VERENIGING VAN EFFECTENBEZITTERS veb

Vereniging van Effectenbezitters
Postbus 240, 2501 CE Den Haag
Bezoekadres: Amaliastraat 7, Den Haag

Tel.: +31 (0)70 313 00 00
Fax: +31 (0)70 313 00 99
Internet: www.veb.net
E-mail: info@veb.net

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Philips to search for growth

Dear Philips shareholder,

Over the past few years Philips has transformed from being a technology concern into a consumer goods producer. Previously the business was a conglomerate with a considerable 'conglomerate discount', but it has now re-focused. The VEB NCVB ('VEB') acknowledges this is a positive development. The question for Philips now is how to make and keep its product range as attractive as possible in order to sustain profitable growth.

Considering the difficult economic circumstances, the 2009 results were respectable. Hospitals unexpectedly ran into difficulties securing loans due to the credit crisis, which had an impact on the Philips' Healthcare division. This division, which is a major supplier to hospitals, was unable to compensate for the problems in the other divisions, which, in the past, have been more sensitive to market trends and fluctuations. Consequently there was a slight fall in Healthcare turnover. Perhaps surprisingly, the Consumer Lifestyle division performed well in 2009. The results for their kitchen appliances, tooth brushes and electric shavers were good. Contrary to previous years sales of television sets also contributed to the positive results. Outsourcing part of the production has proved beneficial.

In 2009 Philips Lighting was hit hard by the crisis in the building and construction sectors. This resulted in a modest positive operational result for a segment which used to be the company's 'cash cow'. However, Philips thinks that the rise of LED-lighting will allow the company to go back to higher profit levels and has high expectations for this market.

Fall in turnover, a lot of money in the bank
At the moment Philips' turnover is a serious cause for concern. Consumer Lifestyle is the weakest performer with a fall in turnover in 2009 of 17 percent, resulting in only moderate profitability. Lighting turnover dropped by 13 percent and dipped into the red. The new Philips is emulating the performance of other companies such as Honeywell and Johnson & Johnson. These are stable businesses which attract relatively conservative investors, enticed, in part, by a high dividend. Philips intends to keep its 2009 dividend at the 2008 level of EUR 0.70, meaning that EUR 200 million more than the 2009 annual profit will be paid out as dividend.

The company can afford to do this because its balance sheet shows a generous EUR 6.3 billion in liquidity, including EUR 4.4 billion in cash. This amount is around 20 percent of Philips' current market capitalisation, enough for 7 years of dividend. The question is how Philips will put this to use. As a result of the credit crunch the business has suspended a major programme for buying back its own shares and, for the first time in 14 years, Philips is now offering its shareholders a choice of receiving their dividends in shares or in cash.

Strategic plan required
Over the last few years the Consumer Lifestyle division has shrunk considerably, which is why the divisions have been approaching each other in size. Healthcare, the medical division, is expected to overtake Consumer Lifestyle as the biggest division soon. Together with Lighting it will be big enough to become Philips' core business. Philips should direct its investments towards these two divisions in order to become less sensitive to market trends. Without any major reorganisations Consumer Lifestyle, which includes television sets, will remain the 'problem child'.

The VEB is of the opinion that Philips should be clear about how they are going to face the challenging market circumstances, how turnover growth can be achieved, what their will growth focus be and what their specific targets for turnover and profitability will be. In 2007 Philips introduced Vision 2010. Now we have reached 2010, investors need another clearly developed growth strategy, Vision 2015 for instance.

Poor to average performance generously rewarded
The 2008 shareholders' meeting voted against the then proposed remuneration plan. Last year Philips introduced a revised long-term remuneration scheme consisting of both shares and stock options. Although this plan was approved, Philips keeps generously rewarding a below average performance. This appears from the annual report that was published on February 22.

Whereas Philips ranked eight (as regards Total Shareholder Return (TSR), stock market return and dividend) within a group of twelve competitors over the period December 2005 up to December 2008 board members still received 80 percent of the shares and 100 percent in options. According to the VEB no long term incentive should be awarded in case of below average performance. Therefore, the VEB suggests shareholders to take this issue into consideration when deciding on how to vote on the discharge of the Supervisory Board.
This long term incentive can even become higher. If board members still own the shares three years after allocation, they will get a bonus share (matching share) for every five shares. The VEB strongly objects to this free allocation of shares. The 'bonus' for retaining shares should be reflected in the results for these shares, as is the case with normal shareholders.

Furthermore, under the current incentive scheme board members still receive 80 percent of the options even if Philips performs very poorly (in the lower quartile). This implies a guaranteed bonus that is in no way related to operational performance. This is why the VEB voted against the remuneration plan last year. At this 2009 shareholders' meeting Philips indicated that it intends to hold its bonus scheme up to the light. The VEB is looking forward to the results of this review.

On behalf of the VEB NCVB (Dutch Investors' Association)

Jan Maarten Slagter, managing director

If you would like to respond to this letter, please email info@veb.net.