Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Philips Lowers 4Q Profit Guidance Due to Production Delays; LED Asset Sale On Track

See Page 2 for the full Analyst Note from 13 Jan 2015

Jeffrey Vonk, CEFA
Equity Analyst
jeffrey.vonk@morningstar.com
+31 20 751 1356

The primary analyst covering this company does not own its stock.

Research as of 13 Jan 2015
Estimates as of 18 Nov 2014
Pricing data through 20 Jan 2015
Rating updated as of 20 Jan 2015

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Contents

Investment Thesis 18 Nov 2014

Philips introduced its first light bulb more than 120 years ago and today is the premier lighting manufacturer in Europe. Through numerous acquisitions and divestitures, the company grew into other businesses and has admirable positions in lighting, health-care products, and consumer lifestyle. The firm is selling its consumer electronics businesses to focus the portfolio on healthy living and prevention products, and management's focus is improving the company's cost structure. In September, Philips announced what we think is the logical next strategic step of its impressive transformation by combining health care and consumer lifestyle into one company and splitting off the lighting solution business into a separate firm. We believe the breakup has potential for shareholder value creation and better allocation of capital and expect a trade sale or IPO for lighting in 2015-16.

With the market's transition to LED lighting products, the competitive landscape is changing. New players are entering the market and the intensified competition is strongly apparent at the LED component business. In June, Philips announced it would combine the LED component and automotive lighting divisions in order to explore strategic options, with expected completion in the first half of 2015, as it doesn't want to participate in the next capital expenditure cycle given limited visibility on returns. Instead, Philips is focusing on the strong and growing demand for professional lighting solutions. Fewer players are active in this market, and we think Philips is well positioned, given its deep application and systems integration expertise.

We see softer demand resulting from hospital consolidation and focus on cost, which hurts Philips' imaging business. Imaging is effectively a three-player market with GE and Siemens, and long-term emerging-market growth is mitigating our concerns. Philips' suites of products ties well into growing demand for integral value-based health-care solutions and aging population with more chronic diseases. Philips has a clear strategy to partner with hospitals to manage the workflow, lower the cost of care, and offer home-care devices and solutions.

Vital Statistics

Market Cap (EUR Mil)	23,298
52-Week High (EUR)	28.31
52-Week Low (EUR)	20.69
52-Week Total Return %	-9.8
YTD Total Return %	4.9
Last Fiscal Year End	31 Dec 2013
5-Yr Forward Revenue CAGR %	1.6
5-Yr Forward EPS CAGR %	4.2
Price/Fair Value	0.94

Valuation Summary and Forecasts

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Price/Earnings	39.0	20.2	*46.9*	*18.9*
EV/EBITDA	7.8	7.8	*11.1*	*7.7*
EV/EBIT	18.3	13.1	*26.2*	*12.6*
Free Cash Flow Yield %	7.8	2.2	*6.8*	*7.9*
Dividend Yield %	1.4	1.1	*3.2*	*3.2*

Financial Summary and Forecasts (EUR Mil)

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Revenue	24,788	23,329	*22,475*	*23,070*
Revenue YoY %	9.8	-5.9	*-3.7*	*2.7*
EBIT	1,030	2,019	*983*	*2,044*
EBIT YoY %	-5.2	96.0	*-51.3*	*107.9*
Net Income, Adjusted	471	1,217	*499*	*1,242*
Net Income YoY %	-64.5	158.4	*-59.0*	*148.7*
Diluted EPS	0.51	1.32	*0.54*	*1.34*
Diluted EPS YoY %	-63.4	159.8	*-59.1*	*148.7*
Free Cash Flow	1,609	380	*1,511*	*1,770*
Free Cash Flow YoY %	-512.1	-76.4	*297.2*	*17.1*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

Profile

Philips Electronics is a diversified global manufacturer operating in three main segments: lighting, health care, and consumer lifestyle. About 41% of revenue comes from the health-care segment, which features Philips imaging systems, customer services, home health-care solutions, and, patient care. Almost 20% of revenue is derived from selling consumer lifestyle products like domestic appliances, health and wellness, and personal care. Lighting sales are responsible for the remaining part of Philips' turnover.

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Morningstar Analysis

Philips Lowers 4Q Profit Guidance Due to Production Delays; LED Asset Sale On Track 13 Jan 2015

Narrow-moat Philips expects fourth-quarter 2014 EBITA to be negatively affected by production delays, ongoing softness in certain markets, and stronger-than-anticipated foreign exchange headwinds. The firm predicts adjusted EBITA to be approximately EUR 735 million. Due to the slower-than-anticipated ramp-up of production and shipment of medical equipment at the Cleveland facility, the negative impact of full-year 2014 EBITA will be approximately EUR 225 million instead of the previously estimated EUR 180 million. As our expectations regarding Cleveland's production ramp-up were already more conservative than management's, we are not changing our moat rating or EUR 27 fair value estimate. We expect Cleveland production to be 100% operational by end of second quarter versus management's guidance for the end of the first quarter. Not only does Philips' updated quality management system need to be externally certified, but also the firm's supply management has to be thoroughly analyzed and certified, which is a very time-consuming process, in our view.

As Philips progresses in attracting an external investor for the combined Lumileds/automotive business, the results of the LED component business will be classified as discontinued operations. We are pleased with the progress of asset sales and expect the sale to be a positive catalyst. In our view, the LED component business is worth EUR 1.5 billion, but according to recent press statements, the transaction value could exceed EUR 2.5 billion based on indicative offers of buyout groups including Bain, CVC, CD&R, KKR, and Onex. Our LED component business valuation is based on our expectations of an EBITA multiple of 10 times, sales of EUR 1.5 billion, and an EBITA margin of 10% in 2015. The multiple of 10 times reflects our belief that the Lumileds and automotive lighting market will be characterized by high growth, especially in high-power LEDs, but also margin pressure as a result of increasing competition.

Valuation, Growth and Profitability 18 Nov 2014

We are increasing our fair value estimate to EUR 27 per share from EUR 25 based on higher margin expectations than we previously modeled. The management team's key moves to improve profitability have been accretive to cash flow, but as result of reduced production of the Cleveland health-care factory and sharp revenue decline of traditional lighting sales, revenue will decline by about 3.6% in 2014. Our model assumes a five-year earnings compound annual growth rate of 1.6%, reflecting sluggish activity in 2014 but meaningful growth in health-care, lighting, and consumer lifestyle end markets beyond 2014, driven by global activity and increased production of medical devices. We expect the Cleveland facility production ramp-up to be completed during the second quarter of 2015, resulting in 2% revenue growth for the health-care division in 2015. We model conventional lighting product sales to continue to decline 10% in 2015, but we believe this will be more than offset by growth north of 20% for LED products and systems and services, resulting in 2% revenue growth for the lighting unit. This combined with 5% revenue growth in consumer lifestyle translates into 2.7% expected revenue growth for the firm for 2015. We forecast operating margins of 8.9% in 2015 and expect these margins to expand to 9.6% for 2018. Management's focus on operational performance and reshaping the portfolio will enhance operating margins. Using our assumptions, we expect Philips to generate returns on invested capital of 14%, on average, during our five-year discrete forecast horizon, above the firm's cost of capital of 9.2%. We assume a long-term effective tax rate of 30%.

