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# EDITED TRANSCRIPT

LIGHT.AS - Q2 2022 Signify NV Earnings Call

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

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## PRESENTATION

**Operator**

Hello, and welcome to the Signify Second Quarter and Half Year Results 2022. (Operator Instructions).

Today, I'm pleased to present Eric Rondolat, CEO; Javier van Engelen, CFO; and Thelke Gerdes, Head of Investor Relations. Please go ahead with your meeting.

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

Good morning, everyone, and welcome to Signify's earnings call for the second quarter and half year 2022. With me today are Eric Rondolat CEO of Signify; and Javier van Engelen, CFO. During this call, Eric will first take you through the business and operational performance, after which Javier will review the company's financial performance for the second quarter and half year. Eric will then discuss the outlook 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 conference call will be made available as soon as possible on our Investor Relations website. And with that, I now hand over to Eric.

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**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 of the highlights for the second quarter on Slide 4. We delivered 5.1% comparable sales growth, driven by continued traction of the professional segment. This was achieved despite headwinds from the war in Ukraine, lockdowns in China and an overall weaker consumer environment. This illustrates the improvement in our growth profile fueled by the continuing shift towards connected lighting. Nominal sales, including FX and acquisitions, increased by 14.1%.

The adjusted EBITA margin declined by 140 basis points to 9.5%. Net income increased to EUR 248 million, and free cash flow was EUR 135 million. We successfully completed the acquisitions of Fluence and Pierlite in May. We also divested a nonstrategic real estate, the nonoperational gains of which are included in the net income.





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On the next slide, Slide 5, we see Signify's overall Q2 performance. So we increased the number of connected light points from EUR 100 million in Q1 to EUR 103 million at the end of Q2. LED-based sales represented 84% of total sales. Nominal sales increased by 14.1%, with comparable sales up by 5.1%.

Adjusted EBITA remained broadly stable at EUR 174 million in Q2 compared to EUR 175 million last year. EBITA margin decreased to 9.5%, a 140 basis point decline versus Q2 2021 as the lower gross margin was partly offset by operating leverage and indirect cost savings. Net income increased from EUR 82 million to EUR 248 million, primarily driven by the gain from the disposal of nonstrategic real estate assets. And finally, our free cash flow was EUR 135 million, which Javier will explain in more detail.

Now let's move on to our divisions, starting with Digital Solutions on slide 6. The Digital top line performance remained strong with comparable sales growth of 11.6% and an adjusted EBITA margin of 9.5%. The double-digit CSG growth was driven by continued strong action in the Professional segment across most markets.

I would like to highlight that the CSG growth was driven by a healthy combination of volume, price and positive sales mix. The nominal sales growth of 24.4% includes positive FX variances as well as the acquisitions of Fluence and Pierlite. Adjusted EBITA margin has decreased by 120 basis points to 9.5% as price increases compensated higher input costs, but with positive sales mix and operating leverage only partly offsetting the sudden FX movements.

On the next slide, on Slide 7, I would like to discuss a couple of business highlights of our Digital Solutions division. We installed our BrightSites solution in the city of Tampere, in Finland. BrightSites provides a super-fast to wireless communication using high-quality and the streetlights. It removes the need to dig and lay fiber connections throughout the city while requiring only a fraction of the time and cost as compared with traditional methods. This allows the City of Tampere to accelerate the deployment of present and future broadband IoT applications such as 5G, WiFi and smart city services.

Next, as we are celebrating 15 years of leadership in developing horticulture lighting, I would like to highlight the following projects. We are helping Kwekerij Loos to make the switch to 100% LED-lighting for both its strawberry cultivation sites. The installation follows a successful actual switch to LED last year. And the full LED installation provides considerably more light in its greenhouses, more efficient plant growth and energy savings around 40%.

Let's now move on the next division on Slide 8. So in the second quarter, the Digital Products division reported a comparable sales growth of 2.6% on a strong comparison base of 20.4% last year. The positive CSG was driven by strong demand for LED electronics, while consumer connected sales slowed down versus the strong comparison base in the previous year. The adjusted EBITA margin was 10.6%, driven by a gross margin decline impacted by the higher COGS space and negative effects and sales mix.

Moving on to Slide 9 for the business highlights of Digital Products. So we launched various new products for Philips Hue illustrating the continuous extension of this range. We also added new features to the Hue app. With the new Sunrise wake-up style, users can mean the sun appearing over the horizon with a rich colorful transition through blue to soft orange light. We also added the new demo to the app. The new demo mode and to the app through which both prospective and existing Philips Hue users can explore the full suite of features that Philips Hue has to offer.

After the launch of the Ultra Efficiency aboard in Q4 last year, we now launched the first Ultra Efficiency TLED Class A in Europe. We extend the Ultra Efficiency family with the most efficient LED tube today on the market. That saves up to 44% of energy consumption versus a standard LED Tube. This innovation breakthrough is having great market response as it brings a great response to increasing energy prices.

