21 January 2015 │ 39 pages

Electrical Equipment
Western Europe │ Netherlands

Philips (PHG.AS)

Buy – HealthTech Should Drive Re-rating Part 2

■ Estimate Change

- **Healthcare Deep Dive** – This report is the Part 2 to our October 2014 Deep Dive report on *Philips (PHG.AS)* that focused on why HealthTech should re-rate. In the Part 2 we do a deep dive on the long-term fundamentals of the Healthcare industry (66% of HealthTech sales and 70% of adj. EBITA, on our 2015 forecasts).

- **Buy, TP €33** – Philips is a key Buy across our sector and is part of the Citi Focus List Europe. Since 2013 CMD (Sep 18), when Philips 2016 EBITA margin target of 11-12% missed market expectations, Philips has underperformed the market (DJSTOXX) by >10% on the back of significant downgrades (2015 consensus EPS cut by 23%) partly driven by Cleveland facility shutdown, significant FX headwinds and partly by weakening demand in Healthcare and Lighting. We believe that Philips is at a cross roads and expect outperformance. We lower our adj. 2014-15E EPS by c15% due to a move of Lumileds and Automotive Lighting into discontinued operations, the underlying EPS downgrade is around 2%. Our SOTP TP is €33.

- **What's New?** – Financieele Dagblad reported this Tuesday there was substantial joint interest in Philips Lighting Solutions from Private Equity firms KKR and CVC, valuing the business at €9.5bn (c.1.3x 2015E EV/Sales and c13x EV/EBITA), above our €8.4bn implied EV. The headlines on Bloomberg suggest that this relates only to Lighting Solutions. Worth noting that both KKR and CVC (Reuters: Nov 2014) were among the four Private Equity firms bidding for Lumileds components business with indicative offers valuing the business between €2.5-€3bn (EV/EBITDA of 8.6x-10.3x) vs. our implied EV of €2.5bn.

- **Under-Estimated Healthcare Secular Growth** – According to Deloitte total global health spending is expected to accelerate to an av. growth of 5.3% over 2014-2017, up from 2-3% growth during 2012-2013. The share of global GDP spent on healthcare could almost double to 20% by 2040 (from 10.5% today). We see long-term structural growth attractions emerging on the back of evolving US and China Healthcare reforms as well as challenges from disruptive technologies.

Buy	**1**
Price (20 Jan 15)	€25.33
Target price	€33.00
Expected share price return	30.3%
Expected dividend yield	3.2%
Expected total return	**33.5%**
Market Cap	€23,674M
	US$27,475M

Price Performance
(RIC: PHG.AS, BB: PHIA NA)

Philips (EUR)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales (€M)	24,788.0	23,329.0	21,362.6	22,299.3	23,256.0
Net Income (€M)	1,341.0	1,457.5	1,176.0	1,516.0	1,810.1
Basic EPS (€)	1.45	1.60	1.28	1.65	1.97
Basic EPS (Old) (€)	1.45	1.60	1.53	1.95	2.05
PE (x)	17.4	15.8	19.8	15.4	12.9
EV/EBITDA (x)	6.6	6.6	7.5	6.4	5.7
DPS (€)	0.75	0.80	0.80	0.80	0.80
Net Div Yield (%)	3.0	3.2	3.2	3.2	3.2

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PHG.AS: Fiscal year end 31-Dec | **Price: €25.33; TP: €33.00; Market Cap: €23,679m; Recomm: Buy**

Profit & Loss (€m)	**2012**	**2013**	**2014E**	**2015E**	**2016E**
Sales revenue	24,788	23,329	21,363	22,299	23,256
Cost of sales	-17,027	-13,642	-14,842	-14,114	-14,414
Gross profit	7,761	9,687	6,521	8,185	8,842
Gross Margin (%)	31.3	41.5	30.5	36.7	38.0
EBITDA (Adj)	**3,742**	**3,749**	**3,363**	**3,921**	**4,304**
EBITDA Margin (Adj) (%)	15.1	16.1	15.7	17.6	18.5
Depreciation	-971	-888	-1,166	-1,132	-1,154
Amortisation	-472	-461	-334	-393	-396
EBIT (Adj)	**2,299**	**2,400**	**1,863**	**2,396**	**2,754**
EBIT Margin (Adj) (%)	9.3	10.3	8.7	10.7	11.8
Net interest	-246	-330	-300	-280	-230
Associates	-214	-25	67	0	0
Non-op/Except	0	0	0	0	0
Pre-tax profit	**570**	**1,635**	**285**	**1,640**	**2,077**
Tax	-308	-466	-61	-459	-582
Extraord./Min.Int./Pref.div.	-36	-1	125	-3	-3
Reported net profit	**226**	**1,168**	**349**	**1,178**	**1,493**
Net Margin (%)	0.9	5.0	1.6	5.3	6.4
Core NPAT	1,341	1,458	1,176	1,516	1,810
Per share data	**2012**	**2013**	**2014E**	**2015E**	**2016E**
Reported EPS (€)	0.24	1.28	0.40	1.34	1.69
Core EPS (€)	1.45	1.60	1.33	1.72	2.05
DPS (€)	0.75	0.80	0.80	0.80	0.80
CFPS (€)	2.39	0.93	1.65	2.67	3.06
FCFPS (€)	1.36	-0.27	0.51	1.48	1.87
BVPS (€)	12.24	12.31	12.00	12.03	12.85
Wtd avg ord shares (m)	922	911	919	919	919
Wtd avg diluted shares (m)	926	911	882	882	882
Growth rates	**2012**	**2013**	**2014E**	**2015E**	**2016E**
Sales revenue (%)	9.8	-5.9	-8.4	4.4	4.3
EBIT (Adj) (%)	31.2	4.4	-22.4	28.6	14.9
Core NPAT (%)	104.8	8.7	-19.3	28.9	19.4
Core EPS (%)	111.3	10.5	-16.7	28.9	19.4
Balance Sheet (€m)	**2012**	**2013**	**2014E**	**2015E**	**2016E**
Cash & cash equiv.	3,834	2,465	1,796	2,321	3,157
Accounts receivables	5,199	5,769	5,994	6,219	6,444
Inventory	3,495	3,240	3,465	3,690	3,915
Net fixed & other tangibles	2,959	2,780	2,420	2,224	2,364
Goodwill & intangibles	10,679	9,766	9,625	9,345	8,704
Financial & other assets	2,913	2,539	2,682	2,758	2,834
Total assets	**29,079**	**26,559**	**25,982**	**26,557**	**27,418**
Accounts payable	3,039	2,605	2,755	2,905	3,055
Short-term debt	809	592	592	592	592
Long-term debt	3,725	3,309	3,309	3,309	3,309
Provisions & other liab	10,332	8,826	8,726	8,676	8,626
Total liabilities	**17,905**	**15,332**	**15,382**	**15,482**	**15,582**
Shareholders' equity	11,140	11,214	10,584	11,056	11,814
Minority interests	34	13	16	19	22
Total equity	**11,174**	**11,227**	**10,600**	**11,075**	**11,836**
Net debt (Adj)	**700**	**1,436**	**2,105**	**1,580**	**744**
Net debt to equity (Adj) (%)	6.3	12.8	19.9	14.3	6.3

Valuation ratios	**2012**	**2013**	**2014E**	**2015E**	**2016E**
PE (x)	17.5	15.8	19.0	14.7	12.3
PB (x)	2.1	2.1	2.1	2.1	2.0
EV/EBITDA (x)	6.6	6.6	7.5	6.4	5.7
FCF yield (%)	5.4	-1.1	2.0	5.8	7.4
Dividend yield (%)	3.0	3.2	3.2	3.2	3.2
Payout ratio (%)	52	50	60	47	39
ROE (%)	1.9	10.5	3.2	10.9	13.1
Cashflow (€m)	**2012**	**2013**	**2014E**	**2015E**	**2016E**
EBITDA	2,473	3,339	2,018	3,445	3,857
Working capital	542	-1,417	-300	-300	-300
Other	-799	-1,076	-267	-789	-862
Operating cashflow	**2,216**	**846**	**1,452**	**2,356**	**2,696**
Capex	-958	-1,094	-999	-1,049	-1,049
Net acq/disposals	36	97	0	0	0
Other	-234	-101	0	0	0
Investing cashflow	**-1,156**	**-1,098**	**-999**	**-1,049**	**-1,049**
Dividends paid	-255	-272	-706	-706	-735
Financing cashflow	**-1,036**	**-98**	**-37**	**-1,231**	**-1,571**
Net change in cash	**24**	**-350**	**416**	**76**	**76**
Free cashflow to s/holders	**1,258**	**-248**	**453**	**1,307**	**1,647**

For definitions of the items in this table, please click here.

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Investment Summary

We reiterate our Buy recommendation on Philips and our Target Price of €33/share. Our target price methodology is based on SOTP following the company's announcement on September 23 to break-up the group into two companies: "New Philips" – HealthTech (Healthcare and Consumer Lifestyle) and Lighting Solutions (with all options being considered).

Philips is at a crossroads, and we believe it is set to outperform, driven by both earnings upgrades as we look into 2015 and multiple re-rating on the back of Automotive/Lumileds Lighting disposals expected in the first half of 2015, and more importantly the split of its Lighting Solutions business by the end of 2016.

Part 1 of *Philips (PHG.AS)* Deep Dive report was focused on why HealthTech should re-rate. HealthTech has considerably higher growth and returns profile than Philips. HealthTech's addressable market, the size of which is over €100bn, is growing at mid to high single digits compared to Philip's organic growth average of 2% over the past 10 years. 10 year adjusted EBITA margin for HealthTech has been on average at 10% compared to 7% that of Philips. We expect an adj EBITA margin 14.6% (excluding central costs) in 2015E and 15.5% by 2016E, which is at the top end of the company guidance range of 14-15.5%. In addition, HealthTec's ROIC would improve to over 16% on our estimates compared to 14-15% at Philips. As such we think the HealthTech business merits a multiple of 12x EV/EBITA. This should bring it closer to its Healthcare and Consumer Staples peer group valuation.

Figure 1. SOTP Valuation (based on our 2015 forecasts)

Sum of the Parts	Sales	EBITA	EBITA Margin	Sales Multiple	EBITA Multiple	Comment	EV	Per Share
Base Case	2015E	2015E	2015E					919.3
HealthTech (pro-forma)	14,588	2,068	14.2%	1.8	12.5	peer group average EV/EBITA	25,849	28.12
Lighting Solutions	7,199	812	11.3%	1.2	10.3	peer group average EV/EBITA	8,363	9.10
Lumileds and Automotive Lighting Business	1338	127	9.5%	1.9	20.0	lower end of indicative offers of €2.5-3bn in the press	2,542	2.77
IG&S	630	(338)	nm	nm	10.0	10x EV/EBITA multiple	(3,380)	(3.68)
Value	23,755	2,669	11.2%	1.4	12.5		33,375	36.30
Net cash (debt)							(1,580)	-1.72
Masimo law suit provision (after tax benefit)							(264)	
Net pension deficit							(1,616)	-1.76
Minority interests							(36)	
TOTAL							29,879	33

Source: Citi Research

This report is the Part 2 to our October 2014 Deep Dive report on *Philips (PHG.AS)* that focused on why HealthTech should re-rate. In the Part 2 we do a deep dive on the long-term fundamentals of the Healthcare industry (66% of HealthTech sales and 70% of adj. EBITA, on our 2015 forecasts).

Forecasts Changes

We lower our adj. 2014-15E EPS by c15% due to a move of Lumileds and Automotive Lighting into discontinued operations, the underlying EPS downgrade is around 2% on the back of the recent profit warning. Worth noting our forecasts now include Volcano acquisition.

