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Ericsson Outlook Revised To Developing As Governance Issues Offset Strong Cash Flow Prospects; Affirmed At 'BBB-/A-3'

- The U.S. Department of Justice (DoJ) has assessed as insufficient the disclosures by telecommunications equipment vendor Telefonaktiebolaget LM Ericsson prior to a deferred prosecution agreement (DPA) in connection with misconduct in Iraq during 2011-2019.
- The DoJ has also determined that, during a three-year monitoring period that started in summer 2020, Ericsson failed to make subsequent disclosures relating to the investigation post DPA. Consequently, our assessment of Ericsson's management and governance is weaker than it was before the DoJ's assessment.
- At the same time, we anticipate that Ericsson's EBITDA margin and annual free operating cash flow (FOCF) after leases will remain strong in 2022-2023, at 15.5%-17.5% and Swedish krona (SEK) 15 billion–SEK 30 billion, respectively, after a solid performance in 2021 and positive market prospects.
- As each of the two factors above could lead to an opposite rating action, we revised our outlook on Ericsson to developing from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term issuer credit ratings on the company and our 'BBB-' issue rating on its unsecured debt.
- The developing outlook reflects the possibility that we could lower, raise, or affirm our ratings on Ericsson in the next 24 months. We could lower the ratings if we revised our management and governance assessment on Ericsson to weak, or if the ongoing DoJ

investigation resulted in a weakening of Ericsson's credit profile due to the financial, reputational, or business impact. We could raise the ratings if Ericsson managed to report credit metrics in line with our base case on a sustainable basis, while maintaining a fair management and governance assessment.

PARIS (S&P Global Ratings) March 17, 2022--S&P Global Ratings today took the rating actions listed above.

As a result of misconduct in Iraq and insufficient disclosures to the U.S. authorities, we now view Ericsson's governance as a negative consideration in the ratings.Through an internal investigation carried out in 2018-2019, Ericsson found evidence of past misconduct in Iraq on multiple occasions, including payments to intermediaries for alternative transportation routes to avoid Iraqi Customs at a time when militant groups, including ISIS, controlled some routes. Ericsson took remedial measures, including several employee departures and the termination of some relationships with third parties. On March 2, 2022, the U.S. DoJ determined that the information that Ericsson disclosed regarding the misconduct in Iraq was insufficient during the investigation in 2011-2019. The DoJ also concluded that after 2019, during a compliance monitoring period as part of a three-year DPA, Ericsson failed to make additional disclosures relating to the investigation. Consequently, we view the company's governance as weaker than before the DoJ's pronouncements, and it now sits at the weaker end of our fair management and governance assessment. This is a negative consideration in our issuer credit ratings on Ericsson, resulting in a downward revision to 'G4' from 'G3' under our environmental, social, and governance (ESG) credit indicators. At this stage, this revision does not lead to a change in the issuer credit ratings because we do not expect that the ongoing investigation will materially affect Ericsson's credit profile.

We believe that Ericsson's compliance and ethics framework has strengthened since 2019, but the company could face greater consequences from the DoJ investigation than we anticipate.Since the appointment of the new CEO, Chief Legal Officer, and Chief Compliance Officer during 2017-2019, Ericsson has enhanced its compliance framework, including anti-bribery and corruption policies and procedures. We believe that Ericsson is committed to preventing misconduct through its strengthened internal controls in its 180 countries of operation and through mitigating measures when it finds wrongdoings. At this stage, we do not know which piece of information Ericsson failed to disclose to the U.S. authorities and the reason for the lack of disclosure. We understand that, as part of the DPA with the DoJ, Ericsson is restricted from providing more details on this subject. We continue to monitor developments in this area, and if we conclude that failures to prevent and disclose misconduct continue under the enhanced governance framework, or that the undisclosed information was material, we could revise Ericsson's management and governance downward to weak from fair, leading to at least a one-notch downgrade.

