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EDITED TRANSCRIPT

LIGHT.AS - Q4 2022 Signify NV Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

Benedict Ernest Uglow *Morgan Stanley, Research Division - MD and Head of European Capital Goods Equity Research*

Daniela C. R. de Carvalho e Costa *Goldman Sachs Group, Inc., Research Division - MD and Head of the European Capital Goods Equity Research Team*

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

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

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

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

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

PRESENTATION

Operator

Hello, and welcome to Signify's Fourth Quarter and Full Year Results 2022. (Operator Instructions) Today, I am pleased to present Eric Rondolat, the CEO; Javier Van Engelen, the CFO; and Thelke Gerdes, the Head of Investor Relations. 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 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 2022 highlights, after which Javier will review the company's financial performance for the fourth quarter. Eric will then discuss the full year 2022 performance and 2023 outlook. After that, we'll 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.

With that, I now hand over to Eric.

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

Thank you, Thelke. Good morning, everyone. Many thanks for joining. So let's start with some of the highlights of 2022 on Slide 4. 2022 has been a year with a challenging external environment, which became increasingly volatile throughout the year. This led us to adapt our expectations and adjust accordingly while making further progress on key strategic priorities. Our connected lighting sales grew to EUR 1.6 billion and our growth platforms grew to EUR 400 million. Our Digital Solutions and Digital Products divisions now represent more than 85% of sales, profit and cash, up from 80% last year as the transformation of our business accelerated, driven by high demand for energy-efficient lighting solutions.

We also made continued progress in the second year of our Brighter Lives, Better World 2025 sustainability program, which I will detail later. As far as the financials are concerned, comparable sales growth for the year, as you can see, came in at 1.2%. Margin and cash were below our expectations for the first time since our IPO as we delivered an adjusted EBITA margin of 10.1%. And the free cash flow at 5.9% of sales. Net debt over EBITDA ratio over to 1.3x from 1.4x last year, including the impact of the Pierlite and Fluence acquisitions. Excluding these acquisitions, we reached our

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goal of reducing the net debt-to-EBITDA ratio to 1x at the end of 2022 from about 2.7x after the Cooper acquisition in March 2020. Finally, we are proposing to increase our cash dividend over 2022 to EUR 1.5 per share.

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

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

Thank you, Eric, and good morning, everyone. Let me start by diving into the quarter 4 results starting on Page 6. We increased the installed base of connected light points from 109 million in Q3 to 114 million at the end of Q4. LED-based sales represented 82% of total sales. Nominal sales in Q4 were EUR 2 billion, translating into a nominal decline of 1.5% and a comparable sales decline of 8.8%.

As mentioned in our previous announcement, the Q4 under delivery versus our expectation was mainly driven by continued disruptions in China due to the zero-COVID policy, a slowdown in the OEM channel, lower sales in professional indoor lighting and the continued softness in the consumer segment. Adjusted EBITA margin came in at 10.2% versus 13.2% in Q4 last year. Gross margin continued to be stable versus Q2 and Q3 as pricing again offset the impact of product cost increases. However, under coverage of fixed costs due to the lower volumes and continued negative impact of FX were the key drivers behind the year-on-year margin decline.

Net income came in at EUR 86 million, compared to EUR 170 million in Q4 last year. The year-on-year decrease is due to the lower income from operations and higher financial expenses, the latter due to the combined effect of higher interest costs, a negative adjustment to the value of our virtual power purchase agreements and the recognition of a monetary loss due to hyperinflation in Turkey.

Finally, cash flow. Free cash flow was EUR 364 million in the quarter, an increase of EUR 107 million versus Q4 '21 with faster collection and lower inventories only partly offset by lower operating profit and lower payables.

Now let's move on to our divisions, starting with Digital Solutions on Slide 7. Nominal sales in Q4 were EUR 1.1 billion, with comparable sales showed a decline of 5.8% against a high comparison base of plus 11.2% in Q4 2021. Q4 CSG was negatively impacted by the COVID-related disruptions in the Chinese market. We believe this is a short-term effect as China has now opened up again. While the outdoor segment and especially the public segment continued to grow, we saw a more challenging indoor professional business, particularly in Europe and in the U.S. Adjusted EBITA margin was 9.7% against a high comparable base of 14.1% in Q4 2021. The lower margin was the combined result of an under absorption of fixed costs and adverse year-on-year currency impact.

On the next slide, Slide 8, I would like to discuss a couple of business highlights of our Digital Solutions division. We installed a suite of smart lighting solutions at NSG Group. These include cutting edge connected lighting systems via our Lighting-as-a-Service model, innovative 3D-printed luminaires, Trulifi and Interact. We have upgraded the lighting at those 2 U.K. sites and have ongoing work across several sites in the U.K. These changes help NSG Group in achieving their sustainability and smart factory goals.

Canadian grower Den Haan Greenhouses switched to our LED horticulture lighting for both its tomato and cucumber cultivation. We installed Philips GreenPower LED interlighting and toplighting linear at their facilities. The decision to move to our LED horticulture lighting was driven by high electricity prices, insufficient natural light during winter and year-round demand. As a result of the switch to our LED horticulture lighting, production increased by as much as 40%.

Let's now move on to Digital Products on Slide 9. In the fourth quarter, the Digital Products division saw a comparable sales decline of 12.9%, while the adjusted EBITA margin remained at a healthy 14.1% level. On the sales side, we continue to see weakness in the consumer segment also during the peak sales period. Our business in China and in particular, Klite, which is reported in Digital Products division was impacted by continued COVID disruptions. We also saw a slowdown of [LED] electronic sales in the OEM channels leading to lower growth than what we had anticipated. This follows several quarters of strong growth in the channel. Adjusted EBITA was 14.1% compared to 15.5% in Q4 2021. While pricing and mix compensated the increase of material and logistic costs, the margin was impacted by lower fixed cost absorption due to the volume reduction.

