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Research Update:

Swedish Telecom Supplier Ericsson Downgraded To 'BB+' On Weaker Revenue And Margin Prospects; Outlook Stable

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Overview

- On July 18, 2017, Swedish telecom supplier Ericsson reported weaker-than-expected second quarter results and continued challenging market conditions across its key segments, and the company expects additional losses from existing customer projects.
- We think these factors will delay improvements in profitability and weaken cash flow generation compared with our previous projections.
- We are lowering our long-term corporate credit rating on Ericsson and the issue ratings on its unsecured debt to 'BB+' from 'BBB-'.
- The stable outlook reflects our expectation that Ericsson will manage to slow its revenue decline and achieve adjusted EBITDA margins of at least 5% in 2018, while maintaining a net cash position of at least Swedish krona (SEK) 20 billion.

Rating Action

On July 24, 2017, S&P Global Ratings lowered its long-term corporate credit rating on Swedish telecom supplier Ericsson (Telefonaktiebolaget L.M.) to 'BB+' from 'BBB-'. The outlook is stable.

We consequently also lowered our short-term Nordic regional scale rating to 'K-4' from 'K-3'. We affirmed our 'A-3' short-term rating on the company.

At the same time, we lowered our issue ratings on Ericsson's unsecured bonds to 'BB+' from 'BBB-' and assigned our '3' recovery rating to the debt, reflecting our expectation of 65% recovery prospects in the event of a hypothetical payment default.

Rationale

The downgrade reflects our view that the expected recovery in the wireless infrastructure market is likely to be more protracted. Ericsson is also likely to incur additional costs for the realignment of existing customer projects. In our view, these factors make it unlikely that the company will stabilize revenues and achieve EBITDA margins and cash flows by 2018 that are commensurate with an investment-grade rating. Based on current market and operating trends, we think Ericsson's revenues will continue to decline next year, albeit at a slower pace than in 2017, compared with flattish revenues in our previous forecast. Moreover, the company is projecting additional charges of SEK3 billion-SEK5 billion in connection with adjustments to existing customer contracts. Nevertheless, we still think Ericsson will be able to improve profitability over time, but expect our adjusted EBITDA margins to remain well below 10% until at least 2019. We think margin recovery will be supported by the gradual phase-in of cost savings, the exiting, renegotiating, or transforming of unprofitable managed services contracts, as well as a continued ramp-up of the Ericsson radio system and new product portfolio in the IT and cloud segment. In addition, pay-outs for restructuring and other nonrecurring items will weigh on cash flows, leading us to project only about break-even free operating cash flow (FOCF) next year.

Overall, we think Ericsson's portfolio of wireless solutions is competitive, but faces headwinds originating from a pronounced slump in demand for wireless equipment and fierce competition from other players including Nokia and Huawei. According to the most recent forecast by research firm Dell'Oro' from July 18, 2017, the global radio access network equipment market is set to decline in low-single digits in both 2018 and 2019, after a high-single digit percentage decline in 2017. Furthermore, visibility on future market conditions remains low, in our view. We acknowledge that Ericsson is dedicated to absorbing topline pressure with accelerated cost savings, but project that these measures will lift EBITDA margins only gradually over several years, starting from 2018, while constraining profitability in the near term.

The ratings continue to be supported by a strong balance sheet with meaningful reported net cash of at least about SEK20 billion in our forecast for 2017-2018, and well-spread debt maturities. However, given constraints on revenues and low margins, coupled with outflows for restructuring and other nonrecurring items, we forecast FOCF of less than SEK3.5 billion in 2017 and only break-even or negative FOCF in 2018, which is much lower than historically. At the same time, we note that in 2017 Ericsson cut dividend payments by more than 70% compared with 2016, and we think the company could be willing to further reduce distributions to preserve cash if industry conditions remain very challenging.

Our base case assumes:

- Consolidated revenues to decline by a high-single-digit percentage in 2017, and by 2%-5% in 2018, driven by weaknesses in the networks and media divisions, and by declining IT and cloud infrastructure sales in 2017. Revenues declined by 9.8% year-on-year in 2016.
- Annual restructuring costs of about SEK8 billion in 2017 and SEK3 billion–SEK5 billion in 2018, compared with SEK7.6 billion in 2016. We include these costs in our EBITDA calculation. We assume the cash flow impact for 2017 charges to be equally split over 2017 and 2018.
- Provisions related to customer projects totaling SEK9.5 billion–SEK11.5 billion in 2017, decreasing to SEK1.0 billion-SEK3.0 billion in 2018, which we assume will be included in EBITDA. A meaningful portion of these will affect cash flows over 2017-2019.
- Reported gross margin of about 30% in 2017, rising to 32%-34% in 2018 thanks to the phase-in of cost savings, compared with 29.8% in 2016.

