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Research Update:

Swedish Telecom Supplier Ericsson Downgraded To 'BBB-' On Weaker Profitability And Cash Flow; Outlook Negative

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Overview

- On March 28, 2017, Swedish telecom supplier Ericsson announced material provisions and additional restructuring charges, leading us to significantly revise our base-case expectations for 2017 and 2018.
- Despite a positive impact on future profitability, we now project only low-single-digit adjusted EBITDA margin in 2017 (compared with 7%-8% in our previous forecast) and close to break-even free operating cash flow (FOCF) in 2018 (compared with above SEK5 billion in our previous forecast).
- As a result, we are lowering our long-term corporate credit rating on Ericsson to 'BBB-' from 'BBB' and our short-term corporate rating to 'A-3' from 'A-2'.
- The negative outlook reflects the possibility of a further downgrade in the next 12-24 months if Ericsson's margins don't improve materially and sustainably, or if its cash flows continue to deteriorate.

Rating Action

On March 31, 2017, 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 consequently also lowered our short-term rating on the company to 'A-3' from 'A-2' and our short-term Nordic regional scale rating to 'K-3' from 'K-2'.

Rationale

The downgrade reflects our downward revision of Ericsson's profitability and cash flow in 2017 and 2018 following Swedish krona (SEK) 7 billion-SEK9 billion provisions relating to a few large customer projects, and additional restructuring charges in 2017 that offset lower costs in coming years. We estimate a material impact on profitability and cash flow in 2017 and 2018, recognizing that the cash impact from these charges and provisions is likely to be split over some years. At the same time, we continue to think that industry conditions remain poor. We have limited visibility on the direction of the telecom infrastructure market but we think that demand for mobile telecom equipment will continue to decline until at least the second half of

2017, and competition will remain intense. As a result, we are uncertain regarding Ericsson's ability to stabilize revenues and improve margins and cash flow, with some execution risks associated with the ongoing restructuring program.

On March 28, 2017, Ericsson announced its new strategy, organization, and management team. The company is refocusing on its core business areas, including networks, digital services, and "Internet of Things," and will explore strategic opportunities for the struggling media and information technology (IT) and cloud infrastructure hardware businesses. In relation to the refocused strategy, Ericsson has accelerated cost reduction measures. As a result, the company estimates SEK6 billion-SEK8 billion restructuring charges in 2017. This is materially higher than the previous estimate of SEK3 billion. Ericsson expects significant improvement in its profitability in 2018 and targets doubling its company-adjusted operating margin of 6% in 2016 in the long term.

The ratings on Ericsson continue to be supported by a strong balance sheet with meaningful reported net cash, despite our assumption of weakening to about SEK20 billion in 2018, 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 and provisions, we forecast only modest reported FOCF in 2017-2018. This is partly offset by much lower dividends to be paid in 2017 compared with the previous year.

Our base case assumes:

- Weak macroeconomic situation in some emerging markets, and lower demand in the wireless infrastructure market.
- Consolidated revenues to decline by a high-single-digit percentage in 2017, before stabilizing in 2018. Revenues declined by 9.8% in 2016.
- Still weak demand for networks products in 2017, following a 12% decline in 2016, and services (-9% in 2016). Continued revenue decline in media and IT and cloud infrastructure hardware businesses.
- Annual restructuring costs of SEK6 billion-SEK8 billion in 2017 and materially lower in 2018, compared with SEK7.6 billion in 2016. We include these costs into our EBITDA calculation. We assume the cash flow impact to be equally split over 2017 and 2018.
- SEK7 billion-SEK9 billion provisions in 2017, most of which we assume will be included in EBITDA and affect cash flow over some years.
- Reported gross margin of about 30%-31% in 2017, compared with 29.8% in 2016. This reflects only a slight improvement from the cost-cutting measures due to lower revenues and higher share of services sales, which have a lower gross margin. Further improvement in 2018 on the back of stabilizing revenues and efficiency measures.
- Annual operating expenses savings to gradually reach about SEK9 billion in 2018.
- Annual capital expenditures (capex), including capitalized development cost of about 4.5%-5.0% of revenues and some bolt-on acquisitions.
- Annual dividend payment of SEK3.3 billion in 2017; we assume similar

dividends in 2018.

Based on these assumptions, we arrive at the following adjusted credit measures for 2017-2018:

- Adjusted EBITDA margin of about 1%-4% in 2017 and 8%-10% in 2018, compared with 6.3% in 2016.
- Flat reported FOCF in 2017, compared with FOCF of SEK3.5 billion in 2016, and declining to a small positive amount in 2018.
- Funds from operations (FFO) to debt above 60%, except for 2017.
- Adjusted debt to EBITDA to temporarily peak at above 2x in 2017, compared with 0.9x in 2016, but to return comfortably below 1.5x in 2018.
- Reported net cash position remaining broadly the same in 2017 compared with SEK23.6 billion at the end of 2016, and declining to about SEK20 billion in 2018.

We adjust Ericsson's reported gross debt by adding the following key items:

- Present value of operating lease liabilities of about SEK12 billion.
- Net unfunded pension liabilities of about SEK20 billion.
- We also deduct from Ericsson's debt the surplus cash that we assume would be readily available for debt repayment. We consider cash reserves above about SEK5 billion as surplus.

Liquidity

The short-term rating is 'A-3'. 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 Dec. 31, 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 12 months starting from Dec. 31, 2016:

- Consolidated cash and equivalents of SEK50 billion on Dec. 31, 2016.
- Annual FFO of about SEK13 billion-SEK15 billion.
- Issuance of €1.0 billion of new notes in total in February 2017.
- 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.
- SEK3.3 billion annual dividend to be paid in 2017.
- Debt maturities and short-term debt of about SEK8 billion 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 materially and sustainably improve its profitability in 2018 or if its cash flows deteriorate more than we currently expect.

Downside scenario

We could lower the ratings if Ericsson's revenues continued to decline for a prolonged period or we thought that adjusted EBITDA margins would remain sustainably and significantly 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 the company is set to generate only break-even FOCF or significantly negative discretionary cash flow (DCF), or if Ericsson's adjusted debt-to-EBITDA ratio remained above 1.5x and FFO to debt below 60% sustainably.

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 improving to about 10% or more and stabilizing revenues. In addition, we would expect Ericsson to preserve an adjusted debt-to-EBITDA ratio of below 1.5x, FFO to debt above 60%, solid net cash position of at least SEK20 billion, and at least break-even DCF generation.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Negative/A-3

Business risk: Fair

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

Financial risk: Modest

- Cash flow/Leverage: Modest

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

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014

- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Downgraded

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Corporate Credit Rating	BBB-/Negative/A-3	BBB/Negative/A-2
Nordic Regional Scale	--/--/K-3	--/--/K-2
Senior Unsecured	BBB-	BBB

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