Scenario Analysis

We model three scenarios of varying revenue growth and operating margin assumptions. The pace of the economic recovery has a profound impact on these variables. In our

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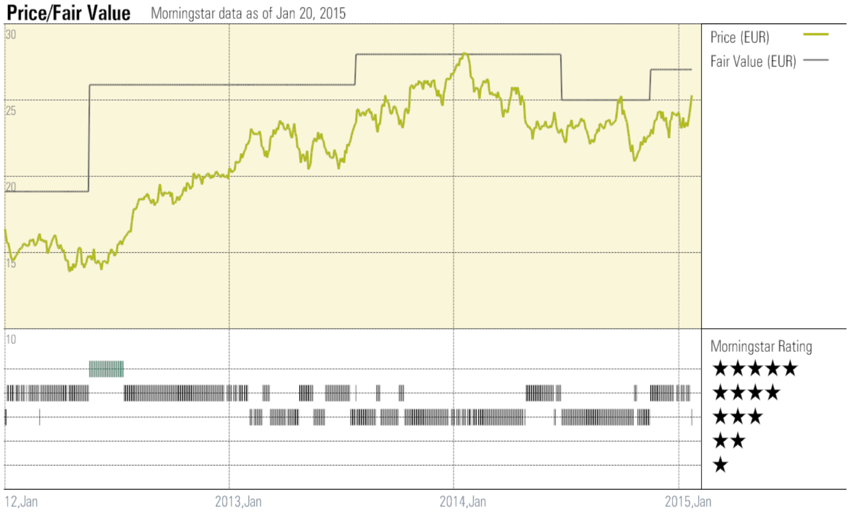
Price/Fair Value Morningstar data as of Jan 20, 2015



base-case scenario, we assume internal revenue growth of 2.7% in fiscal 2015, based on mid-single-digit growth of consumer lifestyle and modest growth at health care and lighting. Our base model assumes cost reduction and portfolio optimization resulting in operating margins of 9.6% by 2018 and generates a fair value estimate of EUR 27 per share. In our more optimistic model, we assume average core growth of 6% during each of the next four years, with margins expanding 240 basis points more than in the base model over the same horizon. Under this scenario, our fair value estimate increases to EUR 35 per share. When thinking about the bear case, we assume declines in revenue in 2015 and 2016, reflecting a protracted recovery. Operating margins in this scenario are 7% in 2015 and return to previous midcycle levels of 6% by 2016. Under these assumptions, our fair value estimate drops to EUR 15 per share.

Economic Moat

We assign a narrow moat rating to Philips mainly due to switching costs and, to a lesser extent, intangible assets and technology leadership. The firm's strong competitive positions in health-care diagnostics and imaging, traditional lighting, and professional lighting solutions should result in returns on invested capital exceeding the cost over our five-year forecast period. The switching costs result from the firm's health-care products being well integrated in hospitals and Philips' strong focus on training of doctors at hospitals, which ensures strong relationships. Its medical equipment has a long economic lifetime, and support services increase customer loyalty. Patents for health care and lighting products are Philips' main sources of intangible assets. At its 2014 capital markets day, management expressed its intention to establish two companies by combining health care and consumer lifestyle (into HealthTech) and transition lighting solutions into a separate legal structure. More information about the ownership structure of lighting solutions will be presented in 2015-16. The sale or spin-off could enhance our moat rating in the future for the remaining HealthTech company.

The lack of pricing power for domestic appliances, LED components, and consumer luminaires, due to competition, prevents us from assigning the firm a wide moat. Although Philips has dominant positions in the personal-care and health and wellness markets, like male grooming and oral health care, we believe the entry barriers and switching costs for consumer products are low. Philips has an excellent position in conventional lighting, but this market will be taken over by energy-saving light solutions like LED and OLED. The value chain of LED products is much more fragmented than the conventional lighting value chain, given the former's strong Asian competition.

We consider the health-care division to have a narrow economic moat. This division generated 41% of sales and 56% of adjusted EBITA in 2013. Next to equipment sales, Philips is focused on integrated solutions in diagnosis, treatment, recovery, and home care. The company has a strong market position based on technology leadership for imaging products like MRI and CT scanning machines. Although we see softer demand resulting from the U.S.

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hospital consolidation and related focus on cost, we still believe Philips is attractively positioned in the high end of the imaging business, which is effectively a three-player market with General Electric and Siemens. In the lower segment of the market, the big players face competitors out of Asia like Mindray Medical.

Philips has a clear strategy to partner with hospitals to manage the workflow, lower the cost of care, and offer home-care devices and solutions. In our view, the health-care business moat is based on high switching costs and technology leadership in the diagnosis market. Philips' end-to-end integrated solutions are well embedded in the patient-care process. As such, many companies elect to stay with the incumbent product for several years rather than convert to something new, irrespective of the technology improvement or cost savings. Philips also develops a sticky relationship through maintenance support services.

Consumer lifestyle is a no-moat business. The consumer lifestyle division generated 20% of sales and 20% of adjusted EBITA in 2013. In January 2014, Philips sold the remaining stake in its television joint venture and has clear intentions to sell its DVD and multimedia assets. The firm is selling its consumer electronics businesses to focus the portfolio on healthy living and prevention products. We think Philips has excellent positions in personal care (32% of 2013 sales) and health and wellness (21% of 2013 sales), like men's electric shaving and oral health care. However, 42% of consumer lifestyle 2013 revenue was derived by selling domestic appliances. The markets for kitchen appliances, garment care, and coffee are very competitive, and barriers to entry are low. The Philips brand is well known but not strong enough to justify a moat.

The lighting division is also a no-moat business, in our opinion. The lighting division generated 36% of sales and 32% of adjusted 2013 EBITDA, and switching costs are very high. Two trends are affecting the lighting industry value chain: first, a gradual migration from light sources to applications and solutions, and second, a far-reaching technological change toward solid-state lighting technologies like LED and OLED. Conventional lighting continues to be a large part of the market, but management forecasts LED penetration to grow to about 50% by 2015. We estimate current LED penetration is less than 25%.

The competitive situation varies strongly among segments and value chain components. For instance, the traditional lamp and ballast market is comparatively concentrated, with three top players (Philips, OSRAM, and GE) reaching a combined share of over 50%. On the other hand, the luminaires market in the general lighting segment is highly fragmented and regionally focused, where the top five players do not reach a combined share of 30%. With the transition to SSL products, the competitive landscape is changing. New players are entering the lighting market from different industries despite barriers to entry such as intellectual property rights, market channel access, and technology and application know-how.

Philips is currently evaluating strategic options for the LED component and automotive lighting division, as it doesn't want to participate in the next capex cycle given limited visibility on returns. After the sale or listing of the component business, lighting sales will be derived from light sources (60%), consumer luminaires (6%), and professional lighting solutions (34%). Professional lighting solutions comprises systems of interconnected lighting products and software integration and servicing an installed lighting system through its lifecycle. In our view, Philips is well positioned in professional lighting solutions, given its deep application and systems integration expertise, but low entry barriers for light sources and consumer luminaires markets prevent our assigning a moat rating for lighting.

