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PRESENTATION

Operator

Hello, and welcome to the Signify Fourth Quarter and Full Year Results 2021. (Operator Instructions) Today, I am pleased to present Eric Rondolat, CEO; Javier Van Engelen, CFO; 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 fourth quarter and full year 2021. With me are Eric Rondolat, CEO of Signify; and Javier Van Engelen, CFO. During this call, Eric will first take you through the highlights of the year; after which Javier will review the company's financial performance of the fourth quarter. Eric will then review the full year 2021 with a close -- and close with the outlook for 2022. After that, we will be happy to take your questions.

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

With that, I will now hand over to Eric.

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

Thank you, Thelke. Good morning, everyone, and thank you for joining us today. So let's start with some highlights on the full year 2021 results. Let's go to Slide 4. So in '21, we continue to improve the growth profile of Signify and our connected lighting sales grew by 21% to EUR 1.4 billion. Our growth platforms grew by 19% to EUR 326 million. Combined, they now represent 25% of our sales. We also delivered our eighth consecutive year of EBITA margin expansion and achieved a 90 basis point improvement in 2021.

Our transformation has happened as our 2 digital divisions now contribute to over 80% of sales profit and also cash. Our Brighter Lives, Better World 2025 sustainability program is off a very good start in 2021. I am proud to see our progress towards our commitment to double our positive impact on the environment and society.

In 2021, our team adapted to unexpected challenges, but relentlessly kept focus on the execution of our strategy. This recipe led us to deliver against all our objectives for the year, putting us on track to achieve our midterm objective with a comparable sales growth of 3.8% for the year, and adjusted EBITA margin improvement to 11.6%, a strong free cash flow generation of 8.9% of sales. And this enabled us to reduce our debt by EUR 350 million, lowering our leverage from 1.7x to 1.4x.

In line with our capital allocation policy, we will propose to pay a cash dividend of EUR 1.45 per share over 2021.

Let me now hand over the presentation to Javier, who will discuss about our fourth quarter performance.

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

Thank you, Eric, and good morning, everyone. I have the pleasure to present our quarter 4 results starting on Page 6. Sales in Q4 reached EUR 2 billion with an adjusted EBITA margin of 13.2% and a free cash flow of EUR 257 million. We increased the installed base of connected light points from 92 million in Q3 to 96 million at the end of Q4. LED-based sales represented 83% of total sales. Nominal sales increased by 6.9% with comparable sales up by 4.5%.

Adjusted EBITA increased from EUR 251 million in Q4 2020 to EUR 265 million in Q4 of 2021. EBITA margin remained strong at 13.2%, a 20 basis point decline versus Q4 2020 as a 70 basis points lower gross margin versus a high base in 2020, was largely offset by operating leverage. Net income increased by 24% to EUR 170 million, driven by a higher income from operations and lower net financial expenses. And finally, free cash flow was EUR 257 million or 12.8% of sales.

Now let's move on to our divisions, starting with Digital Solutions on Slide 7. Digital Solutions delivered a strong Q4 performance with comparable sales growth of 11.2% and an adjusted EBITA margin of 14.1%. The double-digit comparable sales growth was driven by strong underlying growth in many markets and a solid contribution from Cooper Lighting. Adjusted EBITA margin improved by 260 basis points to 14.1% benefiting from operating leverage and from price and sales mix more than offsetting higher cost of raw materials, components and logistics.

The business highlights from our Digital Solutions division on Slide 8 illustrates the continued progress we are making in servicing the needs of our professional customers. The 2 middle projects, Equinix and El Dorado Airport illustrate the continuous demand for connected lighting. Today, though, I'd like to highlight a significant UV-C project in Taiwan, showing our commitment to health and well-being and the ongoing relevance of UV-C disinfection technology amid a fourth phase of infections. Restaurant chain, TTFB, in Taiwan has installed UV-C disinfection upper air luminaires in the dining areas and battens in the kitchen of 34 of its restaurants. The upper air devices in the restaurants are switched on from prior to guests arriving in the morning until the restaurant closure. In the kitchen areas, the battens are used during the afternoon break from 3 to 5 p.m. and after working hours in the night. TTFB is looking at extending UV-C disinfection across another 100 restaurants.

The fourth highlight shows the progress different countries in Europe are making as they transition towards using more renewable energy sources. We provided over 100 Philips Sunstay streetlights to 10 municipalities in Italy. The lights ensure safe and secure roads after darkness by harnessing the power of the sun and limiting the use of electricity from the power grid, thereby showcasing our commitment to both climate action and safety and security.

