Research Update:

Ericsson (Telefonaktiebolaget L.M.) Outlook Revised To Stable On Improved Governance; 'BBB-' Ratings Affirmed

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Rating Action Overview

- We revised our governance assessment of telecommunications equipment vendor Ericsson (Telefonaktiebolaget L. M.) to neutral from moderately negative after the conclusion of the company's four-year independent compliance monitorship on June 2, 2024, and improvements in Ericsson's ethics and compliance program since 2019.
- The investigation of Ericsson and U.S. authorities on Ericsson's misconduct in Iraq prior to 2019 is ongoing but we think the likelihood of negative developments, including fines, will reduce over time.
- At the same time, Ericsson operates in a cyclical industry and we anticipate 2024 will constitute another year of organic revenue decline, after a decline of 10% in 2023. Some improvements in profitability and free operating cash flow (FOCF), compared with 2023, will offset the revenue decline but not enough to meet our upside triggers.
- Therefore, we revised our outlook on the rating on Ericsson to stable from developing. 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 stable outlook reflects our expectations of further organic revenue decline in 2024, with positive, but modest, FOCF, followed by a gradual improvement in 2025, as well as no material negative news on past misconducts.

Rating Action Rationale

Our assessment of Ericsson's governance improved, following the conclusion of its compliance monitorship in June 2024 and improvements in its ethics and compliance program. On June 2, 2024, the independent compliance monitor, which was appointed by the U.S. Department of Justice (DOJ) in June 2020, concluded a four-year monitorship. This follows the monitor certification on March 28, 2024, that Ericsson's anti-corruption compliance program meets requirements and is functioning effectively. Initially, the monitorship was supposed to cover three years from June 2020, as part of the 2019 deferred prosecution agreement between Ericsson and the DOJ. Following the plea agreement that Ericsson entered with the DOJ in March 2023, the monitorship was extended by another year to June 2024.

Since 2019, Ericsson has taken steps to enhance its anti-bribery and corruption policies and procedures. The company embedded ethics and compliance policies across its operations. It continues to implement and test its controls and improved its internal governance, ethics, and compliance policies. In our view, the risk of new misconduct is now similar to that of peers and relatively low.

The Iraq investigation is ongoing but the risk of negative developments is manageable. Ericsson's internal investigation, which the company conducted over 2011-2019, found evidence of misconduct in Iraq on multiple occasions, including monetary donations without a clear beneficiary. Payments were made to intermediaries for alternative transportation routes to avoid Iraqi customs at a time when militant groups, including ISIS, controlled some routes. The ultimate recipients of these payments could not be identified during the multi-year, and still ongoing, investigation but Ericsson remains confident that none of its employees was directly involved in financing a terrorist organization. Ericsson and the DOJ continue to investigate this matter, which was not covered by the plea agreement from 2023.

The outcome of the Iraq investigation remains uncertain. On the one hand, we think the likelihood of an investigation outcome that evidences that Ericsson employees have financed a terrorist organization will decrease over time. On the other hand, the investigation may result in additional financial penalties, after fines of $200 million in 2023 and $1 billion in 2019. Given Ericsson's exceptional liquidity, however, with a current cash balance of Swedish krona (SEK) 52 billion, and low leverage at about or less than 1x, we think the company could accommodate additional fines without impairing its credit ratios.

Ericsson benefits from its leading market position and broad geographic diversification. Ericsson holds a number one position in the global radio access network (RAN) equipment market, excluding China, with a market share of about 36% in 2023. Including China, the company is number two worldwide, after Huawei and ahead of Nokia. By year-end 2023, Ericsson's technology was used in 158 of the approximately 300 live 5G networks globally and about 50% of all mobile traffic outside of China happens over networks provided by Ericsson. This reflects a strong product portfolio that benefits from consistently significant research and development (R&D) investments, with about 19% of sales allocated to R&D expenditures in 2023. Ericsson has a geographically diverse revenue base, with a presence in all major telecom markets worldwide, and focuses on the largest operators in each market. It also has a strong presence in the world's most advanced markets, including the U.S., Korea, and Japan, and the most populated areas.

Ericsson has taken steps to become more resilient over the business cycle. Due to cyclical demand for the RAN market that results from telecom operators' willingness and ability to spend, Ericsson has taken several steps to reduce the volatility of its operating performance. These include:

- A focus on recurring revenue and cash flow streams generated, for instance customer support and software revenues. However, most of the software and services revenues remain linked to the networks division, meaning revenues remain volatile for the time being.
- A highly profitable technology licensing business that monetizes Ericsson's significant

intellectual property rights and more than 60,000 granted patents that generated annual revenues of SEK11 billion in 2023, with an aim to reach SEK12 billion-SEK13 billion in 2024. These revenues meaningfully contribute to EBITDA and cash flows, given limited costs and investments associated with the existing patents.