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Moving on to Slide 10 for the business highlights of Digital Products. Our sustainable 3D-printed Coastal Breeze pendant plant won the prestigious Gold IDEA 2022 design award and received an honorable mention in Fast Company's Innovation by Design Awards. The collection is 3D printed using discarded fishing nets. It helps us in cleaning up the ocean, and it has a low carbon footprint.

Next, with the launch of the Philips Hue Festavia string lights, we move into yet another application of Hue. The Festavia string lights helped create the perfect ambiance inside your home for the holiday season. The string lights allow users to dim and brighten lights, change color, create a gradient light effect, set timers and schedules and more. The string lights include unprecedented effects such as the Sparkle effect and Scattered style. The launch was well received as we saw a great level of interest from consumers. The products were fully sold out within less than 2 weeks after launch.

Moving on to Slide 11 and Conventional Products. Comparable sales declined by 11.4% with further pricing partially compensating a continuing volume decline. The adjusted EBITA margin declined to 12.9% as a combined effect of the following items. Indirect cost savings were not fully offsetting the negative impact of volume decline and an adverse FX impact. Further price increases did largely compensate cost increases and the Q4 margin was negatively affected by one-off bookings. As we move into 2023, we are taking steps to protect the profitability of the business and are expecting to move back to more normalized profitability levels.

Moving on to our adjusted EBITA bridge for fourth quarter on Page 12. Adjusted EBITA decreased from EUR 265 million to EUR 202 million. As you can see, this was mainly driven by a large volume effect worth EUR 103 million, coupled with a negative mix development. At the same time, the positive impact of price increases worth EUR 69 million in quarter 4 continue to fully offset the EUR 45 million negative impact of higher input costs. Although our indirect costs improved by EUR 47 million, they were not sufficient to offset the volume decline. A negative currency effect caused an impact of minus EUR 16 million versus Q4 '21. This is a combined effect from the weakening of the euro versus U.S. dollar and the Chinese RMB and the continued yet temporary headwind for hedging. The resulting Q4 adjusted EBITA margin declined from a high base of 13.2% in Q4 '21 to 10.2% in Q4 '22.

On Slide 13, I'd like to zoom in on our working capital performance during the quarter. While the bridge shows our working capital performance year-on-year, I would like to shortly highlight our performance versus the end of Q3 2022. Versus the end of the third quarter, working capital declined from EUR 820 million to EUR 564 million or 7.4% of sales. This decline was mainly the result of a strong reduction of inventories, a notable reduction of receivables and a favorable impact of currency. The strong reduction of inventories is a sign that our inventories have peaked and are starting to come down. The improvement was partially offset by lower payables and some other working capital items.

The working capital bridge versus the end of December 2021, shown on the slide shows an increase in working capital of EUR 314 million. That increase was mainly driven by the settlement of payments related to the buildup of inventory in 2021 and it was partially offset by lower receivables and lower inventories. We remain confident that we will return to previous mid- to low single-digit levels as supply chain lead times continue reducing.

On Slide 14, you can see our net debt to leverage evolution. At the end of 2022, our net debt position was EUR 1.356 billion, a reduction of EUR 329 million versus the end of September. The lower net debt is mostly driven by our free cash flow generation of EUR 364 million in Q4, which benefited from a reduction in working capital. Other had an impact of EUR 35 million and includes new lease liabilities, derivatives and the FX impact on cash, cash equivalents and debt. As a result of the lower net debt, our net debt-to-EBITDA multiple reduced from 1.5x to 1.3x. Excluding the acquisition of Fluence and Pierlite, Signify reach its goal of reducing the net debt to EBITDA ratio from 2.7x after the Cooper acquisition to a 1x multiple at the end of 2022.

With that, I would now like to hand over back to Eric for the full year '22 performance and the sustainability update.

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

Thanks a lot, Javier. Let's go to Slide 16, where you see that in 2022, Digital Solutions, Digital Products further increased their contribution to our business, now reaching 89% of sales, 86% of adjusted EBITA and 90% of free cash flow. This is driven by innovation in energy-efficient and digital lighting technologies that have generated substantial growth over the past 10 years.

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Sales of connected lighting and growth platforms grew to EUR 1.9 billion. That's what I want to talk to if we move to the performance of connected lighting and growth platform on Slide 17. Connected lighting sales grew by -- to EUR 1.6 billion, and connected lighting had a very strong performance this year, mainly driven by our professional systems' brand Interact as well as a consumer brand WiZ. Philips Hue saw a slowdown due to a weak consumer segment and the exceptionally high growth during the previous year. We believe that Philips Hue will go back to its growth path as soon as we start seeing a recovery in the consumer segment.

On the other hand, the growth platforms grew to EUR 400 million, and we saw an accelerated transition from conventional to LED in horticulture. The acquisition of Fluence, further strengthen our LED horticulture business. While at the same time, the growth platforms were negatively impacted by the discontinuation of UV-C surface cleaning products and of conventional horticulture lighting.

Let's now look at our 3 divisions in more detail on Slide 18. Digital Solutions had a comparable sales growth of 7.8%, showing a strong recovery during the first 9 months of the year despite the negative impact of China and Russia. The adjusted EBITA margin decreased by 130 basis points, reaching 10%, mainly due to negative currency impact, partly offset by operating leverage from higher sales volume.