We do not know whether Ericsson will face any financial sanctions, and, if so, what the magnitude of such sanctions would be, but Ericsson has significant rating headroom to accommodate a fine.At this stage, we do not know if the regulators in the U.S. or elsewhere will impose any additional sanctions on Ericsson. However, the company has a strong balance sheet, with leverage that we expect to be below 0.5x by year-end 2022, including the acquisition of Vonage Holding Corp. (Vonage). We estimate that a fine of more than SEK35 billion could cause leverage to rise above 1.5x and/or funds from operations (FFO) to debt to fall below 60%, our thresholds for a downgrade. This is not our expectation; it just reflects the headroom under the current rating. We continue to closely monitor the potential negative effects on the company's operational, reputational, and financial performance.

Despite some uncertainty linked to the difficult industry Ericsson operates in, we expect the company to continue growing its topline in 2022-2023.We expect that Ericsson's like-for-like revenues could increase by about 0%-3% yearly in 2022-2023. We anticipate that Ericsson's addressable markets will expand in the coming years, mainly driven by telecom operators' 5G rollouts and customers' increased demand for high-speed connectivity. In the longer term, once the 5G rollout is complete, the revenue trajectory in the networks division is uncertain. On one hand, the enterprise business could provide solid growth opportunities, especially the private wireless business, for example as a result of manufacturing plants, railways, and utilities investing in new private networks.

Another supporting factor is Ericsson's strong market share. Competition in mobile networks remains intense as vendors try to get their share of the promising 5G cycle. Ericsson's share of the global mobile radio access network (RAN) market remained stable at around 29% in 2021, according to market research firm Dell'Oro, supported by its strong product portfolio and technological competitiveness. Despite a loss of market share in China, where growth is stronger than in the rest of the world due to the country's large investments in 4G and 5G, Ericsson has increased its market share in other regions. It was helped to some extent by security concerns about and restrictions on Huawei products, primarily in Europe.

At the same time, Ericsson's revenue prospects could be offset in the short term by supply chain disruptions and in the long term by technological risks.With like-for-like growth of 4% in 2021, Ericsson's sales were constrained in the third quarter of the year by disruptions in the supply chains for certain components, especially semiconductors. Although the company has increased its inventory and is mitigating inflation through disciplined cost control, visibility on the future supply chain remains low. We believe that the evolution of the supply chain and inflation could pose a risk for Ericsson and lead to lower FOCF generation than we anticipate. The impact that technological changes such as Open RAN and Cloud RAN could have on Ericsson is still unclear. If it executes the new technology successfully, these trends could also bring about opportunities for Ericsson.

We also anticipate a strong profitability margin and FOCF generation in 2022 and thereafter.Ericsson reached its EBIT margin target of 12%-14% in 2022 one year earlier, in 2021, primarily thanks to cost efficiencies from a previous sizable restructuring. We expect a reported EBITA margin of 13.5%-15.0% in 2022-2023, compared to 14.6% in 2021, and progress toward the company's new target of 15%-18% in the next two-to-three years. On an S&P Global Ratings-adjusted basis, we forecast an EBITDA margin of 16.5%-18.0% for 2022-2023, compared to 17.5% in 2021. Ericsson's cash flows have been volatile over time, which reflects the cyclicality and challenges of the telecommunications equipment sector. The company has undertaken a large restructuring to offset the revenue pressure from severe competition and volatility in demand due, for instance, to technology cycles. In 2021, Ericsson generated about SEK32 billion of FOCF after leases, the highest level for many years. The strong cash flows in 2021 benefitted from customer prepayments and lower capital expenditure (capex) than expected. In 2022, we anticipate higher working capital outflows as the company accumulates inventory while increasing capex, leading to lower cash flow generation than in 2021, at about SEK15 billion–SEK25 billion. We believe that some restructuring could continue in the future due to the cyclicality of the sector and as part of the company's efforts to offset continuous price pressure. However, we think that Ericsson could be able to sustain FOCF after leases of well above SEK15 billion across cycles.

