Case 9

BusinessWeek

Philips Maps Out a New Direction

1 Chief Executive Kleisterlee is refocusing the company on three primary markets, with new product lines and executive changes. Not long ago, Royal Philips Electronics was nowhere in the Chinese television market. But as liquid-crystal display technologies have taken hold, the Dutch conglomerate's flat-screen TV unit has shot up to the No. 2 spot in one of the world's fastest-growing economies. Markets change, says chief executive Gerard Kleisterlee, and so can Philips.

2 The affable but intense CEO, who took office in 2001, looks to have accomplished the impossible: turning around the once-lumbering electronics giant and putting it back on a growth track. Now, he has laid out his plan for the next step in Philips' long revival. At an Amsterdam press conference on Sept. 10, Kleisterlee unveiled a reorganization that will streamline the company into just three major units—and promises to double operating profits by 2010. Philips shares jumped 3.1% in Amsterdam trading on the news and closed up 4% in New York.

A MAKEOVER IN THE MAKING

3 Kleisterlee's makeover has indeed been impressive. When he took over, Philips had more than a half-dozen divisions that barely communicated—and often worked at cross-purposes. Its products spanned toasters, low-margin electronic components, and semiconductors. Kleisterlee launched a multiyear divestiture program, culminating with last year's successful spinout of the volatile chip unit for $10 billion to a group of private equity investors. Meanwhile, he has shelled out more than $6.6 billion during the past two years buying companies to fill out Philips' portfolio.

4 The result is a much more focused company that is now staking its future on three primary markets: health care, lighting, and consumer "lifestyle" products, such as small domestic appliances and consumer electronics. The simplification—and a high-profile marketing campaign—also has helped increase Philips' brand recognition. The company has jumped 23 notches since 2004 in the annual *BusinessWeek*/Interbrand global rankings, from No. 65 three years ago to No. 42 this year, while the value of its brand has soared 75%, to $7.7 billion, over the same period.

5 Kleisterlee also has emphasized market-driven innovation, with a particular focus on making Philips' myriad products easier to use. In *BusinessWeek*'s annual ranking of the world's most innovative companies, Philips jumped from No. 67 in 2006 to No. 38 this year. "Our focus on brand and innovation is paying off," Kleisterlee says.

BOTTOM-LINE (AND OTHER) IMPROVEMENTS

6 Yet for all his progress—including stemming a tide of red ink—the 61-year-old Kleisterlee hasn't been able to drive Philips' revenues through the €30 billion ($41.3 billion) mark, where they have stagnated for years, while also delivering the earnings growth demanded by investors. The reorganization, plus a continuation of Philips' aggressive acquisition strategy and a continued push into emerging markets, is designed to drive that growth. The CEO now says Philips will show at least 6% comparable annual sales growth for 2008–10, on average.

7 He's also looking for bottom-line improvements. Cost efficiencies from the simplified organization should save €150 million to €200 million ($207 million to $276 million). Add to that better margin management, increased profit contribution from recent acquisitions, and improvement in the product mix, and Kleisterlee figures pretax margins for the company's current businesses should exceed 10% by 2010. "This is one more big step—I'd like to think a giant step—in a long journey of transformation," he says.

8 The reorganization will create three core business sectors with a CEO in charge of each. As of Jan. 1, 2008, the existing Consumer Electronics unit will be merged with the Domestic Appliances & Personal Care unit into a new group called the Consumer Lifestyle sector. The main rationale for merging the two is to save on logistical and back-office costs, Philips says, while better meeting the demands of retailers that often sell products from both units.

9 The new group will be run by Andrea Ragnetti, an Italian marketing whiz recruited by Kleisterlee who has led the company's successful rebranding campaign over the last five years. Ragnetti is currently chief of the Domestic Appliances & Personal Care division, as well as chief marketing officer for Philips as a whole. It's not clear whether he'll retain the latter title when he takes charge of the new Consumer Lifestyle unit.

NEW DIVISIONS

10 Thanks to the introduction of new LCD TVs and related product lines, Philips should see good growth this year in consumer electronics, says investment bank Kempen & Co. That, plus the introduction of new domestic appliances such as shavers and an oral-care line, should drive 5% to 6% revenue growth for the combined unit.

11 The second major new division, called Philips Healthcare, will be formed from the merger of Philips' professionally-oriented Medical Systems unit and the former Consumer Healthcare Solutions, now redubbed Home Healthcare Solutions. The business, which should turn in 6% growth this year, will be run by Stephen Rusckowski, currently the CEO of Philips Medical Systems. Medical has been the big star for Philips in recent years, as it rides demographic trends and the increasing role of electronics in health care.

12 The third leg of the stool is Philips' huge lighting division, which produces everything from consumer bulbs to complex displays such as the hourly light show on the Eiffel Tower. Rudy Provoost, now CEO of the Consumer Electronics division, will move to the Philips Lighting sector, taking over from Theo van Deursen, who is set to retire on Apr. 1, 2008.

13 Far from the sleepy business it might appear, lighting is enmeshed in critical changes, such as the evolution from incandescent bulbs to light-emitting diodes. To attack the challenges, Philips acquired American solid-state lighting company Color Kinetics for $793.5 million last June. Overall, the lighting unit is expected to grow 6% this year.

REORGANIZATION OUTCOME?

14 Will the reorganization help Philips achieve its growth goals? Jan Willem Berghuis, a financial analyst at Kempen & Co., says he is convinced Philips can do it. The company has a debt-free balance sheet, so it could double earnings through acquisitions or share buybacks. Instead, it has said it plans to grow its operational margin from 7.5% to 10% organically by 2010. "That is quite a strong target," says Berghuis, "but they have more or less reached all their targets over the last three years, particularly in the medical field, and their track record is very good."

15 Others aren't as convinced. Paul O'Donovan, a consumer electronics analyst in the London office of technology consultancy Gartner, wonders whether Philips can meet its targets. "I can't point to something they have done recently that convinces me that they are on

this path to success," O'Donovan says. He considers Philips "a very clever, very innovative company with lots of good products," but calls it slow, "not fleet of foot like a Samsung."

16 The company still has branding challenges to overcome, as well. In the U.S., some people still think Philips makes Milk of Magnesia or screwdrivers. Complicating matters, Philips products in North America are marketed under a range of names, including Norelco razors, Sonicare toothbrushes, and Magnavox audio and video systems.

17 Counting on emerging markets for growth isn't a sure bet either, says Donovan. In China, for instance, Philips' recent triumph in LCD TVs could be short-lived if Chinese makers increase their local capacity and take back the market. Kleisterlee aims to stay ahead by developing brand loyalty and aspirational products. But as he well knows, though market change is good, it's also a double-edged sword.