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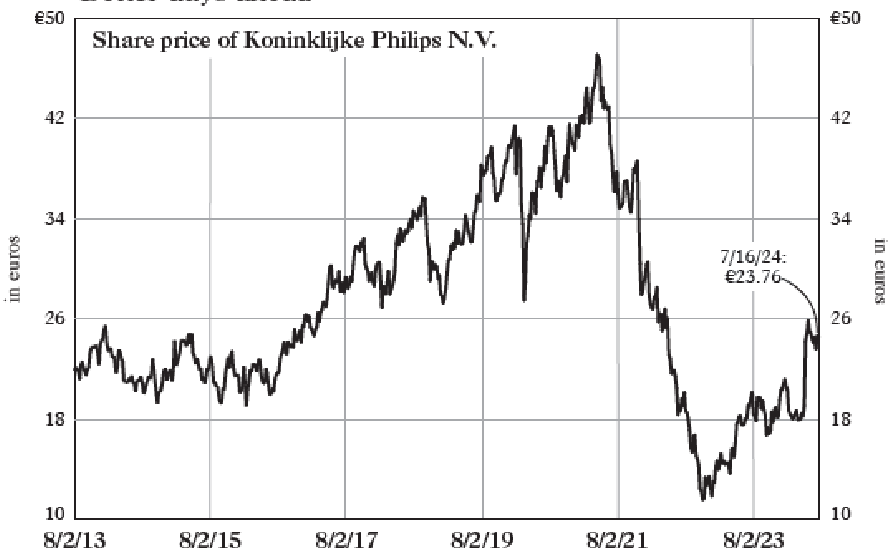
Dutch dowager rebounds

Evan Lorenz writes:

It's a Wall Street truism that good news and good prices are incompatible: You can have one or the other but not both at the same time. However, medical-device manufacturer Koninklijke Philips N.V. (PHIA on Amsterdam) has settled its biggest legal liability for less than investors had feared (good news) yet still trades at an undemanding multiple (a good price). In preview, *Grant's* is bullish.

Better days ahead



source: The Bloomberg

Note: Past performance does not guarantee future results.

Founded in 1891 as a light-bulb manufacturer, Philips at length became the GE of the Netherlands and later, arguably, of Europe. It invented the audio cassette, the first home-video cassette recorder and the rotary electric razor (the "Philishave"); alongside Sony Group Corp., it developed the compact disc and the Blu-ray disc formats.

Various Philips ventures and spinoffs continue to dominate their respective industries. Philips Records, founded in 1950, is a predecessor to Universal Music Group N.V., the No. 1 music company by revenues. In 1984, Philips split off its microchip-equipment division into a joint venture with ASM International N.V. That former j.v., ASML Holdings N.V., is the world's biggest maker of semiconductor-manufacturing equipment. In 1985, Philips became the largest founding investor in the Taiwan Semiconductor Manufacturing Co. Ltd., the leading maker of microchips.

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But when Philips, to its management's eye, became overly diffuse, out came the pruning shears. By 2016, the legacy lighting business (Signify N.V.) was hived off, leaving just four operating units, many devoted to healthcare:

Koninklijke Philips N.V. at a glance
all figures in € mns except per share data

	TTM*	2023	2022	2021	2020
sales	€18,141	€18,169	€17,827	€17,156	€17,313
operating income	1,664	1,632	1,034	1,603	2,100
net income	-118	-454	-1,618	612	999
earnings per share	-0.12	-0.50	-1.76	0.64	1.08
shares outstanding	937	949	953	983	990
cash	1,402	1,869	1,172	2,303	3,226
debt	7,737	7,689	8,201	6,979	6,934
total assets	**	29,406	30,688	30,961	27,713

* 12 months ended March 31, 2024.

** Philips reports its full balance sheet on a semi-annual basis.

sources: company reports, the Bloomberg

- Diagnostics and treatment (49% of revenues in the 12 months ended March 31): a maker of X-ray, magnetic resonance imaging (MRI) and computed tomography (CT) systems as well as high-tech surgical systems;
- Connected care (28%): a producer of hardware and software with which nurses can monitor patients and home medical devices for the treatment of breathing problems (on which, more later);
- Personal health (20%): a manufacturer of such consumer brands as Soni- care toothbrushes and Philips Norelco electric razors; and
- Other (4%): a harvester of the income generated by the company's intellectual property.

Though its domicile is Dutch, Philips generated 42% of trailing revenues in North America in the past year, more than it earned from Western Europe (21%). In total, developed economies chipped in 72% of the top line, and emerging markets the remainder (China accounted for 8% of total sales).

