Philips Simply Makes Sense

by Henry W. Schacht, CFA
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Royal Philips Electronics (PHG) has a bad reputation. Investors know it as a sleepy, unwieldy Dutch conglomerate. Fortunately for Philips, the characterization no longer fits. Under the banner, "Sense and Simplicity", management has transformed the company. More investors should wake up to the opportunity.

Philips earned its reputation for mediocrity. In years past, the company's structure made no sense and was far from simple! But, in GE fashion, Philips has been shedding businesses with no competitive advantage and bulking up in core areas. This is capital reallocation on a massive scale and shareholders are the winners.

Philips shares are up 70% in the last 2 years to $41 a share. Despite the run, the shares should be much higher. Our price target is over $50.

The firm's current market value is $45 billion ($41 a share x 1.1 billion shares). With a 2007 P/E multiple of 18-20, few would argue that PHG is cheap given a cursory glance at the fundamentals. But just scratch the surface and Philips' beauty is revealed.

The first thing that leaps out is a cash balance of $8 billion or 18% of Philips' market capitalization. This is the result of assets sales in recent years whereby the company has pruned its divisions. For instance, last year, the company sold 80% of its Semiconductor business for $8 billion. It continues to hold a 20% or $2 billion stake.

This is far more than a Jack Welch formula at work, however. Philips has also been selling down financial assets accumulated during years of empire-building. There is a lot of work still to do. Despite aggressive sales, Philips' investment portfolio is still worth over $12 billion! Holdings include a 12.8% stake in Taiwan Semi (TSM) which alone is worth more than $6.5 billion.

In total, Philips asset sales have totaled $19 billion. Talk about trimming the fat!

Investors simply do not understand the scope (or the magnitude) of the changes at Philips. Either that or they just don't bother to look at the financials. The balance sheet is a thing of beauty. With $8 billion in cash, the semiconductor stake, and the investment portfolio, PHG has $22 billion in excess capital before debt!

If Philips paid off its $5 billion in debt and a pension liability, there would still be $16 billion in the bank. That's 30% of PHG's current market capitalization. Make this adjustment and the 2007 P/E multiple falls below 13.

So Philips has raised $19 billion. With "only" $8 billion left in the bank, what has Philips done with the proceeds so far? Well, 30% has gone towards acquisitions. Philips has purchased Sentor, Witt Biomedical, Lifeline and Intermagnetics to bolster its Medical division. Lighting has bulked up with the addition of Lumileds and PLI. The Consumer business has grown with the acquisition of Avent, a maker of baby care products. Another 5% of the cash has been used to pay down the aforementioned pension liability.

It is the remaining 65% that gets this analyst excited. This cash has been returned to shareholders via dividends and share repurchases. Philips recently increased its dividend (again) and announced a 4 billion euro share buy-back late last year. Over 10% of the total market value of Philips has been returned to shareholders in just one year!

So where are the investors? Management cannot be accused of their light (bulbs) under a basket. They plainly state in the company's Q1 presentation:

"With our portfolio now clearly defined, we will move forward with our shareholder-value-driven reallocation of capital. We will continue the responsible sell-down of our financial holdings while looking to make value-creating acquisitions in line with our strategic direction. We intend to complete our already-announced share buy-back programs by the end of the year."

Philips' management has recognized the possibilities and is seizing the moment. Cash flow and earnings will continue to grow with acquisitions providing a tailwind. Payouts of excess liquidity will slowly (but surely) reveal the business fundamentals buried underneath. In any case, the obscene undervaluation will get harder to ignore.

To recap, here is a "simple" model for illustration:

Philips Market Value			**$45 billion**
-	Cash	$ 8 billion	
-	Investments	$12 billion	**$16 billion in**
-	Semiconductor stake	$ 2 billion	**net excess capital**
+	Debt	$ 5 billion	
+	Pension liability	$ 1 billion	
= Operating Business Value			**$29 billion**
2007 Free Cash Flow estimate			$2.3 billion
Free Cash Flow multiple (unlevered)			12-13 times

The semiconductor business was Philips most inconsistent performer. If it is worth $10 billion in a private sale, then certainly the four remaining (and superior) businesses are worth more than $29 billion.

Disclosure: The author owned shares of Philips Electronics personally and on behalf of clients at the time of publication..

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