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Business review

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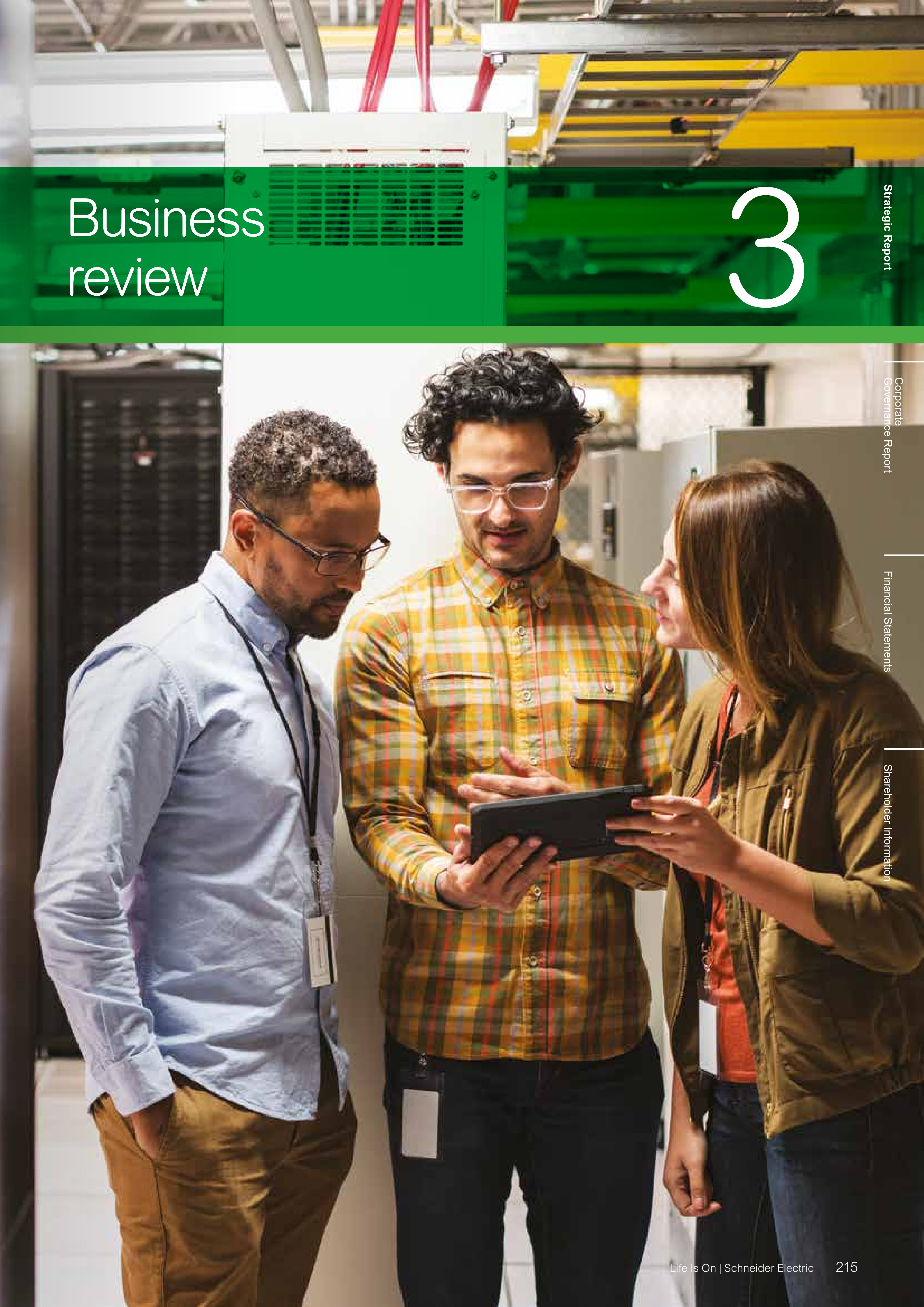

1. Trends in Schneider Electric's core markets

1.1 Construction

In Europe, the residential market grew in Spain, Portugal, the United Kingdom and Central Europe. Emerging economies saw growth, while Sweden and Finland saw declines amid declining housing prices and oversupply. In the non-residential market, growth remained positive across all regions, except for the United Kingdom. Uncertainties over the Brexit dragged down industrial, office, and commercial sectors, while austerity measures hit public health and education sectors.