Morningstar Analysis

We consider the innovation, group, and services division to be a no-moat segment that generated 3% of sales and negative 9% of EBITDA in 2013. The revenue and costs of this division are related to various activities like startup investments and royalty income. Philips receives roughly EUR 250 million per year for royalties related to intellectual property rights of the assets that have been sold during the past couple of years. Royalty income booked in this division will decrease by EUR 15 million per year as patents will be expiring.

Moat Trend

We believe the moat trend is stable as continued equipment competition in health-care diagnostics and LED lighting is offset by strong demand for integrated solutions. In our view, Philips is one of the few companies that has the capabilities and resources to handle large integrated health-care and lighting projects.

Especially in the U.S., rising medical costs have become a political issue and hospitals are more reluctant to invest in high-end imaging equipment. To counter this, Philips focuses more on the lower segments of the market by introducing products with fewer bells and whistles at lower prices. The growing lower end of the market is less focused on technology and could reduce switching costs. However, switching costs rise when Philips' end-to-end solutions are well embedded in the health-care diagnosis and treatment process.

With the transition to SSL products, the competitive landscape in lighting is changing. New players have entered, and we believe more still will enter the LED product market from different industries, despite barriers to entry such as intellectual property rights, market channel access, and technology and application know-how. The competitive environment for lighting systems and services is much more benign, and Philips is well positioned for strong demand for professional energy-saving light solutions.

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Bulls Say/Bears Say

Bulls Say

- Philips will create additional value by a sale or spin-off of lighting solutions and combination of its health-care and consumer lifestyle divisions.

- The health continuum is a growing EUR 100 billion-plus market for Philips. The firm's leading portfolio of medical devices and relationships combined with insights into clinical and consumer needs leads to a strong position to capture this opportunity.

- Philips is a leader in the consumer lifestyle, lighting, and health-care equipment and services markets. Weakness in any one area can be offset by strength in other divisions.

Bears Say

- With the market's transition to LED lighting products, the competitive landscape is changing. New players are entering the lighting market from different industries despite barriers to entry such as intellectual property rights, market channel access, and technology and application know-how.

- Changes in the U.S. health-care system, like lower reimbursement rates, will have an overall negative impact on demand for health-care orders.

- Philips has a record of returning excess cash to shareholders through dividends, but the cash it does retain is often used on expensive acquisitions.

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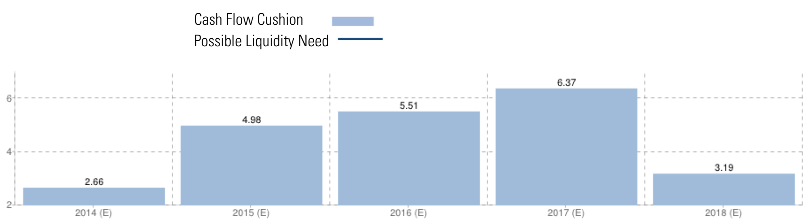
Credit Analysis

Five Year Adjusted Cash Flow Forecast (EUR Mil)

	2014(E)	*2015(E)*	*2016(E)*	*2017(E)*	*2018(E)*
Cash and Equivalents (beginning of period)	*2,465*	*2,276*	*2,596*	*3,188*	*3,796*
Adjusted Available Cash Flow	*252*	*1,268*	*1,297*	*1,321*	*1,345*
Total Cash Available before Debt Service	*2,717*	*3,544*	*3,893*	*4,509*	*5,141*
Principal Payments	*-362*	*-42*	*-26*	*-16*	*-910*
Interest Payments	*-301*	*-301*	*-301*	*-301*	*-301*
Other Cash Obligations and Commitments	*-357*	*-368*	*-379*	*-391*	*-402*
Total Cash Obligations and Commitments	*-1,020*	*-711*	*-706*	*-708*	*-1,613*

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	EUR Millions	% of Commitments
Beginning Cash Balance	2,465	51.8
Sum of 5-Year Adjusted Free Cash Flow	5,483	115.2
Sum of Cash and 5-Year Cash Generation	7,948	167.0
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	7,948	167.0
Sum of 5-Year Cash Commitments	-4,759	—

Credit Rating Pillars–Peer Group Comparison

	PHIA	Sector	Universe
Business Risk	10	4.7	5.1
Cash Flow Cushion	10	4.1	6.0
Solvency Score	1	3.0	4.7
Distance to Default	—	2.3	3.7
Credit Rating	BBB+	A	BBB+

Source: Morningstar Estimates

Note: Scoring is on a scale 1-10, 1 being Best, 10 being Worst

Financial Health & Capital Structure

Philips is in relatively solid financial shape, and Morningstar rates the firm a BBB+ credit issuer. The company had EUR 3.5 billion in long-term debt and EUR 0.7 billion in short-term debt compared with EUR 1.7 billion of cash as of Sept. 28. The firm operates with a relatively straightforward capital structure, composed mostly of U.S. dollar-dominated unsecured bonds, but also uses small amounts of bank loans and finance leases. The unused EUR 1.8 billion standby facility matures in February 2018. The debt maturities issues are spread evenly, and the average tenor of long-term debt is 12.4 years. Only EUR 899 million of the outstanding debt is due in the next five years. We believe Philips can comfortably cover this obligation in 2018 with internally generated cash flow. Thus, we do not expect repayment or refinancing to be an issue for Philips.

Enterprise Risk

We assign a medium uncertainty rating to Philips as the company's portfolio is well diversified in different products, market segments, and countries. The company operates in cyclical end markets, with much of the demand for its products tied to the overall health of the economy. As a result, cash flow forecasts--a key driver of our discounted cash flow model--are susceptible to economic slowdowns, and a prolonged global recession will hamper the company's performance. Further, its acquisition-driven growth in the health-care technology and lighting markets carries a high degree of integration and execution risk. Also, U.S. government spending cutbacks on health care have an outsize effect on Philips' medical equipment business. We will review our medium uncertainty rating after the separation of lighting solutions.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
NA	NA	NA	NA	NA

*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
Dodge & Cox International Stock Fund	4.76	2.01	2,892	31 Dec 2014
Oakmark International Fund	2.44	2.39	-1,142	30 Sep 2014
Longleaf Partners Fund	1.45	5.33	4,252	30 Sep 2014
Vanguard Total Intl Stock Idx Fund	0.67	0.13	193	31 Dec 2014
Undrly Fid DC L&G Eur (ex UK) Eq Idx T	0.50	0.51	-82	30 Sep 2014
Concentrated Holders				
K 2005 Exklusivfonds	0.01	9.33	-16	31 Mar 2014
SSgA Netherlands Index Equity Fund	—	7.86	0	31 Oct 2014
iShares MSCI Netherlands	0.04	7.31	—	09 Jan 2015
Achmea Nederland Aandelenfonds	0.21	6.91	-1,041	30 Nov 2014
BNP Paribas Netherlands	0.04	6.65	30	30 Sep 2014

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Southeastern Asset Management Inc.	1.96	4.39	4,828	30 Sep 2014
Dodge & Cox	4.95	1.89	3,500	31 Dec 2014
Government Pension Fund of Norway - Global	2.20	0.08	2,695	31 Dec 2011
EdgePoint Investment Management Inc.	0.17	1.36	1,535	30 Jun 2014
DWS Investment GmbH	0.07	0.83	643	30 Nov 2014
Top 5 Sellers				
SKAGEN AS	0.40	1.11	-1,657	31 Dec 2014
Banco Madrid Gestión de Activos SGIIC	—	0.47	-1,380	30 Sep 2014
Gestifonsa SGIIC	—	0.50	-1,307	30 Sep 2014
Achmea Beleggingsfondsen Beheer B.V.	0.25	4.36	-1,123	30 Nov 2014
Harris Associates L.P.	2.64	2.36	-1,075	31 Dec 2014