Digital Products had a comparable sales decline of 3.8% due to lower consumer sales and the COVID-related disruptions impact on the Chinese market. The adjusted EBITA margin declined by 180 basis points to 12%, mainly due to a negative impact from currency, lower volumes and an adverse sales mix.

Conventional Products had a comparable sales decline of only 12.6% as lower volumes were partly offset by substantial price increases. The adjusted EBITA margin decreased by 410 basis points to 14.6% as price increases and indirect cost savings were more than offset by higher input costs, the surge in energy costs and an adverse impact from currency. We are taking a very proactive approach in managing the business with a goal of securing a strong management performance. The year 2022 was particularly challenging for the conventional business as high energy costs not only increased the production cost, but also led to a faster market decline and the discontinuation of certain business areas like conventional horticultural lighting.

Next, I would like to discuss our sustainability performance on Slide 19. We completed the second year of our Brighter Lives, Better World sustainability program and made continued progress towards achieving our goal of doubling our positive impact on the environment and society. First, the cumulative carbon reduction across our value chain is on track and to double the pace to the Paris Agreement. This is mainly driven by our energy efficient and connected LED lighting, which reduced emissions in the use phase.

Our circular revenues were 29% on track to reach our 2025 goal of 32%. Circular revenues were mainly driven by serviceable and circular luminaires. Brighter Lives revenues constitute 27% on track to reach our 2025 target of 32%. Women in leadership position was 28%. And while it is an improvement versus the end of 2021, we are slightly off track to reach our 2025 target. In the fourth quarter, we focused on improving inclusive hiring practices and internal talent development. These actions support our diversity ambitions. In the fourth quarter, we also received external recognition for our leadership in sustainability and climate action. We were included in CDP's Climate A List and were included in the Dow Jones Sustainability World Index for the sixth consecutive year.

To wrap up this full year 2022 presentation, let's move to Slide 20 to discuss our intended capital allocation for the year. So for 2022, we proposed to increase the cash dividend to EUR 1.50 from EUR 1.45 in 2021. This is subject to shareholders' approval at our AGM that will take place on May 16. It represents a total cash dividend of EUR 188 million and a yield of 4.8% over the year-end share price of EUR 31.38.

I would like to remind you of our capital allocation policy, where we aim to pay an increasing annual cash dividend per share year-on-year. In 2022, as we already said, we reduced our net debt over EBITDA ratio to 1.3x. And excluding the acquisition of Fluence and Pierlite, we already reached our goal of achieving a net debt ratio of 1x by the end of 2022. Going forward, we remain committed to maintaining a robust capital structure and investment-grade credit rating. We will also continue to invest in organic and inorganic growth opportunities in line with our strategic priorities. After these priorities have been met, we will look at other ways of returning excess cash to shareholders.

Let's now conclude with the outlook on Slide 22. And while we continue to aim for growth both organically and through selected acquisitions, we expect the volatility in our markets to persist in 2023. Therefore, we will not provide a comparable sales growth guidance at this stage. In 2023, we

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will focus our efforts on improving our profitability and returning to a free cash flow generation in line with the previous years. For 2023, Signify expects to achieve an adjusted EBITA margin in the range of 10.5% to 11.5% and free cash flow in the range of 6% to 8% of sales. We are confident that we will manage the external volatility with the same agility as we demonstrated over the past years. The fundamentals of our business remain stronger than ever, driven by the ever-growing need for energy efficient and digital lighting and technologies.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll now take our first question from Daniela Costa at Goldman Sachs.

Daniela C. R. de Carvalho e Costa - *Goldman Sachs Group, Inc., Research Division - MD and Head of the European Capital Goods Equity Research Team*

I will -- I have 2 related questions. But I'll start with the first one, which is actually really just a clarification on your Q4 bridge to start with. So you have EUR 47 million restructuring or indirect cost benefits on the bridge. And then you also have EUR 47 million restructuring costs below. Is this just the coincidence of numbers? Or are you exceptionalizing -- is it because you're exceptionalizing some costs? Can you explain sort of what does it relate to the 2 parts?

And then my second question will be just more looking into your guidance for 2023, the free cash flow conversion of 6% to 8%. I guess this now puts you below your over 8% '21 to '23 guidance. And just to understand specifically for '23, what drives the slightly lower cash conversion than usual? Is it higher restructuring because you say you're intensifying the focus on managing down the decline in conventional? Is it working capital that is still a drag? Would think you have quite a lot of room to destock still. So any clarity on why maybe that is below the over 8% next year, that would be great.

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

Thanks for the questions. I'll take both of them and then if Eric has any additions, I'll open it up to that. Let me go to the quarter 4 bridge. So the EUR 47 million is just coincidence that they're equal. So there is no typo or there's no kind of wrong assumption there. So let's talk both of them. The EUR 47 million NMC reduction year-on-year, as we mentioned before, it is really the NMC reduction after we compensate on an apples-to-apples basis, the effect of FX and also acquisitions. So this is the cost saving on the base business, if you exclude those 2 and as we talked about in terms of compensation of volume decline, we probably have to still look at what we need to do in the future to get more of that cost savings also down.

On the free cash flow, 6% to 8% for 2023. When you look at the reasons why the guidance is, is the second of the reasons that you mentioned from a working capital point of view. Yes, we are still sitting on an inventory, which, although it's been coming down since the peak period of the second quarter, we see it coming down at the end of the year, but we still need to see it further going down if and when we see the global logistics and supply chain being more stabilized. So at this point in time, we're guiding for 6% to 8%.

