Business review

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In this section

1. Trends in Schneider Electric's core markets

1.1: Industry and machines manufacturers

2018 was another year of strong growth for the Industry market. However, growth has moderated during the second half after a very dynamic first half.

Deceleration was driven by the deteriorating business climate resulting from trade wars and Brexit uncertainties, and tightening financial conditions. The deceleration was more pronounced in China, Japan, Western Europe, and some emerging economies.

In the United States, growth remained strong throughout the year, supported by investments in the energy sector and corporate tax cuts.

In Western Europe, growth remained elevated in 2018, with a very strong first half followed by weaker growth during the last quarter. Growth was driven by high production capacity utilization, automation initiatives, and favorable credit conditions.

1.2: Non-residential and residential buildings

Non residential buildings

In Western Europe, the market continues to grow, albeit at a slower pace than last year.

In Germany, non-residential construction decelerated due to slowing domestic consumption.

In Italy, the market continued its expansion, led by commercial segments. In the United Kingdom, the market was hit by intensifying Brexit worries and less government support for public construction.

In Spain, expansion continued, especially in the storage-logistics sector driven by the rise of e-commerce and the office sector due to continuing scarcity of supply.

In the US market, the office and warehouse segments drove the growth.

In India, sustained growth was underpinned by foreign investment flows and solid macroeconomic fundamentals.

In East Asia, growth was mixed across countries. Vietnam, Indonesia, Thailand, and the Philippines continued their strong expansion territory while Malaysia grew marginally driven by softening demand amid excess supply. Singapore and Taiwan bounced back after a weak 2017 year, while South Korea contracted due to excess capacity and fading of the boost from construction related to the Winter Olympics.

Residential

In Western Europe, market growth slowed down in 2018. In France, the market decelerated due to reductions in government financing schemes and lower consumer confidence.

In Norway and Sweden, the market has slowed down after several years of strong growth.

In Germany, growth has continued, albeit at a slower pace, driven by accommodative financing conditions and immigration. In Spain, the residential sector grew steadily, underpinned by accommodative financing conditions and public housing construction initiatives.

In the US, new construction slowed down during the second half of the year as supply-side constraints combined with increasing interest rates to drive prices upwards. Renovation market growth has moderated following several years of strong growth.

In China, market growth remained very strong. Lower-tier cities led strength, boosted by the shantytown subsidy scheme. The market in Tier one cities has rebounded, after a decline last year.

In Australia, residential construction has peaked in 2018 after several years of strong growth. In India, residential construction grew primarily driven by government-led affordable housing schemes.

1.3: Energy and Infrastructures

Electricity companies

The power industry continues to adapt to the New World of Energy. Renewable power generation is becoming the preferred choice for new capacity additions, beating all other forms of generation on cost in many geographies. 26 percent of the world electricity is now produced from renewable sources. Decentralization of power systems is becoming a reality for many distribution companies which are facing a proliferation of rooftop solar PV installations. Preparation for the addition of battery storage to complement solar installations is on the mid-term horizon, as well as a massive rise of Electric Vehicles.

Market growth was driven by aging asset replacement programs, the need for network reinforcements to host new renewable capacity and the digitization of the whole electricity delivery infrastructure.

Profound power sector regulatory changes are likely to happen in many geographies to meet the challenge of power system decentralization, decarbonization and digitization. The utility industry will have to adapt to new conditions and implement new business models accordingly.

Oil & Gas & Petrochemicals

The Brent oil price spent a large proportion of 2018 above USD 70, peaking to 80+ levels that were not attained since the 2014 downfall. However, the last quarter witnessed a price drop to a point slightly above USD 50.

Despite this year-end drop, the industry has regained confidence and ensured fair profitability levels.

Oil and gas operators have now significantly improved spending discipline and reduced their operating cost structures and new projects breakeven costs. This turnaround is largely based on better practice, optimized architectures and digital transformation. It should be sustainable going forward.

The Petrochemical sub-segment continues to be a driving force in investment, as well as US unconventional investment.

Interestingly, we see several oil major actors developing into renewable energy, investigating storage, electricity distribution, or planning electric vehicle fast charging infrastructure for their petrol stations.