Management 18 Nov 2014

Frans van Houten replaced Gerard Kleisterlee as CEO in 2011. Van Houten brings a history of restructuring expertise and is credited with jump-starting Philips' recent success. Corporate governance appears adequate. In the two-tier corporate structure, the supervisory board supervises the policies of the board of management and executive committee. A new long-term incentive plan was introduced in 2013. The new plan consists of performance shares only, and vesting of these shares is based on two equally weighted performance conditions: 50% adjusted earnings per share growth and 50% relative total shareholder return. We like the combination of profit growth and shareholder value creation, two vital measurements of how effectively Philips is running its businesses. Also in 2013, guidance for members of the board of management to hold a certain number of shares in the company was increased to at least 200% of base pay. For the CEO, the level is 300%. Directors serve for four-year terms so the CEO's term ends March 31, 2015. We expect the reappointment of the CEO to be part of the annual general meeting agenda in 2015. A poison pill exists in the form of preference shares. This arrangement allows a Philips-connected foundation to buy a large ownership stake in the case of an unsolicited takeover offer.

For the past several decades, and until relatively recently, we would have considered Philips' stewardship to be poor, as investors have had to endure management's overpaying for acquisitions and layering overhead costs across the globe with little concern for shareholder value creation. The new management team has taken a different approach, stripping layers of overhead, exiting underperforming businesses, and returning cash to shareholders. Under stewardship of the new CEO, the firm has successfully delivered on restructuring, achieving targets in 2013 despite much lower GDP growth than it anticipated at the time of the target setting in 2011, currency headwinds, and a change in pension accounting. In our opinion, actions by current leadership merit a Standard Stewardship Rating.

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Analyst Notes

Acquisition of Volcano Enhances Narrow-Moat Philips' Position in Medical Imaging 17 Dec 2014

Philips' announcement Wednesday of the acquisition of Volcano, a leader in catheter-based imaging, for $1.2 billion is in line with the firm's ongoing strategy of enhancing its imaging operations and bolstering its switching costs. Management expects the acquisition to be accretive to earnings per share by 2017, driven by revenue and cost synergies, and targets an EBITA margin of 20% for its image-guided therapy business by that year. We maintain our fair value estimate of EUR 27 per share and narrow moat rating.

In our view, Volcano's price tag isn't outrageous. Philips is paying $18 per share, a 56% premium to Tuesday's closing price but a 22% discount to Volcano's 52-week high. Based on 2013 sales of $400 million, Philips is paying a 3 times sales multiple, which is fair, in our view, especially for a smaller med tech acquisition. While not perfect comps, recent deals in the med tech space, such as Becton Dickinson's acquisition of Carefusion for 3.1 times sales and Zimmer's purchase of Biomet for 4.2 times sales, provide some support to this deal.

The Volcano acquisition is in line with Philips' strategy to become the leading systems integrator in image-guided therapies and could increase customer switching costs. Volcano's advanced disposable catheters, which are capable of producing ultrasound images of the interior of blood vessels (IVUS) or perform blood flow measurements (FFR), are a natural extension of Philips' strong portfolio of interventional X-ray systems. These systems provide the visual maps that allow the clinician to guide catheters through the body to the area of interest and perform the minimally invasive treatment. Although we have seen increasing competition in IVUS (Terumo and Boston Scientific launched products recently) and FFR (Acist/ Medtronic entering the market), we like Volcano's broad product portfolio around these two technologies.

Philips intends to finance the acquisition through a combination of cash and debt, which would increase our net debt/EBITDA 2015 estimate from 0.39 times to 0.7. Proceeds from the expected sale of the LED component business (north of EUR 1.5 billion, in our view) are not included in this calculation.

Raising Narrow-Moat Philips' Fair Value on Higher Margins; Asset Disposals Catalysts for Rerating 18 Nov 2014

We have changed our moat rating for Philips to narrow from none, due mainly to our belief that the firm enjoys high switching costs and, to a lesser extent, intangible assets and technology leadership. The company's strong competitive positions in health-care diagnostics and imaging, traditional lighting, and professional lighting solutions should result in attractive returns. We expect Philips to generate returns on invested capital of 14% on average during our five-year discrete forecast horizon--above its cost of capital of 9.2%.

We are increasing our fair value estimate to EUR 27 per share from EUR 25 based on higher margin expectations. Our model assumes meaningful growth in the health care, lighting, and consumer lifestyle end markets beyond 2014, driven by global activity and increased production of medical devices. We expect the Cleveland facility production ramp-up to be completed during the second quarter of 2015, resulting in 2% revenue growth for the health-care division in 2015. Combined with 2% revenue growth for the lighting unit and 5% revenue growth in consumer lifestyle, we expect total revenue growth for 2015 of 2.7%. We forecast operating margins of 8.9% in 2015, expanding to 9.6% for 2018. Management's focus on operational performance and reshaping of the portfolio will enhance operating margins.

The next big catalysts are sale of the LED component business and separation of the lighting solution unit. We

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Analyst Notes

believe the breakup of the company has potential for shareholder value creation and better allocation of capital. We expect an enterprise value/adjusted EBITDA multiple rerating due to operational improvements, disposal of LED components (expected in the first quarter of 2015), and a trade sale or initial public offering for lighting solutions in 2015-16. Philips is currently trading at a 9.6 times EV/ adjusted EBITDA multiple on our 2014 forecasts. Our discounted cash flow-driven fair value estimate implies a multiple of 11.4 times.

In our view, the LED component business is worth EUR 1.5 billion, but according to recent press statements, the transaction value could exceed EUR 2.5 billion based on indicative offers of buyout groups including Bain, CVC, CD&R, KKR, and Onex. Our LED component business valuation is based on our expectations of an EBITA multiple of 10 times, sales of EUR 1.5 billion, and an EBITA margin of 10% in 2015. The multiple of 10 times reflects our belief that the Lumileds and automotive lighting market will be characterized by high growth, especially in high-power LEDs, but also margin pressure as result of increasing competition.

Incidentals, Softness in China, and Russia Tensions Cause Philips to Stumble in 3Q 20 Oct 2014

Philips' earnings in the third quarter plummeted on the back of incidentals like the EUR 366 million charge related to the verdict in the Masimo litigation and EUR 43 million in inventory write-downs related to the Cleveland health-care facility. Combined with softness in a number of markets such as China and Russia, Philips reported a net loss of EUR 103 million, compared with net income of EUR 281 million in the third quarter of 2013. It could take 6-12 months before growth in China picks up, which will depress near-term revenue expectations. We're updating our model and plan to publish our new fair value estimates shortly. We're maintaining our no moat rating.

Philips recently announced that it will combine the health-care and consumer lifestyle businesses and spin off the lighting division. The firm has started transitioning the lighting solutions business to a separate legal structure; we expect that the process of separation will take 12-18 months to complete. Lighting sales declined 1% year on year as LED-based sales growth of 28% was offset by a decline of 14% in overall conventional lighting sales. As we believe conventional lighting is in structural decline, we welcome Philips increasing its LED exposure. LED sales now represent 40% of total lighting sales, compared with 30% a year ago.