2 things need to happen for us to basically go towards the upper side. It's logistics really adjusting globally. Number two, China does have an impact and recovery of China also because they have longer payment term there is. So there are a couple of variables in here which can swing the number a little bit up or down. But at this point in time, with the current visibility, we prefer to guide for the 6% to 8% range.

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Daniela C. R. de Carvalho e Costa - *Goldman Sachs Group, Inc., Research Division - MD and Head of the European Capital Goods Equity Research Team*

Sorry, my bad maybe, but I didn't quite understand the answer to the first. Because if you have 60 -- minus 16% and minus 8% on currency and other on the bridge. So maybe I didn't understand your explanation of the positive EUR 47 million there. And then the other EUR 47 million further down, I guess, is much higher than in the prior quarter. Is it just -- is it because the prior quarters were -- had net real estate gains or sorry, maybe I just didn't get the answer.

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

Sorry, let me go back. So the EUR 47 million that you mentioned was about the NMC basically. So the positive on the NMC (inaudible), the Indirect cost, which is a year-on-year saving on our indirect cost, if you exclude the FX impact in absolute and you exclude the impact of acquisitions. So that is just a saving on NMC. It's not related to the EUR 47 million that you talked about in terms of restructuring.

In terms of restructuring on the conventional, especially what we see in Q4 is that there are some charges for a horticulture business and for discontinued business. But so the numbers are not related to each other.

Operator

We'll now move on to our next question from Sven Weier at UBS.

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

The first one is actually on the outlook for '23. And I understand that you don't provide a quantitative revenue guidance yet, but at least it sounds to me you expect positive organic growth. You just don't know how much yet? Or is the uncertainty also potentially including a negative organic growth rate? That's the first one.

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

Yes. Look, we do have a regular exercise of forecasting and just a few days before -- we talk together, and that's a normal process we have in the company. Now what we're trying to describe when we do that exercise is the traction that we see on our end markets. And when you look at the potential volatility that we see on those end markets, we really come with very different types of results, which can be negative, which can be positive. It depends.

If the world goes into a situation where the war is ending in Ukraine and we get on the consumer segment, an environment which is less recessive than it is at this point in time. If we have an ease on inflation and specifically the price of energy, then we will surely expect to have a positive growth. If things are continuing the way they are and eventually degrading a bit more, that it's going to be much more complicated because we're going to have a consumer market, which is going to continue to be soft. We're going to have a very high probability to see investments on the private side, on the professional side of the business that are not going to be as dynamic as they should be, not fully compensated with the investment in infrastructure.

So at the end of the day, what we see in front of us at this stage is a very high volatility on the end markets that concern one way or another way. So we didn't have all the discussions we had with our team, and we do really a worldwide check. We didn't have any certainty of where things could end up at this point in time. It can go in one direction, it can go into the other one. That's why we said also, but the priority will be to recover what we have lost in terms of operating margin and to also rebuild our cash position in 2023. Now if we see clearer in the coming quarters, we may be more assertive and give a direction, but we are not in a position to do that at this point in time.

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

Yes. Thank you, Eric. And I guess what you also quantified in the press release that it's a volatile H1 and then improving performance in the second half, sounds like a bit of a tough start than in Q1 given that there the volatility is probably the highest end, especially in China still.

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

Yes. What you have also, Sven on the complexity of managing performance is that we have very uneven base of comparison. So when you start 2023, a very high compare in Q1 slightly lower but still high compare in Q2. And then you have H2 where the compare is lower. So at the end of the day, we have also on a quarter-by-quarter approach, look at the base of comparison is not always making the numbers very speechful but we have also to deal with that. So that's the reason why we see, given the volatility and the short-term situation of the economies, we see in H1 that's going to be less dynamic than H2.

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

And maybe the second question is just on what you're observing on the pricing dynamic. I mean, obviously, the last year was quite positive on pricing now that some of the cost inputs have come quite down on the energy, logistic costs and so forth. I mean are you observing that your peers are starting to reduce prices? Or is it still quite stable at the moment?

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

Well, what we have seen is that a lot of our peers had a big impact on the P&L, especially the ones that didn't transmit on prices at the right time. And many companies in the lighting industry is -- are listed, so you can have a look at it, and it's public information. Now when you look at our pricing strategy, what was very important for us was to cover the increase of the cost of goods sold. And if you look at the bridges that we are showing on a quarterly basis, you've seen that in the past quarters, we're doing that.

Now what we have not covered with our pricing up is what I have always called the transitory part of the inflation, namely cost of logistics or cost of energy with which we believe are going to go down in the future. But they have impacted our margin in 2022 as we didn't price up for those because we expect them to go down in the future. So we don't see at this point in time, the price decreasing. Our bet is we should see partly the cost reducing especially cost of logistics, especially cost of energy and to a given extent, the bill of material, while we know that the direct labor cost will increase because of inflation. At the end of the day, we expect to see a rebuilding of the gross margin without massive price reductions on the market.

Operator

We will move on to our next question from George Featherstone at Bank of America.

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

I'd like to just start with a little bit of context on the outlook, if possible, in terms of the market dynamics that are happening right now. Clearly, there's a lot of general weakness in construction markets, and it appears to be fairly indiscriminate to whether products deliver energy efficiency or not.

So I just wondered as a result, do you expect your activity levels to just flow with the broader market dynamic regionally that you're seeing in sort of construction activity levels? Or is there any indication that you could outperform on the basis of underlying building energy efficiency demand? That's the first question.

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

So, George. Look, to be very simplistic, let's try to split the market on the professional side in 2 different buckets. The first one is what I would call the infrastructure, investment in all different types of infrastructures. So we see in the U.S. and in Europe, a very good dynamic on that front. IGA in the U.S. We have the Green Deal being implemented in Europe, and we see an increased level of business linked to that. So that's a positive.