Let's move on to the next division on Slide 9. In the fourth quarter, the Digital Products division grew comparable sales by 1.6% with an adjusted EBITA margin of 15.5%. On the sales side, LED Electronics and Klite had a particularly strong performance. Connected Home sales were stable despite both the high 2020 comparison base and supply chain issues that impacted product availability in 2021.

Adjusted EBITA margin reached 15.5% versus a record base of 18% in 2021. While pricing and mix compensated the increase of material costs and logistics costs, a stronger Chinese Renminbi negatively impacted gross margin. Also, our increased growth investment in both R&D and marketing could not be fully diluted due to supply chain shortages.

Slide 10 shows a few business highlights from the Digital Products division, all illustrating our commitment to innovation. Let me highlight 2 of these. Just as with our professional customers, I'd like to start with our commitment to health and well-being as UV-C disinfection devices are also more relevant than ever for our consumers. In Q4, we launched the UV-C disinfection air cleaner in The Netherlands, South Korea, Australia, Indonesia, Thailand, Vietnam and Japan. This device deactivates more than 99% of viruses and bacteria in an average sized room in about 3 hours, making it easier than ever before for people to disinfect the air in their homes. It's easy to use and has an automatic switch off timer, a silent mode and an indicator light that lets you know when the product is active. As the UV-C light source is shielded by a casing, it's safe to use around people, animals and plants.

Another highlight is how we help our customers in North America to accelerate the replacement of fluorescent lighting with this new Type B Corepro TLED range. This range delivers up to 55% energy savings, making it a natural replacement for fluorescent tubes. Its double-end connection also makes it very easy to do the rewiring and installation, and on top of that is the most affordable Type B LED tube in the range.

Moving on to Slide 11. Conventional Products comparable sales declined by 11.4% thereby continuing to outperform the market. Adjusted EBITA margin reached 16.9%, a decline of 200 basis points versus Q4 2020, mainly driven by negative operating leverage.

On Slide 12, we visualized the adjusted EBITA bridge for total Signify. Compared to Q4 2020, the adjusted EBITA margin decreased by only 20 basis points to 13.2% basically as pricing momentum accelerated and we were able to fully offset higher cost of goods with price and sales mix. In more detail, we have a positive volume contribution of EUR 22 million. Positive pricing impact accelerated versus Q3, and together with positive mix effect more than offset both structural and transit cost increases. The net effect was a positive EUR 23 million, a clear acceleration versus Q3. Indirect costs increased by EUR 15 million from increased investments in future growth.

Finally, FX had an adverse impact of EUR 14 million, mainly from the appreciation of the Chinese Renminbi.

On Slide 13, I'd like to zoom in on our working capital performance during the quarter. On an absolute basis versus Q4 2020, working capital decreased by EUR 63 million to EUR 250 million or from 4.7% to 3.6% of sales. The lower year-on-year working capital was mainly the result of higher payables, more than offsetting higher inventories from both longer order lead times and increased safety stock levels.

Finally, on Slide 14, you can see our net debt evolution. At the end of December, our net debt position reduced to EUR 1.16 billion, thereby reducing our net leverage ratio from 1.8x to 1.4x. This reduction was mainly driven by the EUR 257 million free cash flow generation in the fourth quarter.

In line with our commitment, we also repaid EUR 350 million of debt in the fourth quarter. Overall, we remain well on track to deliver on our commitment to reduce our leverage ratio back to 1x EBITA by the end of 2022.

And with this, I would now like to hand over to Eric for the full year 2021 performance.

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

Thank you, Javier. Let's go to Slide 16. In 2021, Digital Solutions and Digital Products further increased their contribution to our business, now reaching 87% of our sales, 82% of adjusted EBITA and 85% of free cash flow, driven by innovation in energy efficiency and digital lighting technologies that have generated substantial growth over the past 10 years. I would like now to discuss the performance of Connected Lighting and our growth platforms in more details. We go on slide -- we go to Slide 17.

Connected Lighting grew by 21% driven by demand for our consumer brands, Philips Hue and WiZ, and our professional systems brand, Interact. Our growth platforms, agricultural lighting, solar lighting, UV-C and 3D printing grew by 19%. Together, they now represent 25% of our sales and an important part of our growth in 2021. The soon addition of our latest acquisition, Fluence will further strengthen our growth and the growth of our growth platforms.