Frans van Houten was the CEO who, in 2016, led the corporate redirection to medical devices, and he did something else that bore on the share price. "He ran Philips as a bureaucracy," David Samra, a managing director and portfolio manager at Artisan Partners, L.P., which owns 10% of Philips's outstanding shares, tells me. "It had a big matrix structure [in which some employees report to multiple bosses]. Reporting lines were blurred. And he added complexity to the organization in terms of the way the supply chain worked and by making acquisitions and not fully integrating them."

The bloated organization delivered lower operating margins than peers Siemens Healthineers A.G. and GE HealthCare Technology, Inc. (in 2020, Philips earned 12.1% compared with an average of 15.3% for its two peers) , and earned itself unwanted notoriety with a succession of product safety embarrassments. From the value investor's perspective, Samra observes, such missteps provided a low-cost investment entry point.

Product recalls happen in the medical-device manufacturing industry just as they do in the auto industry, but they've happened too frequently at Philips. In 2014, for instance, the U.S. Food and Drug Administration found fault in Philips's Cleveland, Ohio, factory and with the MRI and molecular-imaging machines it manufactures there; two-and-half years passed before management received regulatory clearance to resume full production. And in 2017 the FDA banned Philips from selling defibrillators that the agency judged substandard; while Philips returned to the U.S. market in 2020, it will remain under a consent decree until 2025.

The granddaddy of such unforced errors was the 2021 worldwide recall of Philips's

Respironics brand CPAP machines—i.e., "continuous positive airway pressure" machines—which relieve the nighttime breathing problems of the sufferers from sleep apnea. In 2015, a foam supplier warned Philips about the material it produced for use inside the devices to muffle noise. The foam breaks down over time, management was advised, releasing volatile organic compounds and particulates directly into the patient's airways. Philips promptly began to investigate—and kept right on investigating for the next six years. Only at the end of the long course of study did management institute a recall of what turned out to be 5.5 million CPAP devices. "And that," says Samra, "kicked off an FDA review. It kicked off the U.S. litigation machine. The share price went into a tailspin, with the result that Frans van Houten eventually lost his job."

In 2022, the board of directors, led by chairman Feike Sijbesma, replaced van Houten. Sijbesma had previously turned around the struggling Dutch conglomerate Koninklijke DSM N.V. and has been quoted as delivering such investor-inspiriting lines as "We're not a philanthropy, we're not the Boy Scouts, we've got to deliver."

Roy Jakobs, van Houten's successor, is a longtime Philips executive who formerly led the connected-care unit. He has simplified lines of executive authority, reinstituted a culture of safety and begun to implement a planned 10,000-employee reduction in head- count (out of a year-end 2022 employment total of 77,233).

Like many businesses, Philips suffered from Covid-era supply-chain snafus. However, unlike better-managed businesses, Philips has continued to suffer them. To streamline manufacturing, the company is replacing its central procurement policy with a de-centralized one; individual business units will now source their own components. Also in the cause of manufacturing efficiency, the company is reducing the number of products it sells and re-designing (with an eye to cost reduction) the ones it retains.

To date, not one consumer death has been definitively linked to the foam fiasco, but investors understandably tremble before the risk of a generous American jury granting mega-size awards to an appealing plaintiff at the cost of an unsympathetic foreign corporate defendant. On April 29, Philips announced it had settled its U.S. litigation for $1.1 billion, well un- der base-case expectations of $2 billion–$4 billion, not to mention a $10 billion "worst-case fears" figure that Barclays Capital, Inc. analyst Hassan Al-Wakeel had floated in April. On news of the settlement, the Philips share price leapt for joy, by 29%.

However, there remain a few hurdles before Philips can put the sleep-product problems to rest, including that of the U.S. Department of Justice, which continues to investigate the big CPAP recall. The possibility exists of a DOJ-levied civil fine, though few expect that Philips would have to pay more than a fraction of that $1.1 billion price tag. While Philips continues to sell sleep aids outside the United States, it is barred from doing so stateside until the FDA signs off on Philips's proposed design and manufacturing fixes.

Despite the recall and the American sales ban, the Respironics brand survives. "Philips massively benefits from the fact that this market is essentially a duopoly," Lisa Bedell Clive, who rates Philips a buy for Sanford C. Bernstein & Co., tells me. And as Philips has stepped back from the market to fix its problems, ResMed, Inc., the other half of the duopoly, has taken the opportunity to lift prices.

Clive says she's been on the phone with doctors to determine if they would prescribe Respironics machines again. "I was pleasantly surprised by how much they were rooting for Philips to turn things around," she says. "They all thought that, sure, there were some mistakes made in the recall and in the events leading up to it. But the over-all impression that I got was they were pretty happy with how Philips was handling it. They all made it very clear that they wanted Philips to come back into the market as soon as possible and that they would be willing to use Philips again."