In the United States, residential market gradually improved during the second half of 2019. Growth was amplified by the roll out of regulations related to the adoption of dual-function circuit breakers. Non-residential construction slowed down, due to a decline in the retail segment.

In China, the construction market continued to grow at a solid pace. In the residential market, property market sentiment improvement, Hukou relaxation (system of population registration), and increased availability of mortgages underpinned the expansion. Non-residential market growth was led by office buildings.

In Australia, residential market slowed down following several years of strong growth. Tighter credit conditions and falling property prices curbed activity.

In India, residential market growth was moderated in high and medium-end segments in major cities. Non-residential market continued its strong expansion, driven by urbanization and tax cut stimulus.

1.2 Industry and machine manufacturers

The industry market slowed down in 2019, mainly driven by US-China trade tensions. A business climate deterioration, amid elevated uncertainties, increasing tariffs and global trade slow down, led companies to delay some investments. However, easing trade tensions during the last quarter reduced recession risks and provided traction for a market stabilization.

In the US, the slow down in 2019 was aggravated by fading contribution from tax stimuli.

In China, weaker export growth, impacted by tariffs, amid an uncertain trade environment, dragged down corporate profits and firms' confidence. However, the market improved in Q4, amid resumption of trade talks and further fiscal easing.

The European market was also impacted by uncertainties over Brexit.

In East Asia and Japan, markets slow down was driven by lower demand from China, a weaker business climate, and cyclical downturn in the semiconductor industry.

1.3 Data Center and Networks

The Data Center market continued its strong expansion in 2019, boosting demand for Secure Power and Medium Voltage/Low Voltage systems technologies. Enterprises continued their digital transformation journey and leveraged a hybrid environment for their computing load. The result is a shift of their computing load to off-premise facilities, while modernizing their own on-premise data centers for select core applications. Enterprises continued to leverage leased space in collocation, where they host their own IT equipment, or to Internet Giants, where they are renting platforms, infrastructure and services. Adding to this shift, the growth of social media and e-commerce has generated even more demand within the off-premise market. Companies continue to maintain hybrid environments on both installations on existing sites, and off-premise markets, through collocation services suppliers.

Over the course of their digital transformation, enterprises are developing a new customer experience or process applications that are increasingly bandwidth intensive. Video, social media, augmented reality and the increasing adoption of the Internet of Things are driving the need for computing and storage at the edge of the network. These applications are not limited to traditional IT environments. There is a growing opportunity within Commercial and Industrial markets as Industrial IoT continues to gain momentum. Schneider Electric is the 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 Edge Computing.

1.4 Oil & Gas & Petrochemicals

This year has shown continuity with regards to 2018 in many aspects. The Brent oil barrel price has experienced ups and downs, oscillating between USD55 and USD75 over the year. These price levels were enough to ensure profitability for most projects, thanks to a recurrent improvement in operations and project design and execution by all players across the value chain. Schneider Electric contributes to these improvements with the newly launched EcoStruxure Power & Process architecture for Oil & Gas.

The OPEC group together with Russia have maintained their curtailment measures on crude oil pricing which has keep oil prices largely stable. The Strait of Hormuz and general Iran tensions have so far not generated major price upsurge. These two elements have somewhat compensated the global and Chinese GDP slow downs and its historic impact on oil prices.

The general feeling of confidence in the industry was reflected in rig count growth, significant LNG projects and FPSO launches, sustained investment in Petrochemicals projects, as well as in the record levels reached by Saudi Aramco's partial IPO in 2019.

We nevertheless could witness a major evolution in 2020. The whole industry now realizes that it is confronted to a potential slow down in its growth and a likely plateau and decline that may happen in 10 to 20 years. Developing more sustainable operations in the Oil & Gas industry is now key to its social and financial license to operate. Schneider Electric is in a unique position to help the industry move forward in energy efficiency and on the path to the electrical future of Oil & Gas.

1.5 Electricity Companies

The power industry is at the heart of the battle for greenhouse gas reduction. Global electricity generation has grown by 4% in 2019, led by China, with 68% of new capacity in renewables.