I would now like to spend a moment on 2021 supply chain developments on Slide 18. So as you can see, component supply lead times have substantially increased even more so on the active component side. We have reached an unequaled number of Level 4 escalations. This led us to redesign products and find alternative sources of supply in record times. At the same time, logistic disruptions have hampered our capacity to deliver our customers because of container shortages and congested ports. This led us to look for multi-model transportation solutions.

We have seen our distribution centers replenishment lead time reach an all-time high, while good in transit and back orders sharply increased. We had to increase our levels of inventory to deliver our customers under these conditions. Overall, we are remaining cautious on the supply chain situation. And based on the most recent trends, we are expecting continued logistic issues in H1 2022 with improvements in H2 2022. For components, we are expecting to see further and continuing improvements in H1.

Looking at the 3 divisions in more details, we go to Slide 19. Digital Solutions had a comparable growth of 3.4% as the division faced a slower recovery throughout the year driven by continued lockdowns and a high exposure to component shortages. Demand picked up in the second half of the year with a particularly strong fourth quarter. The division improved its margin by 110 basis points, reaching 11.3%, mainly driven by operating leverage and indirect cost savings.

Digital Products achieved a comparable growth of 8.8%, particularly driven by the strong demand of our 2 connected home brands, Philips Hue and WiZ. The division improved its margin by 90 basis points reaching 13.8%, driven by operating leverage and positive price and mix, which more than offset higher input costs and investments in marketing.

Conventional Products had a comparable sales decline of only 6.9%, driven by the low base of previous year and continued market share gains. The division improved adjusted EBITA margin by 70 basis points, mostly driven by indirect cost savings.

Next, I would like to discuss our sustainability performance on Slide 20. We have now completed the first year of our Brighter Lives, Better World 2025 program, making significant progress towards doubling our impact on the environment and society. By the end of 2021, the cumulative carbon reduction over our value chain was 60 MT which puts us ahead of track in achieving our 2025 target. Circular revenues increased to 25%, driven by a further expansion of serviceable professional luminaires and the continuous stable contribution of consumer luminaires and circular components. This also puts us on track for the 2025 target of 32%. Brighter Lives revenue were 27%, which means that we are making good progress towards the target of 32% in 2025.

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%. In Q4, we launched the Powering Inclusion series, which aims at increasing the awareness of our leaders and people managers on how to foster inclusion.

Lastly, we are very proud that S&P Global Corporate Sustainability recognizes our sustainability commitment and has ranked us in the top 1% in the electrical components and equipment category. We are included in the Dow Jones Sustainability World Index now for the fifth consecutive year. We ranked first for 4 years and second 1 year, last year. These achievements reaffirm our commitment to leadership in sustainability.

Another important highlight is the intended acquisition of Fluence announced in December, as shown on Slide 21. We reached a definitive agreement with AMS Osram to acquire Austin, Texas-based Fluence for $272 million on a cash basis. This will strengthen our agriculture growth platform in North America and will enable us to capture the full potential of The U.S. market for bio-based crops to which cannabis belongs and also non-bio-based crops building on our strong existing European footprint. We expect the global market for agricultural lighting to grow by more than 20% per year to EUR 1.6 billion in 2024. The acquisition adds Fluence's complementary technology and market segments to our existing horticulture lighting operations. The transaction is expected to close in the first half of 2022, subject to regulatory approvals and other conditions.

To wrap up our discussion for the full year 2021, let's move to Slide 22 to discuss our intended capital allocation for the year. So for 2021, we will propose to pay a cash dividend of EUR 1.45 subject to shareholder approval at our AGM on May 17th. This is in line with our capital allocation policy to pay an increasing annual cash dividend per share year-on-year. We also expect to achieve a leverage ratio of reported net EBITDA of 1x by the end of 2022, including the cash outflow from the intended Fluence acquisition and cash inflows from our operations and the continued rationalization of the company's real estate portfolio. In addition, we will continue to invest in organic and inorganic growth opportunities in line with our strategic priorities.

So in line with 2021 to 2023 guidance, given our Capital Market Day, we are providing an outlook for the year. So I guess this is on the next slide. As we continue to actively navigate through the gradually improving components and logistics environment, we are expecting a comparable sales growth in the range of 3% to 6%, the continued adjusted EBITA margin improvement of up to 50 basis points and a free cash flow generation in excess of 8% of sales. So we are confident that we will manage the external volatility with the same agility as we demonstrated in the past 2 years. The fundamentals of our business remain stronger than ever, driven by the ever-growing need for energy efficient and digital lighting technologies.