Figure 2. Philips forecast changes

	Previous Forecasts		Current Forecasts		Change in Forecasts	
EUR mn	2015	2016	2015	2016	2015	2016
Sales	23,985	24,968	22,299	23,256	-7.0%	-6.9%
Adjusted EBITA	2,750	3,067	2,496	2,854	-9.2%	-6.9%
Basic EPS cont ops	1.95	2.05	1.65	1.97	-15.4%	-4.0%

Source: Citi Research

Citi vs. Consensus:

Figure 3. 2016E Forecasts – Citi vs. Consensus (note Consensus is pre-profit warning issued in January 2015)

2016E (EUR mn)	Citi	Consensus	% diff
Sales			
Healthcare	10,028	10,091	-1%
Consumer Lifestyle	5,234	5,280	-1%
Lighting	7,364	7,375	0%
Innovation, Group & Services	630	598	5%
Total Sales	**23,256**	**23,344**	**0%**
Reported EBITA			
Healthcare	1,614	1,534	5%
Consumer Lifestyle	691	652	6%
Lighting	736	663	11%
Innovation, Group & Services	-338	-308	10%
Total EBITA	**2,703**	**2,541**	**6%**
Reported EBITA margin			
Healthcare	16.1%	15.2%	89 bps
Consumer Lifestyle	13.2%	12.3%	86 bps
Lighting	10.0%	9.0%	101 bps
EBITA margin	**11.6%**	**10.9%**	**74 bps**
Adjusted EBITA			
Healthcare	1,649	1,562	6%
Consumer Lifestyle	696	661	5%
Lighting	817	736	11%
Innovation, Group & Services	-308	-256	20%
Total adjusted EBITA	**2,854**	**2,703**	**6%**
Adjusted EBITA margin			
Healthcare	16.4%	15.5%	96 bps
Consumer Lifestyle	13.3%	12.5%	78 bps
Lighting	11.1%	10.0%	112 bps
EBITA margin	**12.3%**	**11.6%**	**69 bps**

Source: Citi Research, Philips for consensus data

2016 Targets Reiterated, Upside Scope Beyond 2016

In the longer-term (by 2016, Figure 4) we expect a continuing transformation at Philips through ongoing cost-reduction programme as the 'fuel for growth' as well as cultural change and standardization of business models. Philips by the end of 2016 is now targeting to achieve €1.8bn cost savings (raised at the recent Capital Markets Day) from previously targeted €1.5bn (by the end of 1H14 Philips has achieved cumulative cost savings of €1.144bn). This is the fourth time Philips raised its cost savings target guidance since the progamme started in 3Q11. The company targets an (reported) EBITA margin of 11-12% (vs. 10.5% in 2013) on a comparable sales CAGR of 4-6% (4.5%) and ROIC of >14% (15.3% in 2013). Philips under the stewardship of the CEO, Frans van Houten, has already successfully delivered on restructuring achieving targets in 2013 (set in 2011) despite much lower GDP growth than the company anticipated at the time of the target setting, currency headwinds and a change in pension accounting. We believe there is further upside scope beyond 2016, with full potential not fully reflected in both our and consensus forecasts.

Figure 4. Philips – 2016 Group Financial Targets

Group financial targets 2016	Achieved in 2013	YTD (9M14)	Philips 2016 Target	Comment	Citi 2016 Forecast	***Consensus 2016 Forecast
Group comparable sales growth	4-6% (CAGR)	0%	4-6%	revised from previous target of 4-6%	3% CAGR over 2014–2016	
Group reported EBITA margin	10.50%	9.1%*	11-12%		11.6%	10.9%
HealthTech		5.7%	14-15.5%	excluding IG&S cost allocation	15.10%	
Healthcare	15.80%	3.6%	16-17%	excluding IG&S cost allocation	16.10%	15.20%
Consumer Lifestyle	10.50%	10.1%	11-13%	excluding IG&S cost allocation	13.20%	12.30%
Lighting Solutions	8.30%	7.4%	9-11%	excluding IG&S cost allocation	10.00%	9.00%
Group ROIC	**15.3% (vs. negative ROIC in 2011)	13.2%^	>14%	group ROIC (excluding M&A impact);	14.10%	

* adjusted for currency and Cleveland (which combined accounted for 210bps negative impact)

^excluding Masimo impact

** Note: HealthTech ROIC is well above the current Group target (ROIC 1H2014 Healthcare 11%; Consumer Lifestyle 29%)

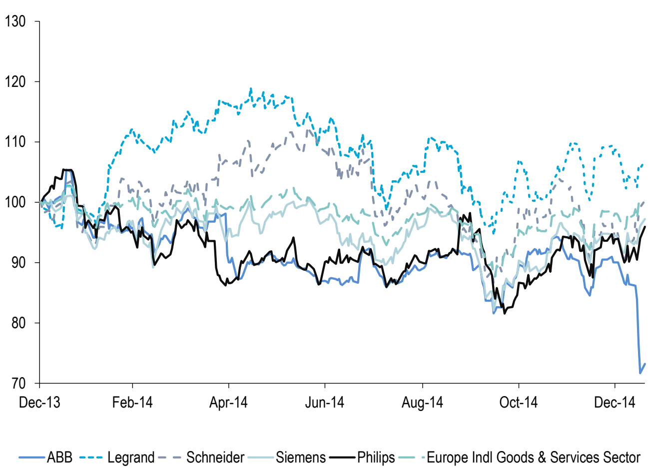
*** Note Consensus is pre-profit warning issued in January 2015)

Source: Company reports, Citi Research, Philips for consensus data

Valuation

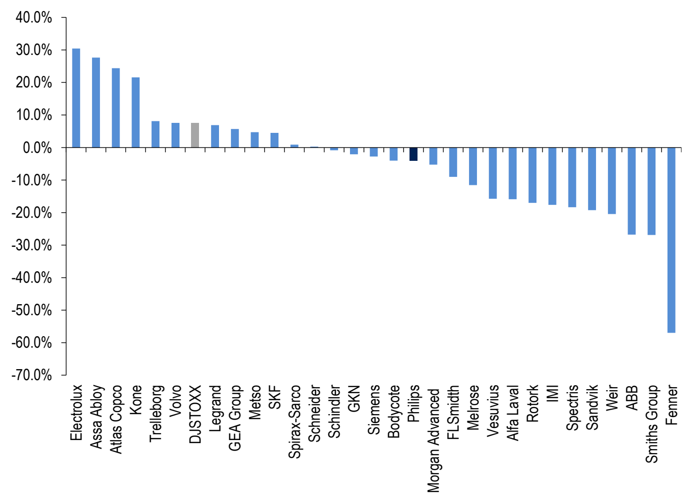
Philips' share price since Jan'14 is now down 4.1% in absolute terms and has underperformed the market (DJSTOXX) by >10%. Underperformance has been driven by significant downgrades. Consensus EPS has been cut by c23% for 2015 on the back of (1) issues faced in the Healthcare Cleveland factory; (2) softer demand in Healthcare (weaker than anticipated demand in the developed market and China); (3) structural decline in the conventional lighting (as a result of a rapid shift away from incandescent bulbs to more energy-efficient LEDs) with Philips now expecting the market to decline by 10% p.a. compared to a previous guidance of high-single digit growth; and 4) considerable FX headwinds.

Figure 5. European Electricals Absolute Share Price Performance YTD (rebased at 100)



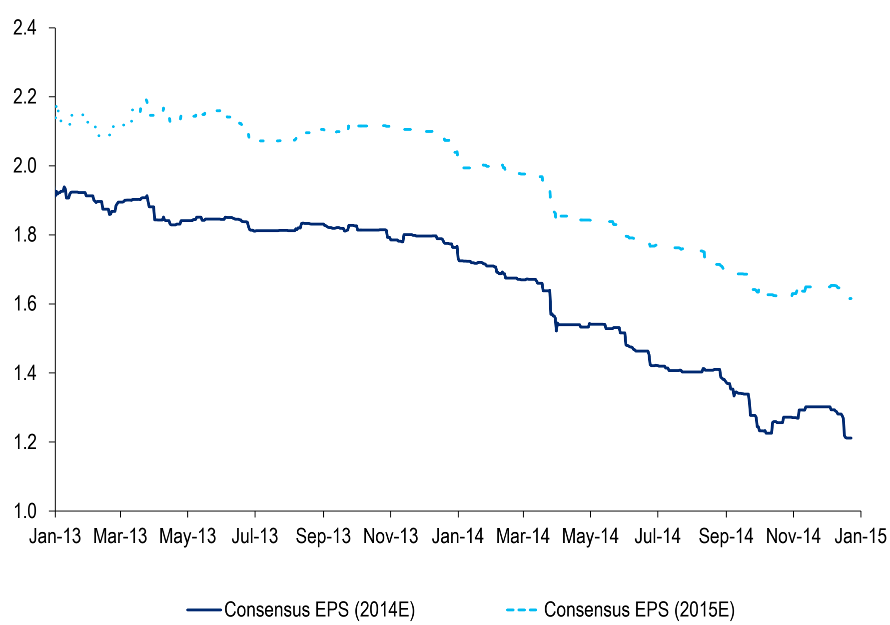
Source: Datastream

Figure 6. Pan European Sector Share Price Performance YTD Relative to the Market (DJSTOXX)



Source: Datastream

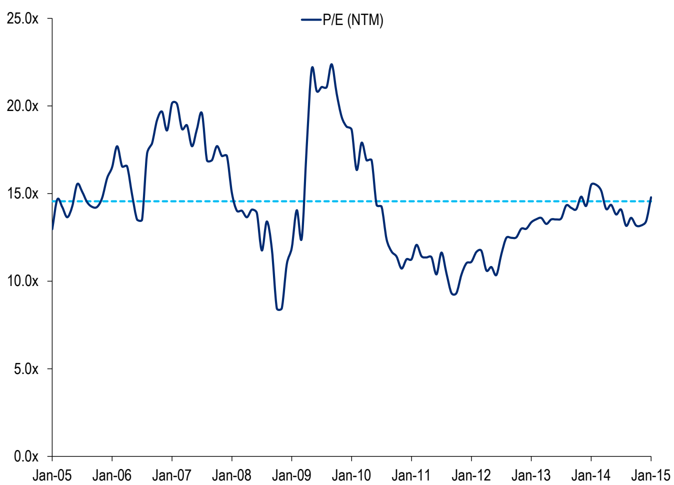
Figure 7. Philips Consensus EPS by Year (€)



Source: Bloomberg

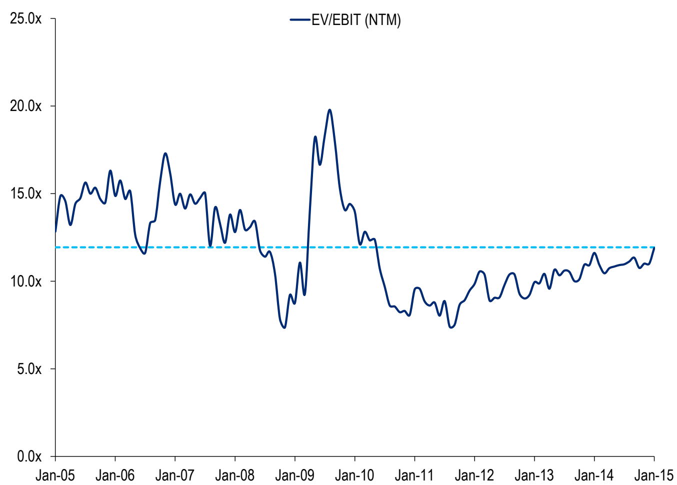
The Philips valuation, in our view, is attractive both relative to history and our Pan European Capital Goods sector and its peers. The company is trading on a P/E of 15.4x 15E, 12.9x 16E and EV/EBIT 12.2x 2015E, 10.1x 2016E compared to its historical 10-year averages of NTM P/E and NTM EV/EBIT of 14.8x and 11.9x respectively. The business has gone through numerous changes over the past decade and as such the comparison to history might be difficult. However, even relative to our Pan European sector Philips is trading on a 10% discount on a 2016E P/E basis and a 7% discount on an 2016E EV/EBIT basis. An EV/Sales of 1.1x 2015E also looks attractive against our 12% EBITA margin forecast in 2016 (company guidance: 11-12%). Combined with a dividend yield of 3.1%, we believe the valuation case is compelling.

Figure 8. 10-Year Historic Valuation - P/E



Source: Citi Research, Datastream

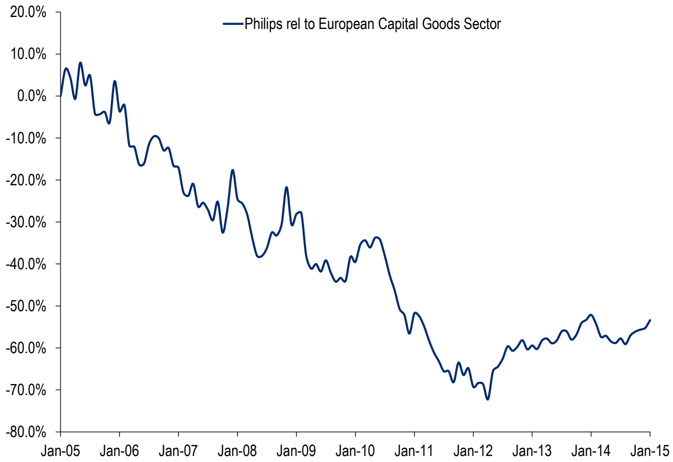
Figure 9. 10-Year Historic Valuation - EV/EBIT



Source: Citi Research, Datastream

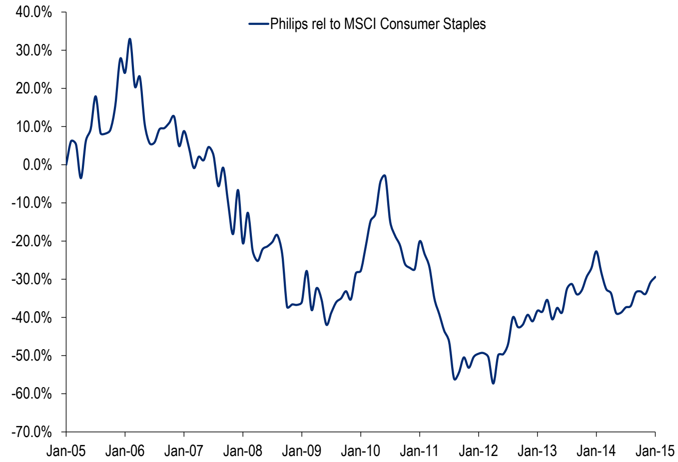
We view the move as a significant strategic shake-up which has potential to create value for shareholders through a re-rating of Philips' core businesses, which we believe should trade on more than 12x EV/EBITA multiple (Philips is currently trading on 10.1x, on our 2016 forecasts) as well as removal of the traditional conglomerate discount (10 year average historic discount for European Capital Goods sector and MSCI Consumer Staples Index, at >50% and >25% discount respectively).