Health-care EBITA, adjusted for the intellectual property patent charge and inventory write-down, amounted to EUR 267 million compared with EUR 330 million during the prior-year quarter. The decrease was mainly attributable to the voluntary suspension of production at the Cleveland facility as well as negative currency impacts. On a positive note, production at the Cleveland facility is ramping up, which should contribute to improved performance for the health-care division in the fourth quarter and into 2015.

Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2011	2012	2013	*Forecast 2014*	*2015*	*5-Year Proj. CAGR*
Revenue	*-2.8*	-11.2	9.8	-5.9	*-3.7*	*2.7*	*1.6*
EBIT	*-0.8*	-47.4	-5.2	96.0	*-51.3*	*107.9*	*3.6*
EBITDA	*-1.2*	-28.7	-2.3	38.7	*-31.4*	*44.6*	*1.6*
Net Income	*-5.6*	-8.1	-64.5	158.4	*-59.0*	*148.7*	*4.2*
Diluted EPS	*-4.7*	-8.9	-63.4	159.8	*-59.1*	*148.7*	*4.2*
Earnings Before Interest, after Tax	*1.0*	-42.7	-17.0	116.8	*-33.4*	*51.2*	*2.2*
Free Cash Flow	*-33.5*	-130.2	-512.1	-76.4	*297.2*	*17.1*	*37.5*

Profitability	3-Year Hist. Avg	2011	2012	2013	*2014*	*2015*	*5-Year Proj. Avg*
Operating Margin %	*5.9*	4.8	4.2	8.7	*4.4*	*8.9*	*8.3*
EBITDA Margin %	*11.8*	11.0	9.8	14.4	*10.3*	*14.5*	*13.7*
Net Margin %	*4.3*	5.9	1.9	5.2	*2.2*	*5.4*	*5.0*
Free Cash Flow Margin %	*2.1*	-1.7	6.5	1.6	*6.7*	*7.7*	*7.4*
ROIC %	*8.4*	6.6	5.6	12.9	*9.2*	*13.9*	*13.1*
Adjusted ROIC %	*9.2*	7.5	6.8	13.3	*9.6*	*14.2*	*14.0*
Return on Assets %	*0.3*	-4.2	0.8	4.2	*2.0*	*4.9*	*4.6*
Return on Equity %	*1.0*	-9.5	1.9	10.5	*4.7*	*12.1*	*11.3*

Leverage	3-Year Hist. Avg	2011	2012	2013	*2014*	*2015*	*5-Year Proj. Avg*
Debt/Capital	*0.26*	0.24	0.29	0.26	*0.28*	*0.28*	*0.27*
Total Debt/EBITDA	*1.53*	1.55	1.87	1.16	*1.69*	*1.17*	*1.23*
EBITDA/Interest Expense	*7.46*	7.06	6.90	8.42	*7.68*	*11.11*	*10.85*

Valuation Summary and Forecasts

	2012	2013	*2014(E)*	*2015(E)*
Price/Fair Value	0.77	0.95	—	—
Price/Earnings	39.0	20.2	*46.9*	*18.9*
EV/EBITDA	7.8	7.8	*11.1*	*7.7*
EV/EBIT	18.3	13.1	*26.2*	*12.6*
Free Cash Flow Yield %	7.8	2.2	*6.8*	*7.9*
Dividend Yield %	1.4	1.1	*3.2*	*3.2*

Key Valuation Drivers

Cost of Equity %	10.0
Pre-Tax Cost of Debt %	5.8
Weighted Average Cost of Capital %	9.2
Long-Run Tax Rate %	30.0
Stage II EBI Growth Rate %	3.0
Stage II Investment Rate %	15.0
Perpetuity Year	15

Additional estimates and scenarios available for download at http://select.morningstar.com.

Discounted Cash Flow Valuation

	EUR Mil	Firm Value (%)	Per Share Value
Present Value Stage I	6,757	26.1	7.54
Present Value Stage II	9,578	37.0	10.69
Present Value Stage III	9,579	37.0	10.69
Total Firm Value	**25,914**	**100.0**	**28.93**
Cash and Equivalents	2,465	—	2.75
Debt	-3,901	—	-4.35
Preferred Stock	—	—	—
Other Adjustments	-1,444	—	-1.61
Equity Value	**23,034**	**—**	**25.71**
Projected Diluted Shares	896		
Fair Value per Share (EUR)	—		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Morningstar Analyst Forecasts

Income Statement (EUR Mil)
Fiscal Year Ends in December

	2011	2012	2013	*Forecast* 2014	*Forecast* 2015
Revenue	**22,579**	**24,788**	**23,329**	***22,475***	***23,070***
Cost of Goods Sold	13,932	15,379	13,641	*13,141*	*13,490*
Gross Profit	**8,647**	**9,409**	**9,688**	***9,333***	***9,581***
Selling, General & Administrative Expenses	6,001	6,266	6,024	*5,803*	*5,957*
Research & Development	1,610	1,810	1,733	*1,670*	*1,714*
Other Operating Expense (Income)	-50	303	-88	*877*	*-134*
Depreciation & Amortization (if reported separately)	—	—	—	—	—
Operating Income (ex charges)	**1,086**	**1,030**	**2,019**	***983***	***2,044***
Restructuring & Other Cash Charges	—	—	—	—	—
Impairment Charges (if reported separately)	1,355	—	28	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**-269**	**1,030**	**1,991**	***983***	***2,044***
Interest Expense	352	352	400	*301*	*301*
Interest Income	112	106	70	—	—
Pre-Tax Income	**-509**	**784**	**1,661**	***682***	***1,743***
Income Tax Expense	283	308	466	*204*	*522*
Other After-Tax Cash Gains (Losses)	16	—	2	*-2*	*-2*
Other After-Tax Non-Cash Gains (Losses)	-515	-245	-25	*10*	—
(Minority Interest)	-4	-5	—	*21*	*21*
(Preferred Dividends)	—	—	—	—	—
Net Income	**-1,295**	**226**	**1,172**	***507***	***1,240***
Weighted Average Diluted Shares Outstanding	956	927	922	*923*	*923*
Diluted Earnings Per Share	**-1.35**	**0.24**	**1.27**	***0.55***	***1.34***
Adjusted Net Income	1,328	471	1,217	*499*	*1,242*
Diluted Earnings Per Share (Adjusted)	**1.39**	**0.51**	**1.32**	***0.54***	***1.34***
Dividends Per Common Share	0.75	0.75	0.75	*0.80*	*0.80*
EBITDA	**1,131**	**2,428**	**3,340**	***2,312***	***3,344***
Adjusted EBITDA	**2,486**	**2,428**	**3,368**	***2,312***	***3,344***

Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Morningstar Analyst Forecasts

Balance Sheet (EUR Mil)

