

# The Philips strategy: focusing on profitable growth

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**PHILIPS**

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At the Annual General Meeting of Shareholders of Royal Philips Electronics on March 30, 2006 in Amsterdam, Gerard Kleisterlee, President and CEO, gave an update on the Philips performance and the company's strategy focusing



on profitable growth. The worldwide interest in health and wellbeing and the growing significance of emerging economies were identified as major economic trends of which Philips is well positioned to benefit.

Ladies and Gentlemen,

I too would like to bid you a warm welcome to this meeting, also on behalf of my colleagues on the Board of Management.

It is good to meet our shareholders here once again. Following the publication of our annual results you know that 2005 was a successful year for our company. After a hesitant start, growth in sales, income and shareholder value went hand in hand in the second half of the year.

As usual after the publication of the annual results, I went on a roadshow, visiting institutional investors and analysts together with my colleague Pierre-Jean Sivignon. I encountered almost unanimous appreciation both for our strategy of making Philips a more market-driven and enterprising company, focusing on steady profitable growth in the areas of healthcare, lifestyle and technology, and for the consistent implementation of this policy and the good results that it is delivering.

This appreciation translates into growing interest on the part of investors and hence in concrete shareholder value, as witnessed by the 37% increase in the Philips share price in 2005.

### **Ongoing transformation**

In the past three years our results have shown a consistent improvement and we are convinced that our company is at the beginning of a long period where the focus will be on growth. Our transformation as a company, however, is not yet over – we can and we shall continue this process. In a rapidly changing world, that is the only way to seize the many new opportunities that present themselves. In this context, both our global presence and our regional spread are of great help to us. Did you know that in the whole world there are only a few large companies that achieve more than 20% but less than 50% of their sales in all three of the main economic regions, Europe, the United States of America and Asia? And Philips is one of those companies.

<b>PHILIPS</b>			
<b>Performance of the Philips Group<sup>1</sup></b>			
<i>EUR million</i>			
	2003	2004	2005
Sales	27,937	29,346	30,395
Sales incl. MDS	29,037	30,319	31,048
Earnings before tax and interest	502	1,586	1,779
Net income	695	2,836	2,868
Cash flow from operations	2,012	2,623	2,090
Net capital expenditures	(833)	(1,185)	(819)
Inventories as % of sales	11.1	10.7	11.4
Net debt to group equity	18 : 82	1 : 99	-5 : 105
Employees	164,438	161,586	159,226

<sup>1</sup> – Restated to reflect the intended sale of the MDS activities except employees

Our results for 2005 again represented a good step forwards. As stated, last year, top-line and bottom-line growth went hand in hand at Philips. Our sales increased by 4% in 2005 to more than thirty billion euros. Earnings before interest and taxes climbed to nearly 1.8 billion euros, an increase of

nearly 200 million compared with the previous year. This corresponds to a gross profit margin of 5.9%, and we expect that we shall achieve our target of operating at a profit margin of between 7 and 10% by the end of this year.

Last year I presented a management agenda to you with the following points:

- Grow Healthcare as part of the portfolio;
- Continue the transformation of Philips into a market driven organization;
- Focus on innovation across the Group;
- Reduce earnings volatility of cyclical businesses;
- Further simplifying Philips – reducing overall costs by an additional € 500M in savings (3-4 years).

I would like to report on what we have done to put it into practice.

### **Healthcare is our main growth area**

First of all, healthcare. Healthcare has now become the company's main area of growth. The sales of Medical Systems rose by 8% in 2005. We are achieving this growth primarily with innovative products, like our CT and MRI scanners, and new concepts such as our Ambient Experience solutions that help improve the treatment of patients in hospitals and raise productivity. In addition,

we are realizing growth through alliances and takeovers. Through our alliance with Schering we are extending our field of operations into optical imaging techniques, and we shall also further explore the promising field of molecular imaging together.

In the field of healthcare-related ICT, in particular in Picture Archiving and Communications Systems, or PACS, we are among the global front-runners as a result of the takeover of the American company Stentor in July last.

And in the field of Consumer Health and Wellness we announced in January the acquisition of the U.S. firm Lifeline Systems, a market leader in the field of medical alert systems for the elderly or people with a handicap who wish to go on living independently in their own home.