Figure 10. Philips at a discount relative to Capital Goods peers



Source: Datastream

Figure 11. Philips at a discount relative to MSCI Consumer Staples



Source: Datastream

Relative to the sector Philips is trading on a 10% discount on a 2016E P/E basis and a 7% discount on an 2016E EV/EBIT basis. Relative to the peers Philips is trading on a 15% discount on a P/E basis and a 14% discount on an EV/EBIT basis.

Figure 12. Peer valuation – Philips trading at a discount

Company Name	Currency	Price	Rating	EV/Sales			EV/EBIT			P/E			EBIT margin		
				2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E
Electricals															
ABB	USD	19.3	(2)	1.2x	1.2x	1.1x	10.8x	11.1x	9.6x	16.4x	16.7x	14.2x	10.7%	10.4%	11.8%
Legrand	EUR	43.1	(2)	2.8x	2.7x	2.5x	14.4x	13.5x	12.6x	21.7x	20.2x	18.5x	19.5%	19.9%	20.2%
Schneider	EUR	64.6	(2)	1.8x	1.7x	1.6x	14.6x	13.0x	11.6x	16.0x	14.6x	13.4x	12.0%	13.0%	13.5%
Siemens	EUR	97.8	(1)	1.4x	1.3x	1.2x	15.0x	13.9x	11.4x	13.2x	13.1x	12.1x	9.7%	9.9%	10.9%
Healthcare															
Agfa-Gevaert	EUR	2.1	-	0.2x	0.2x	0.2x	3.9x	3.8x	3.6x	5.6x	4.7x	4.9x	5.7%	5.9%	6.2%
All Scripts Healthcare	USD	12.4	-	2.0x	1.9x	1.8x	132.8x	40.4x	26.6x	39.1x	25.9x	20.4x	1.5%	4.7%	6.6%
Cerner	USD	65.6	(1)	6.3x	5.4x	4.7x	27.2x	21.5x	18.1x	38.9x	32.2x	28.0x	23.3%	25.2%	26.0%
Elekta	SEK	85.5		3.3x	2.9x	2.7x	21.3x	14.9x	14.7x	27.2x	20.5x	17.9x	15.5%	19.7%	18.4%
Express Scripts	USD	85.4	(1)	0.7x	0.7x	0.6x	18.8x	15.4x	12.8x	17.2x	15.3x	13.8x	3.8%	4.4%	5.0%
Getinge	SEK	172.0		2.2x	2.1x	2.1x	20.5x	14.0x	12.2x	17.6x	13.8x	12.1x	11.0%	15.2%	16.8%
Hologic	USD	29.0		4.6x	4.5x	4.3x	32.3x	16.7x	17.2x	18.9x	18.5x	16.6x	14.1%	26.8%	25.1%
Mindray	USD	27.2	(1)	2.4x	2.0x	1.7x	13.3x	11.0x	9.4x	14.0x	12.7x	11.3x	18.0%	18.2%	18.3%
McKesson	USD	74.4		2.5x	2.5x	2.4x	17.5x	16.4x	15.8x	21.9x	20.6x	19.0x	14.5%	15.0%	15.1%
Siemens	EUR	97.8	(1)	1.3x	1.2x	1.1x	13.4x	12.6x	10.4x	13.2x	13.1x	12.1x	9.7%	9.9%	10.9%
Varian	USD	87.6		2.7x	2.6x	2.4x	14.7x	12.7x	11.7x	21.8x	19.7x	17.4x	18.5%	20.2%	20.5%
Consumer Staples															
Europe Consumer Staples	EUR	226.8		1.8x	1.7x	1.6x	-	-	-	19.0x	17.6x	16.1x	-	-	-
US Consumer Staples	USD	507.6		1.5x	1.4x	1.4x	-	-	-	20.0x	18.3x	16.7x	-	-	-
Asia Consumer Staples	USD	177.5		1.2x	1.1x	1.1x	-	-	-	21.5x	19.2x	17.3x	-	-	-
Lighting															
Acuity	USD	150.6		2.5x	2.2x	2.0x	20.1x	15.9x	12.9x	34.1x	27.0x	23.2x	12.6%	14.0%	15.8%
Cree	USD	30.9		1.6x	1.5x	1.4x	32.5x	34.1x	20.0x	24.2x	26.8x	19.2x	4.8%	4.4%	6.7%
Fagerhult	SEK	139.8		1.7x	1.6x	1.5x	16.2x	14.4x	13.3x	19.9x	17.5x	15.9x	10.7%	11.2%	11.6%
Hubbell	USD	104.7		1.8x	1.8x	1.7x	12.0x	11.3x	10.3x	19.5x	17.8x	16.0x	15.3%	15.6%	16.3%
Osram	EUR	38.4	(1)	0.8x	0.8x	0.8x	10.1x	8.9x	8.0x	14.6x	13.5x	12.4x	8.2%	8.8%	9.5%
Zumtobel	EUR	18.8		0.7x	0.7x	0.7x	19.8x	12.0x	9.0x	20.5x	14.8x	10.5x	3.8%	6.1%	7.7%
LED and Automotive															
Autoliv	USD	102.1	(2)	1.0x	1.0x	1.0x	10.8x	10.7x	9.9x	17.7x	15.5x	13.9x	9.0%	9.4%	9.8%
Continental	EUR	191.9	(1)	1.3x	1.1x	1.0x	11.3x	9.6x	8.8x	15.1x	13.1x	12.4x	11.2%	11.9%	11.9%
ElringKlinger	EUR	30.3		1.8x	1.7x	1.6x	13.8x	12.3x	11.1x	17.0x	15.5x	13.7x	12.8%	13.5%	14.1%
Everlight	TWD	73.1	(1)	0.9x	0.7x	0.6x	10.5x	7.9x	6.2x	15.1x	12.6x	10.1x	8.5%	8.9%	9.8%
LG Innotek	KRW	109500.0	(3)	0.6x	0.6x	0.5x	13.3x	12.2x	10.8x	19.1x	16.7x	14.8x	4.8%	4.6%	4.8%
Lite-On	TWD	39.7		0.4x	0.3x	0.3x	10.5x	8.3x	7.3x	13.1x	10.8x	9.7x	3.4%	4.0%	4.4%
Sanan Optoelectronics	CNY	17.0		7.8x	5.6x	4.2x	26.3x	20.7x	17.5x	26.9x	19.7x	15.2x	29.7%	27.2%	24.1%
Toyoda Gosel	JPY	2488.0		0.5x	0.5x	0.4x	8.1x	7.9x	7.3x	18.1x	13.0x	11.9x	5.9%	5.8%	6.0%
Valeo	EUR	116.6	(1)	0.9x	0.7x	0.6x	12.1x	9.1x	8.0x	15.7x	12.1x	10.8x	7.1%	7.9%	8.1%
Average															
Electricals				**1.8x**	**1.7x**	**1.6x**	**13.4x**	**12.6x**	**11.1x**	**16.8x**	**16.1x**	**14.6x**	**13.0%**	**13.3%**	**14.1%**
Healthcare				**2.6x**	**2.4x**	**2.2x**	**28.7x**	**16.3x**	**13.9x**	**21.4x**	**17.9x**	**15.8x**	**12.3%**	**15.0%**	**15.4%**
Consumer Staples				**1.5x**	**1.4x**	**1.4x**	**-**	**-**	**-**	**20.2x**	**18.4x**	**16.7x**	**-**	**-**	**-**
Lighting				**1.5x**	**1.4x**	**1.3x**	**18.4x**	**16.1x**	**12.2x**	**22.1x**	**19.6x**	**16.2x**	**9.2%**	**10.0%**	**11.3%**
LED and Automotive				**1.7x**	**1.4x**	**1.1x**	**13.0x**	**11.0x**	**9.7x**	**17.5x**	**14.3x**	**12.5x**	**10.3%**	**10.4%**	**10.3%**
Philips	**EUR**	**25.44**	**(1)**	**1.2x**	**1.1x**	**1.1x**	**16.1x**	**12.2x**	**10.1x**	**19.9x**	**15.4x**	**12.9x**	**7.6%**	**9.4%**	**10.6%**

Source: Citi Research, Bloomberg consensus

Note: Share prices as of 19 January 2015

We believe risk/reward is attractive against (1) levelling off downgrades; (2) significant portfolio shake-up, which we believe will be value-accretive; (3) ongoing transformation journey (cultural change, change a way of working, standardization of business models); 4) ongoing cost-reduction programme as the 'fuel for growth' and (5) attractive secular long-term growth story especially in Healthcare. We see the current share price as an attractive entry point.

SOTP Valuation

We set our €33 target price at our SOTP fair value following the announcement of a strategic shift that will see the set up of two companies by 2016: the "New Philips", HealthTech, and Lighting Solutions (all options being considered).

Figure 13. SOTP Valuation (based on our 2015 forecasts)

Sum of the Parts	**Sales**	**EBITA**	**EBITA Margin**	**Sales Multiple**	**EBITA Multiple**	**Comment**	**EV**	**Per Share**
Base Case	2015E	2015E	2015E					919.3
HealthTech (pro-forma)	14,588	2,068	14.2%	1.8	12.5	peer group average EV/EBITA	25,849	28.12
Lighting Solutions	7,199	812	11.3%	1.2	10.3	peer group average EV/EBITA	8,363	9.10
Lumileds and Automotive Lighting Business	1338	127	9.5%	1.9	20.0	lower end of indicative offers of €2.5-3bn in the press	2,542	2.77
IG&S	630	(338)	nm	nm	10.0	10x EV/EBITA multiple	(3,380)	(3.68)
Value	23,755	2,669	11.2%	1.4	12.5		33,375	36.30
Net cash (debt)							(1,580)	-1.72
Masimo law suit provision (after tax benefit)							(264)	
Net pension deficit							(1,616)	-1.76
Minority interests							(36)	
TOTAL							29,879	**33**

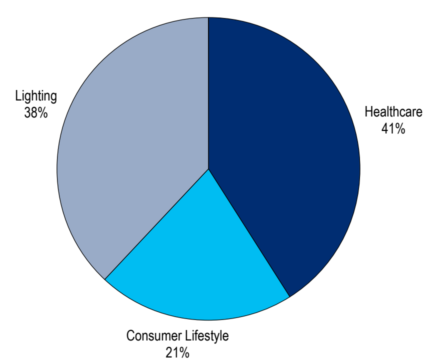
Source: Citi Research

Old Philips vs. New Philips

The new structure will see Philips combine its Healthcare and Consumer Lifestyle businesses to form a new company under the banner HealthTech by 2016. Over the same time period a Lighting Solutions company will be formed and in the interim Philips will be selling a majority stake in its Lumileds/Automotive business.

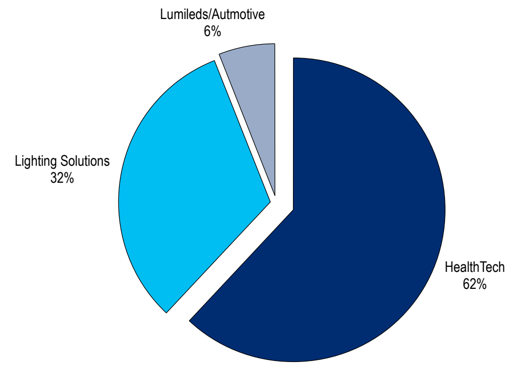
Lifestyle (HealthTech) will run parallel to the sale process of the previously announced Lumileds/Automotive Lighting business, which is expected to be completed by 1H15.