Fiscal Year Ends in December	2011	2012	2013	Forecast *2014*	*2015*
Cash and Equivalents	3,147	3,834	2,465	*2,276*	*2,596*
Investments	—	—	—	—	—
Accounts Receivable	4,415	4,585	4,678	*4,353*	*4,468*
Inventory	3,625	3,495	3,240	*3,176*	*3,260*
Deferred Tax Assets (Current)	—	—	—	—	—
Other Short Term Assets	1,293	614	1,091	*1,091*	*1,091*
Current Assets	**12,480**	**12,528**	**11,474**	***10,896***	***11,415***
Net Property Plant, and Equipment	3,014	2,959	2,780	*2,935*	*3,119*
Goodwill	7,016	6,948	6,504	*6,504*	*6,504*
Other Intangibles	3,996	3,731	3,262	*2,608*	*1,968*
Deferred Tax Assets (Long-Term)	1,713	1,917	1,675	*1,675*	*1,675*
Other Long-Term Operating Assets	544	819	703	*703*	*703*
Long-Term Non-Operating Assets	203	177	161	*171*	*171*
Total Assets	**28,966**	**29,079**	**26,559**	***25,492***	***25,555***
Accounts Payable	3,346	2,839	2,462	*2,376*	*2,439*
Short-Term Debt	582	809	592	*592*	*592*
Deferred Tax Liabilities (Current)	—	—	—	—	—
Other Short-Term Liabilities	5,415	6,307	5,422	*5,422*	*5,422*
Current Liabilities	**9,343**	**9,955**	**8,476**	***8,390***	***8,453***
Long-Term Debt	3,278	3,725	3,309	*3,309*	*3,309*
Deferred Tax Liabilities (Long-Term)	77	92	76	*76*	*76*
Other Long-Term Operating Liabilities	1,880	2,132	1,903	*1,903*	*1,903*
Long-Term Non-Operating Liabilities	1,999	2,001	1,568	*1,568*	*1,568*
Total Liabilities	**16,577**	**17,905**	**15,332**	***15,246***	***15,309***
Preferred Stock	—	—	—	—	—
Common Stock	202	191	188	*188*	*188*
Additional Paid-in Capital	813	1,304	1,796	*1,796*	*1,796*
Retained Earnings (Deficit)	12,917	10,713	10,415	*10,183*	*10,684*
(Treasury Stock)	-1,690	-1,103	-718	*-1,468*	*-1,968*
Other Equity	113	35	-467	*-467*	*-467*
Shareholder's Equity	**12,355**	**11,140**	**11,214**	***10,232***	***10,233***
Minority Interest	34	34	13	*13*	*13*
Total Equity	**12,389**	**11,174**	**11,227**	***10,245***	***10,246***

Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Morningstar Analyst Forecasts

Cash Flow (EUR Mil)

Fiscal Year Ends in December	2011	2012	2013	Forecast 2014	Forecast 2015
Net Income	-1,046	-77	1,170	*486*	*1,219*
Depreciation	617	678	632	*615*	*600*
Amortization	783	720	717	*714*	*700*
Stock-Based Compensation	—	—	—	—	—
Impairment of Goodwill	1,387	14	38	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	—	—	—	—	—
Other Non-Cash Adjustments	-62	-125	-30	*-10*	—
(Increase) Decrease in Accounts Receivable	-363	-191	-530	*325*	*-115*
(Increase) Decrease in Inventory	-216	-32	-165	*64*	*-84*
Change in Other Short-Term Assets	—	—	—	—	—
Increase (Decrease) in Accounts Payable	-43	769	-722	*-86*	*63*
Change in Other Short-Term Liabilities	-297	326	28	—	—
Cash From Operations	**760**	**2,082**	**1,138**	***2,109***	***2,382***
(Capital Expenditures)	-640	-661	-587	*-530*	*-544*
Net (Acquisitions), Asset Sales, and Disposals	-342	134	61	*-300*	*-300*
Net Sales (Purchases) of Investments	—	—	—	—	—
Other Investing Cash Flows	-293	-398	-471	—	—
Cash From Investing	**-1,275**	**-925**	**-997**	***-830***	***-844***
Common Stock Issuance (or Repurchase)	-671	-768	-562	*-750*	*-500*
Common Stock (Dividends)	-259	-255	-272	*-739*	*-739*
Short-Term Debt Issuance (or Retirement)	-217	133	-285	—	—
Long-Term Debt Issuance (or Retirement)	-643	597	-122	—	—
Other Financing Cash Flows	—	—	—	*21*	*21*
Cash From Financing	**-1,790**	**-293**	**-1,241**	***-1,468***	***-1,218***
Exchange Rates, Discontinued Ops, etc. (net)	-381	-177	-269	—	—
Net Change in Cash	**-2,686**	**687**	**-1,369**	***-189***	***320***

Royal Philips NV PHIA (XAMS) | ★★★

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25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Valuation Analysis

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	0.79	17.1	14.3	13.5	16.2	14.1	13.7	13.1	7.0	8.0	2.2	1.7	1.7	1.9	1.6	1.6
Siemens AG SIE DEU	1.13	17.7	15.4	15.1	8.2	9.8	9.3	11.6	16.1	16.5	2.3	2.7	2.6	0.9	1.2	1.2
Average		17.4	14.9	14.3	12.2	12.0	11.5	12.4	11.6	12.3	2.3	2.2	2.2	1.4	1.4	1.4
Royal Philips NV PHIA NL	**0.94**	**20.2**	**46.9**	**18.9**	**7.8**	**11.1**	**7.7**	**45.4**	**14.8**	**12.7**	**2.2**	**2.3**	**2.3**	**1.1**	**1.0**	**1.0**

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	656,560 USD	4.3	4.7	4.6	6.1	6.6	6.9	12.0	11.2	11.2	2.3	2.3	2.3	2.8	3.7	3.8
Siemens AG SIE DEU	— EUR	9.0	10.5	13.6	10.4	12.8	16.7	14.5	18.2	17.4	4.1	5.2	5.2	3.9	3.0	3.4
Average		6.7	7.6	9.1	8.3	9.7	11.8	13.3	14.7	14.3	3.2	3.8	3.8	3.4	3.4	3.6
Royal Philips NV PHIA NL	**26,559** EUR	**12.9**	**9.2**	**13.9**	**13.3**	**9.6**	**14.2**	**10.5**	**4.7**	**12.1**	**4.2**	**2.0**	**4.9**	**1.1**	**3.2**	**3.2**

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	146,045 USD	-0.4	1.5	0.3	-5.1	-0.5	10.4	8.3	0.8	5.8	54.4	-43.1	-34.2	11.7	15.8	4.6
Siemens AG SIE DEU	73,445 EUR	-5.1	-2.1	1.0	-10.2	25.9	7.1	7.1	25.3	1.8	53.5	15.1	101.1	—	10.0	—
Average		-2.8	-0.3	0.7	-7.7	12.7	8.8	7.7	13.1	3.8	54.0	-14.0	33.5	11.7	12.9	4.6
Royal Philips NV PHIA NL	**23,329** EUR	**-5.9**	**-3.7**	**2.7**	**96.0**	**-51.3**	**107.9**	**159.8**	**-59.1**	**148.7**	**-76.4**	**297.2**	**17.1**	**—**	**6.7**	**—**