### **Market focus**

Ladies and Gentlemen, satisfied customers are the basis of success for every company. With the launch of "sense and simplicity"

we made a clear choice regarding the way in which we mainly intend to achieve that. In terms of brand awareness and brand value we are now seeing good results, reflected for instance in a 12-place move up the Global Brands Scoreboard of Business Week/Interbrand. But “sense and simplicity” also means greater simplicity in distribution, in our dealings with suppliers and customers, and in our own organizational structure. That is why “sense and simplicity” is much more than just an advertising campaign. “Sense and simplicity” defines the underlying principles of our transformation in all these fields, namely the three pillars: designed around you, advanced, easy to experience.

To improve our market focus even more, we are also working hard on business models that take greater account of the customer. For instance, we have set up an International Retail Board that oversees the relationships with our largest retail customers worldwide. This Board has already succeeded in increasing sales to our six

main customers by 25% in one year, while we won several awards, including “International Supplier of the Year” from our largest customer Wal-Mart.

### **Innovation is key**

Innovative new products form the basis of growth and profitability. This slide (see page 6) shows a selection of our market launches last year.

We are convinced that the combination of innovation and market focus is the key to profitable growth. In 2005, 49% of our sales consisted of products that had been launched less than two years earlier. This year we are aiming for 54%.

We made considerable progress last year in creating a more stable and more predictable profit flow. I am thinking here of the changes within CE and Semiconductors and the divestment of Mobile Display Systems. But the stability of our financial results has also been enhanced by the reduction of our stakes in volatile sectors through the sale



of part of our share in TSMC and LG.Philips LCD and our policy of acquisitions, such as Lumileds, Stentor and Lifeline.

Probably the most important step in the definitive transformation of Philips is our decision to create a separate legal structure

for Semiconductors. This is an important precondition for opening up various strategic options for this product division. Some of the markets in which the Semiconductor division operates will further consolidate in the coming years. Philips wants to play an active role in these developments rather



than just follow. At the same time we do not want to further increase Philips's exposure in this sector. Hence our pro-active strategy.

Making "One Philips" the foundation of the way we work enables us to share solutions more effectively throughout the company, to reduce the number of suppliers, and to deploy shared service centers for support functions. All this contributed to a cost reduction of 250 million euros in 2005, and we are convinced that we shall achieve or even exceed the savings target of 500 million euros by the year 2007.

Our strategic focus on sustainable, profitable growth within Healthcare, Lifestyle and Technology puts Philips in an excellent position to benefit from some of the major economic trends. First, the worldwide interest in health and wellbeing as the driving force behind the next phase of economic growth in the developed world. Second, the growing significance of the emerging economies of Brazil, Russia, India and China,

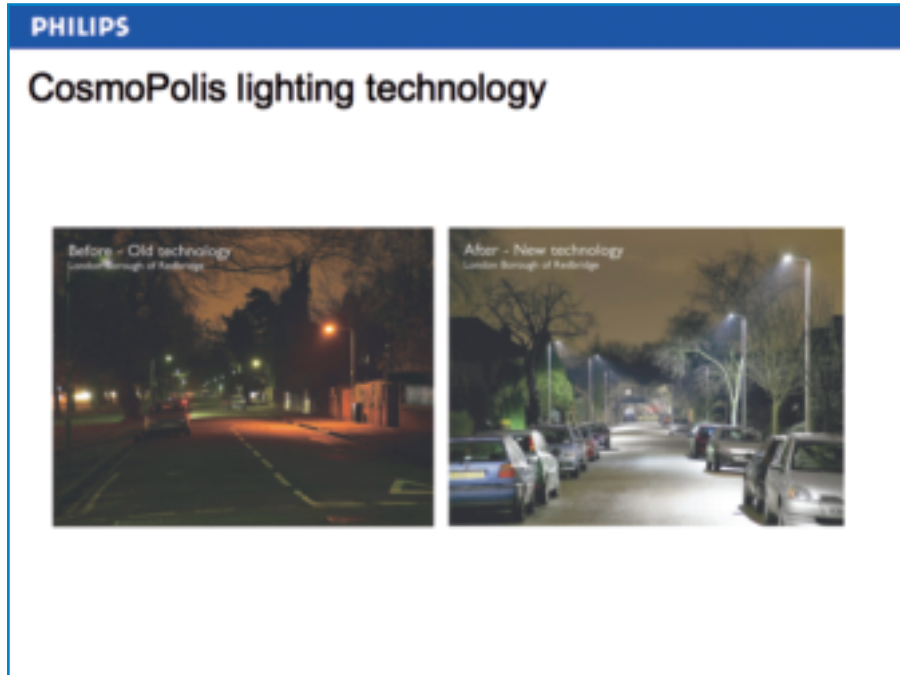
the so-called BRIC countries. And third, the question of global energy needs and the associated issue of CO<sub>2</sub> emissions.