Moving on to Slide 10 and conventional products. Comparable sales declined by 13.8%. The adjusted EBITA margin declined to 15.5%, as significant Q2 price increases were not sufficient to compensate the sudden negative impact of energy and transportation costs and FX.

Next, I would like to discuss our sustainability performance on Slide 11. The cumulative carbon reduction over our value chain is ahead of track. This is mainly driven by the sales of energy efficient and connected LED lighting, which helped reduce emission in the use phase of the product.





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Circular revenues increased to 31%, well on track, for our 2025 target. Circular revenues helped by the upgrade and to serviceable luminaires. Our brighter lives revenues of 26% are slightly up track due to a shortfall of UV-C disinfection lighting and LED Electronics. We have identified initiated follow-up actions and remain confident that we will be able to achieve our 2025 target. The percentage of women in leadership positions of 27% was on track, and we continue to drive actions to achieve our 2025 commitment, including inclusive job posting and diverse hiring panels.

In addition, we conducted training sessions together with a halt and international business course. These trainings equipped our teams with the right tools to realize our diversity ambitions.

Slide 12 highlights that this quarter we successfully completed the acquisitions of Fluence in the U.S. and Pierlite in our Pacific region. First, the acquisition of Fluence strengthens our agricultural lighting growth platform. We previously already had a strong horticulture lighting business in Europe with a global reach. And with Fluence, we are expanding our position in the attractive North American horticulture lighting market. Fluence will operate as an entity within the agriculture lighting business of Digital Solutions.

The acquisition of Pierlite strengthens our position in Australia and New Zealand. It will help combine Pierlite indoor portfolio which Signify's indoor and outdoor lighting portfolios, while adding Pierlite's leading access to the Pacific distribution channel.

With this, let me hand over to Javier, who will take you through the highlights of our financial performance in Q2.

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

Thank you, Eric, and good morning to everyone on the call. Let me dive straight into the key financial highlights on Slide 14, where we are displaying the adjusted EBITA bridge for total Signify. Adjusted EBITA in absolute euro terms was about flat versus Q2 2021. Mainly as we have continued to successfully offset cost on goods increases of EUR 83 million by price increases worth EUR 86 million. Also, the negative currency impact of EUR 9 million, mainly the result of the Chinese RMB strengthening versus the Euro was offset. The adjusted EBITA margin did decrease from a record level of 10.9% in 2021 to 9.5% in Q2 2022.

Gross margin was down 290 basis points versus 2021 due to the sudden rise of energy prices, the strengthening of the Chinese RMB and the continued negative impact of the disrupted supply chain on inventories, warehouse costs and distribution expenses. Indirect costs decreased by only EUR 2 million as we continue to invest in marketing to support our growth momentum. As a percent of sales, though, indirect costs decreased from 30.6% to 29.3% of sales, thereby helping us to offset part of the gross margin pressure.

On Slide 15, let me talk you through our working capital performance during the quarter. Versus Q2 2021, working capital increased by EUR 514 million to EUR 783 million or from 4% of sales to 10.5% of sales. While inventory volume stabilized in Q2 versus Q1 2022, in value terms, they increased by EUR 515 million versus Q2 2021. About 2/3 of this increase was due to higher unit value and USD and RMB strengthening versus Europe. The other 1/3 represents inventory volume increase due to both longer lead times and as a result, also lower forecast accuracy.

Other components of working capital net to about 0 as higher receivables, partly due to higher level of disputes are offset by higher payables and other working capital items. Based on the structural working capital improvements we had made prior to the current supply chain disruption, we are confident that we will return to previous mid- to low single-digit levels as soon as supply chain lead times reduce.

On Slide 16, you can see our net debt and leverage evolution. At the end of June, our net debt position increased by EUR 371 million to EUR 1.749 billion mainly as we were able to partially finance both the 2021 dividend payment and EUR 183 million and the EUR 297 million acquisitions of Fluence and Pierlite with a positive EUR 135 million free cash flow.

Even the EUR 35 million free cash flow is the combination of a EUR 59 million cash outflow from operating activities and the and gross CapEx and EUR 194 million of proceeds from the sale of nonstrategic real estate assets. As a result of the higher net debt, our net leverage ratio increased from 1.6x to 1.7x.





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On Slide 17, I briefly summarize our first half 2022 performance. Overall, we continue to see solid top line growth, thereby seeing continued strong recovery from COVID affected half 1 in 2021. In half 1 2022, growth is mainly driven by continued strong traction in the professional segment. On the consumer side, decreasing consumer confidence and high inflation negatively affected half on 2022 sales, following a strong acceleration of connected lighting in the first half of 2021. For the second year in a row, we did achieve a double-digit adjusted EBITA margin as compared to the half quarter of 2020, the combination of pricing, mix and indirect cost discipline allowed us to more than offset over the higher input costs and the incidental costs linked to the shortage of components and supply chain disruption.