1.4: Data centers and Networks

The demand for computing continued to shift from on-premise to off-premise facilities. Enterprises continued to move their computing load to leased space in colocation, where they house their own IT equipment, or to Internet Giants, where they are renting platforms, infrastructure and services. To add to this shift, the continued growth of social media and e-commerce has generated even more growth in the off-premise market. Enterprises continue to maintain hybrid environments between existing on-premise facilities and the off-premise market through colocation service providers. With its strong portfolio and global footprint, Schneider Electric is well-positioned for all markets of the hybrid data center environment bringing the strength of our Low Voltage, Medium Voltage, Building Management and Secure Power businesses to serve those clients under the EcoStruxure for datacenter architecture.

As internet usage continues to grow in bandwidth-intensive applications including video, social media, augmented reality and the increasing adoption of the Internet of Things, there has been an increased need for computing and storage at the edge of the network. Schneider Electric is a leader in distributed IT environments and with its modular systems coupled with its EcoStruxure IT software, is in a strong position to capture this next wave of computing.

Market growth remained strong for secure power in commercial and industrial applications. Applications within the Oil & Gas, Transportation and Healthcare segments particularly led the market.

2. Review of the consolidated financial statements

2.1: Review of business and consolidated statement of income

Acquisitions & divestments occurred in 2018

Acquisitions

AVEVA

On September 5, 2017, the Group announced that it had reached agreement with AVEVA Group PLC on the terms and conditions of a combination of AVEVA and the Schneider Electric Software business, to create a global leader in engineering and industrial software.

On February 28, 2018, the transaction was finalized, following the issue of ordinary shares in the capital of AVEVA to Schneider Electric. The Group owns 60% of the enlarged AVEVA Group, on a fully diluted basis. AVEVA has been fully consolidated into the *Industrial Automation* business since March 1, 2018. The consideration paid amounted to EUR 1,994 million, of which EUR 577 million paid in cash (net of acquired cash).

The purchase accounting resulting from the acquisition was not completed at the closing date. As at December 31, 2018, the Group recognized intangible assets for a preliminary amount of EUR 553 million (trademark, patents and customer relationships), and an amount of Goodwill of EUR 1,449 million.

The impact on non-controlling interests reflects 40% of the AVEVA total consideration combined with the carrying value of the Schneider Electric Software business evaluated at the time of the acquisition of INVENSYS Group by Schneider Electric.

IGE+XAO

On November 8, 2017, the Group announced the signing of a memorandum of understanding pursuant to which SEI SAS filed with the Autorité des Marchés Financiers (AMF) a voluntary public tender offer for the shares of IGE+XAO.

On January 25, 2018, after the successful public tender offer and following the delivery of the shares tendered to the offer, the Group announced that SEI SAS owned directly and indirectly 70.57% of the share capital of IGE+XAO, and therefore had taken the control of the Company.

From February 22, 2018, after the reopening of the public tender, the Group owns 70.69% of the share capital of IGE+XAO.

IGE+XAO, has been fully consolidated in the Low Voltage business since February 1, 2018. The consideration paid amounted to EUR 86 million (net of acquired cash).

The purchase accounting resulting from the acquisition was not completed at the closing date. As at December 31, 2018, the Group recognized intangible assets for a preliminary amount of EUR 56 million (trademark, technologies and customer relationships), and an amount of Goodwill of EUR 100 million.

Disposals

No significant disposals occurred during 2018.

Discontinued operations

On April 20, 2017, the Group announced its decision to dispose of its “Solar” activity. During the second semester of 2018, the Group disposed of the “Mobile” line of business. The Group also decided to restructure the “Power Plant” line of business and to keep the “Commercial & Industrial” line of business under strategic review.

This activity used to be reported within the *Low Voltage* business segment of Schneider Electric. Solar activity net loss of EUR 23 million has been reclassified to discontinued operations in the Group consolidated financial statements.

Changes in foreign exchange rates

Changes in foreign exchange rates relative to the euro had an adverse impact over the year, amounting to negative EUR 1,000 million in consolidated revenue and negative EUR 192 million in adjusted EBITA(1).

Revenue

On December 31, 2018, the consolidated revenue of Schneider Electric totaled EUR 25,720 million, a 3.9% increase at current scope and exchange rates compared to EUR 24,743 million on December 31, 2017.

This variance breaks down into an organic increase of +6.6%, a net scope effect of +1.8% and a negative exchange rate effect of -4.5%, mainly driven by the depreciation of the US dollar against the euro.