### Energy saving lighting

Let me start with the last of these. No less than 75% of Europe's offices have environmentally-unfriendly, energy-wasting lighting of sub-optimum quality. More than 30% of the streets and roads in our continent are still lit by technology from the 1960s.

The lighting solutions offered by Philips, such as our CosmoPolis street lighting, provide substantial savings on electricity consumption. If our latest products for street, office, domestic and other lighting were now used throughout Europe, we would be saving about 4 billion euros a year in running costs and emitting about 28 million tons of CO<sub>2</sub> less – the equivalent of 12 medium-size power stations!

Unfortunately the changeover to new technologies is still proceeding too slowly in these sectors, although this changeover



could make a fundamental contribution to meeting Europe's obligations under the Kyoto Treaty. That is why Philips is working hard on innovative partnerships with governments to speed up this transition.

### **The next economic wave**

Macro-economists forecast that the focus on health and wellbeing will be one of the main drivers of the next phase of economic development. Whereas at present in the developed western world we spend on average about 10% of Gross National

Product on health, in the coming decades this will rise to 20% of the total economy. At the same time, the emphasis will shift from the curing to the earlier detection and prevention of illness through a healthier lifestyle and living environment, with greater personal responsibility for health, also in a financial sense. In other words, a broad-based approach to physical and mental wellbeing in general.

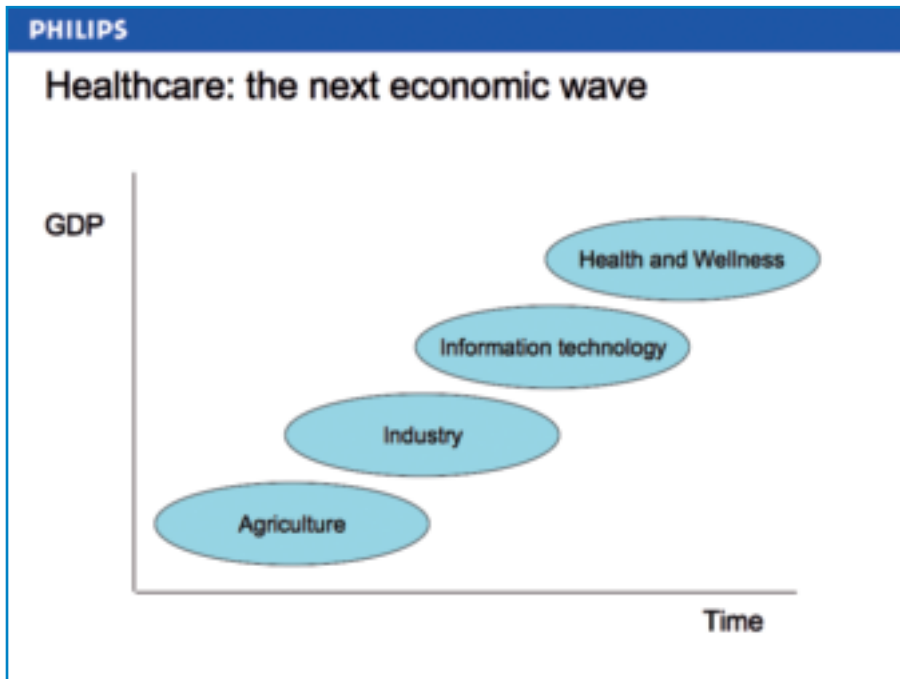
Philips has everything that is needed to play a leading role in the transformation of healthcare. In doing so, we can build on our technological expertise and the confidence that our brand inspires, but above all on what makes us unique: our focus on people as consumers, patients and care providers.