Half on free cash flow generation was a negative EUR 54 million this year, mainly as the inventory buildup due to longer supply lead times was not fully offset by proceeds from the sale of nonstrategic real estate assets. And with this, I'm handing back to Eric for the outlook and some closing remarks.

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

Thank you, Javier. I will conclude with the outlook on Slide 19. So we maintain our comparable sales growth guidance of 3% to 6% for the year, driven by the continued momentum in the professional segment and our solid order book. At the same time, we revised our adjusted EBITA margin guidance 11% to 11.4% for the year, reflecting the lower margin performance in Q2. For the remainder of the year, we are taking adaptive measure and expect margin headwinds to ease in the second half of the year. We remain firmly committed to investing in our business and driving not only our long-term growth objective, but also to support the momentum we continue to see in our business.

We now expect free cash flow of 5% to 7% of sales in 2022, including the proceeds from real estate divestments. We expect to return to our previous target of over 8% as soon as the extended supplier lead times no longer require us to carry higher inventory. And with that, I would like to open the call for questions, which both Javier and myself are happy to answer.

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## QUESTIONS AND ANSWERS

**Operator**

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

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

My first one would be around the organic growth outlook. You've delivered 2 quarters now in succession of organic growth at the top end of the guidance you set for the year, obviously getting clear traction on pricing. But you've not raised organic growth expectations for the full year. So I'd just like to try and understand that considering you've got an easy comparative in Q3. What are you expecting for volume growth in the second half of the year?

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

Yes. Effectively we are at the end of H1 at the higher end of the guidance that we have given for the year. Nevertheless, we are cautious regarding the potential -- well, I don't know if we have to say potential, I think we are facing the recession at this point in time. What we don't know is the magnitude of that recession moving forward. Effectively, we have an easier comparison base in Q3, but a much harder one in Q4, especially on the consumer-based business. So this is why we've maintained the 3% to 6%, which when we have done our detailed forecast for the full year, which has happened at the beginning of this month. We believe we have the capacity to maintain it. But as you know, there is still an uncertainty in H2 regarding the recessive scenario. So that's the reason why we've done it like that.

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

Okay. And then given we got one follow-up, just on the connected demand in Professional. I'd just like to try and get a sense of how the typical payback period has changed at this point with energy costs where they are compared to last year.

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

Yes. It really depends on the segments and it depends on the country energy prices. But in some segment applications where the return investment was 3 years, it has come down to 1. So it's quite substantial. And where it was -- sometimes difficult to base an investment only on energy efficiency. When we had an ROI, which was rather around 7 to 8 years. This has come down to 3 to 4 years. So we see a renewed traction on energy-efficient lighting. We see also a renewed traction on connected as it brings additional energy savings.

And I would say that in some specific segments in the industry segment, now customers understand fully what our systems are bringing not only in terms of energy efficiency, but also in terms of workspace optimization and in terms of improving the productivity and the safety of people at work, which is fundamental also for the return investment. And if you bring all these criteria together, it's only a matter of weeks. So that helps also the decision to invest.

Now you have -- you may remember, George, that we brought to the market the Ultra energy-efficient build in Q4, now we're continuing with the new form factor in Q2, which is the LED tube, where we can reach 44% more energy efficiency than the available ones on the market today. And that's also another very important one because this was one part of the market where it was difficult to reach the right level of return on investment.

Now with the price of energy going up and with this new technology that helps to do further savings, we are betting a lot on that technology. So the bulb will be touching the consumer, but also the professional market and the TLED, I mean the LED tube, will touch mostly the professional market.

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**Operator**

(Operator Instructions) The next question comes from Philippe Lauwerys from Goldman Sachs.

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

I ask you on the guidance one being just on the free cash flow margin target, just seems sort of low -- guidance seems low for the second half of the year, given it also includes the one-off in 1H. Just if you can give some more color on that for the second half, how you're thinking networks there?

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

Thanks, Philippe. It's a good question. If you look through the numbers, and we've also mentioned it in the presentation, in the script is, if you look at the first half, the end of the first half, if you exclude the proceeds of the real estate assets, we end up with a negative cash flow. If you go back to the underlying dynamics, it's the buildup of inventory that's happened over the last 3 quarters and therefore, the payments we've done to finance that inventory in the first half of this year. So if we start with that as a half 1, then if you look at half 2, we will return to a much more healthy generation of cash flow. And if you compare it with the guidance, you will still see that our second half cash flow generation will probably more in the tune of EUR 400 million that we have to generate.

As we, at this point in time, don't see a significant improvement in supply chain before the end of the year. We do think that we'll have an improvement on inventories as we also volume-wise are adjusting our outlook for the year in a more conservative way. But we don't think we're going to get back to the levels of working capital or inventory that we had before all the disruption. Therefore, the guidance includes what we have done in the





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first half, including the real estate proceeds, but the second half is, of course, a much more healthy cash flow generation, and that's where the guidance between 5% and 7% comes from.