And with that, we would like -- I would like to open the call for questions, both Javier and myself are happy to answer.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from George Featherstone of Bank of America.

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

Firstly, on the order book, if you can break it out by composition. Firstly, in terms of contribution from deferrals due to supply chain issues and then also underlying demand? And then comment on which divisions are seeing strong visibility about growth?

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

Yes, George, so on the order book, you may remember that at the end of Q3, beginning of Q4, we stated that we had something like 90% plus in terms of additional order book compared to Q4 2020. If you now project this at the end of Q4 and the beginning of Q1 2022, we have a backlog, an order backlog, which is 67% bigger than what it used to be at the same period last year. So as when we started Q4, this is good for the intended sales that we have to expect in Q1.

Now the nature of this backlog is also better in terms of quality because that backlog in order has seen a substantial reduction. We're not disclosing this number, but a substantial reduction of the overdue orders. So it is a backlog that has continued to perform because we're getting more demand. But we have been able to sell, we have been able to deliver to our customer a lot of the overdue orders. So that's extremely positive.

When you look at the dynamic, we probably had more increase in the backlog in Q4 on digital products than digital solutions. We had some issues to deliver on digital products, especially on the connected businesses because they require a lot of components. And to cut a long story short and to give an idea, I mean, we have a lot of inventory for instance of light strips. And the light strips go with the HDMI box, but we have a big shortage of HDMI box. So at the end of the day, the shortage of HDMI box is preventing us from selling the light strips. And then the backlog increased in that fashion quite substantially in Q4. So at the end of the day, it's 67% more than what we had in Q1 last year. It's backlog which is much better in terms of quality and it has increased a bit more in digital products than digital solutions.

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

And then just a follow-up on something as you said on the connected lighting revenues. I think normally, you do break this out by digital solutions and digital products. Could you just give us the share of each from the EUR 1.4 billion of connected revenues, please?

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

Yes, George. So you will verify that. I think -- so we were at 1 point -- I think we were at EUR 1.1 billion, EUR 1.135 billion in 2021, and we are at EUR 1.375 billion in 2021. So that's a great progression of 21%. And the proportion is that we have about -- I think it's about EUR 600 million, probably on the digital products and the rest will be digital solutions. So roughly EUR 600 million on the side of the digital products and the rest is Digital Solutions.

Operator

Our next question is from Lucie Carrier of Morgan Stanley.

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

Congratulations on a strong finish of 2021. The first question I would have is trying to think a little bit between the different components of your portfolio in terms of growth, I think you mentioned that between connected lighting and your growth platform, this is now about 25% of sales, and that has been growing 20% in 2021. And I'm not sure whether the 20% is organic or all in. But regardless, that suggests that the rest of the business, 75%, was not growing at all or even declining, if the 20% is organic. So my question is when you kind of project yourself in the future, do you think you can maintain that 20% pace of growth for that group of business, i.e., the connected and the growth niches or that 20% we are seeing now potentially at some point because of the comp effect maybe -- would be slowing. And so what does that tell us for effectively the combination of that and the drag of the remaining 75%, which doesn't seem to be really growing despite the comp effect, which was quite easy this year.

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

Lucy, well, if you take into account 25% of sales, which is connected and growth platform, they have generated about EUR 240 million of growth. I think for the whole group, we are around EUR 350 million of growth for the full year, meaning that the rest is also growing by EUR 90 million. But in this EUR 90 million, you need also to take into account conventional, which has been declining by EUR 50 million. So if you have the growth platform contributing to EUR 240 million of the overall growth in absolute value, you have the rest of the business contributing also by EUR 140 million roughly to offset the decline of conventional. So it's not only the growth platform that are growing, it's also the other business. And you know because you know very well the company that we've been declining now for many, many years in conventional.

Now if I take a different perspective and I look at where we are compared to 2019, the consumer-based businesses, whether they are connected or not, are at 100% index. Meaning that we have gone back at the end of 2021 to where we were in 2019 for our consumer-based businesses. Now if you look at our -- and if you look at digital, the Digital Solutions division specifically, we are at 89%. So this is where we have a big reservoir of growth coming up in 2022 and 2023.

