FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Ericsson's Outlook to Negative, Affirms at 'BBB+'

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Fitch Ratings-Moscow-11 January 2017: Fitch Ratings has revised Telefonaktiebolaget LM Ericsson's (Ericsson) Outlook to Negative from Stable. The telecom equipment company's Long-Term Issuer Default Rating (IDR) and senior unsecured rating have been affirmed at 'BBB+'.

The Negative Outlook reflects significant execution risks around the strategy of Ericsson to reduce its cost base, stabilise its financial performance and maintain its capital structure. The company experienced significant revenue contraction and margin pressure in 9M16 and a moderately negative market outlook for 2017 makes a turnaround challenging.

We believe strong dividend discipline, combined with working capital improvements, are key to stabilising the company's net cash position on the back of weak free cash flow (FCF) generation that we project for 2016 and 2017.

KEY RATING DRIVERS

Weak Cash Flow

We expect Ericsson's cashflow to be weak in 2016 and 2017 following double-digit revenue declines, margin contraction and large cash-consuming working capital movements in 9M16. Operating margin stabilisation and a subsequent return to positive post-dividend FCF generation would likely require substantial restructuring efforts that will weigh on cashflow in 2017.

We believe, a gradual improvement in the net cash position will be dependent on the level of dividends paid to shareholders compared with historical levels. We view Ericsson's dividend flexibility as substantial but it remains to be seen if it will be sufficiently utilised. Ericsson paid SEK39bn of dividends in 2012-2015, equal to 44.5% of its funds from operations (FFO) over this period.

We project that the company may return to strong cash flow generation over the next two to three years, with pre-dividend FCF margin rebounding to 5% in 2018, on a par with 2013-2014 levels. A failure to demonstrate progress towards achieving this target and continuing cash burn will likely result in a downgrade.

Market Outlook Remains Subdued

Following the peak of LTE roll-out in large economies, the market for mobile network equipment is likely to remain subdued. However, the market will be supported by ongoing investments into additional LTE capacity in the developed world, and continuing LTE roll-out in emerging markets.

The longer term market outlook remains uncertain, with low visibility on the timing and the extent of the next equipment upgrade cycle. Overall, 5G will likely lead to a moderate increase in operators' expenditure on new infrastructure but the new wave of upgrades are unlikely until 2020-2021 when 5G equipment is expected to become commercially available. Continuing network equipment commoditisation and proliferation of software-enabled functions could flatten capex peaks.

Strong Industry Consolidation Beneficial

The mobile telecoms equipment industry has consolidated to only three large vendors, which reduces risks of irrational competition and protects against intrinsic volatility in capex expenditure by telecoms operators. Key players, including Ericsson, are well positioned to benefit from a new wave of network investment, likely in 5G when it becomes commercially available in the medium-term. The current industry concentration is unprecedented and is a result of ongoing consolidation over the last 15 years, with two other large players being Huawei of China and an enlarged Nokia after its acquisition of Alcatel Lucent in 2015.

Fitch believes telecoms operators are likely to maintain relationships with at least two network suppliers. With some key regions effectively closed to some vendors, and with operators in some countries biased against non-domestic vendors, further industry consolidation is unlikely, which reduces M&A risk.

Heavy R&D Investments

Ericsson's large patent portfolio and a proven track record of leading technology solutions help protect the company's strong market position. Next-generation ultra low-latency 5G networks will likely be intended for applications that are sensitive to network quality (such as driverless cars or remote healthcare solutions), reducing the risk of operators switching to unproven technology providers.

Cisco Partnership Maintains Operating Focus

The strategic partnership with Cisco would allow Ericsson to focus its resources, including R&D expenditure and service capabilities, on its key segment of mobile networks. Although this collaboration falls short of a full joint venture relationship, Ericsson should benefit from substantial cross-selling opportunities with Cisco, and its improved ability to offer more complete end-to-end solutions.

Restructuring Efforts Increases Flexibility
Ericsson's accelerated efforts to reduce operating costs and improve gross margins should contribute to profitability stabilisation in response to lower revenue in 2016 and expected further moderate contraction in 2017.

DERIVATION SUMMARY

Ericsson is an established telecoms equipment manufacturer, with strong positions in the mobile networks - a segment, dominated by only three players with comparable market shares. Consistently large R&D expenditure and wide service capabilities protect against new entrants in an industry that is intrinsically volatile and driven by technology upgrade cycles.

A substantial net cash position helps to withstand short-term pressures and adjust the business to rapidly evolving customer demand. Ericsson is less diversified and more focused on the mobile network segment compared with both Huawei and Nokia. It is lagging Nokia in terms of cost-cutting, which initiated a more ambitious restructuring programme earlier.

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for Ericsson include the following:
- Negative reported revenue growth in 2016 and 2017, due to market weaknesses, with broadly flat growth projected for 2018 and 2019.
- EBITDA margin to sharply decline in 2016-2017, before slowly recovering to approximately 11% in 2019 as management complete cost cutting programme and revenue stabilises.
- Pre-dividend FCF margin to return to above 5% by end-2018.
- Dividend discipline, in light of weak FCF generation, to maintain a healthy net cash position.

RATING SENSITIVITIES

Positive: Future developments that may, individually or collectively, lead to a positive rating action include:
Industry fundamentals imply intrinsically volatile revenues and rapidly changing technology cycles, which make a potential upgrade to 'A-' unlikely in the medium-term and dependent on exceptional strengths such as

- Strong and sustainable market positions in key targeted areas;
- Pre-dividend FCF margin consistently in high single digits.
- Maintenance of strong net cash balance sufficient to withstand short-to-medium term revenue pressures.

Negative: Future developments that may, individually or collectively, lead to a negative rating action include:

-Continuing revenue and net cash erosion with slow progress towards cash flow recovery.
-Pre-dividend FCF margin expected to be consistently below 5%.
-A change in financial policy leading to a balance sheet that is managed close to a net debt basis.

LIQUIDITY

Ericsson's liquidity is strong, with readily available cash of SEK 38.4 bn (assuming SEK4.7bn of restricted cash) at end-3Q16 comfortably covering SEK10.5bn of debt redemptions till end-2020.

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Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
Recovery Ratings and Notching Criteria for Non-Financial Corporate Issuers (pub. 21 Nov 2016)

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Telefonaktiebolaget LM Ericsson	EU Issued

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP/COUPON RATE	RATING TYPE

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Telefonaktiebolaget LM Ericsson	-	Long Term Issuer Defau Rating
Telefonaktiebolaget LM Ericsson EUR 500 mln 5.375% Notes 27 Jun 2017	XS0307504547	Long Term Rating
Telefonaktiebolaget	US294829AA48	Long Term Rating

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