To tackle the challenges brought about by the new energy landscape, transmission and distribution grid operators are investing in digital technologies to improve their operations, experimenting with artificial intelligence for grid balancing, enabling and accelerating the integration of all decarbonization solutions, such as DER, storage, and electric vehicles.

China will focus on digitalization of grid operations and services in the coming years, whereas in the USA investments are mostly directed toward improving grid reliability. In Europe, high rates of distributed energy resources will lead to investment in new infrastructures to reinforce grid capacity and to develop systems to manage a more dynamic grid. Decreasing electricity losses will also drive further investment in grid infrastructure and better network management mainly in India, Latin America, and Southeast Asia.

Along with deploying grid digitalization technologies to cope with their challenges, utilities are facing increasing cyber threats. Many major utilities around the world have deployed processes to manage cyber risks, but will need to adapt them to new regulations to come and face the challenges of their legacy installation base. As cheaper batteries, government incentives, and support policies are driving electric car sales, its adoption is expected to rise in the mid-2020s. Some geographies are expected to move faster due to charging infrastructure investments.

2. Comments on the consolidated financial statements

2.1 Review of business and consolidated statement of income

Acquisitions & disposals of the period

Acquisitions

No significant acquisition occurred during 2019.

Disposals

On March 25, 2019, the Group announced having entered exclusive negotiations with Transom Capital Group regarding the sale of its Pelco business. On May 24, 2019, the sale of Pelco, which previously reported within the *Energy Management* segment, was finalized.

On December 5, 2019, the Group announced having signed an agreement with Vinci Energies regarding the sale of Converse Energy Projects GmbH, which reported within the *Energy Management* segment. On December 30, 2019, the sale was finalized.

Follow-up on acquisitions and divestments occurred in 2018 with significant effect in 2019

Acquisitions

AVEVA

On February 28, 2018, the Group finalized a transaction with AVEVA Group PLC to combine AVEVA and Schneider Electric Software business, and create a global leader in engineering and industrial software. 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 is fully consolidated in the *Industrial Automation* business since March 1, 2018. The consideration paid amounted EUR 1,994 million, of which EUR 577 million paid in cash (net of acquired cash).

As of June 30, 2019, the Group has finalized the purchase price allocation and recognized intangible assets for an amount of EUR 482 million (trademark, patents and customer relationship), and an amount of goodwill of EUR 1,434 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 January 25, 2018, after the successful public tender offer for the shares of IGE+XAO, the Group announced that it had taken the control of the company.

IGE+XAO, is fully consolidated in the *Energy Management* business since February 1, 2018. The consideration paid amounts EUR 86 million (net of acquired cash).

As of June 30, 2019, the Group has finalized the purchase price allocation and recognized intangible assets for an amount of EUR 49 million (trademarks, technologies and customer relationships) and an amount of goodwill of EUR 100 million.

As of December 31, 2019 the Group owns 67.89 % of the share capital of IGE+XAO.

Disposals

No significant disposals occurred during 2018.

Application of IFRS 5 – *Non-current assets held for sale and discontinued operations*

On April 20, 2017, the Group announced the disposal of its “Solar” activity, and started implementing the necessary measures and procedures to formalize this transaction. The initial plan has been reoriented, part of the business being sold or restructured, and part of it still being considered as discontinued operations. This activity used to be reported within the *Energy Management* business segment of Schneider Electric. Solar activity net loss of EUR 3 million has been reclassified to discontinued operations in the Group consolidated financial statements.

On October 24, 2019, the Group agreed to establish a Joint Venture with the Russian Direct Investment Fund (RDIF), to further strengthen the long-term outlook for the Group’s Electroshield Samara business, which is currently consolidated under the *Energy Management* segment and generated revenues of EUR 168 million in 2019. The related assets and liabilities have been reclassified at fair value in the lines “Assets and liabilities held for sale” in the balance sheet.

2.2 Changes in foreign exchange rate

Fluctuations in the Euro exchange rate had a positive impact over the year, increasing the consolidated revenue by EUR 495 million and the adjusted EBITA by EUR 35 million, due mainly to the positive effect of the US Dollar compared to the Euro.