Figure 14. Old Philips structure



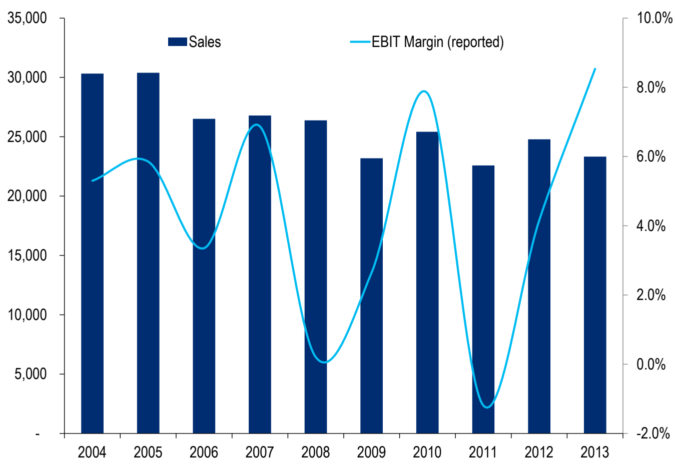
Source: Company reports, Citi Research

Figure 15. New Philips structure



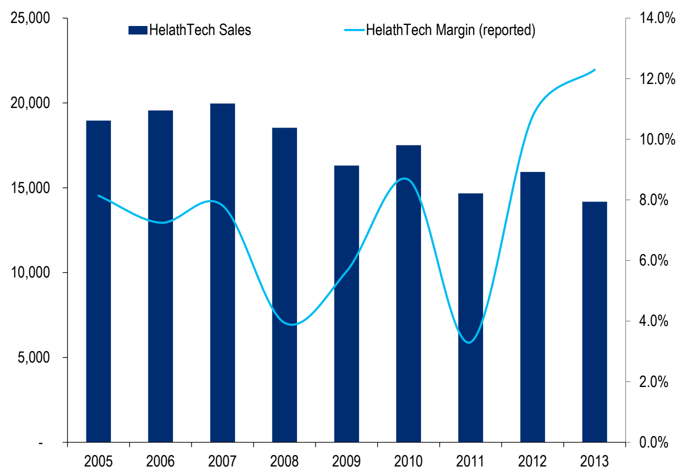
Source: Company reports, Citi Research

Figure 16. Philips sales and margins over period (EUR mn)



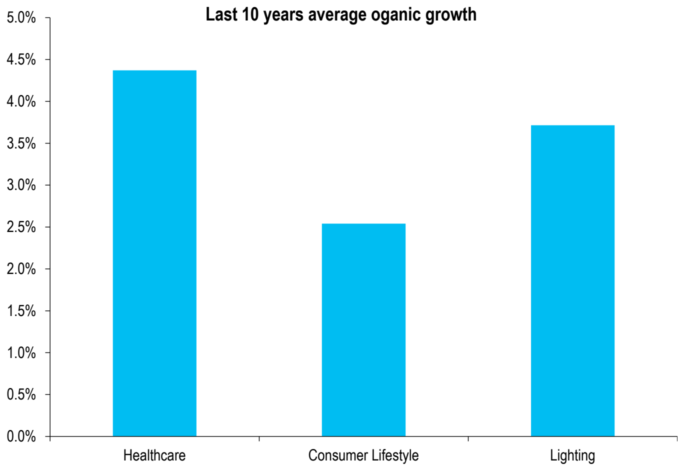
Source: Company reports, Citi Research

Figure 17. HealthTech sales and margins over period (EUR mn)



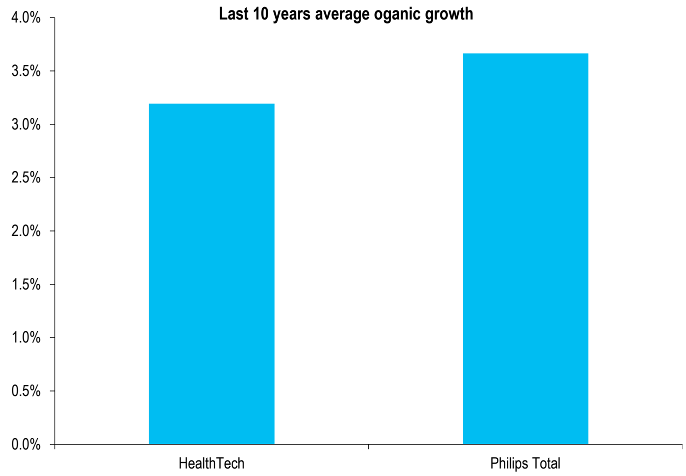
Source: Company reports, Citi Research

Figure 18. Philips divisional organic sales growth (10 year avg)



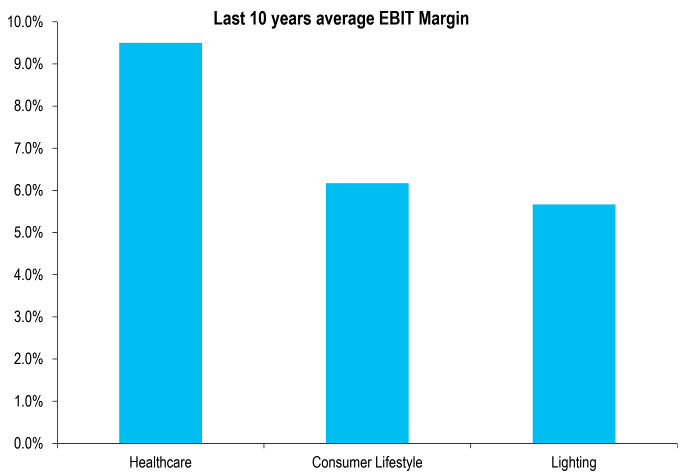
Source: Company reports, Citi Research

Figure 19. Philips HealthTech and total organic growth (10 year avg)



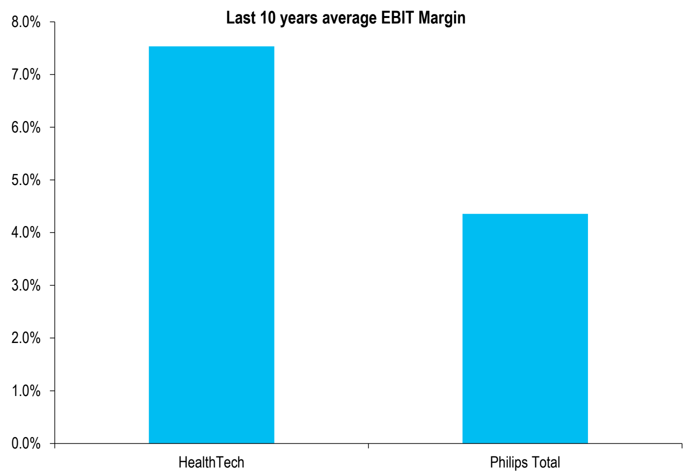
Source: Company reports, Citi Research

Figure 20. Last 10 year average EBIT Margin for divisions



Source: Company reports, Citi Research

Figure 21. Last 10 year average EBIT Margin for HealthTech and Philips



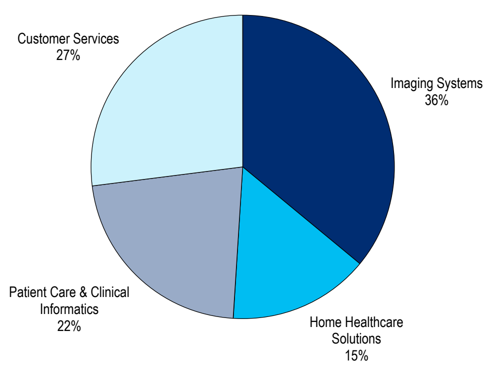
Source: Company reports, Citi Research

Philips Healthcare

We view the Healthcare business as the crown jewel of Philips and the business has been a good example of value creation by management. In 1998, the group focused capital resources on the medical imaging, monitoring and picture archiving markets. Over the next decade Philips has built the business through a number of acquisitions and has managed to build top three positions in all markets and a unique position in home healthcare solutions. The overall Healthcare business accounts for c.40% of Philips sales and is by far the biggest driver of group earnings at c.60% of EBITA.

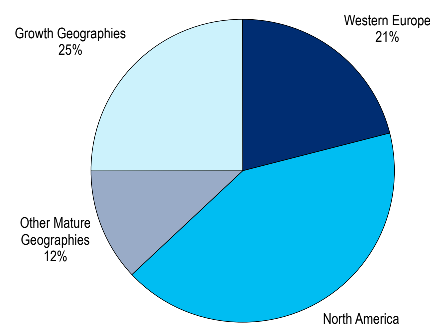
The business is the #3 medical solutions group globally. The business mix consists of imaging equipment, home healthcare solutions, patient care and clinical informatics and customer services. The imaging systems business is the largest within the division and Philips here is able to offer products in all major technology areas which include MRI, CT scanners and general x-ray. We estimate Philips has a market share of c.21% in the imaging market (3rd position). The biggest and most important geographical regions for is North America at 42% followed by other growth geographies at 25%.

Figure 22. Healthcare Business Split (LTM June 2014)



Source: Citi Research and Company Reports

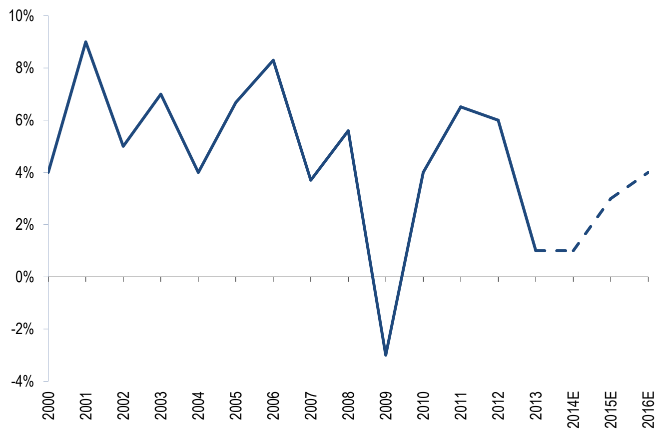
Figure 23. Healthcare Geographical Split (LTM June 2014)



Source: Citi Research and Company Reports

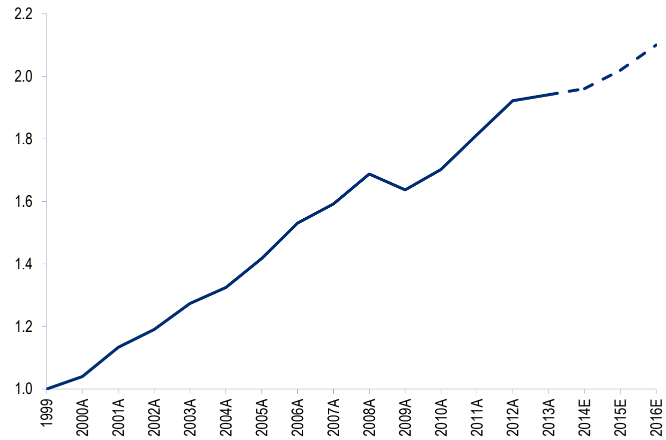
Philips Healthcare business has been a steady grower, with the only year of negative growth being 2009. Organic growth in the business has generally fluctuated between 4-8% for most of the last decade, although has been moving towards the lower end of this range since 2006.

Figure 24. Philips Healthcare Organic Sales Growth History



Source: Citi Research and Company Reports

Figure 25. Philips Healthcare Organic Sales Index (Indexed to 1.00 in 1999)



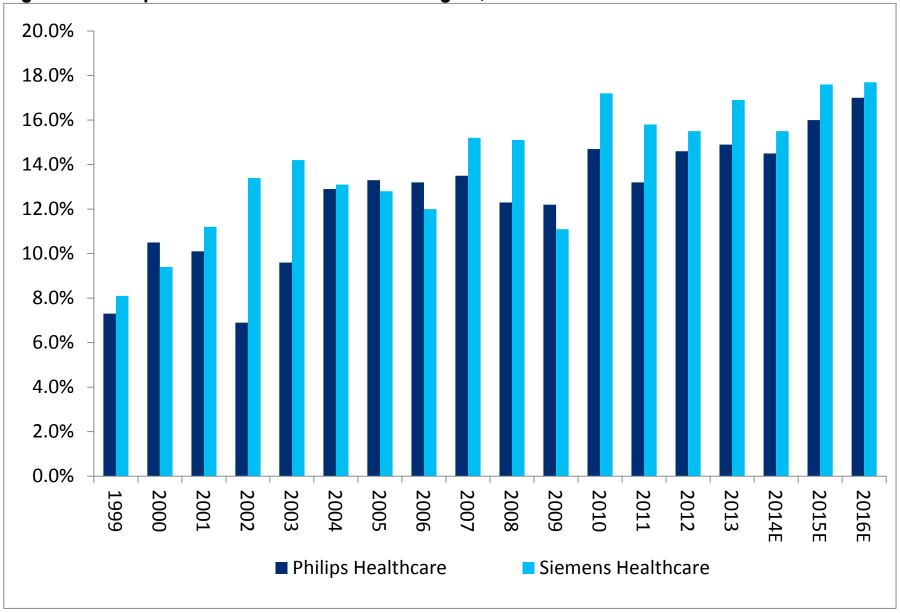
Source: Citi Research and Company Reports

Margins Can Go Higher

Healthcare has been one of the more consistent underlying margin performers for Philips over the past 5 years. Divisional management has been successful in being able to offset ongoing pricing pressure of c.3-4% in the imaging market as well as more recent headwinds such as the medical device tax. The business delivered record Adj EBITA margins of 14.9% in 2013.

Despite this, in terms of margins, Philips is running slightly below its peers (Siemens) at present. Although the business mixes do vary we believe an effort to step up to an equivalent share in Imaging as these peers, as Philips is targeting, combined with some volume recovery in the US, could be a medium term positive and can see margins trend higher. This should, however, be taken in the context of ongoing pricing pressure at c.3-4% in the imaging market.