In this respect we are clearly more than just a supplier of medical systems. It goes without saying that hospitals are still extremely important to us. Our ambition, however, is to participate in the entire cycle of healthcare: prevention, early detection, diagnosis, treatment and remote care for patients in

their homes. Our positioning also fits in perfectly with the trend towards prevention as opposed to cure; and also the trend towards enhancing one's own health and wellbeing through one's own lifestyle and decisions. In the United States and in the Netherlands we have begun pilot projects involving remote monitoring via interactive broadband communication. With Lifeline we can enable elderly and handicapped people to continue to live independently in their own homes. The positive results of this approach have already led to a large number of project applications, particularly in Europe.

### Emerging markets

The second major development in the world economy is the growth of the emerging markets and in particular the rise of the BRIC economies. For example, the share of China, India, Brazil and Russia in the total world economy will increase in the coming two decades from 10% at present to 20%. They will then account for 40% of total global economic growth.



We are on the eve of a radical realignment of the world economy. And here too Philips is very well positioned. Our brand awareness in China, for example, is almost as great as in the Netherlands, and in 2003 and 2004 we were the largest foreign multinational in that country. In Brazil and

India, Philips has had a presence since the 1920s and we have leading market positions in virtually all the businesses in which we operate.

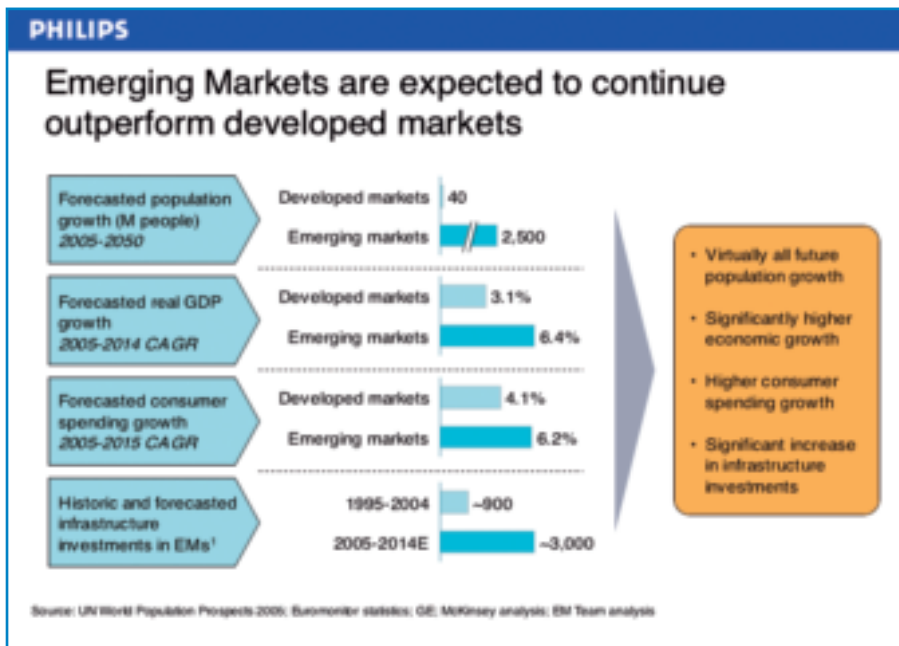
From March 1st to 3rd this year we had a meeting with 170 Philips managers in

Delhi in India. At this first Philips Summit we talked at length about our strategy for emerging markets. We also visited local companies and markets.

After this visit we are more convinced than ever that emerging markets can and should

make a crucial contribution to the profitable growth of our company.

Within the emerging markets there is a rapidly-growing middle class, but also the gigantic 'bottom of the pyramid', the majority of the world population who lack



real purchasing power. As far as both these groups are concerned, smart products and solutions tailored to specific needs could make a tremendous contribution to improving their lives.