- Diversification away from telecom operators to the enterprise segment. This segment generates only about 10% of revenues but Ericsson focuses on expanding the division. Currently, more than half of the segment's revenues come from the Global Communications Platform (from the Vonage acquisition). Investments in the segment are focusing on building a Global Network Platform for network application programming interfaces.
- A more flexible and lower cost structure. Ericsson expects long-term annual restructuring costs of 0.5% to 1%. That said, the company announced restructuring costs of SEK3 billion-SEK4 billion for 2024, corresponding to slightly more than 1% and including a 10% workforce reduction in Sweden to offset the current weak market demand.

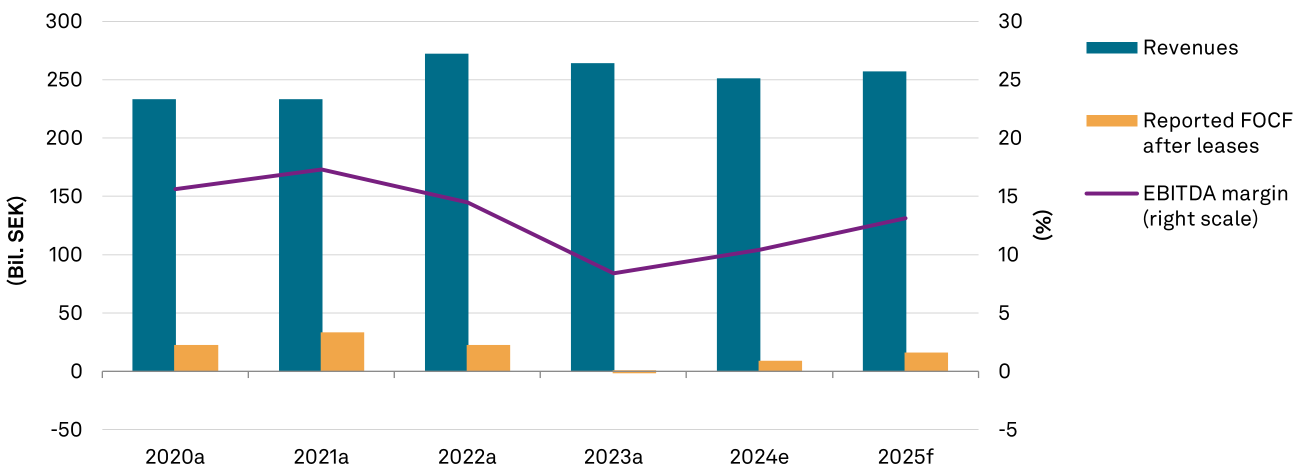
The industry Ericsson operates in remains cyclical, highly competitive, and suffers from weak demand this year. We expect the RAN market will shrink for the second year in a row in 2024. As a result, we think Ericsson's like-for-like revenues will decline by 5% this year, after 10% in 2023. The visibility of its long-term topline growth remains limited due to cyclical demand for telecommunications equipment, including economic and technology cycles. Technological changes, such as Open RAN and Cloud RAN, could lead to both risks and opportunities, such as Ericsson's AT&T contract win.

Strong competition, primarily from Huawei and Nokia, and significant bargaining power from customers also contribute to price pressure and earnings volatility. Furthermore, the geographic mix has an effect on Ericsson's revenues and profitability. For instance, North America, where Ericsson has a strong position, is the company's most profitable market, while the expansion in India in 2023 reduced Ericsson's overall profitability and cash flows.

Our outlook revision to stable is supported by our expectation of modest, but positive, and gradually growing FOCF over the next two years. Cash flows were strong over 2019-2022 when the RAN market expanded on the back of large initial 5G roll-outs. In 2023, cash flows turned negative for the first time in many years. The company's long-term profitability and cash flow target (based on a stable top line) translates into an S&P Global Ratings-adjusted EBITDA margin of at least 16% and FOCF after lease payments of about SEK25 billion. However, we think these targets can only be sustainably achieved if the topline becomes less volatile. Conversely, a prolonged revenue decline could lead to additional restructuring, with lower profitability and FOCF.

Chart 1

Ericsson's revenues, EBITDA, capital expenditure, and FOCF over 2020-2025



a--Actual. e--Estimate. f--Forecast. FOCF--Free operating cash flow. SEK--Swedish krona. Source: S&P Global Ratings.

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Outlook

The stable outlook reflects our expectations of further organic revenue decline in 2024, with positive, but modest, FOCF, followed by a gradual improvement in 2025, as well as no material negative news on past misconducts.

Downside scenario

We could downgrade Ericsson if revenues and profitability declined (caused by continued market decline, a material loss of market share, or additional large restructuring), resulting in an adjusted EBITDA margin sustainably below 8%, reported FOCF after lease payments remaining sustainably at or below SEK5 billion, or discretionary cash flow sustainably at or below breakeven.

Although unlikely, we could also lower the ratings if adjusted debt to EBITDA rose sustainably above 1.5x or if funds from operations (FFO) to debt dropped sustainably below 60%. This could occur if the U.S. authorities' ongoing Iraq investigation resulted in a large fine or if Ericsson conducted a large debt-funded acquisition.