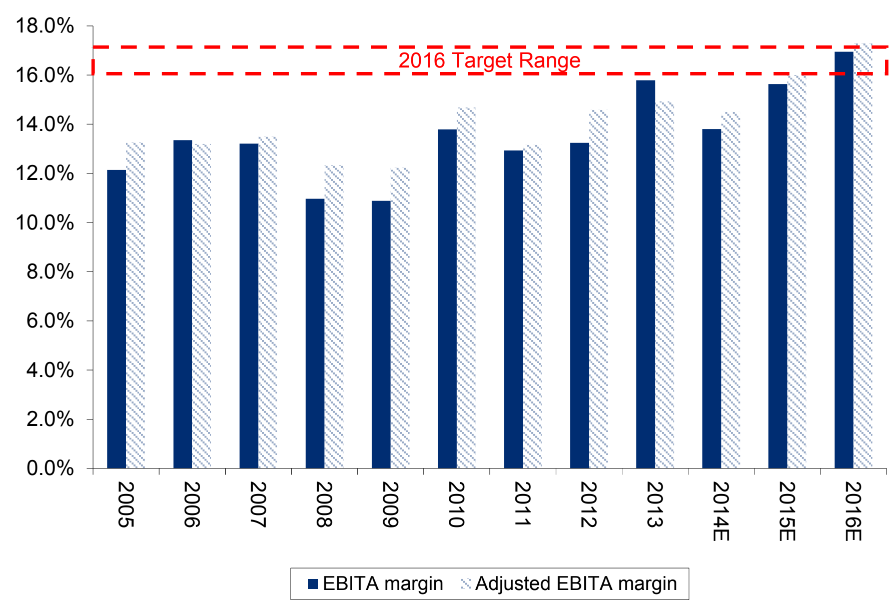
Figure 26. Philips and Siemens Healthcare Margins, 1999-2016E



Source: Citi Research and Company Reports

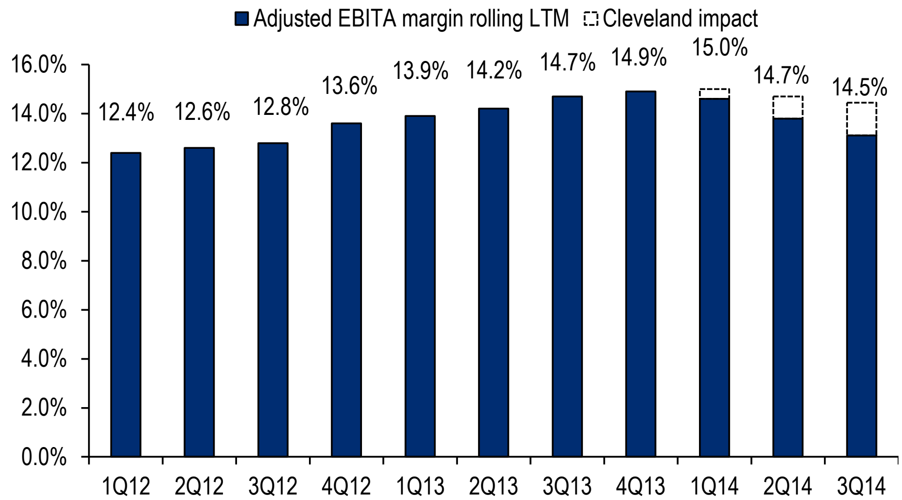
Under the 2016 targets, Philips is targeting an EBITA margin for Healthcare for 16-17% after having achieving 15.8% in 2013. The performance YTD has been negatively impacted by charges related to the self-imposed Cleveland facility shutdown, further by FX headwinds and lower volume growth. Following a drop out of these headwinds and improving volume growth we expect margins to recover from 2015 and Philips to reach the higher end of its targeted range by 2016.

Figure 27. Healthcare Adjusted and Reported EBITA Margin, 2005-2016E



Source: Company reports, Citi Research

Figure 28. Healthcare – Adjusted EBITA Margins (Excluding Cleveland Impact)



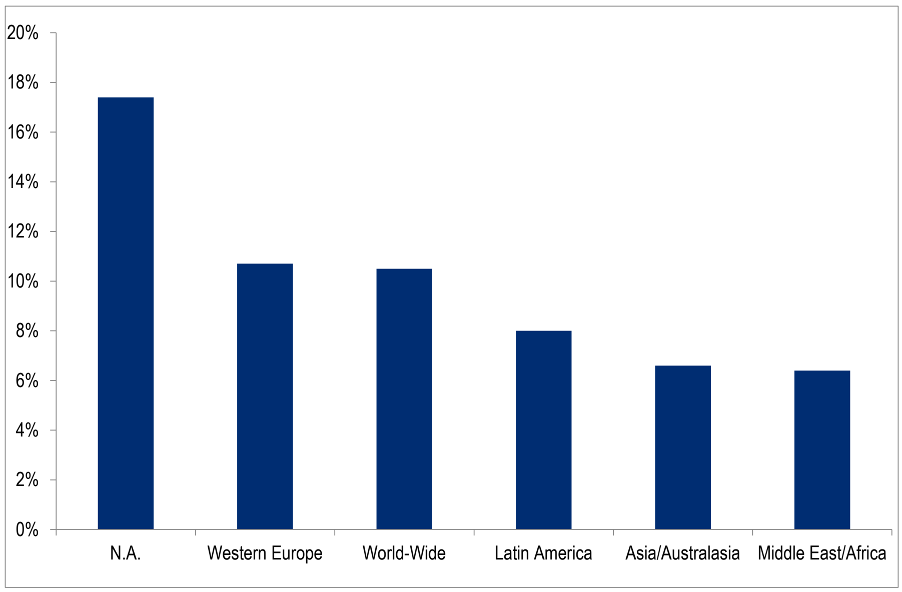
Source: Company Data

Healthcare Capex Outlook

The industry outlook below is based on the studies done by Deloitte, World Bank, Deloitte, Economist Intelligence Unit, Ministry of Health, KPMG, GE Capital Survey, Citi Proprietary Surveys and Citi Research.

According to Deloitte total global health spending is expect to accelerate to an average growth of 5.3% over 2014-2017, up from 2.6% in 2013 and 1.9% in 2012, and compared to GDP of 2.8% and IP of 3.6%. Given population growth, this implies global healthcare spending per head is projected to rise by an average of 4.4% per year from 2014-2017. Healthcare accounted for 10.5% of global GDP over the past 2 years making it one of high cost industry sectors. According to the World Bank, healthcare spending in developed countries is the second-largest category of government spending.

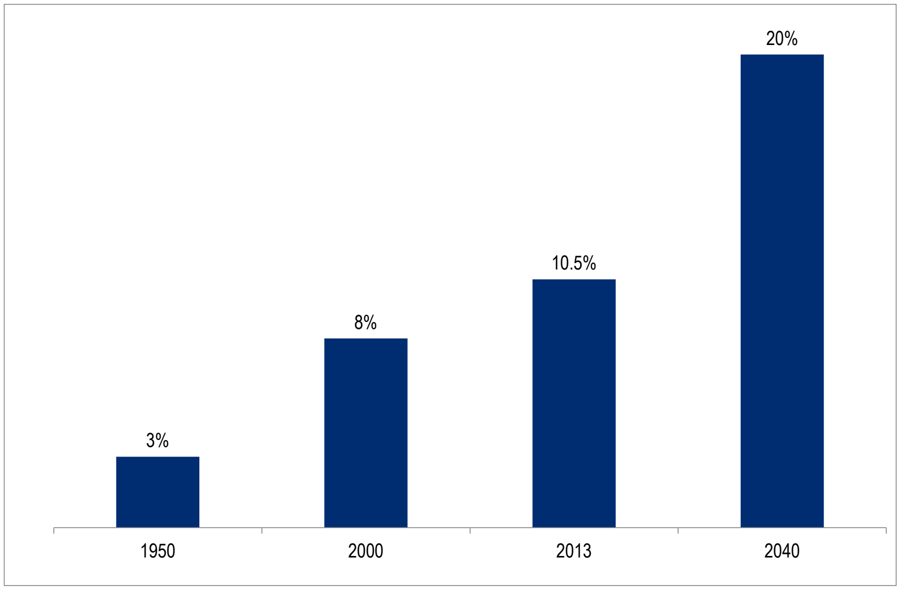
Figure 29. Healthcare spend as a percentage of GDP (in 2014)



Source: World Bank, Citi Research

The share of global GDP spent on healthcare has risen progressively from c.3% in 1950 to 10.5% today and is forecasted to reach 20% by 2040.

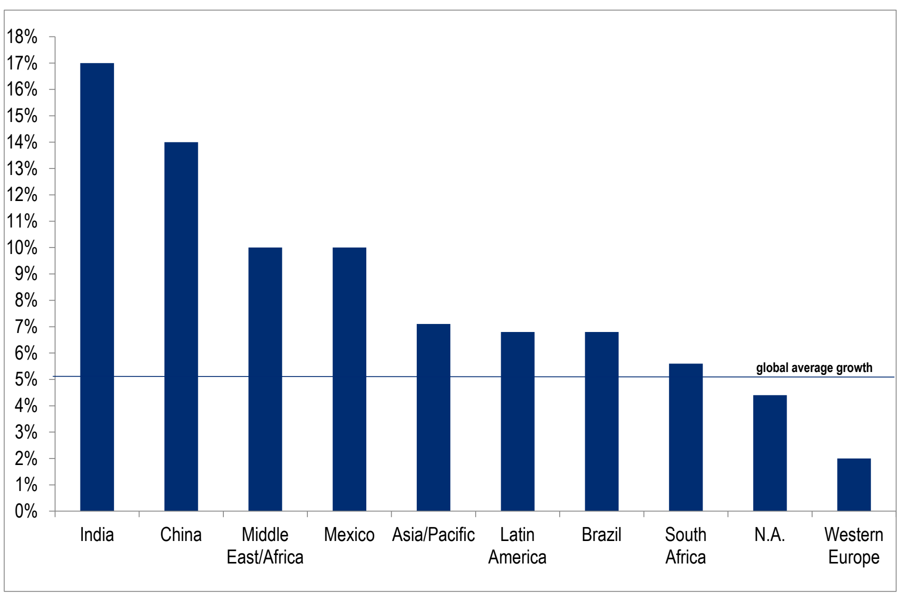
Figure 30. Global healthcare spend as a % of GDP



Source: World Bank, Citi Research

Geographically, healthcare spending in Asia-Pacific is expected to grow at a rate of 7.1% from 2013-2017, driven by: (i) rollout of public health care systems; (ii) growing consumer wealth; and (iii) lifestyle changes. With rising number of high-income households (earning annually > $25,000), up by around 10% to over 500 million world-wide (of which over 50% of that growth is to come from Asia) governments in many emerging markets are planning to roll out public health care services to meet consumers' rising expectations. Healthcare spending in India and China is estimated to grow at CAGR of 17% and over 14% per year, respectively, during 2013-2017.

Figure 31. Healthcare spending average annual growth estimated during 2013-2017 by region



Source: Deloitte, World Healthcare Outlook, Economist Intelligence Unit, August 14, 2013, Citi Research

Figure 32. Regional healthcare outlook

Region	CAGR)	Drivers	Issues/ Challenges
North America	4.4%		
United States	~3.6%	Health insurance coverage expansion due to ACA (Affordable Care Act) and Medicaid	Implementation of ACA, margin preservation, consolidation, moving from volume to value based care, technology driven transformation, growing consumer power, managing expectations
Canada	-	Aging population, advance of chronic diseases	Cost management and alternative revenue creation
Mexico	10.2%	Fiscal reform bill which Mexico's congress passed on November 1, 2013	Insufficient health infrastructure, poor distribution of resources, limited public-private partnerships, low quality health services
Latin America			
Brazil	-	Government policies aimed at extending the availability of medicines to low-income consumers	Defining best practices for the physician payment model, the public system is financially stressed, lack of standardized processes
Europe			
Germany	2.8%	Aging population (population aged 65 or older is likely to exceed 20% by 2017), better infrastructure	Falling number of healthcare graduates, cost containment and process optimization, demands for increased transparency around clinical quality and patient outcomes
United Kingdom	~4.4%	Aging population	Constraints on government spending, growing demand for services driven by the U.K.'s aging population and the increasing burden of chronic and lifestyle-related diseases
Asia Pacific	7.1%		
Australia	~0.1%	Aging population, treatment and technology advances, consumers' increasing awareness of health-related issues	Funding, provider reimbursement, regulatory uncertainty, and rapid technological change
China	13.8%	Rapidly rising income level, dramatic increase in Internet and mobile phone usage, aging population, urbanization	Cost management, quality improvement
India	~15.8%	Increasing sales of generic medicines, continued growth in chronic therapies, greater penetration in rural markets, heightened health awareness, increasing affluence, changing lifestyles, increasing government expenditure	Inadequate primary health care infrastructure, high out-of-pocket-expenditure by patients
Japan	2.7%	Aging population (People >65 make up one fourth of Japan's total population and the number of elderly is expected to reach about 35 million by 2025)	Control spending, cost management
Southeast Asia		Non-traditional, innovative health care business models, services, and geographic expansion	Need to control runaway health care costs, meeting citizens' demands for fair and equitable access to universal care/coverage
Middle East	10.0%	Growing and aging population, increasing total health care expenditures per capita, continually improving health care standards; governments' increasing investments in technological advancements and health awareness	To provide a framework that enables the private sector to participate more fully in the health care system and supplement state systems
Africa			
South Africa	8.8%	Communicable diseases, aging population, rising incidence of chronic diseases	A double burden of disease, with communicable disease putting strain on the health care system alongside growing instances of non-communicable disease