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

Okay. Got it. And then just a quick follow-up on the comparable sales target for H2. Just can you give some more color on the split between price and volume going into the second half?

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

So going to the second half, it's a bit more complicated, but I can tell you where we stand now because it's very different across the businesses. If you look at the comparable sales growth that we have experienced in Q2, I would say the majority of it is price. But it's very different when you look at the divisions. I would say that there's a lot of price in the conventional product division. Meaning that the volume is a bit more negative than what we see on the CSG. We had slightly negative in volume in digital products. So its price brings the CSG to 2.6%.

But when it comes to the Digital Solutions division, most of the growth is volume. So we see the first signs of the recession clearly appearing on digital products, but on Digital Solutions on the new provisional part of the business, we see that volume is still there. And the order book that we have at the beginning of this quarter, if we take the same approach as we did in the previous quarters. And if we look at the normalized quarter because Q2 last year already had some backlog, but we're still around 50% above the backlog that we used to have when we started the quarter -- I mean, backlog order book.

So at the end of the day, we see more volume coming from Digital Solutions and the Professional segment than the consumer business, which has started to slow down as we commented already in the previous earnings call.

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**Operator**

The next question comes from the line of Jingyi Zheng from Credit Suisse.

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**Jingyi Zheng** - *Crédit Suisse AG, Research Division - Research Analyst*

I would like to ask about the revised guidance on margin for 2022 and its implications on the second half. So if we take margin guidance at midpoint, our calculation would imply some flattish to slight improvement in the second half after about 80 bps down year-on-year in H1. So could you talk us through your thoughts on that and how you see the various actions helping margin progression in H2 and where the improvements will likely come from?

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

Thank you for your question. The -- if you look at the margin guidance, exactly what you're saying, we expect that after the decline we see in Q2 that we will see a recovery coming into the second half of the year. The reason why we're projecting that is we expect slightly less headwinds than what we faced in Q2. More specifically, if we plan out the full second half, if you look at the key reasons why we have seen a deterioration of margin in Q2, it was FX. It was also some impact we had on warehousing and distribution costs. And we also took some write-downs of some specific inventory items where demand has dropped.

Those negatives that we had in Q2, we expect that they will not reappear in Q3, Q4. And also, what we expect is, number one, pricing will still be an element, and we expect that bill of material pressure will slightly come down. As you know, we've seen prices in the market going down on a number of materials, but also on logistics. Number two, we have started early in the year a lot of work on refocusing the organization, also on cost savings, product cost savings.





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So we will be working on bill of material savings, and we have already some specific results where we can take costs down. They will not all rotate in this year because of the inventory, but we have other items where inventory is lower. We will see some of those savings already coming through.

So if you take that balance, we believe, sequentially, margin will recover in Q3 and then in Q4. And then we will be closer again to the margin and the profitability we had in last year second half. So we see a path to recovery with the visibility we have, but it's shifting the organization back to making sure we get more cost savings from the products, from redesigning products and with demand going down in general in the market, we do see easy and easing of the pressure of cost in general, inflation in general in our P&L.

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**Jingyi Zheng** - *Crédit Suisse AG, Research Division - Research Analyst*

That's very helpful. Can you also touch a bit upon the consumer segment in particular? So how much is Hue as a proportion of sales. As I understand, the product line is accretive to margin and last year you benefited from investment in [TLED] this year, we'll be seeing some impact from consumer confidence. So essentially, we're trying to understand to what extent you can drive the margin improvement.

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

Yes. In the past Hue has certainly driven the margin improvement was one of the businesses that drove margin improvements in the Digital Products division for sure. So let's talk about the consumer market first and the way we see it.

In general, all over the world, maybe with some nuances, probably that there's a bit more dynamic in the U.S. market than there is in Europe at this point in time. And on the side, the North China, which is an important market for us because it's our second biggest market given the situation of the 0 commit policy, we were still quite substantially impacted still in Q2. So overall, we see a consumer market, which is going down. And that's also the case for Hue, but we need also to remember that the base of comparison for Hue last year was absolutely huge. We took a very strong double-digit performance. So you have the confidence of the consumer, which is going down and you're comparing to a very high base. So that's how we need to judge the performance in Q2.

Moving forward, we're still extending, as you probably have seen and the range with new products with a new innovation in the app and by experience, every time we do this, we drive more business of customers who have the existing ecosystem already installed and the increase in that ecosystem. So -- but this is the dynamics around that business.

You may remember that we have also bought a company called (inaudible) to be also present in the smart home on the WiFi base and smart home communication. And on that business, which is today much smaller than Hue. We've seen still a strong traction as we are penetrating the market with a new offer, while on the side of Hue, we are more established.