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

I understand the point you're making on the growth profile, but the number I was mentioning was also including your connected lighting, which you said was connected lighting close to growth platform was 25%. And as in your slides, you said that combo has grown roughly 20% this year. So if 25% of the business have grown 20%, 75% hasn't been growing or has been declining for it to produce 3.8%. So I think this is my point. I'm just trying to understand whether that 20% pace of growth for the combination of connected lighting and the growth platform businesses is something that you see as sustainable. Because the 75% seemingly hasn't been growing.

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

Yes. In the 75%, you take also the conventional part of the business, which is declining. So I'm saying that if those 75% you take out the conventional part of the business, the rest is also growing less than connected and growth platform, but it's also growing now.

Let's go back on the first part of your question. Do we see a sustainable growth potential of the connected lighting business and growth platform? Yes, we absolutely do. And if I look at these businesses even during the crisis, they had a much better performance in terms of growth than the rest of the business.

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

My second question, I wanted to kind of a little bit to ask on the profitability of the business. We've seen a big kind of a jump in terms of profitability in Digital Solutions in the fourth quarter. Just wanted to understand a little bit how we reconcile that versus also the guidance you have provided? Do we think that the 14% you have kind of published now in the fourth quarter is something sustainable or something that can be normalized? And in light of that, obviously, the guidance that you've given for 2021 maybe comes a little bit below consensus expectations. So is it a case of a mix shift that maybe prevents you from pushing further or maybe the 14% we saw in Digital Solutions is maybe not the normalized level?

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

Thank you, Lucy, Javier here. Let me just answer those 2 questions separately. First of all, the improvement you see in quarter 4 on Digital Solutions, the important part for us is that, first of all, in the quarter, we have this offset from pricing index of cost of goods. And one of the concerns, as you know, throughout the year, is the ability for pricing versus cost of goods. And if you look at the bridges we have on the total company, that also portrays the digital solutions. So the first positive message is from a margin stability point of view, the offset of pricing versus increase of cost inflation is happening.

Now in terms of further dilution of cost and what's driving the margin in Q4, obviously, the growth of Digital Solutions at more than 11% also has a significant impact on dilution of cost, and that basically drives the margin improvement of about 260 basis points year-on-year. So that explains the change. Now you know also from history that typically our quarter 4 in the company is a high sales quarter, which has a disproportionate, I would say, lower NMC percentage. So the improvement is there. But to assume that Q4 rates is what you go forward, I think it's pushing a little bit because Q4 typically is always a very high margin quarter.

Linking that to the '22 guidance, we don't believe that we're below expectations. Look, we come from, what, 7, 8 years of continued EBITA margin progress. The 90 basis points we have delivered in 2022 is probably more than what many people have expected. And we've been able to grow, we've been able to offset across the total year pricing and cost of goods and get the synergies on the overhead. So assuming that we can continue growing at that pace, probably pushing it a bit, and as we said, up to 50 basis points improvement in 2022 allows us to continue on that trend of making sure we price, we manage cost of goods and we dilute our overheads by sales. But at the same time, we also want to reinvest in growth opportunities, right?

So we want to invest in those areas, and Eric just talked about it. We still believe there's significant potential to keep on growing our growth platforms and connected. And as we've also said last year, we're going to drive synergies, we're going to drive cost savings, but also with the objective to invest in growth. And with all of that together, improvement up to 50 basis points for 2022, I think would be yet another year with ninth year of consecutive EBITA margin improvement in what we all know are difficult circumstances. I hope that answers your question.

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

I was just referring to consensus expectation. I will go back in the queue.

Operator

Our next question is from Daniela Costa of Goldman Sachs.

Unidentified Analyst

This is (inaudible). My question is around -- can you give us some color on your 3% to 6% organic guide? And how much is like pricing there versus volume? And any color on how you see those which is in like Digital Products versus Digital Solutions?

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

Look, we have given the 3% to 6% guidance after completing the process that we complete every time we finish the quarter. So we have a reforecast for the upcoming quarters and with the reforecast for the full year. So first, an element of context. What is included in that forecast is the assumption that we're going to continue to see an improvement on the component shortage side. And we have imagined that we will still be hampered in H1, but we would be going back to close to normality or normalcy by the end of the first semester on the component side.

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We have also assumed in that guidance that we will still see some disruptions on the supply chain side, which is containers availability and congestions of ports until the end of the year, but starting to see an improvement in the second semester. And if this is actually happening. So we believe that the 3% to 6% is where we should be, as a company and whether we're going to be at 3% or whether we're going to be at 6% will depend on the same thing as we've said, and I think we rightly said it in 2021, which is the disruption caused by COVID-19, if markets are being locked down, if ports are being stopped from operating. All the -- unfortunately, now usual things that we've seen in the past year. So we believe there's still volatility and uncertainty in 2022, and that is reflected in our guidance.