Source: Deloitte, Citi Research

North America – US Healthcare Reform

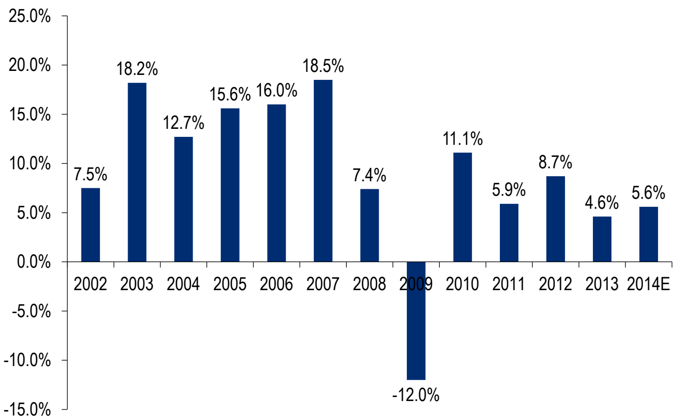
Healthcare spending is expected to have CAGR of 4.4% over 2013-17, partly assisted by the health insurance coverage expansion due to ACA (Affordable Care Act) and Medicaid. However, the implementation of ACA could pose an upside risk. (e.g. problems in the rollout of the federally operated health insurance exchange)

The US is the largest healthcare spender in the world with $2.8 trillion in 2012 (17.2% of GDP). Healthcare spending growth rates since 2009 to 2012 range bound between 3.6%-3.8%. US healthcare spending has remained pressured over the past 2-3 years following fiscal uncertainties and the adoption of the Affordable Care Act (ACA). These factors have both combined to cause uncertainties on development of the medical equipment market for suppliers. ACA implementation could pose challenges for the US Healthcare Reform which could include: i) margin protection, ii) consolidation, iii) moving from volume- to value-based care, iv) technological transformation as well as v) increasing growing consumer power. The ACA combines expanded federal-state health care program, Medicaid, and an individual health insurance mandate covering around 30 million previously uninsured people. The goal is to reach coverage from around 85% of the population today to around 95% by 2019 in an attempt to slow rapidly rising health care costs. Private spending is about 50% of overall spending in the US, which is a relatively high rate by international standards.

According to the recent survey by GE Capital (published on 14th January, 2015) 45% of respondents said implementing the Affordable Care Act (ACA) is the greatest challenge facing the healthcare industry in 2015 followed by regulatory oversight and US economy. Majority of the survey respondents (68%) anticipate their business to perform more strongly in 2015 compared with 2014. With regards to the growth strategies, most of healthcare industry leaders will focus on revitalizing and upgrading existing offerings and buying and/or merging with existing businesses and to a lesser degree. Only 25% are planning to launch new segments or lines of business in 2015. With regards to capex in 2015, majority (67%) of survey participants expect capex to remain unchanged and 27% said they would be significantly higher.

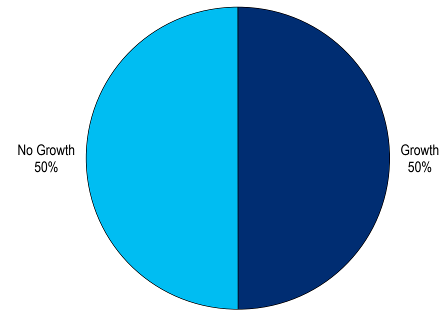
Despite a somewhat slow start to the year, data from our US Healthcare team's annual proprietary nonprofit hospital survey suggests we are close to approaching an inflection point in US hospital capex (*2014 Annual Nonprofit Hospital Survey*). Although respondents were cautious regarding the impacts of Obamacare the survey still forecasts that on a bed-weighted (dollar proxy) basis, 2014 capital spending is expected to increase 5.6% (up from 4.6% in the 2013 survey). The 2014 bed-weighted average of 5.6% includes some replacement facility spending and excluding just three outliers produces a bed-weighted mean of 4.7%. Overall, a similar percentage of hospitals project an increase in their 2014 capex vs. 2013 (Figure 34).

Figure 33. Historical Time Series Data: Bed-Weighted Projected Capital Expenditure Growth



Source: Citi Research 2014 Survey

Figure 34. 2014 Capital Spending Growth



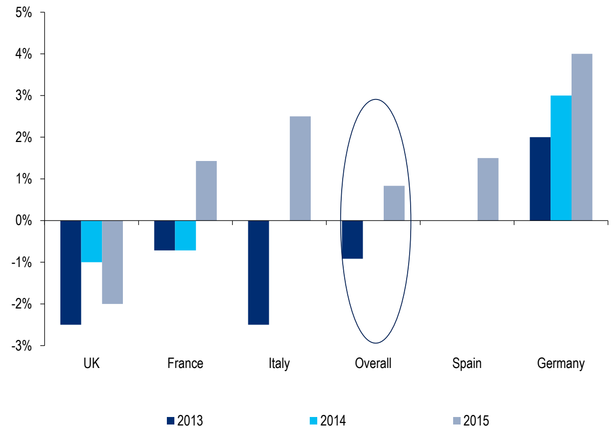
Source: Citi Research 2014 Survey

Western Europe

European hospital capex has been another pressured market over the past 3 years reflecting spending curbs and government austerity measures as well as general hesitation given the tepid economic outlook. Spending could face a challenging CAGR of 2% over 2013-17, driven by economic uncertainty and cost cutting measures. Although European Union (EU) appears to be alleviating, some southern European nations may further reduce public spending in order to cut the debt. Portugal could most affected, where the recovery in healthcare spending is unlikely until 2017, while the growth in Greece and Spain is dubious until at least 2016.

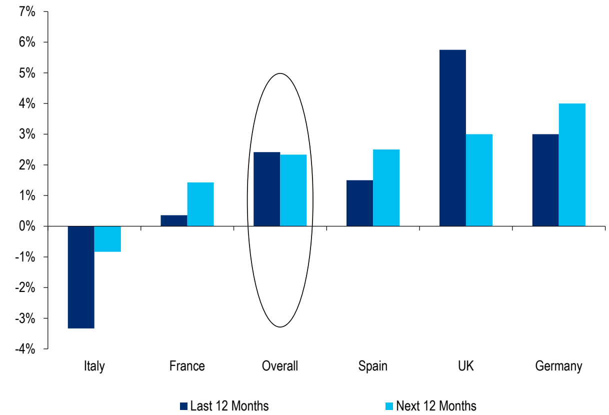
However, this is another region where the outlook appears to be improving as evidence by Philips' improving order intake YTD and Siemens also suggesting a more favorable market for replacement demand in 2015. This ties in well with our results of recent European Healthcare survey which show that hospital capital expenditure is expected to be flat in 2014 and then increase by 0.8% in 2015 vs. the -0.9% decline seen in 2013. Regionally, respondents from Germany expect the highest growth in capex (+3% in 2014 and +4% in 2015), while respondents in UK expect lower spending (-1% in 2014 and -2% in 2015) through 2014/15. In our survey we also sought to understand what respondents wished to purchase from within a range of equipment, where respondents could choose multiple options if they so wished. The top 3 responses were: 1) endoscopy; 2) Electronic medical records / IT and 3) Inpatient beds/MRI. The results of the question are broadly the same as when asked the same question in our 2013 survey. Separately, growth in Utilization rates is expected to continue at just over 2% with all regions, with the exception of Italy, showing growth.

Figure 35. Capex –Expectations for 2014 Flat and Slight Uptick in 2015



Source: Citi Research 2014 Survey

Figure 36. Utilization Rates – Expectations for 2014 Similar To 2013



Source: Citi Research 2014 Survey

Germany

Germany's total health care spending is expected to rise by an average of 2.8% a year from 2013-2017, to $461bn, and from 11.7% of GDP in 2009 to 11.9% in 2017. Germany's population aged 65 or older is likely to exceed one in five by 2017, increasing demand for elder care and treatment of age-related conditions, and heightening concerns about the public health care system's sustainability. Among the issues facing Germany's health care sector in 2014 are a continued need for cost containment and process optimization; and demands for increased transparency around clinical quality and patient outcomes. These challenges could drive increased market consolidation, strategic partnerships, and privatization as providers strive for scale and cost efficiencies.

U.K.

U.K.'s total health care spending is estimated to be at $235bn in 2012 and is expected to rise to $292bn by 2017, with the ratio of spending to GDP increasing to 10.3%. However, constraints on government spending mean that the National Health Service (NHS) may be facing its tightest budgetary squeeze since the 1950s, with expectations that spending will be constrained at least for the next few years. Insufficient funding to meet rising demand may lead to tighter reimbursement policies, as well as rising patient out-of-pocket costs. Over the last three years, the U.K. government has increased health care funding by only 0.1% in the face of increasing demand of around four per cent per year. This has resulted in stringent austerity measures being applied, including staff pay freezes, pressure on pharmaceutical and medical technology spending, and rationing of some services. The current requirement to achieve around four percent annually in productivity and efficiency savings by 2014-2015 is likely to continue to 2020-2021; in the absence of changes to the delivery model, the funding gap is likely to increase to $47 billion.

Asia-Pacific

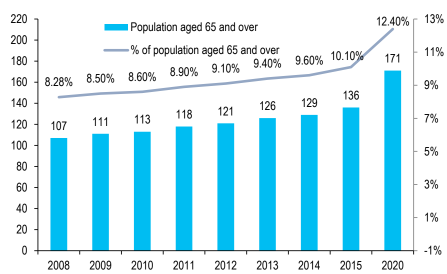
Asia-Pacific is expected to grow at a CAGR of 7.1% in 2013-17 driven by rollout of public health care systems, growing consumer wealth, and lifestyle changes. India is expected to increase spending at a CAGR of 17% due to its primary care policy priority. China is expected to grow at over 14%. Indonesia, Thailand, the Philippines, and Malaysia could also see double-digit growth due to expansion in their health

insurance systems. Japan also could further increase the spending due to its rapidly aging population.

China – Healthcare Reform

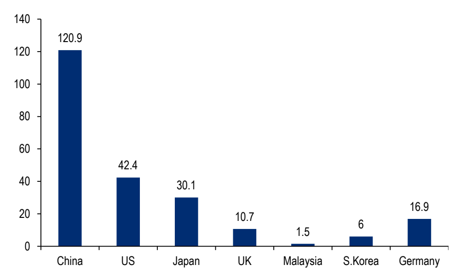
China has become an increasingly important growth engine for many of the medical equipment suppliers over the past decade. Philips in particular is well positioned in the Chinese market and has witnessed three years of 20%+ growth. The longer term outlook continues to remain structurally attractive with the market still set to benefit from themes such as ongoing urbanization, a growing middle class and increasing access to healthcare insurance. However, the near-term outlook has seen a slowdown in the market due to government interventions in relation to how contracts are awarded and Philips notably has seen orders declining in China YTD. Health care spending in China is expected to near $890 billion a year by 2017, growing by an average rate of 13.8% annually in local currency terms from 2013-2017. Total spending is forecast to reach the equivalent of 5.9% of GDP by 2017, up from an estimated 5.3% in 2012. The central government spent an additional $125 billion in health care expenses above and beyond its planned expenditures over the past three years. China's rapidly rising income level and dramatic increase in Internet and mobile phone usage are increasing patients' ability to pay for treatment and driving new expectations for quality of care. The proportion of urban population has grown from 36 percent in 2010 to 52.6 percent in 2012. Urbanization and continued westernization of the population have driven lifestyle changes centered on an increasingly western diet, high prevalence of smoking, and increased pollution, which have materially changed the profile of disease in China.

Figure 37. Aging population in China



Source: Economist Intelligence Unit Monitor Deloitte Analysis

Figure 38. Comparison of population 65+ (2012) in millions



Source: Economist Intelligence Unit Monitor Deloitte Analysis

The healthcare system is changing rapidly in China. The government is significantly increasing spending on this area, both as part of a reform of the medical system, as well as an initiative to boost internal consumption. Most notable in this regard is the launch of a basic medical insurance program so that, by the end of 2009, 92% of the total population had coverage. The government's goal is to provide basic medical insurance to all residents by 2020.