So this is -- it's going pretty much with the market dynamic. I think at this point in time, we're not losing market share, and we have put in place the means that are going to help us to capture whichever growth there is in front of us. But at this point in time, the market is going into a slowdown. From a margin perspective, these businesses and the smart business of Hue is clearly accretive as we have said it to the Digital Products division.

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**Operator**

The next question comes from the line of Martin Wilkie from Citi.

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**Martin Wilkie** - *Citigroup Inc., Research Division - MD*

It's Martin from Citi. Just a question on the margin progression in the quarter. When we look at the bridge, the net price number looks to have been slower in Q2 than it was in Q1, you had a positive EUR 5 million from mix pricing, the COGS benefit. Just to understand, you mentioned earlier that





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there are these mix differences clearly by division. And it is that difference relative to Q1 and less positive net pricing just to do with mix. Was it is inventory write-downs you mentioned earlier, just to understand what's going on in terms of that net price number.

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

Let me try to take it, Martin. When you look at the bridge, the first thing is just look at the pricing income you've seen over the last couple of quarters, that number has been increasing. So we do see positive traction on pricing. If you remember, kind of Q4 last year was about EUR 30 million, went to EUR 60 million, it's now EUR 80 million. And you basically see that, that is really moving on as we expected pricing implementation to be going through the market along the year.

When you look at the cost of goods number here, do you have the right comparison versus (technical difficulty) material and other cost of goods we should break out that number. From the EUR 83 million, there's about EUR 55 million of that, which is a bill of material and if you compare those EUR 86 million versus EUR 53 million, EUR 55 million of bill of materials, you do see that we've been able to price for what we expected to come in terms of inflation of bill of materials.

There's another EUR 20 million to EUR 30 million or EUR 20 million, EUR 25 million in that cost of goods, which is more related to the sudden impact of distribution costs, Q2 energy cost sudden spike. I don't want to call them incidentals because we know that some of that will continue. And this is the part of the cost of goods, EUR 83 million that you would not -- well, that we were not able to immediately collect for pricing. So fundamentally, the pricing of EUR 86 million does cover our bill of material cost increase. But then some of the write-downs, the distribution and warehousing costs, a sudden increase that we've seen has not yet been offset by the pricing that we had. So it's kind of splitting out at EUR 83 million to make it really comparable versus some of the bridges we showed in the past.

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**Martin Wilkie** - *Citigroup Inc., Research Division - MD*

That's helpful. And -- sorry, go on.

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

That's because you still had the question of mix. If you look at the mix, if I try to make it simple, if you look at the company total, mix has a little impact on the total company. When you look at by division, though, it does have a significant impact especially on digital products because of Hue but that negative mix that goes within digital product is then, set up to global level by the mix between digital solutions, conventional and digital products. So on a total company level, mix does not have a significant impact within the individual divisions, especially in digital products, it does have a significant impact.

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**Martin Wilkie** - *Citigroup Inc., Research Division - MD*

Yes. That's really helpful. And the follow-up, just on the currency number because obviously, you've talked about the appreciation other Chinese RMB impacting you here. How do you think about that cost in terms of -- I mean we could think of out as just another piece of cost of goods sold inflation if you're purchasing components in China and selling them globally. So -- and it seems like you're less concerned about that continuing into the second half. So just to understand how you think about that currency exposure.

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

If you break down, Martin, the currency to make a long story short we are -- we are short in RMB, but long in U.S. dollar -- but we are a much more shorter RMB than U.S. dollar, which means that the net effect of the weakening, I would say, of the euro versus those 2 currency isn't negative.





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How to look at that from a cost point of view? When the RMB strengthens, we normally have that in our cost of product calculations. And when I talked about the price increases that we have guided for in the market, that was including an assumption on what would happen with the Chinese RMB.

The problem in Q2 has been that a sudden drop of the euro versus, especially the RMB, is something that was not factored into our pricing decisions. But in principle, for the imports of the product that coming RMB, we would normally include a transaction exposure as we call it, as part of cost of goods and as part of things that we should price for or find offsetting cost savings for us.

It is just this Q2 impact where you had a sudden 9% drop of the Euro versus the RMB that we were not able to react against immediately. For the rest of the year, we think -- you can't predict the exchange rate, but if we assume the current exchange rate, we would still have a year-on-year potentially negative impact in Q3, but then in Q4, the comparable starts being different. So we still see an impact in the rest of the year, but probably we'll get less towards the end of the year. Eric will still add some comments, if you want.

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

Yes. Just to complement and to take a bit of distance, Martin, just beyond FX because if you look at the performance in Q2, we need to look at the gross margin because we have a gross margin decline of 290 basis points, which is quite substantial. And there are a few elements in those 290 basis points. So there is the effects but this is one element. And Javier just commented in detail and what we see coming for the rest of the year.