Now if you look at Digital Products, Digital Products at 100% level compared to where we were in 2019. Digital Solution is at 89%, so we still believe that we have a higher reservoir of growth on the side of Digital Solutions rather than Digital Products to go back to historical levels.

Unidentified Analyst

Just a follow-up question on that. So I can see in your Page 12, you have EUR 27 million mix FX and the bridge. What products are contributing to it more? Is that Digital Products or Digital Solutions?

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

Yes, if you look at our portfolio, you're right that the impact we have and you will see from the margin impact on Digital Products. They will be more exposed to the Chinese RMB. So the FX impact is more skewed towards Digital Products indeed and that's also why the margin isn't...

Unidentified Analyst

Sorry, I mean the mix impacts.

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

So mix impact. Sorry, I understood FX, excuse me. So mix impact happens now across -- it was in the previous quarter. It was more on the DDP side. We now see it both on Digital Solutions and Digital Products.

Unidentified Analyst

Does it -- which one [doesn't] contribute and more if that's okay to ask?

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

Let me see if there's any significant difference if you look at the flow. They're roughly equal, Daniela -- sorry, they're roughly equal in terms of their contribution.

Operator

Our next question is from Joseph Zhou of Redburn.

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

Thank you for taking my questions, Eric and Javier. And my first question is about the cost headwind that we're seeing. It seems to have eased from Q3, which, to me, was a slight surprise given that Q4 is seasonally the highest sales season as well. So how should we expect the shape of it going forward into Q1, Q2, et cetera? Do you expect the cost headwind to continue to ease? Or shall we expect differently?

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

Yes. Thanks, Joseph. Look, it's true when you look at the bridge, you see that we have year-on-year, a slightly different impact. That doesn't mean that in absolute, it's necessarily different. But if you look at Q3, we also broke down what was structural cost versus transitory costs. We have seen increase relative to last year. We've seen both slightly less. We're still very cautious. It's true that there's been some peak rates, for instance, on logistics freight, which have now come down a little bit, but they're still relatively high or they're still very high compared to historical averages. We have had slightly less amount of spot buys that we needed to do, also because Eric has talked about component shortages where we have seen a slight improvement. So on that sense, we have seen some improvements.

On the other hand, to watch out (inaudible) the also the energy prices that have increased in Q4 more. So we still believe that also going forward, there will be the continued prices, the cost price pressure. It will become slightly easier comparable because we'll start comparing Q1, Q2 versus the increases we saw coming in -- throughout the year in 2021. And therefore, also the pricing offset will continue pushing that. So yes, there's still pressure, but let's assume that the comparable base will slightly become easier, and we don't think we'll have that kind of escalation in 2022, like we had at the beginning of 2021, especially also on the logistics side.

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

That's very helpful. And my second question is about your Digital Products division, and I understand that is to have some component shortage issues, which hits on the mix and the margin. You also have higher investment. So there are 3 parts, really. One is that as your customer and what do you see the inventory level is at for the connected home product? And then secondly, when I get that you may have some Phililps Hue lighting products, for example, out of stock for Q4, if I understood it correctly, but why do you -- why did you increase the marketing spend in Q4, which was reflected in your negative EUR 15 million in the cost savings number? And also, within that, the minus EUR 15 million, or actually, if we talk about the increase in investment, can you break it down by R&D versus SG&A for Digital Products? Just roughly, is it more due to R&D or SG&A?

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

Yes, Joseph, the inventory of our customers is at a low level at this point in time in that business that we have especially the connected part of our consumer business, which is Philips Hue and WiZ. It was very hampered still in Q4 by component shortages. We were depending on components -- we're dependent on components for these businesses.

But when you look at the performance in Q4, it's still a decent performance that needs to be fueled by (inaudible) actions, and that's what we do on the marketing side. We have adapted them from what we originally thought, but they're still there. And they are mostly SG&A. But there's another type of cost which is also impacting that business in Q4, which is not only about the tactical actions that we do to pull the market during the quarter, but it's more longer-term investments that we have done over the past years on our digital platforms. Our direct connection to customers, and we have a portal, which is very well made. By the way, if you go there, we're improving it on a regular basis. It's not available in many countries. And we still need to invest in that platform to make it special and different from the other one. So there's also some investment that you see in Q4 linked to that initiative.