We anticipate strong credit metrics despite the large acquisition of Vonage. Ericsson's plans to finalize the acquisition of Vonage in the second quarter of 2022 for SEK55.6 billion ($6.2 billion) in cash supports the company's growth trajectory and diversification by expanding its presence in the enterprise segment and monetizing 5G technology beyond mobile broadband. We believe that the acquisition of Vonage, an integrated communication services provider with cloud-based platforms serving 120,000 business customers and one million developers, will help Ericsson accelerate growth in the enterprise segment and expand its offerings and customer base. The company's long-term target is to provide wireless products to the whole ecosystem, including telecom operators, businesses, and developers. While the immediate impact of the transaction on revenue is an additional 5% in 2022, we believe that it provides some growth opportunities for Ericsson, and could partly offset the volatility in revenue over technology cycles. The likely business benefits from the acquisition are partly offset by the acquisition price of SEK55.6 billion, resulting in weaker leverage of below 0.5x and FFO to debt of well above 100%, compared with a net adjusted cash position excluding the acquisition.

The developing outlook reflects the likelihood that we could lower, raise, or affirm our ratings on Ericsson in the next 24 months. We could lower the ratings if we revised our management and governance assessment to weak, or if the ongoing investigation resulted in a weakening of Ericsson's credit profile due to the financial, reputational, or business impact. We could raise the ratings if Ericsson managed to report credit metrics in line with our base case on a sustainable basis, while maintaining a fair management and governance assessment.

We could lower the ratings if we lowered our management and governance assessment to weak once we have clarity on the investigation by the DoJ. This could be the case if it transpired that Ericsson had deliberately hidden material information from the regulators in recent years; if we believed that the company's governance framework was weaker than we currently assess because of new examples of misconduct in recent years; or if there was evidence that Ericsson does not fulfill its compliance monitoring.

We could also downgrade Ericsson if reported FOCF after lease payments decreased to below SEK9 billion, discretionary cash flow approached breakeven, adjusted debt to EBITDA rose above 1.5x, or FFO to debt dropped below 60%. This could occur, for instance, as a result of a fine of more than SEK35 billion, a material loss of market share due to reputational damage, and/or legal restrictions on continuing operations.

We could raise the ratings if the improvement we expect in Ericsson's revenue and profitability, along with at least a stable market share in the main business segments, leads to FOCF after lease payments of above SEK15 billion, adjusted leverage of below 1.5x, and FFO to debt of above 60%, all on a sustainable basis. This would need to be coupled with our assessment of Ericsson's governance assessment as fair after the DoJ's resolution.

ESG credit indicators: To E-2, S-2, G-4 from E-2, S-2, G-3

Governance factors are now a more negative consideration in our credit rating analysis of Ericsson as a result of the DoJ's conclusion that Ericsson's disclosures were insufficient during the 2011-2019 investigation, as well as after 2019, while the company was in a monitoring period. As a consequence, Ericsson could face additional regulatory fines and reputational damage. While Ericsson has taken measures to mitigate the situation and has enhanced its compliance framework, we believe that any future events would weigh more on Ericsson than on its peers due to its track record.

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Governance structure

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

— **General Criteria: Principles Of Credit Ratings**, Feb. 16, 2011

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 for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

Regulatory Disclosures For Each Credit Rating Including Ratings List Table

Disclosures include requirements relating to press releases or reports published in accordance with Article 10(1), 10(2), and 10(5), and Annex I, Section D, I, 1, 2, 2a, 4, and 5. These requirements are available by rating via the link titled "Regulatory Disclosure" and include, but are not limited to:

- Key Elements Underlying The Credit Rating
- ESG Credit Factors
- Solicited Or Unsolicited Status
- Analysts Primarily Responsible For The Credit Rating
- Office Responsible For The Credit Rating
- Materials Used In The Credit Rating Process
- Criteria Applied
- Models Applied, Loss, And Cash Flow Analysis Performed
- Scenario Analysis
- Sensitivity Analysis
- Risk Warning, Understanding Credit Rating Categorizations, And Criteria

- Rated Entity Notification
- Ancillary And Additional Services
- Attributes And Limitations Of The Credit Rating
- Information Specific To Structured Finance And Securitization Instruments

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