While Respironics has dominated the news flow, the business makes up only 5% of total corporate revenues. Across all divisions, Philips holds the No. 1 or 2 position in products making up around 70% of sales. In MRI, where it has a No. 3 slot, Philips has recently begun selling the world's leading helium-free machine. (Helium, of which standard MRI machines require large volumes to keep magnets cold, is in short supply.)

The connected-care unit, which includes problem child Respironics, also houses Philips's enterprise-informatics platform. The business is a world leader in areas such as remote-imaging collaboration (which, for example, allows radiologists to view X-rays at remote locations and use artificial intelligence to help interpret results), workflow orchestration (e.g., using AI to prioritize emergency patients based on the severity of CT scans) and clinical integration and insights (pulling and aggregating data from Philips and third-party patient sensors and alerting caregivers to potential problems).

The informatics unit is growing rapidly (Barclays projects 9.7% annual growth between 2023 and 2026) and sits in a sweet spot for healthcare spending. Aging populations in developed countries present hospitals with rising patient populations but with no corresponding increase in medical staff. Informatics helps such hospitals bridge the caregiver gap. While the business is currently breakeven, its future looks promising; a high component of sales from software means attractive incremental margins. Last year, it produced 6.5% of total sales.

Despite the springtime pop in the share price, Philips remains capitalized as a serial disappointer. The stock trades at 14.5 times estimated 2025 earnings and 13.1 times the 2026 guesstimate. For comparison, Healthineers trades at 20.9 times consensus 2025 earnings and 18.4 times the 2026 figure.

Philips's efforts to fix its supply chain, reengineer its products and reduce organizational bloat should boost profitability over time. Management targets a mid-to-high teens operating margin after 2025. Doubting analysts rather predict an 11.8% operating margin in 2026, or slightly below the margin the company earned in 2020. Healthineers, in contrast, will generate an 18.4% operating margin in the same year, or so says the Street.

"Now, over 18 months in as CEO, I can tell you that I'm more determined than ever to ensure that Philips gets back to where it belongs, delivering value for all of its shareholders," Jakobs promised at the May 7 annual meeting. "And while I remain realistic about the global challenges and uncertain- ties, I'm also confident that we will continue to deliver on our three-year plan that we laid out," a roadmap that includes higher margins.

As of March 31, Philips showed a net debt balance of €6.3 billion, equal to 2.2 times trailing and depressed Ebitda. In the first quarter, operating income, adjusted for litigation settlement and restructuring costs, covered interest expense by 4.9 times. The debt rating is Baa1/triple-B-plus, the lower end of investment-grade.

Unusually for a non-junk-rated company, Philips pays shareholders a dividend in common stock (a 3.6% yield at the current share price) rather than in cash. The quirk is traceable to Respironics. Philips initiated the CPAP recall on June 14, 2021. Six weeks later, former CEO van Houten began a €1.5 billion buyback program through forward purchase agreements, an initiative that could not be canceled without a monetary penalty. In 2023, as the severity of the recall began to dawn, the company stopped paying cash dividends to preserve balance-sheet flexibility. But it had to pay something—income-seeking investors demanded it—so it chose to pay in scrip.

Thanks, however, to the litigation settlement in April and a €540 million insurance recovery related to the recall (Philips expected to collect it by June 30), cash dividends may soon resume.

Philips remains a controversial name. Of the 22 analysts covering the stock, 7 say buy, 2 say sell and 13 remain on the fence. In May, Clive upgraded Philips to a buy—a move, she says, that her clients have called "brave. I was speaking to a healthcare analyst at one of the top asset managers who said that her portfolio managers were simply not interested in this stock."

Over the past 12 months, insiders have purchased 25,277 shares at a cost of €469,918. In an external vote of confidence, Exor N.V. accumulated 17.4% of shares outstanding, also over the past 12 months. (The Exor imprimatur is only burnished by the holding company's investment record; in the decade ended 2023, it compound- ed net assets per share at a 16% annual rate.)

"There are four key characteristics that we look for in a business: an undervalued security that's a good business with a strong balance sheet and a good management team," Samra tells me about the Artisan M.O. "Of course, a combination of all four characteristics is very rare."

Philips is one such rarity, he concludes: "It's one of the cheapest, largest, high-quality businesses trading outside of the United States."

David Samra is the lead portfolio manager for Artisan International Value Strategy. This article represents the views of Grant's Interest Rate Observer and David Samra as of 19 July 2024 and those views and opinions presented are their own. The views and opinions expressed are based on current market conditions, which will fluctuate, and those views are subject to change without notice. While the information contained herein is believed to be reliable, there is no guarantee to the accuracy or completeness of any statement in the discussion. Artisan Partners is not affiliated with Grant's Interest Rate Observer.

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