Then we have the cost of logistics, which is impacting quite substantially the performance in gross margin in Q2. I can give you very precise examples that we had some routes between China and U.S., where we pay the spot rate which is much more expensive than the one that we have negotiated because we had not forecasted these routes in our agreements. And we had a very strong business in the U.S. So we had to continue to flow the markets with products. That is something that we are -- we have started to tackle during the quarter and we believe we can improve that for the rest of the year.

Another element is obsolescence, which is very on 2 very specific businesses. One is UV-C. When we started the UV-C business, we were targeting surface and air. And in hindsight, the business is more geared towards air disinfection as there's 10,000x more infection that come from air than surface. So we had products that we have developed in surface and that we declared obsolete.

On the other hand, part of that obsolescence is also touching quite strongly the conventional part of the business as with energy price rising a lot of our customer growers in the horticulture business are moving to LED and not anymore using conventional technology, and we had to declare obsolete some of these horticulture conventional product.

And the last element -- so obsolescence, we're managing it, and we think it's going to improve in the coming quarters. And then the price of energy has also been an element to consider in Q2. And there are a few actions there that we're driving specifically on our industrial sites to try to mitigate that exposure.

So 290 basis points, that's how we explain it on the gross margin. What is also good to see is that there is operating leverage because at the level of the operating margin the impact is only on 140 basis points. But as Javier has explained on FX and as I have commented on the other elements, that's how we're going to work on these different buckets for the end of the year.

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**Operator**

The next question comes from Akash Gupta from JPMorgan.

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**Akash Gupta** - *JPMorgan Chase & Co, Research Division - Research Analyst*

My first one is on China. Maybe if you can provide more details on what you saw within the quarter, particularly the exit rates towards that -- and when we had some lower impact of lockdowns? And what are your expectations for China and rest of the year given we are seeing mixed signal out of the country?

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

Yes. Look, China has been after Q1, again in Q2, distracting market for us on the growth side of things. So the impact of China is negative on our overall growth quite substantially so. I cannot say it's been very volatile during the quarter because China goes into ups and downs of opening and closing, opening and closing. Nevertheless, the good sign is that the quarantine has also been revised from 14 plus 7 days, it is now 7 plus 3. So I believe this is also a good illustration that the strategy of the government in China is adapting to the reality of the situation and to the severity of the COVID impact there. So we expect to have an improvement in the second half of the year.

There are projects that are waiting to be delivered. So we see an improving situation in H2 very clearly. And I hope that China will be a positive growth factor in the second half of the year, which has not been very clearly in the first half.

Exit rates, it's very difficult to say because the situation is very volatile. But if I don't speak too much about the exit rate, I can speak about the improvements, which is expected in the second half.

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**Akash Gupta** - *JPMorgan Chase & Co, Research Division - Research Analyst*

And my follow-up is on earlier topic of COGS inflation that you briefly touched upon that you have seen some prices of components coming down. Maybe if you can elaborate more on that. I think energy prices are still going up. So cost of glass and glass fitted materials might go up. But I don't know what's happening on the chip side and some of the components and as well as logistics costs. And if commodity or COGS prices go down -- further down the line, is there any risk that you may need to take inventory write-downs in the late end of the year?

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

So Akash a lot of different elements. On the component side, the situation is a bit mixed. But on mechanics, on metals, on plastics, on optics, we think that there is a potential for us after big increases in the past quarters to come back to a situation where we should be able to bring some of the costs down.

So we have started negotiating with our suppliers. Now the new format of management of the supplier prices has changed completely from the 1-year negotiation session that we had previously. Now it is an ongoing and permanent discussions we are having with our suppliers. On one hand, we give them a commitment on volume. But on the other hand, we want to have a commitment on savings.

We have already started to get from some of our suppliers a commitment on pricing going down. It's going to take place probably in Q4. That's when we're going to see the impact of it, but it's important for us to start to do this for the beginning also of 2023. When it comes to potential write-down of inventory, we're not there yet. It depends where the level of our inventory is going to be at that point in time. So we haven't simulated it yet. What is important for us is to try to gain some improvement at the level of the gross margin. It doesn't mean that if we're capable to bring our gross margin to a higher level, we will immediately reduce prices.

So it's for us to manage the situation well in order to make sure that we serve that new wave properly. So it's very tactical, but we have already put the efforts in place to get an improvement there.

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**Operator**

The next question comes from Marc Hesselink from ING.

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

First question is on the trade-off between growth and your margin. Is it a trade-off that you can deliberately make at the moment? Or is the fact that you keep your growth target to lower the margin that's simply dictated by the market. And if it's your choice, what kind of thinking is behind it?

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

Marc, that's a key question. Today, our position is the following one. Growth is the most important for us because this is what we had structured the whole organization to go for at the beginning of the year. And I think we've commented very clearly to all of you that, that was the objective, meaning that even in the performance that you see in Q2, there are some investments for growth, especially in digitization of the company. The offers, our processes, our customer interfaces. And that's what we want to keep on doing. So at this point in time, reducing our cost to be able to improve operating margin is something that is possible to do now. We need also to understand that 1 percentage point of gross margin is 5% of cost. So it would require a big effort on costs, which we believe at this point in time would not be the right strategy.