2.3 Revenue

Consolidated revenue totaled EUR 27,158 million for the period ended December 31, 2019, up 5.6% on a current structure and currency basis, compared with last year.

Organic growth was positive for 4.2%, acquisitions and disposals accounted for (0.6)% and the currency effect for 2.0% due mainly to the positive effect of the US dollar compared to the Euro.

2.4 Changes in revenue by reporting segment

Energy Management generated revenues of EUR 20,847 million, equivalent to 77% of the consolidated total revenue. This represents an increase of 6.8% on a reported basis, and an increase of 5.2% on a like-for-like basis, with growth across all regions. Residential & small building offers sustained mid-single digit for the year. EcoStruxure architecture for Commercial & Industrial Buildings continued to deliver growth. *Energy Management* systems saw good growth across end-markets, notably in Data Center, both in large and small installations. The Group experienced a mixed picture in Industry & Infrastructure, where OEM softness has limited pull-through of Energy Management, while Infrastructure remains positively oriented. The recent ASCO and IGE+XAO acquisitions showed strong growth. Services posted a high-single digit growth.

Industrial Automation generated revenues of EUR 6,311 million, equivalent to 23% of the consolidated total revenue. This represents an increase of 1.8% on a reported basis, and an increase of 0.8% on a like-for-like basis. There was resilient growth across the industrial automation coming from the Group's balanced portfolio across the cycle. Process & hybrid offers (c. 50% of *Industrial Automation* revenue) grew mid-single digit, with strong growth in orders. Offers for discrete industries (c. 50% of Industrial Automation revenue) showed a slowdown in most regions due to market softness. U.S. Panels activity was sold during the second quarter of the year. The Group made good progress on developing joint value proposition with AVEVA, with good trends in industrial software. Services showed double-digit growth.

2.5 Gross margin

Gross margin was up 5.5% organically with a Gross margin rate improving by +50bps organically to 39.5% in 2019 mainly driven by net price and productivity.

2.6 Support Function costs: Research and development and selling, general and administrative expenses

Research and development expenses, net of capitalized development costs and excluding research and development costs booked in costs of sales, increased by 10.1%, from EUR 597 million for 2018 to EUR 657 million for year 2019. As a percentage of revenues, the net cost of research and development is increasing slightly to 2.4% of revenues for 2019 (2.3% for 2018).

Total research and development expense, including capitalized development costs and development costs reported as cost of sales (see Note 4 to the Consolidated Financial Statements) increased by 5.3% from EUR 1,299 million for 2018 to EUR 1,368 million for 2019. As a percentage of revenues, total research and development expenses decreased slightly to 5.0% for 2019 (5.1% for 2018).

In 2019, the net effect of capitalized development costs and amortization of capitalized development costs amounts to EUR 60 million on the operating income (EUR 61 million in 2018).

Selling, general and administrative expenses increased by 4.8%, to EUR 5,840 million in 2019 (EUR 5,572 million in 2018). As a percentage of revenues, selling, general and administrative expenses decreased slightly to 21.5% for 2019 (21.7% for 2018).

Combined, total support function costs, that is, research and development expenses together with selling, general and administrative costs, totaled EUR 6,497 million in 2019, compared to EUR 6,169 million in 2018, an increase of 5.3%. As a result, the support functions costs to sales ratio remains stable at 24%.

2.7 Other operating income and expenses

For the year 2019, other operating income and expenses amounted to a net expense of EUR 411 million, mainly due to losses on disposal and impairment of assets for EUR 289 million (mostly due to the disposals of Pelco and Converse Energy Projects GmbH as well as the fair value adjustment Electroshield Samara business) as well as costs of acquisition of EUR 98 million.

2.8 Restructuring costs

For the period ended December 31, 2019, restructuring costs amounted to EUR 255 million compared to EUR 198 million for 2018, attributed mainly to Support Function Cost improvement initiatives.

2. Comments on the consolidated financial statements

2.9 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 reached EUR 4,238 million in 2019, compared to EUR 3,874 million for 2018, increasing organically by 8.7%. Adjusted EBITA margin improved by 70 bps organically to 15.6%.

EBITA stabilized at EUR 3,572 in 2019, from EUR 3,573 million in 2018. As a percentage of revenue, EBITA decreased to 13.2% for 2019 (13.9% for the year 2018).