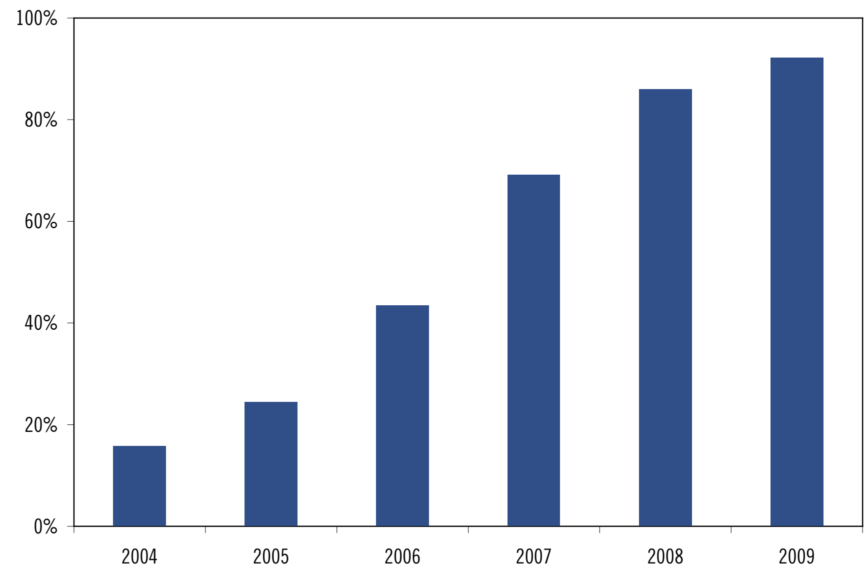
China's healthcare reform and expansion of insurance coverage should increase drug consumption, which would be a positive for a range of companies, including Sinopharm, one of the largest retail pharmacy chain store operators in China.

Unlike developed countries such as the US and Japan, where drugs are largely distributed through retail pharmacies, the majority of drugs in China (roughly 60%) are dispensed in hospital pharmacies. Even so, China's drugstore sector has experienced strong revenue growth in recent years, driven by growing demand for pharmaceuticals attributed to the increasing health awareness and disposable income of Chinese residents.

Going forward, an aging population and greater expansion of insurance coverage should further increase customer traffic and sales volume for drugstores. Then, too, the construction of thousands of new health service centres and health clinics will mean that patients who seek medical aid will no longer be wholly dependent on hospitals, which should be another factor spurring increased consumption of drugs.

Finally, note that, under the universal health care plan, there will be a return to the non-profit motive for health care in China, which will impact the way hospitals are run, among other things.

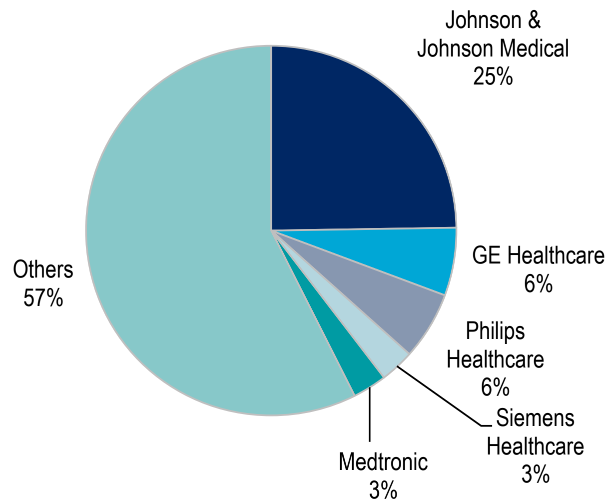
Figure 39. Percentage of China's Population Covered by Basic Medical Insurance



Source: Ministry of Health, Citi Research

To date the healthcare business of Philips has been focused on developed markets but has been increasingly focused on the opportunity in Emerging markets. Philips is a top three player in the Chinese market.

Figure 40. International companies with prominent market share in China (Medical Devices)



Source: Medical Devices in China, New Zealand Trade and Tourism, July 2012, KPMG

Our healthcare team in China recently published conclusions from their discussions with an industry expert regarding the Chinese healthcare sector policy and outlook. The key conclusion was the new policies in 2015 should be largely positive for the industry and the below two are particularly positive for the industry:

- 1. The impact of online drug sales could be phenomenal on the sector, with major breakthroughs including: 1) opening up the online prescription drug sales market (vs. previously OTC drugs); 2) allowing the use of third-party distributors for drug distribution, which would broaden the geographic coverage to include remote rural areas that were unreachable before (vs. previously self-owned distributors only); 3) all pharma manufacturers / distributors / retailers can operate online pharmacies (vs. prev. retail pharmacy chain) with the approval procedure for B2B/B2C licenses exempted.

- 2. Lower-priced drug list: The list could go up to ~6000 drugs in total. Last week a new policy was also released which will replace the drug tendering with online trading for emergency drugs or drugs that are in small demand in the clinical setting. There could be similar policy for gynecology/pediatric drugs in the near future. So basically the lower-priced drug policy opens the door to a tender-free and market-driven drug pricing market, and more selected drugs abandoning the tendering system. Besides, as NDRC had announced to cancel the maximum retail prices, there is a potential for a more-market driven pricing mechanism with the implementation of the flat reimbursement rate model.

Reimbursement price policy is still under construction. This could get out in 2H15. The suggestions by the industry players could be positive for the overall industry. For more detail see *China Healthcare - Transcript: 2015 Chinese Healthcare Sector Policy and Outlook*.

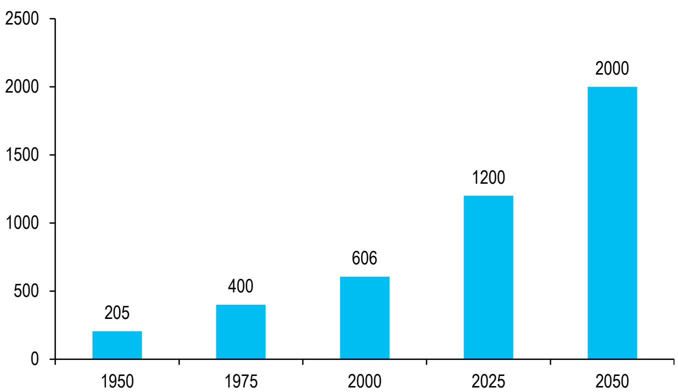
What are the Growth Drivers?

Demand for the Healthcare spending is largely driven by an (1) ageing population; (2) the rise of chronic disease; (3) rising healthcare costs; (4) access to care and workforce shortage; (5) lack of infrastructure. These drivers combined make a solid case for healthcare equipment market being able to deliver above GDP growth over the medium term.

Aging population

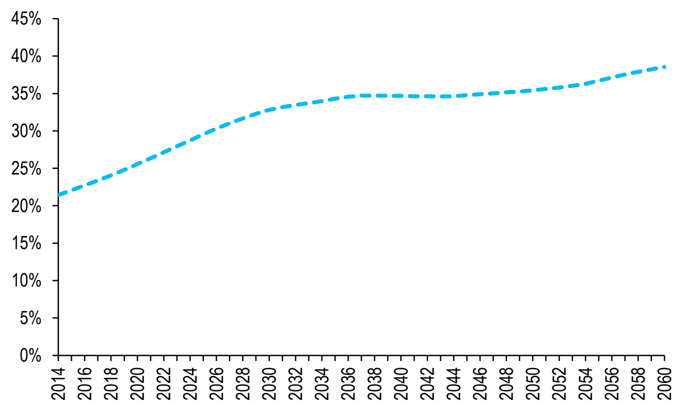
Life expectancy is projected to increase from an estimated 72.6 years in 2012 to 73.7 years by 2017, equating to a number of people over age 65 to around 560 million worldwide, up to more than 10% of the total global population. The global population age 60 or above has tripled over the last 50 years and is expected to more than triple again over the next half-century, to reach nearly 2bn in 2050. According to the EU, in Europe, the budgetary impact of ageing (the need for public provision of age-related transfers and services) is expected to be substantial and to increase by more than 5% of GDP by 2060 in the euro area especially for pension, healthcare and long-term care spending.

Figure 41. World population over 60 year old (in millions)



Source: DTTL Global Life Sciences and Health Care Industry Group analysis of United Nations data statistics

Figure 42. US – Population over 65 as share of working age population



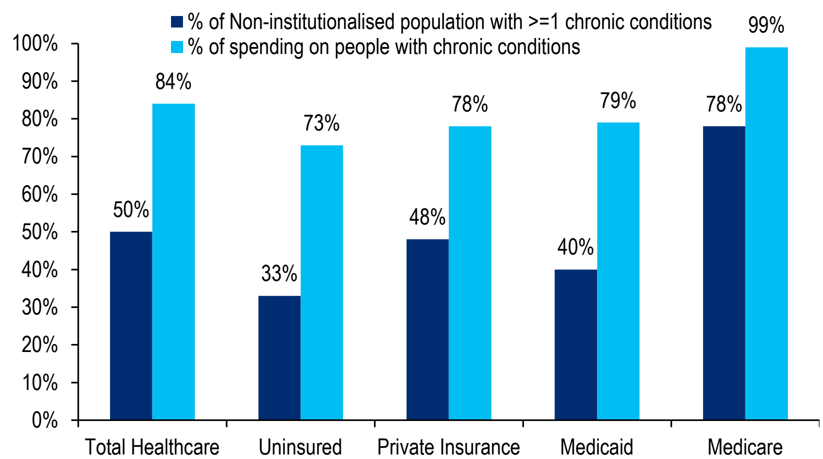
Source: US Census Bureau

Rise of chronic disease

the rise of chronic disease is changing focus in healthcare towards prevention

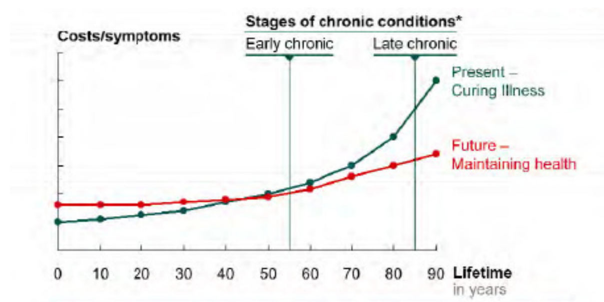
Most healthcare expense is incurred in the last 16 years of life due to patient conditions that are predominantly chronic. For example, in the US almost half the population has one or more chronic conditions accounting for 84% of national health care dollars and 99% of medical spending. If the current trends in healthcare continue, then the projected annual growth rate in healthcare expenditure is 3.4% through 2023. If prevention and early diagnosis take place, it could save $218bn in treatment expenditure annually in 2023.

Figure 43. US - the population has one or more chronic conditions accounting for 84% of national health care dollars and 99% of medical spending



Source: Medical Expenditure Panel Surevy, 2006 and Robert Wood Johnson Foundation, Chronic Care: Making the Case for Ongoing Care, February 2010

Figure 44. Prevention: the changing focus of healthcare



Source: LifeTech

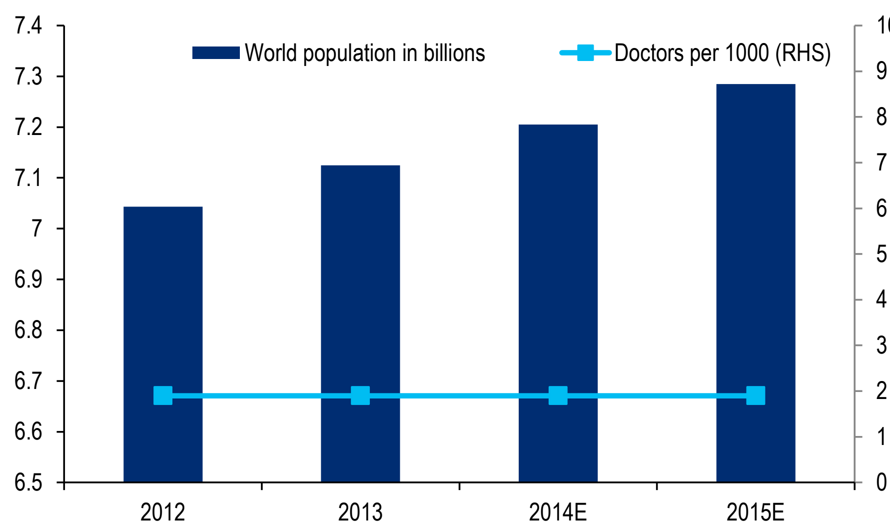
Rising healthcare costs

Today, the US, for example, spends more on healthcare services than any other country world-wide with healthcare spending rising faster than inflation and the economy as whole (in most years). A 2013 survey conducted in 11 countries by the Commonwealth Fund found that the United States spends $8,508 per person on health care (spending nearly 18% of GDP), nearly $3,000 more per person than Norway, the second-highest spender. According to National Health Expenditure, in the U.S. compared to OECD nations, hospital spending is more than 60%; spending on physicians, specialists and dentists is almost two and a half times higher than in other OECD countries. According to the Congressional Budget Offices, federal deficits under current law will continue to rise faster than tax revenue, mainly driven by health care liabilities. According to Institute for Alternative Futures in the US health care cost to grow to 20% of GDP by 2020. By 2040, health expenditures in the US could be around 30% of GDP.