Now moving forward, if we have the recessive situation at the level of the economy, which is bound to last for a long time. If that would have a consequence on the top line, and that we would not be able to grow the company as much as we want, we would have to go into another strategy of reducing cost.

What we believe is that there should be a positive traction on everything which is bringing energy efficiency given the prices of energy, and this is where we are positioning the company, both on the consumer segment, but even more so on the professional part of the business. So we believe that we should be able to grow and growth is clearly our priority at this point in time.

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

Very clear. And my second question is on the onetime net debt-to-EBITDA target for the end of the year. I think it depends a little bit on where you end up in the guidance for margin and free cash flow. But what's your thinking on it? If you reach that point, is that also the point then to think again on the share buybacks or given all the uncertainty you want to have a bit more -- maybe a bit more flexibility there.

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

Marc, I'll take this one. So you've seen that in terms of net leverage where we are today, we have also stated, we disclosed that we wanted to further go down in terms of leverage to closer to the 1x multiple. In view of working capital, inventory, it might take slightly longer to get there, but the trajectory is still there, which takes them back to the question that you're referring to in terms of capital allocation that we have always talked.

And again, if you look at the performance of the company so far, underlying, if you take out the onetime hits in Q2, underlying is still healthy. And we have not changed our strategy in either our approach to capital allocation, which means dividend for the shareholders. And then as soon as leverage is at a level that we feel we have the opportunity to acquisitions and there's opportunities, we'll go for acquisitions.

So we've always said like dividend, deleverage, when deleverage is at a good level, then also M&A, as you've seen from the acquisition of Fluence and Pierlite becomes a reality because we can drive inorganic growth with the cash we generate. It's obviously, we don't have the right ideas to invest ourselves, we return the money back to the shareholders. And that priority has not changed in the current environment or what we currently see from, let's call it, a recession point of view.



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So we hang on to that one as you see from the acquisition we've done. And again, we now see inventories being slightly higher as soon as we get them back down, our leverage will again improve and the question will remain on the table. Do we have the right opportunities for organic and inorganic growth, again, as Eric said, a growth focus and if we don't, then we'll return money to shareholders.

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**Operator**

The next question comes from Joseph Zhou from Redburn.

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

I have 2. And first is on your free cash flow. Obviously, the lower guidance implies some very substantial cuts in the underlying free cash flow in the second half, given that you also in dried walk on EUR 194 million one-off real estate gain in Q2. So basically, it looks like a majority of that is basically working capital. So can you maybe help us understand the details of those in the second half? And in terms of breaking it into inventory, are you still going to build inventory? Or is that and mainly going to be payables or receivables, et cetera. And also what kind of working capital to sales ratio do you expect to happen in the second half and maybe do you expect any more real estate gains in the second half as well? Some details will be appreciated.

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

I'll take the question. Let me start from the high level, and I'll go ran into some of the detailed questions. First of all, as we mentioned, if you look at the performance of free cash flow in the first half of the year, it's obviously not where we wanted to be, but the silver lining here is that it's clearly all tuned back to inventory.

The structural improvements we've made in the last years on receivables and payables are there. We have a bit of an opportunity on receivables disruption of supply chain, products on the rising on time, there's a bit more disputes on how to collect money, but that is fundamentally, if you look at our days of -- days on hand on -- sorry, days receivable or you look at our payables, structurally, we still (technical difficulty) after what we have in the last couple of years.

So you narrow down all down to inventory. If you look at the inventory and here I'm going to slightly adjust perhaps what you said. If you look at our guidance, 5% to 7%, if you take into account that in the first half of the year, we were negative on free cash flow, excluding proceeds but then positive proceeds still for the second half of the year its significant cash flow generation. So just like that, we expect to recover also the gross margin. From a cash flow generation in the second half, in fact, is going to be not far away from the cash flow we generated last year.

How do we expect that cash flow generation to come? Number one, again, keeping the discipline on receivables and payables as we have been doing all along the last quarters. But indeed, the key question here is on inventories. We believe -- we believe at this point in time that inventory buildup is reaching its peak versus what we have seen in the last number of quarters.

With the payment terms we have, it also means that we have now at the end of Q2 have actually paid for most of those inventories we have. That's also why you look at the balance sheet, you see that the payables has come down more than the inventory has increased, which means that we have paid for the inventory we've been building up in Q4 last year, Q1, Q2 this year. And then we expect in the second half, our inventories to go back down.

As you know, normally by the end of the year, our inventories go lower because we prepare for a slightly lower sales season in Q1 of any year. So we do expect inventories to go down not get to the levels that we were used to because of the fact that we do not expect supply chain to be fully regularized, which means that we're still sitting on goods in transit and selling some of the stock we have at hand.