On the other hand, when you look at, what I would say, the rest of the construction non-res market, we see today projects being delayed because of the overall pressure that companies are experiencing on the P&L. So probably that investments are not lost, but they will slightly be delayed. And we see that in most of the geographies where we're operating, namely Europe and U.S., I would say that the case of China is a bit particular because the market was really impacted by the COVID measures when it was blocked and when it was unblocked. We had in China, in some instances, more than 50% of our teams that were COVID positive. Thank God, with no big consequences, but we had to stop our activity there. So China being a bit of a specific case, I would say that we see traction on infrastructure, and we see a softer market on the construction on West.

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

Okay. And then maybe a couple of follow-ups on some of the things that have already been asked. But just on the free cash flow comments you made in terms of trying to get that back to what you've had historically. Do you mean in absolute euro terms to the cash that you delivered each year or just the free cash flow margin, that would be the one of the follow-ups.

The second one would just be on China. Could you give us some context to just how much that market declined for you in the fourth quarter?

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

I'll take the free cash flow. So we -- on free cash flow, we keep on focusing on a percent of sales, also on working capital. You've seen working capital has gone down from over 10% in the middle of last year, now to 7%. And so that's going to be the focus why percentage because it's very difficult to beat the absolute numbers with all the ForEx volatility we have.

So the focus is absolutely getting back to the percentages of working capital where we have been, and there's still a way to go for us on that one. The percent of sales is what we focus on. On China, I think, Eric, you can add some perspective.

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

Maybe let me just give some data that can explain the free cash flow dynamic. George, maybe also to illustrate a little bit the question that Daniela asked previously. So if you look at some of the fundamental elements on how the supply chain is behaving, what we expect to see in 2023 is a reduction of the supply chain lead time. And that's absolutely critical for our cash generation. That's what has impacted us in 2022, and we expect to go to a more normalized levels in 2023.

But that's not going to happen or it didn't happen January 1. It will improve during the year. But there are some selling figures. So for instance, if we look at our supplier commodity lead time, in the commodities where we were the most impacted, components namely, we have reduced by nearly half the lead time to be supplied. Our component scarcity, that's an indicator that we get to you on a regular basis. If you remember, I surely remember the 232 escalations, level 4 in Q2 last year, we are now at 5. So we have gone back to historical levels.

If you talk about Ocean carrier reliability, which is a statistic that we follow on a monthly basis, 80% when everything was okay. It went down to 30% and we are now back up to 57%. Our replacement lead time of our DCs has dramatically gone down, and that's an improvement of nearly 30%. So all these elements are telling us that the supply chain is improving. While the supply chain is improving, we should be able to reduce our time from supply to sell, and we should be able to recover on the cash.

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But that is not going to happen at the very beginning of the year, is going to improve gradually over the period of 2023. China, we have been declining substantially in Q4. I don't know if we communicate on that number specifically. But you can imagine it's a double-digit decline pretty substantial. At the same time, George, we have 2 elements in China. We have our market position where we declined double digit, but we have also Klite that was extremely impacted in Q4 because we had at one stage, let me remember, but in a plant, I think we had more than 70% of the people that were touched by COVID, and we could not operate the plant normally. So really, China has been a big, big, big negative impact for us in Q4.

Operator

We'll now take our next question from Akash Gupta at JPMorgan. Please go ahead.

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

My question is on destocking in Q4. I mean if I look at your overall growth and back out the volume decline in Q4, I get to low double-digit decline. And when we look at your geographic breakdown of sales, we see that this deadline is kind of broad-based rather than concentrated in China or one region.

So the question I have is how much of this decline is driven by destocking in OEM channels as well as some of the distributors? And do you have any view on where do we currently stand on the channel inventory i.e., could that be an incremental headwind in terms of destocking in the early 2023 or we done with most of the destocking?

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

Yes. Very clearly, and you have picked it up well. We saw destocking in Q4. I would say that on the distribution side of the business and on the professional side, it had started earlier, but we saw still some destocking in Q4. Where we were very surprised in Q4 was linked to the destocking of the OEM channel, but let's not make any mistake. The OEM channel has done quite well during the year. It follows the performance of our professional business, but we expect it to do much more in 2022 Q4 than what we actually did. And we think that destocking was effectively back to the game for the OEM customers.

When it comes to the consumer part of the business, I think the -- I think our e-tailers or our distributors off-line have done relatively good job at bringing the stock down since the end of Q2 and Q3. And in Q4, the inventory was just adjusted to the volume that needed to be sold. So as we see things at this point in time, I don't expect headwinds in 2023 coming from further destocking except if the market for whatever reason, would go substantially down from where it is today. I mean if the market is sustained or improving, I would -- rather see a tailwind than a headwind on the stock and on destocking.

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

And my follow up is on the margin guidance. I mean, you're guiding 40 to 140 basis points implement in margin. Can you explain the drivers like what needs to happen for you to get to the top end of the range and also with respect to level of organic growth that you might need -- and I guess, I mean, you earlier highlighted that wage would be a headwind, but then you have logistics and energy cost and some input cost as a tailwind. So maybe -- and if you can explain what can take you to the upper end of the range? And what will be driving lower end?

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

Look, Akash, if you look at the performance in terms of operating margin and then translate it to the gross margin, I mean, the name of the game has been gross margin loss in 2022, which about 210 basis points, which translated to an operating margin loss of about 150 basis points. So we could compensate a bit but not completely.