- Negative adjusted EBITDA margins of about 0%-3% in 2017, expanding to 5.5%-7.5% in 2018, supported by higher gross margins and reductions in operating expenses, compared with 6.3% in 2016.
- Annual capital expenditures (capex), including capitalized development cost of about 2.5%-3.5% of revenues in 2017 and 2018, lower than 4.8% in 2016 due to strict capex management and lower capitalization of development costs.
- Some spending on small, bolt-on acquisitions.
- Significant cash inflows from better working capital management in 2017 and to a lesser extent also in 2018.
- 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:

- Reported FOCF of SEK3 billion–SEK3.5 billion in 2017, breakeven or negative FOCF in 2018, compared with SEK3.5 billion in 2016.
- Funds from operations (FFO) to debt above 60% in 2018 (not meaningful in 2017 due to negative adjusted FFO), compared with 62% in 2016.
- Adjusted debt to EBITDA to temporarily peak at 1.0x–1.4x in 2018 (not meaningful in 2017 due to negative adjusted EBITDA), compared with 0.9x in 2016.
- Reported net cash position improving slightly in 2017 from SEK31.2 billion at the end of 2016 thanks to disposals of noncore assets.

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

- Present value of operating lease liabilities of about SEK12.5 billion in 2016.
- Net unfunded pension liabilities of about SEK19 billion in 2016.
- 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 SEK3 billion as surplus.

Liquidity

We consider Ericsson's liquidity to be exceptional because we expect its sources of liquidity to amount to more than 2x uses in the two years from July 1, 2017. 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 July 1, 2017:

- Consolidated cash and equivalents of SEK54 billion.
- An undrawn revolving credit facility (RCF) of $2.0 billion maturing in 2022.
- Annual FFO of about SEK1 billion-SEK3 billion.
- Positive working capital effects, also in connection with noncash nonrecurring items, of SEK4 billion–SEK7 billion.
- Moderate inflows from asset sales.

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

- Annual capex, including capitalized development costs, of about SEK5 billion–SEK7 billion.
- SEK3.3 billion annual dividend payments in 2018.
- Repayments of debt maturities and short-term debt of up to SEK3.2 billion.

Outlook

The stable outlook reflects our expectation that Ericsson will continue to execute its transformation strategy, helping to slow its revenue decline to 2%-5%, and improve its adjusted EBITDA margins to comfortably more than 5% in 2018. At the same time, we expect that cash outflows for restructuring and other provisions will result in about breakeven or modestly negative FOCF next year. We expect Ericsson will maintain a very conservative balance sheet, with reported net cash of at least SEK20 billion.

Downside scenario

We could lower the ratings if continued weak demand, strong price competition, market share losses, or higher-than-expected nonrecurring costs prevented Ericsson from improving adjusted EBITDA margins to at least 5% in 2018. In addition, continued significant negative discretionary cash flow generation or a meaningful deterioration in the group's reported net cash position below SEK20 billion could lead to a downgrade.

Upside scenario

We could raise the rating 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, accompanied by sustainable annual FOCF of about SEK9 billion. In addition, we would expect Ericsson to preserve an adjusted debt-to-EBITDA ratio of below 1.5x and FFO to debt above 60%.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Stable/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: Negative (-1 notch)

Recovery Analysis

Key analytical factors

- Our recovery rating on Ericsson's senior unsecured notes is '3' with recovery prospects at about 65%. Recovery prospects are supported by the moderate total amount of debt, but reduced by the company's unfunded pension deficit and certain amounts related to the sale of receivables which we include as priority liabilities in our analysis. We assume the RCF would be drawn at 50% at default given Ericsson's sizable cash balances.
- In our simulated default scenario, we assume severe macroeconomic and industry weakness affecting the group's activities, together with increased competition. We think that a continued decline in revenues and market share, as a result of customer losses, combined with a sustained use of large cash balances for restructuring and investment in new technologies that do not improve operating performance, would lead to a hypothetical payment default in 2022.
- We anticipate that the group would most likely reorganize in a default scenario, given its geographic spread and established customer relationships, as well as its intellectual property portfolio. We therefore value Ericsson as a going concern.

Simulated default assumptions

- Year of default: 2022
- Minimum capex (% of sales): 1.5%
- Cyclicality adjustment factor: +10% (standard assumption for the hardware and semiconductors sub-segment of the technology sector)
- Operational adjustment: +25% (reflecting Ericsson's low leverage and our assumption that on a hypothetical path to default, Ericsson is likely to refinance or raise debt at higher interest rates than currently)
- Emergence EBITDA after recovery adjustments: about SEK6.4 billion
- Implied enterprise value multiple: 6.0x
- Jurisdiction: Sweden

Simplified waterfall

- Gross enterprise value (EV) at default: About SEK29.6 billion
- Administrative costs: 5%
- Tax-adjusted pension deficit adjustment to EV: about SEK8.6 billion
- Net value available to creditors: about SEK28.1 billion
- Priority claims: About SEK2 billion
- Unsecured debt claims [1]: About SEK39.1 billion
- Recovery expectation [2]: 50%-70% (rounded estimate: 65%)
- Recovery rating: 3

[1] All debt amounts include six months of prepetition interest. Unsecured RCF of $2 billion assumed 50% drawn on the path to default.
[2] Rounded down to the nearest 5%.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 1, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 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; Outlook Action; Rating Affirmed

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Corporate Credit Rating	BB+/Stable/A-3	BBB-/Negative/A-3

Downgraded

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Corporate Credit Rating		
Nordic Regional Scale	K-4	K-3
Ericsson (Telefonaktiebolaget L.M.)		
Senior Unsecured	BB+	BBB-
Recovery Rating	3(65%)	

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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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.