Upside scenario

We could raise the ratings if Ericsson demonstrated an improved resilience over the business cycle, for instance by shifting its revenues to more service-related revenues rather than capital expenditure (capex)-related revenues. This would result in sustainably flat or increasing revenues, adjusted EBITDA margins of 13%-15%, and improving FOCF after lease payments comfortably and sustainably in the SEK15 billion-SEK20 billion range. An upgrade would also require adjusted leverage remaining at or below 1.5x, FFO to debt above 60%, and no additional governance issues.

Company Description

Ericsson is the world's second-largest provider of wireless telecom network equipment and related software and services, with annual net sales of SEK263 billion. It operates across four segments:

- Networks (65% of 2023 revenues), which includes hardware, software, and services that enable connectivity, such as RANs, transport and site solutions, network rollouts, and customer support.
- Cloud software and services (24%), which includes cloud-based solutions for core networks and automation, managed services, service orchestration, and telecom business support systems.
- Enterprise (10%), which includes Enterprise Wireless Solutions, Global Communications Platform, and Technologies and New Businesses.
- Other (1%), which includes media businesses, Ericsson Ventures, and one-offs.

Investor AB and Industrivärden AB, two Swedish investment holding companies, held about 38.9% of the voting rights associated with Ericsson's shares at year-end 2023.

Our Base-Case Scenario

Assumptions

- Global GDP growth of 3.2% in 2024 and 3.4% in 2025.
- Decline in the mobile equipment of about 5% in 2024, including stabilization in the second half after a decline in the first half, followed by a recovery in 2025.
- Revenue decline of 5% in 2024, followed by a 2% growth in 2025.
- Annual decline in the networks segment of about 11% in 2024 due to a weak market environment and cautious investments in major geographies that are partly offset by an expected sales recovery in North America during the second half of 2024.
- Cloud software and services segment to show continued growth and the enterprise segment to remain stable with a seasonality that is similar to that in the past few years.
- Adjusted EBITDA margin to improve to about 10.4% in 2024, compared with 8.4% in 2023, mainly due to lower restructuring costs and cost initiatives, and additional revenues from intellectual property rights.
- Working capital outflows of up to SEK3 billion per year over 2024-2025.
- Annual reported capex of about SEK5.0 billion over 2024-2025.
- Annual shareholder returns of SEK9 billion-SEK11 billion over 2024-2025.

Key metrics

Ericsson (Telefonaktiebolaget L. M.)--Key metrics*

	--Fiscal year ends Dec. 31 --				
(Bil. SEK)	2022a	2023a	2024e	2025f	2026f
Revenues	272	263	250	256	258
EBITDA margin (%)	14.5	8.4	10.4	13.1	>13
Capital expenditure	4.5	3.3	3.5	3.6	3.6
Reported free operating cash flow after lease payments	22.1	-1.2	8.3	15.5	>15
Reported discretionary cash flow after leases	13.7	-10.3	-0.7	4.5	>5
Net debt	7.5	22.5	25.4	23.4	<20
Debt to EBITDA (x)	0.2	1	1	0.7	<0.7
Funds from operations to debt (%)	436.7	63.8	71.6	109.1	>110

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. SEK--Swedish krona.

Liquidity

We consider Ericsson's liquidity exceptional because we expect its liquidity sources will exceed its liquidity uses by more than 3.6x over the two years from April 1, 2024. Furthermore, we believe the company has good relationships with its banks and displays prudent financial risk management, as demonstrated by the maintenance of a substantial cash buffer at all times.

Principal liquidity sources include:

- Consolidated cash and equivalents of SEK52 billion;
- Undrawn revolving credit facilities (RCFs) of $2 billion, maturing in September 2028, and $800 million, maturing in May 2025; and
- Annual FFO of about SEK16 billion-SEK18 billion.

Principal liquidity uses include:

- Repayment of debt maturities of SEK7.2 billion;
- Working capital swings of up to SEK5 billion;
- Annual capex, including capitalized development costs, of about SEK5.0 billion; and
- Common dividends of up to SEK10 billion.

Environmental, Social, And Governance

Governance factors are a neutral consideration in our credit rating analysis of Ericsson, following the successful conclusion of the four-year independent compliance monitorship and the measures Ericsson has taken to enhance its compliance framework and reduce the risk of misconduct in the future.

Ratings Score Snapshot

Issuer credit rating	BBB-/Stable/A-3
Business risk:	Fair
Country risk	Intermediate
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)
Financial policy	Neutral (no impact)
Liquidity	Exceptional (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Ericsson's Profitability And Cash Flow Should Recover In 2024, Oct. 18, 2023
- Ericsson (Telefonaktiebolaget L.M.), May 25, 2023
- Ericsson's Resolution With U.S. Department Of Justice Reduces Governance Concerns, March 7, 2023

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Issuer Credit Rating	BBB-/Stable/A-3	BBB-/Developing/A-3
Nordic Regional Scale	--/--/K-3	
Senior Unsecured	BBB-	

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