### **Innovative business models**

Most of our discussions at the beginning of this month in India were on this theme: How should our company change in order to make the most of the opportunities that the emerging markets offer, particularly for this up-and-coming group of consumers? New forms of organization; new products; innovative business models; original channels of distribution – these are the things that are required.

We also have to overcome deep-rooted prejudices. In the emerging markets there are good opportunities for mass sales of low-price products. And, in this connection, low prices do not necessarily mean low margins. However, the products that are offered must be tailored to the specific needs of these prospective consumers, and that calls for new innovative approaches.

An example of an innovative market approach for the bottom of the pyramid is DISHA, Distance Healthcare Advancement. DISHA is a new form of access to healthcare for the rural population of India. In collaboration with local partners we have fitted out a bus with diagnostic and communications equipment. The bus travels over a large area and offers the population preventive health checks and medical treatment. DISHA illustrates how, together with partners, we are looking for new business models that meet local needs and fit local conditions.

Needless to say, this approach to emerging markets perfectly matches our philosophy of sustainability. For Philips, sustainable business practices not only mean that our company acts in a socially and environmentally responsible way. We want to do more. We also want to offer sustainable solutions to the large group of people who do not yet live at the level of prosperity that we are accustomed to. Sustainable for these consumers, but also sustainable for Philips.



### **Stimulating entrepreneurship**

Ladies and Gentlemen, growth can only be achieved by taking responsible risks. That is why we want to encourage entrepreneurship, and hence balanced risk-taking, within Philips.

In doing so, however, we shall never abandon financial discipline. We are not concerned with growth for the sake of

growth, but profitable growth in our core activities. After all, shareholder value is ultimately created on the bottom line, not on the top line.

Ladies and Gentlemen, we have once again prepared a management agenda for 2006 with clear targets designed to bring us a step closer to achieving our ambition:

- Realize 5 to 6% top-line growth and attain a 7 to 10% EBIT margin as from the end of 2006;
- Continue to grow healthcare as part of the portfolio;
- Accelerate movement to become a simpler, market-oriented organization;
- Set up a separate legal structure for Semiconductors and create value by pursuing strategic options;
- Increase the number of entrepreneurial business leaders with broad-based experience;
- Exceed our EUR 500 million overall cost reduction target within 2 to 3 years.

This is a concrete, simple, inspiring agenda. Now it is a matter of consistent and rigorous implementation.

Ladies and Gentlemen, I would not wish to conclude my remarks without mentioning the passing away of Frits Philips in December. For many people his death marked the end of an era. His ideas on the role of in-

dustry in society are still reflected, however, in our strategy of sustainability.

What I, and all those who knew him at Philips, will remember most is his warm-hearted and caring nature. We shall always remember him with gratitude.

A happier parting is that with Ad Huijser. After 36 years he is leaving Philips on April 1st to enjoy his retirement. Ad has been a member of the Group Management Committee since 1999, and for the last four years was on the Board of Management as Chief Technology Officer. Ad was a leader who was passionate about translating technology into success in the market. Under his leadership the efficiency of our R&D investments has been noticeably enhanced. I would like to thank Ad sincerely for the way in which he gave fresh impetus to our company's innovative drive.

As announced in December, we wish to propose to you that you appoint the five



CEOs of our divisions as members of the Board of Management. There is broad agreement among our top executives about the acceleration and deepening of our growth strategy. The chairmen of the divisions will play a crucial role in the implementation of this strategy and, furthermore, they represent the kind of entrepreneurship that we want to encourage in a growth-orientated Philips. That is why I am convinced that as members of the Board of Management the chairmen of the divisions will be in an even better position to contribute to our success. I am looking forward, therefore, to working together with them on the new Board of Management.

Ladies and Gentlemen, allow me to conclude my remarks.

Our results and our financial position form a solid basis for achieving our growth objectives. We shall concentrate on innovative products, on targeted acquisitions, on the opportunities in emerging markets. In the second half of 2005 in particular, there was

a noticeable acceleration of our growth. We are determined to strengthen this momentum in the coming years. In short, a lot remains to be done. Much has been achieved in the last few years and this motivates us to go further. We shall do everything possible to ensure that Philips can look forward to an even brighter future.

Thank you for your attention.



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