Royal Philips NV PHIA (XAMS) | ★★★

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25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
		2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	16,882 USD	35.1	33.3	31.9	20.3	19.8	20.3	12.5	12.2	13.4	11.6	11.2	11.5	14.7	22.7	19.9
Siemens AG SIE DEU	4,285 EUR	27.4	28.9	29.1	11.7	13.5	14.1	7.9	10.2	10.8	5.8	7.5	7.6	7.5	7.3	7.1
Average		31.3	31.1	30.5	16.0	16.7	17.2	10.2	11.2	12.1	8.7	9.4	9.6	11.1	15.0	13.5
Royal Philips NV PHIA NL	**1,217** EUR	**41.5**	**41.5**	**41.5**	**14.4**	**10.3**	**14.5**	**8.7**	**4.4**	**8.9**	**5.2**	**2.2**	**5.4**	**2.4**	**7.0**	**8.0**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
		2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	299,555 USD	229.4	219.1	209.0	69.6	68.7	67.6	22.2	19.0	19.0	10.1	10.2	9.9	5.0	4.9	4.7
Siemens AG SIE DEU	20,453 EUR	72.8	67.7	64.2	42.1	40.4	39.1	9.2	10.3	86.8	2.4	2.2	2.0	3.6	3.4	3.3
Average		151.1	143.4	136.6	55.9	54.6	53.4	15.7	14.7	52.9	6.3	6.2	6.0	4.3	4.2	4.0
Royal Philips NV PHIA NL	**3,901** EUR	**34.8**	**38.1**	**38.1**	**25.8**	**27.6**	**27.6**	**8.4**	**7.7**	**11.1**	**1.2**	**1.7**	**1.2**	**2.4**	**2.5**	**2.5**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
		2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
General Electric Co GE USA	236,895 USD	8.61	11.00	12.36	2.04	2.07	2.07	1.96	1.99	1.98	1.14	1.42	1.55	51.5	58.9	57.6
Siemens AG SIE DEU	84,959 EUR	10.79	13.68	14.82	1.24	1.31	1.35	0.83	0.90	0.94	4.73	7.20	7.91	59.7	52.4	51.5
Average		9.70	12.34	13.59	1.64	1.69	1.71	1.40	1.45	1.46	2.94	4.31	4.73	55.6	55.7	54.6
Royal Philips NV PHIA NL	**23,298** EUR	**2.67**	**2.46**	**2.81**	**1.35**	**1.30**	**1.35**	**0.97**	**0.92**	**0.96**	**4.16**	**3.84**	**4.39**	**59.0**	**145.7**	**59.6**

Research Methodology for Valuing Companies

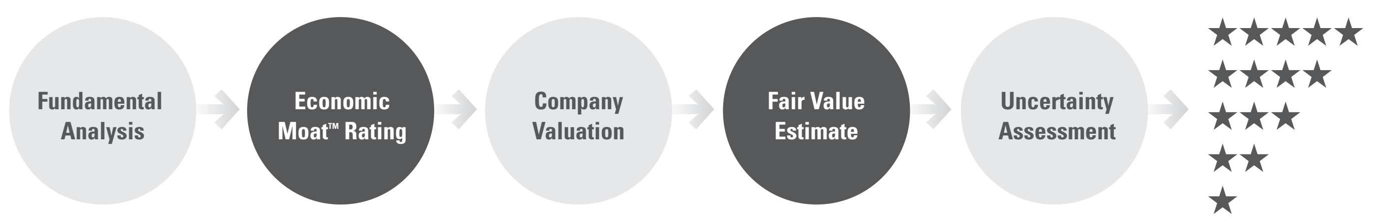
Components of Our Methodology
- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

The Morningstar Rating for stocks identifies companies trading at a discount or premium to our analysts' assessment of their fair value. A number of components drive this rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's intrinsic value based on a discounted cash-flow model, (3) the margin of safety bands we apply to our Fair Value Estimate, and (4) the current stock price relative to our fair value estimate.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our valuation process. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. There are two major requirements for firms to earn either a narrow or wide moat rating: (1) the prospect of earning above-average returns on capital; and (2) some competitive edge that prevents these returns from quickly eroding. The assumptions we make about a firm's moat determine the length of "economic outperformance" that we assume in the latter stages of our valuation model. We also quantify the value of each firm's moat, which represents the difference between a firm's enterprise value and the value of the firm if no future net investment were to occur. Said differently, moat value identifies the value generated by the firm as a result of any future net new investment. Our Moat Trend Rating reflects our assessment of whether each firm's competitive advantage is either getting stronger or weaker, since we think of moats as dynamic, rather than static.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from 0 years (for no-moat firms) to 20 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard

Morningstar Research Methodology for Valuing Companies



Analyst conducts company and industry research: ► Financial statement analysis ► Channel checks ► Trade-show visits ► Industry and company reports and journals ► Conference calls ► Management and site visits	Strength of competitive advantage is rated: None, Narrow, or Wide Advantages that confer an economic moat: **High Switching Costs** (Microsoft) **Cost advantage** (Wal-Mart) **Intangible assets** (Johnson & Johnson) **Network Effect** (Mastercard) **Efficient Scale** (Lockheed Martin)	Analyst considers past financial results and focuses on competitive position and future prospects to forecast future cash flows. Assumptions are entered into Morningstar's proprietary discounted cash-flow model.	Analyst uses a discounted cash-flow model to develop a Fair Value Estimate, which serves as the foundation for the Morningstar Rating for stocks.	The analyst then evaluates the range of potential intrinsic values for the company and assigns an Uncertainty Rating: Low, Medium, High, Very High, or Extreme. The Uncertainty Rating determines the margin of safety required before we would recommend the stock. The higher the uncertainty, the wider the margin of safety.	The current stock price relative to Morningstar's Fair Value Estimate, adjusted for uncertainty, determines the Morningstar Rating for stocks. The Morningstar Rating for stocks is updated each evening after the market closes.

Research Methodology for Valuing Companies

Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

* Please contact a sales representative for more information.

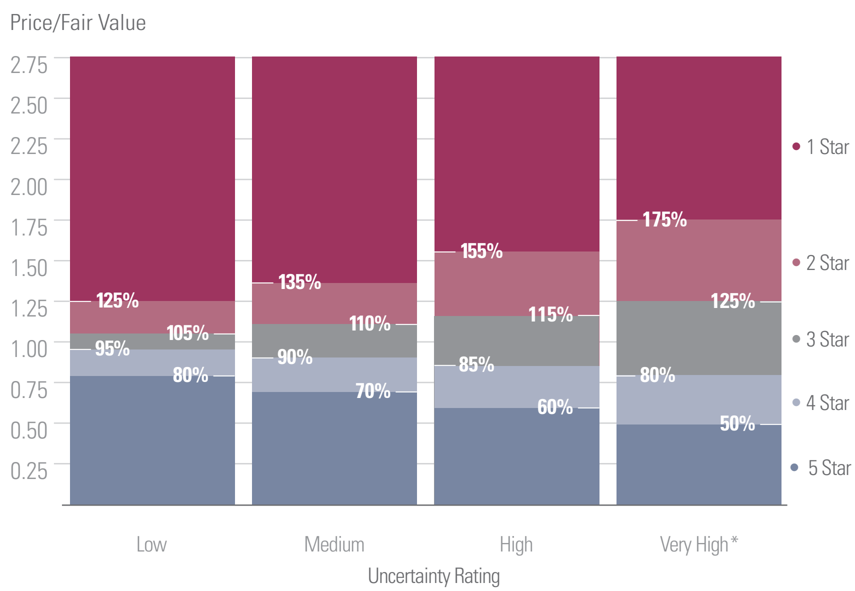
perpetuity formula. In deciding on the rate at which to discount future cash flows, we ignore stock-price volatility. Instead, we rely on a system that measures the estimated volatility of a firm's underlying future free cash flows, taking into account fundamental factors such as the diversity of revenue sources and the firm's fixed cost structure.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts typically model three to five scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of these potential fair values, based on an assessment of a company's future sales range, the firm's operating and financial leverage, and any other contingent events that may impact the business. Our analysts use this range to assign an appropriate margin of safety—or the discount/premium to a fair value we apply in setting our consider buying/consider selling prices. Firms trading below our consider-buying prices receive our highest rating of five stars, whereas firms trading above our consider-selling prices receive our lowest rating of one star.

