

Sweden-Based Ericsson Outlook Revised To Positive On Stronger Cash Flow Prospects; 'BB+' Ratings Affirmed

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[Table of Contents](#)

- Global telecommunications network equipment vendor Ericsson Telefonaktiebolaget L.M. (Ericsson) has successfully completed most of its cost-saving initiatives and has improving revenue growth prospects.
- We think these developments could gradually boost the company's profitability and free operating cash flow (FOCF) in the next 12–18 months.
- We are therefore revising our outlook on Ericsson to positive from stable and affirming the 'BB+' long-term issuer credit and issue ratings on its debt.
- The positive outlook reflects the possibility of a one-notch upgrade in the next 12 months if Ericsson's adjusted EBITDA margin exceeds 10% and its FOCF after lease payments exceeds Swedish krona (SEK) 9 billion in the next 12–18 months.

FRANKFURT (S&P Global Ratings) Sept. 24, 2019—S&P Global Ratings today took the rating actions listed above.

The outlook revision reflects progress with Ericsson's cost-cutting program as well as better revenue growth prospects, which stem from the ongoing recovery of the mobile network equipment market and a strong product portfolio after multiple years of extensive research and development (R&D) initiatives. This could support further improvements in profitability and FOCF in the coming years.

Since 2017, Ericsson has implemented a comprehensive cost-cutting plan including headcount reductions of about 15% (compared with year-end 2016) and the exit of unprofitable customer contracts. In our view, the elements of Ericsson's turnaround plan concerning cost reductions and profitability initiatives are nearly complete. The company achieved run-rate cost savings of SEK10 billion by year-end 2018. This was particularly evident in the Networks segment where operating margins (excluding restructuring and as defined by Ericsson) expanded to about 16% in first-half 2019, up from about 12% in 2017. Progress with cost savings is also reflected in gradually declining restructuring charges of SEK2 billion–SEK 4 billion annually in our projections for 2019 and 2020, compared with SEK8.0 billion–SEK9.0 billion per year in 2017 and 2018.

Moreover, Ericsson has completed the planned exit of 42 commercially unviable contracts in the Managed Services (MS) segment, and addressed 27 out of 45 unprofitable contracts in the Digital Services (DS) segment as of second-quarter 2019. The company aims to complete 75% of DS contract reviews by year-end. Among other factors, this has supported

improvements in MS operating margins to about 6% in first-half 2019 (excluding the reversal of a provision), from about negative 13% in 2017, and DS operating margins to about negative 17%, from negative 64% over this period. The remaining strategy mainly focuses on developing new sources of revenue growth in the DS and MS segments, as well as realizing further efficiency gains in DS, which we think could be margin-accretive over the next two years.

We think Ericsson's topline will increasingly benefit from the ramp-up of fifth-generation (5G) mobile network investments that are taking place faster than we previously expected, as well as the capacity expansion of existing 4G networks. Although 5G spending will mainly be spurred by the U. S. and South Korea in 2019, we believe there is increasing visibility of the roadmap to 5G deployments in several Asian markets that we expect to follow quickly, notably China and Japan. Market research firm Dell'Oro currently projects 5% growth in the global radio access network (RAN) equipment market in 2019, up from a projection of 2% at the beginning of the year, and a 2% compound annual growth rate for 2018–2022. This would mark the second year of growth for the market after 2018, compared with several years of strong declines prior.

Despite the ongoing cost-reduction plan, Ericsson has increased its R&D investments to 17%-18% of sales since 2017 to strengthen its product portfolio, up from 13% in 2016. We believe this has improved the company's competitiveness and helped to stabilize its market shares. According to Dell'Oro, Ericsson had a RAN market share of about 31% in Europe in 2018, compared with about 29% two years earlier, although it clearly remains the No. 2 player behind Huawei, but before Nokia. Globally, Dell'Oro estimates that Ericsson gained about one percentage point of market share between 2016 and 2018 to about 29%. This trails Huawei's roughly 31%, but is ahead of Nokia with about 23%.

This momentum has seen Ericsson's currency-adjusted revenue growth strongly rebound to 7% in first-half 2019, from negative 20% in third-quarter 2016, and contributed to a discernable increase in S&P Global Ratings-adjusted EBITDA margin to about 9% in the 12 months to June 30, 2019, up from negative 4% in 2017. Importantly, we think this also raises the prospects for materially stronger FOCF in 2020, with our base-case forecast of FOCF after lease repayments now SEK8.5 billion–SEK 10.5 billion (SEK11 billion–SEK13 billion before lease repayments) at constant currency rates.

Ericsson is currently subject to an investigation by the U.S. Securities and Exchange Commission and the Department of Justice into potential noncompliance with the U.S. Foreign Corrupt Practices Act. The probe has been ongoing for several years and may result in penalties or fines. At this point, we consider the case to be an isolated and a nonrecurring incident that does not detract from our view that Ericsson will see meaningful improvements in operating trends while maintaining a strong balance sheet, but we will assess the implications when the proceedings conclude

The positive outlook reflects the possibility of a one-notch upgrade in the next 12 months if continued currency-adjusted revenue growth and declining nonrecurring items enable Ericsson to further strengthen its profitability and FOCF in the next 12–18 months.

We could raise the rating if Ericsson's operating performance continued to improve, resulting in adjusted EBITDA margins increasing to more than 10% and annual reported FOCF after lease repayments of more than SEK9 billion on a sustainable basis in the next 12–18 months. In addition, an upgrade would depend on Ericsson preserving adjusted debt to EBITDA of below 1.5x and funds from operations (FFO) to debt of above 60%.

We could revise the outlook to stable if the recovery of the mobile network equipment market stalled unexpectedly or if we observed materially worsening competitive conditions, coupled with setbacks in Ericsson's transformation process or higher-than-expected nonrecurring costs. This could cause the company's profitability metrics and FOCF to fall short of expectations, and, if not offset by flexibility on shareholder distributions, lead to only breakeven or negative discretionary cash flow. In addition, we could revise the outlook to stable if the pending investigation by the U. S. Department of Justice and the Securities and Exchange Commission resulted in penalties that materially weaken the company's strong balance sheet position, causing its adjusted debt to EBITDA to rise above 1.5x or FFO to debt to decrease below 60%.

Related Criteria

- [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: Recovery Rating Criteria For Speculative-Grade Corporate Issuers](#), Dec. 7, 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
- [Criteria | Corporates | General: Corporate Methodology](#), Nov. 19, 2013
- [General Criteria: Country Risk Assessment Methodology And Assumptions](#), Nov. 19, 2013
- [General Criteria: Methodology: Industry Risk](#), Nov. 19, 2013
- [General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities](#), Nov. 13, 2012
- [General Criteria: Use Of CreditWatch And Outlooks](#), Sept. 14, 2009

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