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**Research Update:**

## Swedish Telecom Supplier Ericsson Downgraded To 'BBB' On Lower Revenues And Profitability; Outlook Negative

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## Overview

- Swedish telecom supplier Ericsson reported significantly weaker preliminary results for the third quarter of 2016 than we had forecast. Current negative trends look set to prevail longer than we previously expected.
- Demand for mobile telecom equipment is currently weak, competition has remained intense, and visibility is limited. As a result, we have revised downward our base-case expectations for 2016, and we do not expect any rebound in revenues or margins in 2017.
- We are therefore lowering our long-term corporate credit rating on Ericsson to 'BBB' from 'BBB+'.
- The negative outlook reflects the possibility of a further downgrade in the next 12-24 months if Ericsson's revenues and cash flows continue to deteriorate.

## Rating Action

On Oct. 17, 2016, S&P Global Ratings lowered its long-term corporate credit and issue ratings on Swedish telecom supplier Ericsson (Telefonaktiebolaget L.M.) to 'BBB' from 'BBB+'. The outlook is negative. We affirmed our short-term rating on the company at 'A-2' and lowered our short-term Nordic regional scale rating to 'K-2' from 'K-1'.

## Rationale

The downgrade reflects Ericsson's weakening operating performance caused by poor industry conditions and intense competition. We think that demand for mobile telecom equipment will continue to decline until at least the second half of 2017. Furthermore, Ericsson's market position has declined. According to market research group Dell'Oro, China's Huawei outpaced Ericsson in the mobile equipment market in the first half of 2016, holding a 30% market share compared with 28% for Ericsson. As a result, Ericsson's revenue and profitability decline has accelerated in 2016, and we do not anticipate a material rebound in 2017.

The negative outlook reflects our degree of uncertainty regarding Ericsson's ability to stabilize revenues, given the competitive environment and limited visibility on the direction of the telecom infrastructure market. There is

also execution risk associated with the ongoing restructuring program, and some uncertainty around the company's strategy going forward given recent changes in management.

The ratings on Ericsson continue to be supported by a strong balance sheet with meaningful reported net cash and well-spread debt maturities. Ericsson has a long track record of generating persistently positive cash flows. However, due to the pronounced decline in revenues and low margins, coupled with restructuring charges, we forecast only about break-even reported free operating cash flow (FOCF) in 2016. Furthermore, if the company does not adjust dividends to reflect lower FOCF, we think the balance sheet could weaken.

Our revised base case for Ericsson's revenues and cash flow in 2016 and 2017 is lower than our forecast in July 2016, when we revised the outlook on the company to negative. This follows Ericsson's preliminary 14% year-on-year decline in revenues in the third quarter of 2016, after a 7% year-on-year decline in the first half of the year. Furthermore, the preliminary reported gross margin, including restructuring charges, declined to 28% in the third quarter from 34% a year ago, leading to a 31% gross margin for the first nine months of 2016.

Ericsson announced a cost-cutting program in 2014, targeting annual run-rate savings of Swedish krona (SEK) 9 billion in 2017. In addition, the company announced a reorganization and further cost-reduction initiatives in April and July 2016. We understand that the original savings target has been increased by 50%, and that management aims to meet this target by the second half of 2017. We think that Ericsson is on track to reach about SEK9 billion operating expense savings. However, we expect it to be more challenging for Ericsson to reach its cost-of-sales savings target than we previously assumed due to the company's weaker revenue development.

In our base case, we assume:

- Consolidated revenues to decline by 10%-12% in 2016 and by a mid-single-digit percentage in 2017, before stabilizing in 2018. Revenues to decline in the Networks segment by a mid-teen percentage and in the Global Services segment by high-single-digit percentages in 2016 due to the weak macroeconomic situation in some emerging markets, and lower demand in the wireless infrastructure market following the peak in fourth-generation (4G) wireless rollouts in 2015. We expect a further high-single-digit decline in the Networks segment in 2017.
- Annual restructuring costs of SEK4 billion-SEK5 billion in 2016 and 2017, compared with SEK5 billion in 2015.
- Reported gross margin of about 30% in 2016, compared with 34.8% in 2015. This reflects meaningfully lower revenues in the Networks segment, a larger share of coverage projects and services business, and challenges in the Global Services segment. We anticipate only a slight improvement in 2017 thanks to cost-cutting measures and an expected improvement in business mix, somewhat offset by declining revenues and a higher share of services sales, which have a lower gross margin.