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Morningstar Margin of Safety and Star Rating Bands



* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Morningstar's Approach to Rating Corporate Credit

- Offers a proprietary measure of the credit quality of companies on our coverage list.
- Encapsulates our in-depth modeling and quantitative work in one letter grade.
- Allows investors to rank companies by each of the four underlying components of our credit ratings, including both analyst-driven and quantitative measures.
- Provides access to all the underlying forecasts that go into the rating, available through our institutional service.

Purpose

The Morningstar Corporate Credit Rating measures the ability of a firm to satisfy its debt and debt-like obligations. The higher the rating, the less likely we think the company is to default on these obligations.

The Morningstar Corporate Credit Rating builds on the modeling expertise of our securities research team. For each company, we publish:

- Five years of detailed pro-forma financial statements
- Annual estimates of free cash flow
- Annual forecasts of return on invested capital
- Scenario analyses, including upside and downside cases
- Forecasts of leverage, coverage, and liquidity ratios for five years
- Estimates of off balance sheet liabilities

These forecasts are key inputs into the Morningstar Corporate Credit Rating and are available to subscribers at select.morningstar.com.

Methodology

We feel it's important to perform credit analysis through different lenses—qualitative and quantitative, as well as fundamental and market-driven. We therefore evaluate each company in four broad categories.

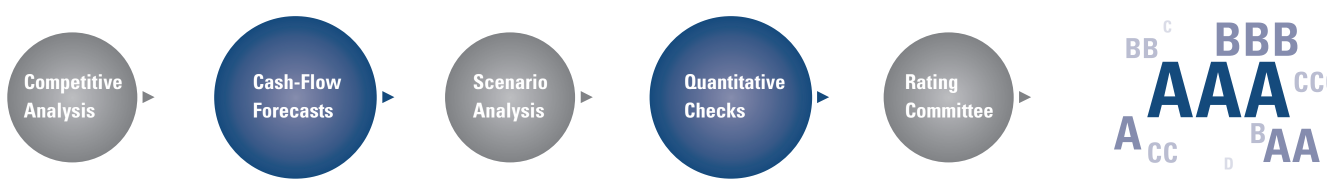
Business Risk

Business Risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. Key components of the Business Risk rating include the Morningstar Economic Moat™ Rating and the Morningstar Uncertainty Rating.

Cash Flow Cushion™

Morningstar's proprietary Cash Flow Cushion™ ratio is a fundamental indicator of a firm's future financial health The measure reveals how many times a company's internal cash generation plus total excess liquid cash will cover its debt-like contractual commitments over the next five years. The Cash Flow Cushion acts as a predictor of financial distress, bringing to light potential refinancing, operational, and liquidity risks inherent to the firm.

Morningstar Research Methodology for Determining Corporate Credit Ratings



Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade show visits
- Competitor, supplier, distributor, and customer interviews
- Assign Economic Moat™ Rating

Analyst considers company financial statements and competitive dynamics to forecast future free cash flows to the firm.

Analyst derives estimate of Cash-Flow Cushion™.

Analysts run bull and bear cases through the model to derive alternate estimates of enterprise value.

Based on competitive analysis, cash-flow forecasts, and scenario analysis, the analyst assigns Business Risk.

We gauge a firm's health using quantitative tools supported by our own backtesting and academic research.

- Morningstar Solvency Score™
- Distance to Default

Senior personnel review each company to determine the appropriate final credit rating.

- Review modeling assumptions
- Approve company-specific adjustments

AAA	Extremely Low Default Risk
AA	Very Low Default Risk
A	Low Default Risk
BBB	Moderate Default Risk
BB	Above Average Default Risk
B	High Default Risk
CCC	Currently Very High Default Risk
CC	Currently Extreme Default Risk
C	Imminent Payment Default
D	Payment Default
UR	Under Review
UR+	Positive Credit Implication
UR-	Negative Credit Implication

Morningstar's Approach to Rating Corporate Credit

The advantage of the Cash Flow Cushion ratio relative to other fundamental indicators of credit health is that the measure focuses on the future cash-generating performance of the firm derived from Morningstar's proprietary discounted cash flow model. By making standardized adjustments for certain expenses to reflect their debt-like characteristics, we can compare future projected free cash flows with debt-like cash commitments coming due in any particular year. The forward-looking nature of this metric allows us to anticipate changes in a firm's financial health and pinpoint periods where cash shortfalls are likely to occur.

Morningstar Solvency Score™

The Morningstar Solvency Score™ is a quantitative score derived from both historical and forecasted financial ratios. It includes ratios that focus on liquidity (a company's ability to meet short term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how does the company finance its operations), and interest coverage (how much of profit is used up by interest payments).

Distance to Default

Morningstar's quantitative Distance to Default measure ranks companies on the likelihood that they will tumble into financial distress. The measure is a linear model of the percentile of a firm's leverage (ratio of Enterprise Value to Market Value), the percentile of a firm's equity volatility relative to the rest of the universe and the interaction of these two percentiles. This is a proxy methodology for the common definition of Distance to Default which relies on option-based pricing models. The proxy has the benefit of increased breadth of coverage, greater simplicity of calculation, and more predictive power.

For each of these four categories, we assign a score, which we then translate into a descriptive rating along the scale of Very Good / Good / Fair / Poor / Very Poor.

Overall Credit Rating

The four component ratings roll up into a single preliminary credit rating. To determine the final credit rating, a credit committee of at least five senior research personnel reviews each preliminary rating.

We review credit ratings on a regular basis and as events warrant. Any change in rating must be approved by the Credit Rating Committee.

Investor Access

Morningstar Corporate Credit Ratings are available on Morningstar.com. Our credit research, including detailed cash-flow models that contain all of the components of the Morningstar Corporate Credit Rating, is available to subscribers at select.morningstar.com.

Royal Philips NV PHIA (XAMS) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
25.32 EUR	27.00 EUR	18.90 EUR	36.45 EUR	Medium	Narrow	Stable	Standard	BBB+	Computer Hardware

The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic value.

Five-star stocks sell for the biggest risk-adjusted discount whereas one-star stocks trade at premiums to their intrinsic value. Based on a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's Equity Analysts, four key components drive the Morningstar Rating: 1. Assessment of the firm's economic moat, 2. Estimate of the stock's fair value, 3. Uncertainty around that fair value estimate and 4. Current market price. Further information on Morningstar's methodology is available from http://global.morningstar.com/equitydisclosures.

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