(1) Adjusted EBITA (Earnings Before Interest, Taxes, Amortization of Purchase Accounting Intangibles) is earnings EBITA before amortization and impairment of intangible assets from acquisitions, impairment of goodwill, other operating income and expenses and restructuring costs.

Material contracts

No material contract (other than contracts entered into in the ordinary course of business) has been entered into for the two years immediately preceding the publication of this document.

2.2: Changes in revenue by operating segment

Energy Management:

Medium Voltage generated revenues of EUR 4,320 million, or 17% of the consolidated total. This represents a decrease of -4.0% on a reported basis, partly due to the disposal of Telvent DTN, and an increase of +2.8% on a like-for-like basis, back to growth after selectivity initiatives in 2017. China and the U.S. were up strongly for the year while Western Europe was down as growth in Spain and Italy was offset by weaker demand from utilities in France and Germany. Services were up double-digit for the year.

Low Voltage generated revenues of EUR 11,572 million, or 45% of the consolidated total. This represents an increase of +7.0% on a reported basis, with contribution from the acquisitions of ASCO and IGE+XAO, and an increase of +8.3% on a like-for-like basis, with growth across all regions. Residential and Small Buildings offers continued to grow strongly, extending a strong track record of growth. *Low Voltage* saw strong growth in Commercial and Industrial Buildings and Data centers leveraging the Group's strong partner network. Asia Pacific was up double-digit for the year while North America and Rest of the world grew strongly. Western Europe was up. Services were up strongly for the year, including Energy and Sustainability Services which grew double-digit.

Secure Power generated revenues of EUR 3,628 million, or 14% of the consolidated total. This represents an increase of +0.4% on a reported basis and an increase of +4.9% on a like-for-like basis, with growth accelerating in the second half of the year. New offers drove the good performance for Distributed Secure Power, while 3-phase UPS, non-IT end-markets, and Edge computing all contributed to growth. *Secure Power* saw growth in all regions. Notably, Asia-Pacific saw good growth, led by demand in India. Services were up mid-single digit for the year.

Industrial Automation:

Industrial Automation generated revenues of EUR 6,200 million, or 24% of the consolidated total. This represents an increase of +6.6% on a reported basis, with contribution from the AVEVA transaction, and an increase of +7.6% on a like-for-like basis. There was strong growth across the *Industrial Automation* portfolio, with demand in Process Industries accelerating. OEM continued strong growth, though demand in China moderated in line with expectations, while the U.S. grew, though impacted by the phasing down in one non-core offer. The Group saw continued good progress for its EcoStruxure offers, including cybersecurity services.

2.3: Gross Margin

Gross profit was up +6.7% organically with Gross margin improving by +60 bps on a reported basis (around flat organically) to 39.0% in full year 2018. This represents the third consecutive year of Gross margin expansion, increasing by +200 bps over 2016-2018 due to a focus on high value-added business, portfolio optimization and industrial productivity.

2.4: Support function costs: research and development and selling, general and administrative expenses

Excluding capitalized development costs and development costs reported as cost of sales, research and development expenses increased by 19.2% from EUR 501 million in 2017 to EUR 597 million in 2018. As a percentage of revenues, the net cost of research and development expenses increased from 2.0% in 2017 to 2.3% in 2018.

Total research and development expenses, including capitalized development costs and development costs reported as cost of sales (see Note 4 to the Consolidated Financial Statements) increased by 9.8% from EUR 1,183 million in 2017 to EUR 1,299 million in 2018. As a percentage of revenues, total research and development expenses increased from 4.8% in 2017 to 5.1% in 2018.

In 2018, the net effect of capitalized development costs and amortization of capitalized development costs amounted to EUR 61 million on operating income *versus* EUR 62 million in 2017.

Selling, general and administrative expenses increased by 4.2% from EUR 5,346 million in 2017 to EUR 5,572 million in 2018. As a percentage of revenues, selling, general and administrative expenses slightly increased from 21.6% in 2017 to 21.7% in 2018.

Total support function costs, i.e. research and development expenses (excluding capitalized development costs and development costs reported as cost of sales) together with selling, general and administrative expenses, totaled EUR 6,169 million in 2018, up 5.5% compared to EUR 5,847 million in 2017. The support function costs to sales ratio increased from 23.6% for in 2017 to 24% in 2018.