Access to care and workforce shortage

Improving health care access is a major goal of governments around the world, and a centerpiece of many reform efforts. In the United States, for example, the Congressional Budget Office (CBO) has estimated that, by 2020, about 24 million people will buy coverage through the new federal and state health insurance exchanges established by the ACA — a substantial addition to the market. To expand citizens' access to medicine in India, the government in 2012 allocated $5.4 billion under a policy to provide free generic drugs/products for patients in government hospitals and rural clinics. More than one billion people worldwide lack access to a health care system, both for caregivers and facilities. The United Kingdom, for example, had an estimated shortage of 40,000 nurses in 2012, and has a shortage of other health care professionals, including general practitioners (GPs). According to a European commission, there will be a shortage of 230,000 physicians across the continent in the near future. China is lacking millions of nursing home employees to care for its growing elderly population. Many countries across the globe are facing a challenge to meet their required number of health care workers, a shortage that directly affects the quality of care. Globally, the number of doctors per 1,000 population is expected to remain virtually the same between 2012 and 2015.

Figure 45. Doctors per 1,000 population vs. world population

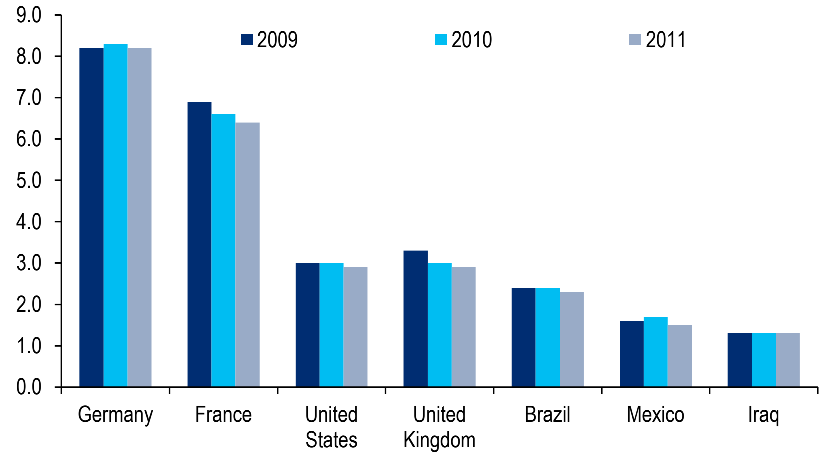


Source: DTTL Global Life Sciences and Health Care Industry Group analysis of Economist Intelligence Unit database

Lack of infrastructure

In addition, the lack of healthcare infrastructure and outdated facilities is another constraint on patient access, which is an issue in both developed and emerging countries.

Figure 46. Access to care: Hospital beds- Hospital beds per 1000 people

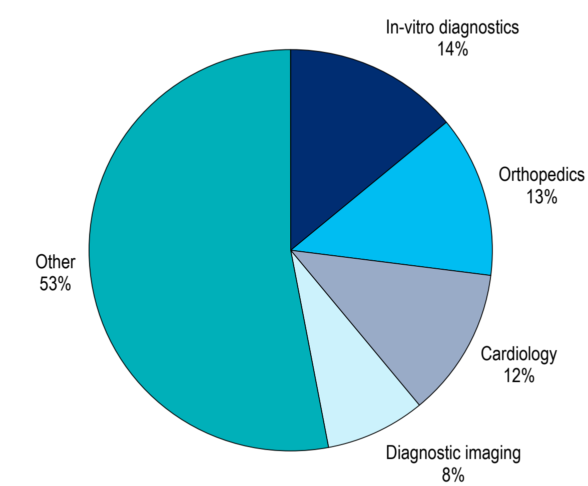


Source: DTTL Global Life Sciences and Health Care Industry Group analysis of World Bank database

Disruptive technologies

According to an S&P Capital IQ (S&P) survey there are four areas within the medical devices industry with technologically advanced products such as 1) In-vitro diagnostics; 2) Orthopedics; 3) Cardiology and 4) Diagnostic Imaging that account for almost half of global medical devices industry. Medical devices account for 4% of health costs and the typical buyers of equipment in the healthcare industry include hospitals, governments and insurance companies and have a degree of pricing power. However, more advanced products may face less competition and in turn generate higher profit margins. The top five global firms (Johnson and Johnson, Siemens, Medtronic, and Philips) represent 28% of global medical device sales. However, advanced technology is evolving fast with innovations from companies such as Google could lead to some disruption technologies. In this sector we highlight a number of disruptive technologies that could change the face of healthcare industry.

Figure 47. Global Medical Devices Industry



Source: S&P Capital IQ ("S&P") survey

Point-of-care Diagnostics technology

Point of care (POC) technology or POC or bed-side testing is medical testing at or near the site of patient care. These are simple medical blood tests which can be performed at the bedside. According to BCC Research, the global POC market has steadily grown, from 2007 to 2013, at CAGR of 4.5%, and is expected to reach at least US$ 19bn by 2018 driven by: (1) the emergence of newer POC technologies that are lowering the costs of diagnostic and treatment tools and replacing health-care workers and professionals; and (2) increasing growth in chronic disease and the opportunities this offers for lifelong use of new products for diagnosis and treatment.

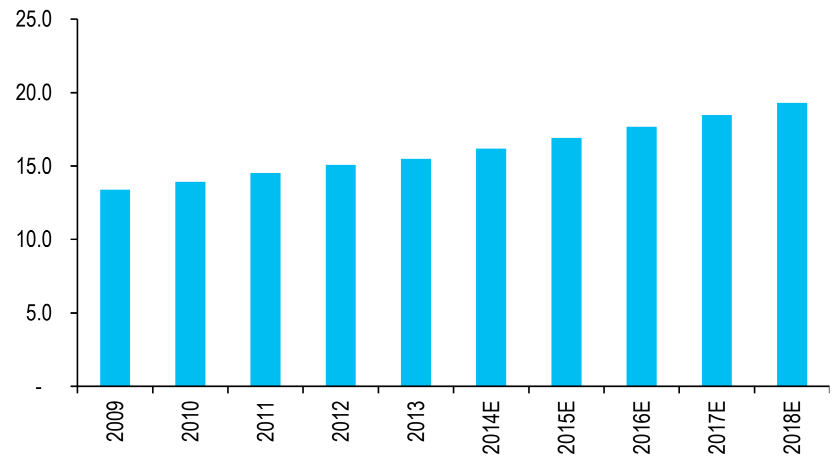
Figure 48. Point of Care Diagnostics Technology

Source: BCC

Figure 49. Point of Care Diagnostics Technology

Source: BCC

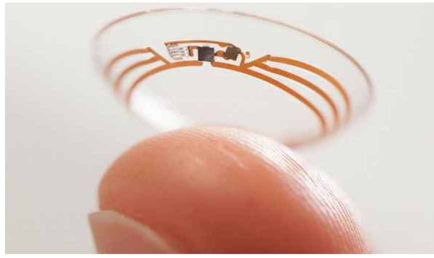
Figure 50. Global POC market (US$ bn)



Source: BCC Research, Citi Research

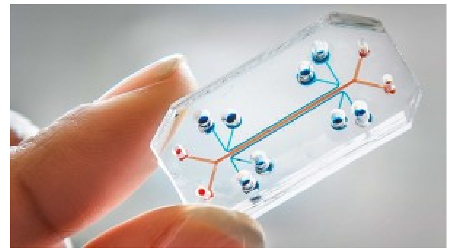
Collaboration between medical technologies companies and companies such as Google is increasing in an attempt to develop non-invasive POC testing systems. For example, Google is collaborating at developing so called Smart Lens, which is a non-invasive means of continuously monitoring blood glucose. Another technology is Organ-on-a-Chip, which is a multi-channel 3D microfluidic cell-culture chip that simulates the activities, mechanics, and physiological response of entire organs and organ systems that could lead to potential to eliminate poor drug formulations and reduce time at the pre-clinical stage as well as customization of a drug according to patient's need. Organs-on-chips may be about to capture a significant share of the global biochip market, forecast to reach US$11.4 billion by 2018.

Figure 51. Smart Lens



Source: BCC, Google

Figure 52. Organ-on –a-chip

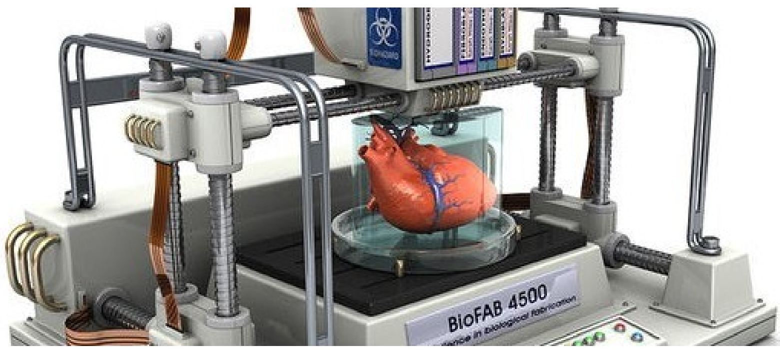


Source: BCC, Harvard Institute

3D Printing

Some exciting advancements are taking place at the intersection of information technology and medical technology, such as using 3D printing to help in preparing tissues for transplants.

Figure 53. 3D Printing in healthcare



Source: BioFab

Philips

Company description

Philips is focused on three main operating divisions, which are Healthcare (providing imaging and home healthcare solutions), Lighting (manufacturing lamps and luminaries for commercial and residential applications) and Consumer Lifestyle (including a diverse range of generally smaller appliances/consumer products).

Investment strategy

We rate Philips a Buy. This is driven by our expectation of continued self-help-driven margin expansion in the business. This supports a forecast EPS CAGR of 13% to 2016E. This should support consistent share price momentum even by just maintaining the current valuation rating.

Valuation

We set our Target Price at €33 target price, in line with our SOTP fair value following the announcement of a strategic shift that will see the set up of two companies by 2016: the "New Philips", HealthTech, and Lighting Solutions (all options being considered). We value HealthTech (pro-forma) on 12x EV/EBITA, Lighting Solutions on 10x and Lumileds and Automotive Lighting on 9x.

Risks

Key industry- and company-specific risk factors include (1) deterioration in end-market demand, (2) cyclical volatility and (3) lower cash returns. Any slowdown in the European economy could provide relative underperformance versus our expectations. These risks could impede the share price from reaching our target price.

Appendix A-1

Analyst Certification

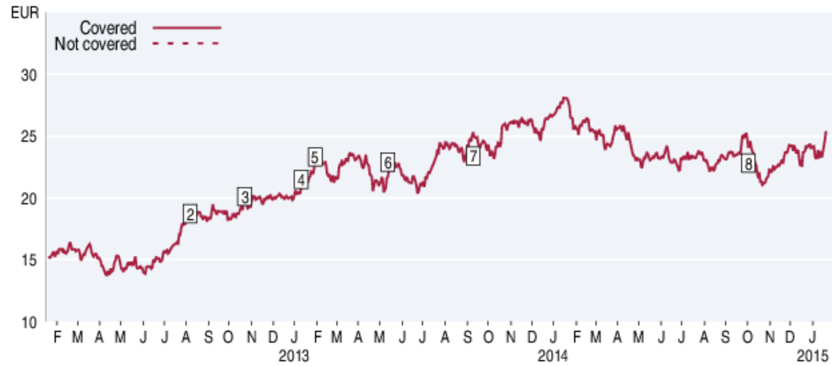
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Philips (PHG.AS)

Ratings and Target Price History
Fundamental Research

Analyst: Natalia Mamaeva
Covered since September 18 2013



#	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	7-Aug-12	3	*13.15	18.55
3	23-Oct-12	3	*14.40	19.60
4	10-Jan-13	3	*18.00	21.00
5	30-Jan-13	3	*19.30	23.13
6	13-May-13	3	*19.80	21.68
7	10-Sep-13	*1	*30.00	25.32
8	2-Oct-14	1	*33.00	24.05

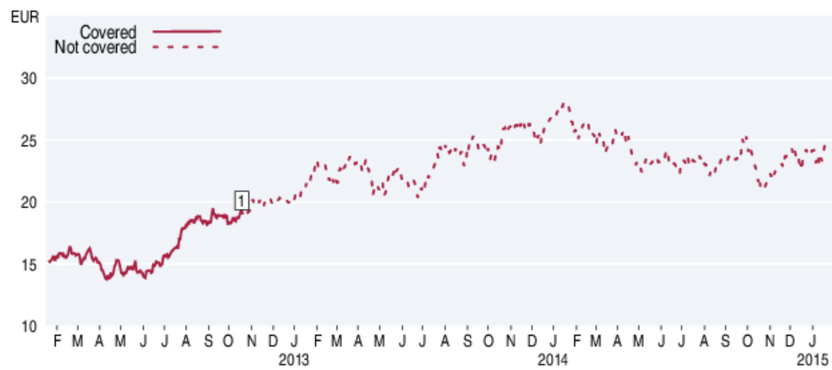
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Philips (PHG.AS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Natalia Mamaeva
Covered since September 18 2013



#	Date	Rating	Target Price	Closing Price
1	18-Oct-12	*REM LP		

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			*Relative Rating*		
Data current as of 31 Dec 2014	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	49%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	65%	62%	54%	0%	63%	0%

Guide to Citi Research Fundamental Research Investment Ratings:
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Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.
Investment Ratings: Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

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