But we do expect inventories to go down towards the end of the year with my receivables and payables remaining at a healthy level. So the dynamic is really about managing inventory. Inventory is built by being very optimistic. Remember, last year, this time, we talked about light at the end of





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the tunnel. We are preparing for growth. We're really investing and also building capacity to sell to the market. We started off very well Q4, Q1 this year. Q2 became more difficult in the crisis. So that inventory has to now flush through. But at least we will not have a significant further inflow of inventory, all providing, of course, that the world doesn't collapse in Q4, but that's something that at this point in time, we do not face the foresee.

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

And then my second question is really on the inventory write-down. And you mentioned about the UV-C and certain conventional products, which makes sense. And are there any other products that still beyond the days when it comes to the current inventory write-downs? And also, do you expect to have more in H2 given that you've been building inventory?

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

Joseph, we have a very tight policy on inventory valuation, inventory write-downs. It's also with the auditors, obviously. So whenever we close the month in the quarter, we look at potential obsolescence and whenever we see a risk, we take those provisions. That's number one. We don't (technical difficulty) for the quarter for the inventory of net provision that we have incurred in light of what we see, where we see (technical difficulty) the majority of those provisions have been taken on the conventional side on UV-C -- sorry, surface disinfection and also on the horticulture conventional business.

We believe, in general, the inventory we have is the inventory that was ordered for our normal products. So it's high inventory, but it's healthy inventory. It's going to take a bit more time to get them through the system. It's also a question about limiting the orders of intake that we have. But fundamentally, we look at the health value inventory. We have in our forecast, I would say, some provisions for obsolescence, but there are normal levels of obsolete that you will have through the years, and there will be some coming in Q3, Q4, but not to the levels of Q2 at this point in time. But we follow our standard rules in terms of the visibility we have today. So we do expect that the impact we saw in Q2 will not repeat to that extent in Q3 and Q4.

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**Operator**

The final question comes from line of Sven Weier from UBS.

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

I joined the call later, apologies if you commented on those 2 questions already. But the first one would be on the Digital Solutions margin trajectory in the second quarter, which I'm trying to square because if I understand it correctly, most of the CSG and DS was volume and not so much price. I guess the energy cost impact you mentioned overall is probably not affecting DS so much. If I understand you correctly, there was no major mix impact outside digital products. The currency I saw the overall impact was 110 basis points on the group margin against 130 basis points in Q1. So I'm struggling a bit to square the 120 bps margin decline in the division in Q2. That's the first one.

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

Yes. Well, there are a lot of different elements that are impacting the gross margin. So I talked to them previously. So I don't know if you were there. But I said it's about FX. And if you look at the gross margin of the group, it's 290 basis points decline. One part is FX, one part is logistic costs, one part is obsolescence and one part is the price of energy.

I would say that the 3 divisions I touched by this, but the Conventional Products division is the one that is the most touched because you see that the delta in terms of operating margin in that division is quite substantial because we're talking about -- how much is it? 310 basis points for the Conventional Products division. When it is much less for DDS at 120 basis points. So you would say that what we see in DDS is basically the impact of FX, which is pretty much the same for the division at the end of the day.





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So we've been able to get much less impact on the digital division than on the conventional division because of logistics and energy and obsolescence, which are more touching the conventional part of the business. So that's the way you should read it. There were a lot of elements that were impacting the gross margin, 290 basis points, but we've been able to compensate and create operating leverage because at the end of the day, for the group, it's only 140 basis points at the level of the operating margin. And for the Digital Solution, it's a bit less than that, it's 120 basis points. So probably on the 3 divisions, it is the one that has I would say, performed the best under those circumstances.

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

Okay. Understood. Thanks for the additional color. The second question was just coming back on inventory, but not your inventory. I was wondering about the channel inventory that you see because my perception is it's getting a bit more elevated, especially on the consumer side, but maybe also on the professional side. And how do you think about how that is impacting your pricing agility in the second half. Wouldn't you think that there is some pressure from channel inventory in the second half?

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

Yes, very good question. On the channel inventory, we see no major over inventory on the professional channel. So on the professional channel, I would say that the inventory of our customers are at the right level. The inventory on the channels of our consumer go-to-market has increased and quite substantially in the past semester. So we are working with our customers to bring that inventory out but we are not doing it through promotions and price decreases. That's not what we want to be doing. So we try to pool the market rather than reducing prices.

But it's true that there is a bit of overstock, which could potentially limit further the top line, but we would try to avoid as much as possible doing 2 strong promotions to flush that inventory out. We prefer to have a good demand playing the -- well, taking that inventory rather than doing big promotions. I mean that's the strategy we have, and that's the principle that we have applied so far.

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**Operator**

There are no further questions. I will hand back to your host to conclude today's conference.

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**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 Q&A. If you ask any additional questions, please do not hesitate to contact us. And again, thank you very much. Enjoy the rest of your day.

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**Operator**

Thank you for joining today's call. You may now disconnect.

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