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Now what is very important to see in the structure of our gross margin at this point in time is that we could cover with price, the increase in cost of goods sold. And that was really the objective in 2022. Now we had additional elements that were not forecast, which was the continued increase of cost of logistics, but also the inflation on the energy prices.

Now when you go towards 2023, we expect to see a few things that would help us to rebuild our gross margin to start with, which is the reduction of cost of goods sold and we're negotiating with suppliers now, I would say, on a monthly basis to take advantage of the cost going down. We would expect also at one stage, and we have also already seen the energy prices going substantially down. And the cost of logistics are also going down. So all in all, this should have a positive contribution to the gross margin rebuilding and to a given extent, also to the indirect cost.

So first element is a real focus on the gross margin. Now we are also operating on our nonmanufacturing cost in order to have a further contribution to the improvement of the operating margin. But we lost 150 basis points in 2022. When you look at how the business is structured, our portfolio is well positioned. When you look at conventional LED and connected and growth platforms, respectively, about 15%, 16% and 20% to 25%. So at the end of the day, the portfolio is well structured. Our underlying gross margin potential is there. We need to have an improvement on the macro element that I've been discussing with you just right now to see an improvement of the gross margin. And we see them happening, we believe they are going to happen.

Now how do we go to the higher end while the higher end is an improvement of 140 basis points, which is basically what we've lost in 2022. I think to be at the higher end of the guidance, we need also to be helped by growth, and we need to be helped by macro economies that are going to be giving a positive level of traction. If that's not the case, we still believe that we can improve our operating margin, but probably not at the upper end of the interval that we have given.

Operator

(Operator Instructions) Now we'll move on to our next question from Jingyi Zheng at Credit Suisse.

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

My first question is on your FX impact on adjusted EBITA margin. So you had 220 bps negative impact in Q3 and 150 bps in Q4 from euro weakening and the tempering FX hedging headwind. Could you quantify how much is from the FX hedging headwind and what exactly is that coming from? And given it's been there for 2 quarters now, do you expect any more impact in 2023, assuming current spot rates?

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

Thanks for the question. It's a bit of a complex question, but let me try to go through it in the logical steps. So evolution from -- so within FX, I think you have to separate 2 topics that we've also commented on in Q3. There is a general movement of exchange rates where typically year-on-year, you look at especially the strengthening of the U.S. dollar and the Chinese RMB versus the euro, which impacts us, obviously. And then there's a hedging component that we've talked about as being more transitory and that would be decreasing over time.

If you look at Q3 versus Q4, in general terms, you would see that the impact of FX, the natural impact of FX has gone slightly down versus a year ago. That's because, of course, in Q4, the Chinese RMB and U.S. dollar versus euro have weakened. Therefore, the gap versus a year ago is a bit more favorable than what we had in Q3. From an FX point of view, a hedging point of view, we roughly had a similar impact in Q4 as in Q3. So that hedging that we talked about and on the dynamic there, what we've discussed last time is this is a question of hedging positions that we have. We had taken with the assumption of growth -- significant growth at the start of 2022. We have taken hedging positions, especially on the U.S. dollar, counting on a faster growth of the U.S. business and that hedge basically is then hurting us in terms of the, let's call it, an over-hedge that we had done at the beginning of the year, which we are gradually unwinding and that should be gone in Q1.

So that overhedging impact, especially of U.S. dollar, it has impacted us in Q3 and Q4, but that effect should disappear as of 2023. So if I look forward to 2023, look at currencies, of course, the base currencies of 2022 will start looking different, which means that at current spot rates, the variability

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that we had seen in 2022 will be much less. Of course, we don't know what exchange rates will do for the future, but the best forecast isn't the spot rate to take. So we should there see a slight improvement, I think, versus the underlying assumptions we have for 2022.

And as I mentioned before, the hedging of the overhedging position at this point in time, we have lowered that significantly. We'll have to see how the business develops. What we have done on hedging, as we just talked about, is we have intervened. We have changed a couple of things. We are in viewed volatility of the market. We're not hedging as far out as we used to do. We used to hedge out for a certain percentage of our -- currencies about up to 15 months out with a decline in percentages by quarter. We have shortened that so that we have more visibility on how much we hedge and that we avoid that we over-hedged in a volatile environment. And we've also looked at the amount of currencies that we're hedging. So we've taken some hedging policy adjustments, which would make that temporary impact of 2022, largely disappear in 2023. So that's how FX should help us also going forward on rebuilding some of the margin.

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

That's very clear and very helpful. My second question, can I just dig a bit deeper into your margin guidance. I appreciate you're not guiding on revenue growth, but can I get an idea of what magnitude of revenue or volume downturn can you tolerate while still achieving the bottom end of your margin guidance of 10.5%. And for 2023, what is the pricing carryover we're assuming?

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

It's on pricing. Look, you -- you can look at how we performed over the past years, and you will see that we were able, when the top line was declining to still improve our bottom line. So if you look at the trajectory that the company had in the past years, I think you will see the potential we have moving forward, increasing the operating profit despite declining.

From a price perspective, we don't expect to price up in the coming quarters. When you look at the gross margin, price is covering the increase in cost of goods sold, and you see the strategy that we had, we achieved it. We don't want to be overpriced on the market because we want still to stay competitive and drive top line.

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

And what is the carryover from 2022 to '23 on pricing, if you don't mind?

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

Look, I think the exact number is not -- we don't have them here. But if you look at the perspective of quarter 4, in quarter 4, there's about the 290 basis points of pricing and mix, which have positively affected this quarter-on-quarter still versus a year ago. As you know, there's a big discrepancy between what we do on conventional where we had to continue significant price increases compared to the 2 other divisions.

