the supply chain challenges into the financial impact in Q4, including shipping and component shortage? And maybe to look at numbers, you obviously had EUR 100 million -- more than EUR 100 million supply impact, but also you had EUR 22 million of cost transitory impact. It looks like they could go up in Q4 and in proportion with the high sales lighting season as well. But do you think Q4 will basically be the worst point and it gets better from there based on these numbers?

Eric Rondolat - *Signify N.V. - Chairman of the Board of Management & CEO*

What impacts us more, Joseph, is not the cost and the pricing. I mean cost and pricing is something that we manage and we adapt. The major issue we have is the uncertainty in the supply chain. Let me give you an example, which is a very concrete example. You have a factory supposed to receive components on the Wednesday, components are not coming. So you have on top of the added cost of logistics, what do you do with the factory? I mean, you have fixed costs and you have variable costs. So you need to dedicate them to another task, but it's not always possible.

So at the end of the day, it generates a lot of underleveraged and specifically, in the Digital Solutions division because this is a division where you're doing a lot of different products, so you need a lot of different components. Those components and those products are made to order. So basically, the situation that we have today breaks the flexibility that we normally have. And that is, for me, the most complicated part of the equation, not so much the cost. I mean the cost, we adapt to it, we price up. We have a policy and we have the processes that are put in place to price up in the logic that we have described previously.

I think that the most and the worst part was Q3, provided there are no additional deterioration of plants closing because of COVID or, I've said that many times, harbors reducing their capacity also because of COVID. If we don't have that, I think the supply chain will go in an improved trend from now on. And we think that we could go back to normal, as I've said before, in the second half of 2022. So I see a much more positive Q4 from a supply chain standpoint than Q3, which was very disruptive. I tell you, I've worked for many, many years, I've never seen anything like it, and we've gone through crisis. But a price of that magnitude on the supply side, like what we have seen in Q3 completely not anticipated, that was very, very tough to face. So I think that Q4 will be better and the upcoming quarters even better.

Operator

Thank you. We unfortunately have no more time for any questions. I'll hand back to the speakers for any further remarks.

Thelke Gerdes - *Signify N.V. - Head of IR*

Ladies and gentlemen, thank you very much for attending today's earnings call and for taking part in the discussion about our results. If you have any additional questions, please do not hesitate to contact Philip or myself. We are happy to answer your questions then. And again, thank you very much, and enjoy the rest of your day.

Operator

This now concludes our conference call. Thank you all for attending. You may now disconnect your lines.