2.5: Other operating income and expenses

In 2018, other operating income and expenses amounted to a net loss of EUR 103 million, mainly due to impairment losses on assets (EUR 36 million) and to costs of acquisitions and integrations (EUR 69 million). These negative impacts were reduced by a EUR 20 million gain on the curtailment and settlement of employee benefit plans in the US.

2.6: Restructuring costs

Restructuring costs amounted to EUR 198 million in 2018, down from EUR 286 million in 2017.

2.7: EBITA and Adjusted EBITA

We define EBITA as earnings before interest, taxes and amortization of purchase accounting intangibles. EBITA comprises operating profit before amortization and impairment of purchase accounting intangible assets and before goodwill impairment.

We define adjusted EBITA as EBITA before restructuring costs and before other operating income and expenses, which includes acquisition, integration and separation costs.

Adjusted EBITA amounted to EUR 3,874 million in 2018, up 6.1% from EUR 3,651 million in 2017. Gross profit expansion combined with tight control of support function costs more than offset the negative impact from foreign exchange outlined in Section 2.1. As a percentage of revenue, adjusted EBITA increased from 14.8% in 2017 to 15.1% in 2018.

EBITA increased by 6.7% from EUR 3,350 million in 2017 to EUR 3,573 million in 2018. This increase is mainly linked to the Adjusted EBITA improvement. As a percentage of revenue, EBITA increased to 13.9% in 2018 up from 13.5% in 2017.

2.8: Adjusted EBITA by business segment

The following table sets out adjusted EBITA by business segment:

Full year 2018

	Energy Management			Automation		
	Low Voltage	Medium Voltage	Secure Power	Industrial Automation	Central Functions & Digital costs	Total
Backlog	2,425	2,455	1,108	1,471	–	**7,459**
Revenue	11,572	4,320	3,628	6,200	–	**25,720**
Adjusted EBITA*	2,382	481	616	1,118	(723)	**3,874**
Adjusted EBITA %	*20.6%*	*11.1%*	*17.0%*	*18.0%*	–	***15.1%***

* Adjusted EBITA: EBITA before restructuring costs and before other operating income and expenses (including acquisition, integration and separation costs).

The amount of backlog to be executed over one year amounts to EUR 350 million at December 31, 2018.

Full year 2017

	Energy Management			Automation		
	Low Voltage	Medium Voltage	Secure Power	Industrial Automation	Central Functions & Digital costs	Total
Revenue	10,812	4,500	3,615	5,816	–	**24,743**
Adjusted EBITA*	2,232	449	600	1,021	(651)	**3,651**
Adjusted EBITA %	*20.6%*	*10.0%*	*16.6%*	*17.6%*	–	***14.8%***

* Adjusted EBITA: EBITA before restructuring costs and before other operating income and expenses (including acquisition, integration and separation costs).

Energy Management:
Medium Voltage adjusted EBITA was up c.+130 bps organic year-on-year (+110 bps reported), delivering on our objective to expand *Medium Voltage* margin by 100-150 bps organically in 2018 and in keeping with the overall objectives of the Infrastructure Rebound program announced during 2016 (with c. +400 bps organic improvement 2015-2018).

Low Voltage reached a record level of adjusted EBITA, up c.+20 bps organic (flat reported) year-on-year.

Secure Power adjusted EBITA was up +40 bps year on year (organic and reported) showing improvement due to good topline growth.

Industrial Automation:
Industrial Automation generated an adjusted EBITA up c.+70 bps organic (+40 bps reported), benefiting from improved volumes which comfortably offset higher investments made in digital offers.

Central Functions & Digital costs amounted to 2.8% of revenues. These costs include investments into the Group's shared Digital platform and I.T. infrastructure, transversal investments supporting the development of the two businesses and the cost of global functions.

2.9: Operating income (EBIT)

Operating income or EBIT (Earnings Before Interest and Taxes) increased from EUR 3,210 million in 2017 to EUR 3,396 million in 2018. This 5.8% increase is explained mainly by the EBITA improvement.

2.10: Net financial income/loss

Net financial loss amounted to EUR 310 million in 2018, down from EUR 367 million in 2017. This reduction is mainly explained by a EUR 18 million decrease in foreign exchange losses, supplemented by a decrease in the cost of net financial debt from EUR 219 million in 2017 to EUR 183 million in 2018.

2.11: Tax

The effective tax rate was 22.5% in 2018, up from 21.1% in 2017. The corresponding tax expense increased from EUR 600 million in 2017 to EUR 693 million in 2018.