So if you look at quarter 4 down to quarter 1, 2, you see that effectively going down. So I would not expect a significant assumption there on pricing, except from conventional side. So look, it's going to be clearly below the 200 basis points, and we will see decreasing throughout the year.

Operator

We'll take our next question from Ben Uglow of Morgan Stanley.

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Benedict Ernest Uglow - *Morgan Stanley, Research Division - MD and Head of European Capital Goods Equity Research*

The first one, and thank you very much for the helpful color on the inventory destocking. Can I sort of make sure I properly understand it. There seems to be a difference between what you're seeing in the professional channel and what you're seeing in the consumer channel. Could you talk specifically a bit more about the professional channel in particular, in North America? I'm sure you're aware, but one of your major competitors Acuity Brands has said that they see an inventory destock lasting several quarters throughout 2023. So I just want to make sure I understand the nuance here or are you seeing something different in Europe?

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

Yes. Ben, good to talk again after many years. Look, yes, it's different between consumer and professional. And let me talk to the situation in U.S. On the consumer channel, we had very early destocking in 2022, in line with the perceived recession or the softness of the consumer market that was also felt by our distributors.

It's been different in Professional. There was still some destocking, maybe not at the same level, and it happened a bit later during the year. And we have seen that on the professional side, not only in Europe but also in the U.S. Now the destocking doesn't only depend on our distributors, but it depends on how much inventory we have at these distributors. So it could be the case that some of our competitors have more stock at those distributors, and they see potentially more destocking in the coming quarters that we see, where we believe that our stock has already been substantially reduced and what we're going to see moving forward is not a further massive destocking also in the U.S.

And if the market is giving signs, especially on the construction non-res that it should be activated, we believe that our distributors will have to replenish and rebuild stock. So it's not -- the distributors may not have the same policy or the same situation depending on competition, but that's the way we see it. So the destocking has, for this part already happened in Europe and in U.S. for us as far as we're concerned on the Professional channel.

Benedict Ernest Uglow - *Morgan Stanley, Research Division - MD and Head of European Capital Goods Equity Research*

That's very helpful. And the second one is really a follow-up to an earlier one. I guess everybody is trying to understand how big the drawdown -- in the minus 8.8% how big China is. If I think that China is down 30% to 40%, it's less than half of your -- of that minus 9% growth number. Am I thinking about this the right way that China is sort of a bit under half? Or is it the majority of that minus 9% number? Any sort of additional color here would be helpful.

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

Yes. So basically, when you look at the Q4 number, you need to look at the Q4 number in perspective of Q4 last year. And Q4 last year has been very strong because it was also on the base of Q4 in 2020, that was the quarter that -- where we less declined during the COVID year. So basically, you start on a base that is quite strong. Now China will be less than half of the decline, Ben, it's not most of the decline. But it's China, it's also the impact of Klite and that will not be in the Chinese market, but also collateral impact it has on other businesses, but also weakness in the consumer market that has continued and some projects that were delayed on the construction non-res.

These projects of medium to big size that customers are delaying even the volatility or the lack of visibility that they have on the economy moving forward. So we should not see China as the 9% of the decline or even less than half at this point in time, but it's substantial.

Operator

We'll now take our next question from Marc Hesselink at ING.

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

The first question is actually on some of the previous calls and updates. You talked about a relatively high backlog. Is that something that's still important at this stage? I know you still have a relatively high backlog that you can convert? Or is that completely done now?

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

So Marc, we were looking at 2 things. We're looking at order book and backlog. So order book is your order position when you entered the quarter, and backlog is basically the orders that you should have converted during the quarter and that you have not converted. At the beginning of the year, we are back to normalized levels.

So if you remember, back in Q3 2021, these 2 elements increased quite substantially and probably the peak was in Q2 2022. And from that point on, we have reduced our backlog and our order book. So at this point in time, we stand with an order book and starting the quarter, which is pretty much in line with what we had before the crisis. And we're talking about 20% to 30% of sales. This is very typical of what we do, and the backlog has also come back to historical levels.

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

Okay. And then the other question is on the weakness in the consumer segment and also mentioning some negative effect from mix. Is it been true that the UA product is weaker than average in the mix? And if that's the case, what are your outlook there? I think it was a very strong product in COVID. And then you said, yes, you expected them -- that people get used to the product that you would see the return orders. And now maybe because it's also a little bit higher priced product, maybe you see some extra consumer weakness. Can you talk a little bit about those dynamics?

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

Yes, I think you have summed up them quite well. The [industry] was effectively declining in 2022, also on the basis of an exceptional growth in 2021. So what you see is effectively a decline, we see that worldwide, very much linked to the consumer market, which is also softer. Now when you look at the offer, the offer is expanding. Every time we do an offer expansion, we get positive traction. So we really believe that when the consumer market will go back to a higher level of traction, we will benefit from it.

The price positioning. You'll probably -- it's an offer that was not so much price increased. We did something, but it was minor compared to other businesses. The gross margin is still well positioned in key geographies, which is very important for us. So at the end of the day, we entered in a situation that was very high base of comparison and then a market which was slowing.

I don't know if you have seen, but we have brought to the market a very interesting innovation at CES, which is the possibility for people who have a Samsung TV to invest in an app, which is in the TV. And in doing so, they're going to be able to synchronize 10 lights that they have close to their TV with whatever is as seen on the screen. That's the fabulous innovation, we were doing that with -- and we're still doing it with an HDMI Sync Box. But in that specific case of Samsung TV, you don't have to buy an additional piece of hardware. We do it with software.