2.10 Adjusted EBITA by reporting segment

The following table sets out EBITA and adjusted EBITA by reporting segment:

Full Year 2019

(in millions of euros)	Energy Management	Industrial Automation	Central functions & digital costs	Total
Backlog	6,399	1,705		**8,104**
Revenue	20,847	6,311		**27,158**
Adjusted EBITA*	3,842	1,141	(745)	**4,238**
Adjusted EBITA (%)	*18.4%*	*18.1%*		**15.6%**

* Adjusted EBITA (Earnings Before Interest, Taxes, Amortization of Purchase Accounting Intangibles). Adjusted EBITA corresponds to operating profit before amortization and impairment of purchase accounting intangible assets, before goodwill impairment, other operating income and expenses and restructuring costs.

As of December 31, 2019, the amount of backlog to be executed over one year amounts to EUR 663 million.

Full Year 2018

(in millions of euros)	Energy Management	Industrial Automation	Central functions & digital costs	Total
Backlog	5,988	1,471		**7,459**
Revenue	19,520	6,200		**25,720**
Adjusted EBITA*	3,479	1,118	(723)	**3,874**
Adjusted EBITA (%)	*17.8%*	*18.0%*		**15.1%**

* Adjusted EBITA (Earnings Before Interest, Taxes, Amortization of Purchase Accounting Intangibles). Adjusted EBITA corresponds to operating profit before amortization and impairment of purchase accounting intangible assets, before goodwill impairment, other operating income and expenses and restructuring costs.

As of December 31, 2018, the amount of backlog to be executed over one year amounted to EUR 350 million.

Energy Management generated an adjusted EBITA, for the year 2019, of EUR 3,842 million, equivalent to 18.4% of revenue, up circa +80 bps organic (up +60 bps reported) thanks to strong growth in volume, improved pricing and continued productivity gains.

Industrial Automation generated an adjusted EBITA of EUR 1,141 million, equivalent to 18.1% of revenue, up circa +30 bps organic, (and +10 bps reported), thanks to positive pricing and a continued focus on costs at a time where positive topline growth is moderated by the high base of comparison from 2018, and with a softening market environment for discrete automation.

Central functions & Digital costs in 2019 amounted to EUR 745 million, slightly reducing its shares of Group revenue to 2.7% (2.8% of Group revenue in 2018). Approximately 50% of these costs are transversal investments supporting the development of the two reporting segments, including I.T, Digital Infrastructure and Marketing. A further c. 20% of these costs are due to Performance Shares. The remaining c.30% of costs represent the underlying corporate costs of around 0.8% of Group revenue, which have been stable in the recent years.

2.11 Operating income (EBIT)

Operating income or EBIT (Earnings Before Interest and Taxes), is stable, with a slight variation of 0.1%, from EUR 3,396 million in 2018 to 3,399 million in 2019 and is following EBITA trend.

2.12 Net financial income/loss

Net financial loss amounted to EUR 261 million in 2019, compared to EUR 310 million for 2018.

This decrease is explained both by the decrease of cost of net financial debt to EUR 129 million in 2019, compared to EUR 182 million in 2018, partially compensated by the impact of the first application of IFRS 16 – *Leases* for EUR 39 million in 2019.

2.13 Tax

The effective tax rate was 22.0% for 2019, compared to 22.5% for 2018. The corresponding income tax expense decreased from EUR 693 million for 2018 to EUR 690 million for 2019.

2.14 Share of profit/(losses) of associates

The share of associates was a EUR 78-million profit in 2019, compared to a EUR 61-million profit for the year 2018.

2.15 Non-controlling interests

Minority interests in net income for the year 2019, totaled EUR 110 million, compared to EUR 97 million for year 2018. AVEVA was the main contributor in 2019.

2.16 Profit for the period (to owners of the parent)

Profit for the period attributable to the equity holders of our parent company amounted to EUR 2,413 million for the year 2019, compared to EUR 2,334 million profit for year 2018.

2.17 Earnings per share

Earnings per share amounted to EUR 4.38 per share for the year 2019 compared to EUR 4.21 per share for the year 2018.