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

All right. And congratulations on delivering your FY '21 guidance, by the way.

Operator

Our next question is from Marc Hesselink of ING.

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

Yes, I actually would like to talk a bit more on the supply chain again. When I recall, I think you also did something on the redesign of the products, how you see the improvement, maybe structural. You've put a lot of focus on getting better visibility of the supply chain. But I think you also did some work on redesign. Is that a big impact of the supply chain? And does that give you even more comfort that indeed those issues will start to become less over the course of '22?

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

Yes, Marc, this is something that we start to see because we also listen to what others are saying. And we believe that we have seen an improvement on the side of the components that many other companies haven't seen so far. And yes, I believe that the redesigning of our products, to take into account, components that are more readily available on the market has helped us. The fact that we have also redesigned some of our architectures to get more suppliers capable to supply the same components, which we didn't do in the past. We were mono-sourced in some very specific components. So we increased our number of suppliers capable to deliver on these components. And what is quite interesting is that we could do that in the space of 3 to 4 months when we would have believed in normal times that to replace such a component, it was minimum 1 year to 1.5 years. So I think we've been finding the right processes in order to go very fast, changing those components to more readily available components or to other suppliers.

I think in hindsight, that has certainly helped us in Q4. It will continue to help us in 2022. There's 1 specific component. Well, in itself, it's not a big amount that we purchase every year, but its impact of our capacity to deliver is huge. And in -- I know already that in Q1, we have activated another source of supply and that other source of supply will help us to have the amount of components we need in Q1. So that's an example where probably these actions of redesigning that we took early on and that we manage quite swiftly are going to help us.

We've also talked about better visibility. Well, what we've done is that we've booked capacity at our suppliers in the midterm. So I would say for the vast majority of the critical components, we have booked capacity for the full year of 2021-'22. It's not the case for all, but for most, it's the case. So yes, Marc, that has certainly helped the end of the year, and it should help also 2022.

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

So you've also been less dependent on the spot market?

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

Well, I think in Q4, we still have been quite dependent on stock market, especially on what we have invoiced because what we invoiced in Q4, very often, the components were bought in the beginning of Q4 or in Q3. I still -- we're still doing it, but I see us doing it less and less in the space of 2022. You may know also that just for the anecdote, but the cell that we have created or people that do only that has been very efficient because now we have other companies asking us to use the service of that platform to buy components. So we've been also reselling components to others that needed them. So that has been a very exciting happening in all the complexity and the challenges of 2021. But directionally, yes, to your answer -- to your question.

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

And then on a -- a small follow-up there was on the real estate, which you mentioned, which is going to have an impact on the net debt. And I guess, also on the free cash flow. Can you talk a little bit about the magnitude of that? We've seen in the past that sometimes some years, it was quite a significant amount. Do you have visibility on that?

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

Look, we have some level of visibility, but we cannot disclose anything that has not been really firmed up in terms of contracts. As you know, every year, we look at the portfolio as we've also done in 2021. For the visibility for 2022 is we expect that there might be 1 or 2 transactions which are slightly bigger of size. Once they are concluded inside, we'll communicate those. And as we've also mentioned in our press release, they will come at least to partially compensate some of the acquisitions we're doing. But we're going to have a bit of patience. We'll disclose them as soon as we sign them. We have the visibility on them, but we'll disclose them when we have them firmed up.

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

And that's also included in your free cash flow guidance.

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

Yes, we guide all in. So that's what we say because there we've got -- the free cash flow includes also the Fluence, and basically, it's also now what we guide on the -- more than 8% is including those effects.

Operator

(Operator Instructions) We have a follow-up question from Lucie Carrier of Morgan Stanley.

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

One was on the working capital. If I'm correct, I think you ending the year with payable days around 165 days. It's about 5.5 months. How should we think about that into 2022? And do we risk to see a bit of a reversal in 2022 from that number? Because that seems quite extended for your supplier to not be paid for so long?

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

Now we can debate about the numbers. I don't think your 160 days is correct. We judge it is going to be close to 120 days. And if you look at our payment terms in terms of 3 months, 90 days end of month, plus the benefit we have on sourcing from China, we believe that has been also for the last couple of months sustainable. So we're nowhere close to this 160 days that you're mentioning.

From a sustainability point of view, we've seen that in terms of -- we were slightly lower in the past. We've integrated Cooper to get on our payment terms. As I said, we have the benefit of Klite sourcing, and that brings to that level, which we believe is sustainable.

