MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Ericsson's ratings to Baa3; outlook negative

Global Credit Research - 15 Dec 2016

London, 15 December 2016 -- Moody's Investors Service ("Moody's") has today downgraded to Baa3 from Baa2 the senior unsecured debt ratings and to (P)Baa3 from (P)Baa2 the MTN program rating of Telefonaktiebolaget LM Ericsson ("Ericsson"). The outlook on the ratings is negative.

This rating action concludes the review for further downgrade process initiated on 14 October 2016.

"The ratings downgrade to Baa3 reflects our view of a persistently weak revenue, earnings and cash flow outlook for Ericsson and its core telecom networks equipment market over the next two years, balanced by the company's good liquidity and a track record of shareholder support," says Alejandro Núñez, a Moody's Vice President -- Senior Analyst and lead analyst for Ericsson.

RATINGS RATIONALE

The ratings downgrade principally reflects: (1) the company's weaker revenue and earnings growth outlook for FY 2016 and FY 2017, particularly in the Networks division, which continues to be impacted by softening market demand and intense competition; (2) the lack of sufficient offsetting growth or earnings contribution from the Global Services division; (3) the structural challenge that Ericsson faces because of its heavy exposure to the radio equipment segment, which is unlikely to see material growth until the next technology investment cycle (5G), no sooner than 2020; and (4) the weakened financial profile owing to deteriorating operating performance and negative free cash flow generation. Furthermore, the unpredictable development of pending questions from US authorities regarding Ericsson's anti-corruption program and specific cases represents a potential event risk which further constrains the ratings in the short term.

These negative considerations are balanced against (1) our expectation that most, if not all, of the company's cost savings activities are delivered by mid-2017; (2) a maintenance of the company's good liquidity position; (3) financial policies within the limits of the company's free cash flow generation and liquidity resources; and (4) a track record of shareholder support.

Moody's acknowledges that there are certain measures Ericsson could implement to mitigate the free cash flow loss that the rating agency anticipates for FY2017. While Moody's recognizes that the cost savings program scheduled to conclude in mid-2017 should deliver longer term operating expense savings (after associated restructuring charges), it also highlights that a strategy premised on cost-cutting is not sustainable and could also hamper the company's competitiveness over the medium and long term. While Ericsson's future dividend payouts remain unclear, Moody's notes that the company typically announces its dividend proposal alongside its Q4 results and the rating agency will monitor the extent to which any dividend payout decision could mitigate free cash outflows and help to conserve Ericsson's liquidity.

In addition, Moody's views the appointment of Börje Ekholm as Ericsson's new CEO as a positive development from the perspective that it clarifies doubts regarding the management void left following the ouster of Ericsson's previous CEO. The rating agency interprets this appointment as a signal of continued support from Ericsson's largest shareholder, Investor AB.

In Q3 2016, Ericsson reported a year-over-year revenue decline of 14% (of which Networks comprised a 19% yoy decline on a reported basis), a drop in its gross margin to 28% from 34% yoy and operating income of only SEK300 million (compared with SEK5.1 billion in Q3 2015). The underlying drivers of the revenue and earnings declines included continued macroeconomic weakness in key emerging markets such as Brazil, Russia and the Middle East as well as reduced Networks coverage and capacity sales in Europe, as multi-year mobile broadband projects such as Vodafone's Project Spring were completed.

Following the company's Q3 2016 results, Moody's anticipates sustained revenue decline for Ericsson in FY16 and FY17 (contrasted with +8% reported growth in FY15), with material operating margin compression and negative free cash flow generation in FY17 for a third consecutive year.

Nevertheless, Moody's continues to view the company's position as a global leading telecoms equipment vendor and its good liquidity position as supportive credit factors although the rating agency notes that its declining operating cash flow and restructuring charges are likely to continue to erode Ericsson's cash pile over the coming year.

Although Ericsson's liquidity profile is currently good and supportive of the rating, Moody's expects the company to continue to burn cash through FY2016 and FY2017. The company had SEK43.6 billion of cash and marketable securities at the end of September 2016, down from SEK48.8 billion at the end of June 2016 and from SEK66.3 billion at year-end 2015. The company has no significant short term debt maturities other than a €500 million bond maturing in June 2017. In addition, Moody's understands that all of Ericsson's debt is currently structured on an investment-grade style unsecured basis without financial covenants and that it does not include any rating-based triggers or material contingent liabilities that would be triggered by a potential rating change to below investment-grade.

RATIONALE FOR NEGATIVE OUTLOOK

The negative outlook reflects our expectation that (1) a weak telecom networking end-market and strong competitive pressure will persist over at least the next 12 months; (2) revenue growth and operating profitability will continue their decline into H1 2017, albeit at a reduced pace from H2 2017 onwards; (3) annual free cash flow will remain negative for a fourth consecutive year in FY2017; and (4) Ericsson will continue to maintain a good liquidity profile to buffer the expected negative free cash flows over at least the next year. The outlook also reflects Moody's expectation that Ericsson's adjusted leverage (Gross Debt/EBITDA, as adjusted by Moody's for the pension deficit and including restructuring charges) will trend above 4.0x in FY2016 and FY2017, in the absence of management measures to protect cash flows.

WHAT COULD CHANGE THE RATING UP/DOWN

Upward pressure on the ratings is unlikely in light of the recent rating downgrades. The outlook on Ericsson's Baa3 ratings could be stabilized if: (1) end-market demand were to rebound quicker than currently anticipated into positive revenue growth territory over a 12 month horizon; (2) operating margins were to return sustainably into a high single-digit percentage range; (3) free cash flow were to be materially and sustainably positive; and (4) Ericsson's own liquidity sources were to improve materially from currently anticipated FY2016 -- FY2017 levels.

Negative pressure could be exerted on Ericsson's ratings in the case of: (1) a material decline in operating performance such that operating margins are in the low-single digit range over the next 12 months with no expectation of a material recovery; (2) a failure to reduce the pace of post-dividend free cash outflows in FY2017; (3) lack of capital markets access and/or a further material decline in own liquidity sources; and/or (4) the imposition of a material fine resulting from pending questions from US authorities.

LIST OF AFFECTED RATINGS

Downgrades:

..Issuer: Telefonaktiebolaget LM Ericsson

....Senior Unsecured Medium-Term Note Program, Downgraded to (P)Baa3 from (P)Baa2

....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa3 from Baa2

Outlook Actions:

..Issuer: Telefonaktiebolaget LM Ericsson

....Outlook, Changed To Negative from Rating Under Review

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Diversified Technology Rating Methodology published in December 2015. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

With revenues of SEK246.9 billion in FY2015, Telefonaktiebolaget LM Ericsson ("Ericsson") is a world-leading provider of telecommunications equipment and related services to mobile and fixed network operators globally.

Its equipment is used by over 1,000 networks in more than 180 countries and around 40% of the global mobile traffic passes through its systems. Networks represented 50%, Support Solutions 6% and Global Services 44% of group revenues in FY2015. The company's largest shareholders are Investor AB (Aa3 stable) and AB Industrivärden (unrated), with voting rights of 21.5% and 20.1%, respectively.

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