In 2018, the tax reforms in the USA led to an additional negative EUR 25 million adjustment in the Income statement.

In 2017, the tax reforms in the USA and in Belgium, as well as the additional reform in France, led together to a positive EUR 12 million adjustment in the Income statement.

2.12: Share of profit/(losses) of associates

The share of profit of associates remained stable at EUR 61 million in 2018 (same as 2017).

2.13: Non-controlling interests

In 2018, profit for the period attributable to non-controlling interests totaled EUR 97 million, up from EUR 60 million in 2017. AVEVA was the main contributor to this amount in 2018.

2.14: Profit for the period

In 2018, profit for the period attributable to the equity holders of the parent company amounted to EUR 2,334 million. This represents an 8.6% increase over the EUR 2,150 million profit reported in 2017, mainly due to the improvement in EBITA.

2.15: Earnings per share

Earnings per share increased from EUR 3.85 for 2017 to EUR 4.21 for 2018.

2.16: Consolidated cash-flow

Operating activities

In 2018, net cash provided by operating activities before changes in operating assets and liabilities amounted to EUR 3,405 million, up 12.7% from EUR 3,020 million in 2017, and represented 13.2% of revenues in 2018 up from 12.2% in 2017.

The change in working capital used EUR 533 million in cash in 2018, compared to EUR 79 million used in 2017.

In all, net cash provided by operating activities decreased by 2.4% from EUR 2,941 million in 2017 to EUR 2,872 million in 2018.

Investing activities

Net capital expenditure, which included capitalized development projects, increased by 11.9% to EUR 770 million in 2018, compared to EUR 688 million in 2017, representing 3% of revenues in 2018 (2.8% in 2017).

Free cash-flow (cash provided by operating activities net of net capital expenditure) amounted to EUR 2,102 million in 2018 versus EUR 2,253 million in 2017.

Cash conversion rate (free cash-flow over net income attributable to the equity holders of the parent company on continuing operations) was 90% in 2018 versus 105% in 2017.

The effect of acquisitions and divestments during the year was a net cash outflow amounting to EUR 730 million in 2018. Acquisitions and divestments represented a net cash outflow of EUR 416 million in 2017. Those amounts correspond mainly to the acquisitions and disposals described in Notes 2.1 and 2.2 of the Consolidated Financial Statements (Chapter 5).

Financing activities

In 2018, the Group reimbursed bonds for EUR 749 million and issued a bond in euros for EUR 741 million.

The net increase in other financial debts amounted to EUR 220 million in 2018, compared to EUR 111 million in 2017. The amount of dividends paid by Schneider Electric in 2018 was EUR 1,223 million, compared to EUR 1,133 million in 2017.

3. Review of the parent company financial statements

Schneider Electric SE posted an operating loss of EUR 16 million in 2018 compared with EUR 14 million the previous year.

Interest expense net of interest income amounted to EUR 75 million versus EUR 106 million the previous year.

Current income amounted to EUR 4,390 million in 2018 compared with a current loss of EUR 28 million in 2017.

Net income stood at EUR 4,458 million in 2018 compared with a net loss of EUR 121 million in 2017, mainly due to the dividends of EUR 4.5 billion received from Schneider Electric Industries SAS in 2018.

Equity before appropriation of net profit amounted to EUR 10,078 million at December 31, 2018 *versus* EUR 7,893 million at the previous year-end, after taking into account 2018 profit, dividend payments of EUR 1,126 million and share issues in an amount of EUR 76 million.

4. Outlook

In its main markets, the Group currently expects the following trends:

- China faces a high base of comparison (weighted towards the early part of the year) and softening OEM demand but remains a growth market in aggregate with dynamism in many end-markets including construction, infrastructure and parts of industry.
- In North America, the Group anticipates a continuing favorable environment.
- Other large countries in Asia Pacific continue good momentum.
- The Group expects Western Europe to grow at a moderate pace and the Rest of the world economies to be contrasted based on country.

In the current macro environment, the Group expects continued positive growth in aggregate in 2019 as it continues to deploy its strategic priorities in key markets.

The Group targets 2019 Adj. EBITA growth between +4% and +7% organic. This would be achieved through a combination of organic revenue growth and margin improvement, expected to be:

- Revenue growth of +3% to +5% organic; and
- Adjusted EBITA margin up +20 to +50 bps organic. The improvement is expected to be more pronounced in the second part of the year.