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Becoming simply the best

Dear Philips shareholder,

With net profit at EUR 4.2 billion, Philips is far from doing badly. The times when Philips stood at the brink of disaster are long gone. The company is profitable, enjoys a sound balance sheet and the focus on health care (medical systems) is wise. Yet Philips must compete in competitive markets and appears to be losing ground for years. In the second half of last year Philips succeeded in making inroads into this shortfall, but a more rigorous test awaits it. In all its markets, Philips must become the best and not take refuge in average performance.

Philips must get simple

Philips remains a company with very disparate businesses. Selling big ticket medical equipment requires a different approach than that used for selling television sets, domestic irons or lighting. That multiplicity of businesses and lack of focus depress the growth opportunities in the underlying divisions. This leads Philips into a losing battle against companies with focus (Apple or TomTom) that have mastered the art of turning product innovation into runaway check-out success. Too often Philips is obliged to resort to expensive acquisitions – at three to five times sales – to be able to add new products.

‘Simpler, stronger, better’: the title of this year’s annual report speaks volumes. Philips itself concedes that things can still get much simpler and, by extension, better. Despite superb products, its consumer electronics division turns in low profits combined with minimum growth. Margin pressure on, say, television sets seems a fact and sales growth is disappointing. In the absence of major changes consumer electronics remain a problem child depressing valuations and so blocking expansion opportunities open to other divisions. The VEB will support Philips if it starts to wind down its businesses within Connected Displays (that includes televisions), or if, in this business segment, it withdraws from the North America.

One of the divisions Philips is focussing on is medical systems, now called Healthcare. Last year the focus on medical systems started to show serious strains. The disappointing investment in Medquist aside, sales of this division grew only 0.3% last year. Given the relatively high valuations of potential acquisition targets, acquisitions only make sense once Philips has got its own division in order. In the longer term Philips’ acquisition strategy can only be successful if it can execute acquisitions on the back of a superior stock market capitalisation. As long as Philips can create more value by buying in its own shares (as is now the case) instead of using its resources to make expensive takeovers its growth strategy will not work.

The new 'Vision 2010' strategy is designed to bring about improvement. Philips expects to raise EBITA (earnings before interest, tax and amortisation) to above 10% as from 2010. The company is targeting an annual sales growth of at least 6% in the 2008 - 2010 period. Targeted sales growth of 6% is scarcely very ambitious and is above all related to the decision about Connected Displays that is to be taken. Philips maintains the individual long term objectives set for each of its divisions shrouded in fearful secrecy.

Poor or average performance richly rewarded

The VEB has criticised the current option and share scheme for years. It does very little to motivate. Even in cases of very poor performance (lowest quartile) board members are still rewarded with 80% of their shares. Now – at last – Philips wishes to modify the arrangements. Although the system appears slightly better, Philips still appears to hand out rich rewards for below-average performance. Mr Kleisterlee will receive shares and options worth about EUR 1.8 million if Philips shares perform slightly below the average of eleven competitors over the coming three years. If Philips comes out last but one on the list, he will still get EUR 350,000. Philips has certainly set some remarkably low targets to hit in its remuneration policy. A further point is that, according to the VEB's calculation, the new share scheme will burden the company with higher costs than the current arrangement.

At the same time as Philips intends to increase the maximum bonuses for the executive board once again, it maintains complete secrecy about the level of ambition expressed in the performance targets. Philips is not in compliance with the Frijns Committee's recent recommendations that enjoin that performance criteria be sufficiently clear, quantified and specific that their ambitious nature can in fact be deduced. This is very far from the case for Philips. In the light of the low performance minimum set for the share and options scheme combined with the lack of transparency surrounding performance criteria the VEB recommends voting against the remuneration motions.

Auditors' reappointment

The agenda also calls for KPMG to be reappointed as auditor. KPMG and its legal predecessors have been Philips' auditors for as long as anyone can remember: for at least 30 years to the best of the VEB's research. As well as expertise, independence is one of the most important requirements of an auditor. The VEB recommends a change of auditor and is against KPMG's reappointment.

On behalf of the Vereniging van Effectenbezitters
(Dutch Investors' Association or VEB),



Jan Maarten Slagter, Director

Would you like to respond to this report? E-mail your reactions to info@veb.net.