And the traction, specifically on that new offer was very strong. So at the end of the day, we continue to invest. We continue to make the virtual environment very unique. And I think this will give positive outcomes whenever the consumer market is becoming stronger.

Operator

I'll move on to our next question from Rajesh Singla at Societe Generale.

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

So my question is specifically on your growth business. And so what kind of pricing environment do you see in your growth business and the demand for 2023? And the second question is like can you still better manage your FX exposure and reduce the volatility in your margins driven by the FX-related changes?

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

On the growth business, if we talk about connected lighting and everything we do on the growth platforms, we don't expect massive price increases in 2023. A lot of these businesses are project businesses, so they are more managed on the gross margin and on the price because there's no price reference on the market. When you do a fully connected office project, there's no market price. So this is really a margin driven, no specific price intervention there. Better FX exposure. I'll let you take that, Javier?

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

Yes. I'll come back to what I also mentioned before is if you look at the FX exposure we have, again, let's break it up into the normal FX movements and our total net positions globally and then there's a hedging policy. So if you look at what we are doing or what we can further do to decrease the volatility of FX is, of course, we cannot impact the FX movement itself. But if you look at our global positions, as we always said, we are short on Chinese RMB, and we are long on U.S. dollar. Depending how the business move into different regions and how we do in terms of localization, more of supply or more regionalization supply longer-term that might have an impact on just the balance of currencies we have and perhaps will be slightly less exposed to the Chinese RMB and the movements there. So that's more from a macro point of view, and that is not, let's say, short-term because we don't fully control all that.

The other part, which I mentioned before is the hedging policy. And what we've done recently in the last quarter is revised managing policy. Fair to say the hedging policy, which was a standard policy that we had for a long time. It was a hedging policy that basically hedges out 3, 6, 9 , 12, 15 months out at decreasing percentages, 80%, 60%, 40%, 20% but the lower end of that 40%, 20% went out 12 to 15 months, which means that we were locking in hedging positions on especially the big currencies like the RMB and the U.S. dollar with a forecast, which was supposed to cover 12 months in advance.

As you can imagine, the volatility on that hedging position can be positive and negative. So it's not like it's always in the negative, but in 2022, clearly, because of the over-hedge position on the U.S. dollar, we got a hit on that. In order to decrease the volatility of what we're going to see in 2023, we have changed that hedging policy that, number one, we hedge less currencies. Number two, we don't hedge out until 15 months out, we look only at the 9 months visibility. And therefore, that should decrease, let's say, the part of the hedging over under hedging that, again, can hit both ways. It could have been a positive and a negative throughout the year, but at least it takes out that volatility on a quarter-by-quarter basis. And that's what we're doing with the hedging policy change that we effectively have in place as of the first of Jan 2023.

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

Maybe a couple of follow-ups on both the questions. So first, on the connected lighting part. So I think you mentioned that there is no reference price. So does that mean that there are no major competition with respect to your product portfolio in the connected lighting space or the competition is relatively less as compared to the LED portfolio? And on the hedging part of currency, so by when we are targeting to achieve maximum optimal regionalization of your supply chain so that we can have a fairly natural hedges against the currency movement?

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

So Rajesh, on connected lighting. So let me take it by part. In connected lighting, in general, we have much less competition than in non-connected offers. That's true both on the consumer side and on the professional side. We have more product to product comparison on the consumer side,

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but on the professional side because on top of having less competition on the professional side, what I wanted to say is that it's very difficult to compare one solution to another one.

So imagine that we're going to put connected lighting in a warehouse. We're going to guarantee to our customers' savings. We're going also to provide a software, which is helping the customer to do an integration of the usage of the workspace on any tap of time integration. We would also explain how accident rates will be improved and how the productivity of the people working in the warehouse is going to be also improved.

So all these elements that we bring to a professional customer when we talk about connected lighting. And they are adapted and collateral benefits in other segments more linked to the business that the customers are driving. And when you look at everything that we bring, it's difficult to compare one offer versus another one. That's what I wanted to say. But what is true is that in terms of competition, we have less competition in connected lighting than we do have when it comes to non-connected offers.

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

Yes. And on the hedging part, let me go back to that for a second. First of all, in terms of regional footprint, let's first talk about the top line, okay? So if you look at our hedging position, U.S. dollar, Chinese RMB from a growth opportunities point of view, there are 2 regions where there's clear growth opportunity. So I would not make that a distinction factor in terms of would that rebalance from a top line point of view or short or long positions on either currency?

So what really plays here is, as you mentioned, it's going to be more the supply chain. On supply chain, as you can understand, regionalization of supply chain is not a short-term project. It's something that will take time, and that will basically be a moving number over time. But let's not forget that from a short position point of view on the Chinese RMB, the dependency of supply from China is still going to be there. So yes, there's going to be regionalization, which will move the needle but they're still going to be -- I assume there's still going to be a short position for a long time in Chinese RMB because of dependency of all component sourcing, all of that.

So I would not expect that, that is going to materially change short-term. It's going to be more a long-term gradual shift to perhaps a bit more balanced portfolio, but I still expect the Chinese RMB to be short for a long while.

Operator

Ladies and gentlemen, that's all the time we have for Q&A. I will now hand it back to the host for any additional or closing remarks. Thank you.

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

Ladies and gentlemen, thank you very much for joining our call today. If you have any additional questions, please do not hesitate to contact Philip or myself. We will also follow up with those of you who did not have an opportunity to ask questions during this call. And again, thank you very much, and enjoy the rest of your day.

Operator

This concludes today's call. Thank you for your participation. Stay safe. You may now disconnect.

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