2.18 Consolidated Cash-flow

Cash flow from operating Activities
Net cash provided by operating activities before changes in operating assets and liabilities reached EUR 4,012 million for the year 2019 (including EUR 274 million due to the first application of IFRS 16 – *Leases*), increasing compared to EUR 3,405 million for the year 2018. It represents 14.8% of revenues for the year 2019 (13.2% of revenues from 2018).

Change in working capital requirement generated EUR 270 million in cash in 2019, compared with a consumption of EUR 533 million in 2018.

In all, net cash provided by operating activities increased from EUR 2,872 million in 2018 to EUR 4,282 million in 2019.

Cash flow from investing Activities
Net capital expenditure, which included capitalized development projects, increased, at EUR 806 million for 2019, compared to EUR 770 million for 2018, and representing 3% of sales in 2019, stable compared to 2018.

Free cash-flow (cash provided by operating activities net of net capital expenditure) amounted to EUR 3,476 million in 2019 versus EUR 2,102 million in 2018.

Cash conversion rate (free cash-flow over net income attributable to the equity holders of the parent company on continuing operations) was 144% in 2019 versus 90% in 2018.

The acquisitions net of disposals represented a cash out of EUR 79 million (net of acquired cash) for the year 2019, compared with EUR 730 million for 2018. Those amounts correspond mainly to the acquisitions and disposals described in Note 2.1 et Note 2.2.

Cash flow from financing Activities
Net cash flow from financing activities amounted to EUR 2,125 million in 2019, compared to EUR 1,757 million in 2018, mainly due to changes in net debt.

The net decrease in other financial debts amounted to EUR 1,078 million in 2019, compared with a net increase of EUR 220 million in 2018. The 2019 decrease is mainly due to the reimbursement of commercial papers of EUR 610 million as well as the impact from the first application of IFRS 16 – *Leases* of EUR 274 million in 2019.

The amount of dividends paid by Schneider Electric in 2019 was EUR 1,296 million, compared to EUR 1,223 million in 2018.

3. Review of the parent company financial statements

Schneider Electric SE posted an operating loss of EUR 15 million in 2019, compared to EUR 16 million the previous year.

Interest expense net of interest income amounted to EUR 62 million versus EUR 75 million the previous year.

Current loss amounted to EUR 15 million in 2019, compared to an income of EUR 4,390 million in 2018.

The net income stood at EUR 57 million in 2019, compared to EUR 4,458 million in 2018, mainly due to dividends of EUR 4.5 billion received from Schneider Electric Industries SAS in 2018.

Equity before appropriation of net profit amounted to EUR 9,007 million as of December 31, 2019 versus EUR 10,078 million at the previous year-end, after taking into account the 2019 profit, dividend payments of EUR 1,296 million and share issues of EUR 168 million.

4. Outlook

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

- In North America, the Group anticipates that markets will continue to be positive in 2020, though the first half of the year would be impacted by the high base of comparison for *Energy Management* and the impact of certain large projects. In *Industrial Automation*, the Group expects pressure on discrete to remain in the first half, though a rebound could be expected in the second half of the year. Mexico is expected to continue to remain challenged in the near term.
- China continues to remain a growth with dynamism in many end-markets and segments including construction, infrastructure, transportation, data centers and healthcare. The OEM demand could strengthen in the second half of the year. The Group is assessing the impact of the Coronavirus to the business. There will be an impact in the first quarter of 2020 due to factory closures in January and February. At this point, this impact has been estimated at c. EUR 300 million mainly in China and the Group assumes it will be almost entirely compensated in 2020, largely in the second half of the year.
- For the rest of Asia Pacific, the Group expects India and South East Asian countries to continue to be growth markets.
- The Group expects Western Europe to grow at a moderate pace with a higher weight in the second half of the year.
- The Group expects the performance in Rest of the world to be contrasted based on country.

In the current macro environment and incorporating the current view on the impact of coronavirus, the Group expects positive growth in aggregate in 2020 as it continues to deploy its strategic priorities in key markets.

In 2020, the Group therefore sets its targets as follows:

- Revenue growth of +1% to +3% organic;
- Adjusted EBITA margin between +16.0% and to +16.3% (excluding FX and impact of acquisitions).