In absolute terms, if you look at the absolute payables, yes, we expect that they will come down, obviously, because we come from a strong quarter. And therefore, in Q1 specifically, we believe that cash flow for next year will be more under pressure as inventory for all the good reasons of goods in transit, but also making sure we have components on stock rules, they are relatively high, but we're going to take the absolute number of payables will come down. The days will roughly stay where they are. But therefore, we also expect that in the phasing of next year, Q1, Q2 will be more stretched in terms of cash flow than the second half of the year.

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

The [165] is versus cost of goods sold, not sales. Just on the -- my second follow-up was around the Fluence business. Could you maybe make some indication around profitability? And historically was, I mean, when it was owned by Osram, it was a little less profitable than your level here at Signify? Is it still the case? And if not, how quickly do you think you can bring it to the Signify level or even higher?

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

Yes, Lucie. We think we -- effectively, it might be on paper at this point in time, slightly lower in terms of profitability to the business that we have, our horticulture business, which is based in -- mostly in Europe, even if we sell in the whole world. So now with Fluence, we're acquiring a business which is this time based in The U.S. and for the whole world. So one we'll sell under the Philips brand and the other one under the Fluence brand. At this point in time, yes, Fluence is slightly below in terms of profitability. But we think that looking at the back office costs, the SG&A and also the optimization of purchasing and procurement that we can bring them very quickly at the right levels and generate the right amount of value creation, understanding that -- that deal is really a growth deal. Our objective in acquiring Fluence is to have another company that will reinforce our growth platforms with a clear growth objective over the coming years.

Operator

We have another follow-up from Daniela Costa of Goldman Sachs.

Unidentified Analyst

Actually just following up on Fluence, what's the impact on synergy you're expecting on Fluence and how big will -- will you expect your overall exposure to horticulture after the acquisition?

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

Well, the -- I mean, the synergies are going to be mostly back office, SG&A, as I've said, and procurement. But once again, the value creation principles and the business plan that we're establishing for Fluence is really based on growth. So this is a company that has been growing extremely well in the past years. I think we've indicated a turnover around EUR 145 million. And our objective is to support fully that entity, so that entity continue to grow strong double digits as it has done in the past. So synergies, there will be, but as I've answered to Lucie, probably more to improve profitability. Otherwise, the #1 objective is to grow further.

Now we have already stated that our growth platforms at the end of 2021 around EUR 326 million. So if we add roughly EUR 130 million from Fluence, that we are now in the EUR 450 million rather and of course, horticulture is the biggest part of that number and will continue to impact very positively the growth of our growth platforms.

Operator

Our last question is from Marc Hesselink of ING.

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

I also had a follow-up question on Fluence. The market growth that you're projecting, we saw very strong growth markets in cannabis in The U.S. until now, but probably they're slowing a bit. What are the opportunities in other geographies? And how can you leverage it? And is there also maybe a possibility to leverage some of the products in other product categories?

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

Yes, Marc, Fluence is not only involved in making products that help the crop of cannabis to grow, but they're also involved in what we call non-bio-based plants, vegetables, fruits. And they are developing their sets extremely quickly in that direction too, in The U.S. and also beyond The U.S. So at the end of the day, if you take a bit of distance, you see that we're going to have 2 entities, 1 based out of Europe, 1 based out of The United States, primarily operating on their markets where they have already a very strong market share, but also selling worldwide. What we see is, in general, the horticulture market growing and growing nearly everywhere. And that's the case for non-bio-based but also for bio-based. So if you just take another viewpoint, you have 70 countries at this point in time that have legalized cannabis for medicinal use and 19 that have done it for recreational use. And if you look at The U.S., The U.S. is part of both categories and has been growing extensively in the past years, which explains why Fluence has also benefited from this market growth.

Now, for us, it's not only about bio-based, it's bio-based, non-bio-based, we use the same technology. And we have now the possibility to grow very strongly in the 2 fundamentally important economies in the world, Europe on the one hand and The U.S. on the other hand, for this business.

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

But is it the right way to think about it that if Germany maybe moving up to legalizing that, that is a big incremental opportunity for you or is that the wrong way to look at it?

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

No, it's the right way to look at it. If there are more countries and we see to the trends, having more and more countries legalizing cannabis for medicinal use, which is also in line with the strategy of investment in areas that bring additional health to the world, yes, this will benefit us for sure.

Operator

Thank you. There are no further questions so I'll hand back over to our speakers.

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. And again, thank you very much, and enjoy the rest of your day.

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