- Annual operating expenses savings to gradually reach about SEK9 billion in 2018.

Annual capital expenditures (capex) of about 2.5%-3.0% of revenues and some bolt-on acquisitions.

- Lower annual dividends (from SEK12 billion in 2016) in 2017 and 2018 to address weaker FOCF and in order to preserve a solid net cash position.
- Higher adjusted gross debt, primarily due to an increase in postretirement obligations as a result of low interest rates. We consider cash reserves above about SEK5 billion as surplus and deduct them from gross debt.

Based on these assumptions, we arrive at the following adjusted credit measures for 2016-2018:

- Adjusted EBITDA margin of about 7%-8% in 2016 and 2017, improving to above 10% in 2018, compared with 12.7% in 2015.
- Break-even reported free operating cash flow (FOCF) in 2016, compared with FOCF of SEK9 billion in 2015. We anticipate FOCF of SEK4 billion-SEK5 billion in 2017 and further improvement in 2018.
- Funds from operations (FFO) to debt above 60%.
- Adjusted debt to EBITDA of about 0.8x in 2016 and about 1x in 2017, declining comfortably below 1x thereafter.
- Reported net cash position of about SEK27 billion at the end of 2016, and about SEK23 billion-SEK24 billion in 2017 and 2018.

## **Liquidity**

The short-term rating is 'A-2'. We consider Ericsson's liquidity to be exceptional because we expect its sources of liquidity to amount to at least 2x uses in the two years from June 30, 2016. Furthermore, we think the company has good relationships with its banks and a high standing in the credit markets.

We anticipate the following primary liquidity sources over the next 12 months:

- Consolidated cash and equivalents of SEK49 billion on June 30, 2016.
- Annual FFO of about SEK13 billion-SEK14 billion.
- An undrawn revolving credit facility of \$2.0 billion maturing in 2021 that has no financial covenants.

We anticipate the following primary liquidity uses over the same period:

- Annual capex, including capitalized development costs, of about SEK10 billion.
- Our anticipation of significant intrayear peak working capital outflows.
- Lower annual dividend in 2017 compared with 2016 (SEK12 billion) to reflect weaker FOCF.
- Short-term debt of about SEK10 billion on June 30, 2016, including €500 million notes maturing in 2017.

## **Outlook**

The negative outlook on Ericsson reflects the potential for a downgrade in the next 12-24 months, if the company is not able to stabilize its revenues and

materially improve its profitability in 2018.

### **Downside scenario**

We could lower the ratings if Ericsson's revenues grow less than the industry average for a prolonged period, or if we thought that EBITDA margins would remain sustainably below 10%, despite the ongoing restructuring. We think this could happen because of higher competition, loss of market shares, or inadequate cost reductions. We could also consider a downgrade if Ericsson's strong balance sheet were to deteriorate, demonstrated by S&P Global Ratings-adjusted leverage reaching 1.5x on a sustainable basis. A further substantial reduction in reported net cash due to shareholder distributions that materially exceed FOCF or material acquisitions could also lead to a downgrade.

### **Upside scenario**

We could revise the outlook to stable if Ericsson's operating performance strengthened sustainably. This could be reflected in the adjusted EBITDA margin increasing to above 10% and stabilizing revenues at least in line with average industry growth. In addition, we would expect Ericsson to maintain a strong balance sheet, including a solid net cash position and at least break-even discretionary cash flow generation.

## **Ratings Score Snapshot**

Corporate Credit Rating: BBB/Negative/A-2

Business risk: Fair

- Country risk: Very low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Minimal

- Cash flow/Leverage: Minimal

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

## Related Criteria And Research

### Related Criteria

- National And Regional Scale Credit Ratings, Sept. 22, 2014
- S&P Global Ratings' National And Regional Scale Mapping Tables, June 1, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Key Credit Factors For The Technology Hardware And Semiconductors Industry , Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013

### Related Research

- Swedish Telecom Supplier Ericsson Outlook Revised To Negative On Weaker Profitability; 'BBB+/A-2' Ratings Affirmed, July 25, 2016

## Ratings List

Downgraded; Ratings Affirmed

	To	From
Ericsson (Telefonaktiebolaget L.M.) Corporate Credit Rating	BBB/Negative/A-2	BBB+/Negative/A-2
Nordic Regional Scale	K-2	K-1
Ericsson (Telefonaktiebolaget L.M.) Senior Unsecured	BBB	BBB+

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [www.spcapitaliq.com](http://www.spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings'

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