FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ericsson at 'BBB+'; Outlook Stable

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Fitch Ratings-London-14 January 2016: Fitch Ratings has affirmed Telefonaktiebolaget LM Ericsson's (Ericsson) Long-term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB+'. The Outlook on the IDR is Stable.

The ratings take into account Ericsson's consistently strong industry position, its solid track record in managing customer relationships through technology migrations and at times volatile sales cycles, its long-term approach to R&D investment and deep understanding of a complex, competitive and consistently evolving industry. An incremental rather than transformational approach to M&A and conservative balance sheet further support its ratings.

Industry conditions remain tough despite the consolidation that has taken place over the past 15 years - with the networks industry increasingly dominated by three global vendors. Ericsson's ability to maintain a strong and often leading position despite intense competition underlines the

company's ability to adapt. An increasing emphasis on software and services (66% of 2014 revenues), away from lower-margin hardware, focus on cost savings and exploitation of patent royalties should help support margins. Near-term cash flow pressures exist and are always likely given the sales cycle and cash flow profile of network rollout; over the longer term Ericsson's cash conversion remains sound.

KEY RATING DRIVERS
Long Investment Cycles
Technology migrations lead to long investment cycles, with equipment vendors having to prepare for technology standards well in advance of the next decade and when global industry standards can take years to formalise.

4G networks have been rolled out in most western parts of the world, although in many cases spectrum has only recently been made available. Vendors need to manage complex layers of network rollout, coverage, capacity and network densification while at the same time ensuring R&D is focused on future technologies - at present most obviously 5G mobile - which will only become commercially operative in five or six years' time, and then ramp up over the following decade. A move to all IP networks is an equally important transition requiring broader and ever more complete product solutions, complex software and systems integration skills.

Fitch believes Ericsson understands these challenges well, that it plans its research investment accordingly and is open in communicating the financial implications (cyclicality) of these challenges to investors.

Margin & Cash Flow Volatility
Revenue mix and investment cycles lead to margin and cash flow volatility - which can at times be protracted. Network rollout is a low-gross margin, working capital-intensive, but important part of the business mix - a feature which compressed Ericsson's margins throughout 2012 and 2013, while 4G roll-outs in China in 2015 have so far impacted working capital materially.

Ericsson's network sales are categorised broadly, as coverage and capacity - with coverage that part of the cycle involving initial network rollout (either on a greenfield or replacement basis). Involving a high level of hardware, labour-intensive field work, and in some cases long payment terms, this part of the cycle which in a given project lasts around a year is low-margin and can be cash flow- negative. Capacity or network densification revenues, the balance of a 10-year sales cycle, are much higher margin and have stronger cash flow characteristics.

Ericsson has reported negative free cash flow (FCF) on a 12-month trailing basis for each of the past three quarters. Its own cash conversion measure (operating cash flow after working capital divided by pre-working capital cash flow) is currently well below its target of 70%. These trends are cyclical and not at present considered a rating pressure.

Consolidating and Competitive Industry

The telecom equipment industry has gone through significant consolidation over the past 15 years - throughout which Ericsson has maintained a leading position despite the absence of transformational M&A. In networks the industry is increasingly dominated by Ericsson, Huawei of China and the enlarged Nokia, currently in the process of acquiring Alcatel Lucent. Each offer significant competition and an equally rounded product offering.

Reported market shares fluctuate from quarter to quarter - in 3Q15 IHS Infonetics placed Ericsson marginally behind the combined share of Nokia and Alcatel's in mobile infrastructure, but percentage points ahead of Huawei. The recently announced partnership with Cisco, the market leader in IP routing (see below), should help round out Ericsson's service offering. An increasing focus on systems integration and software mean competition is also present from the large enterprise software and IT consultancies such as IBM and Accenture.

Both the enlarged Nokia and expansive ambitions of Huawei are likely to maintain industry pressures. In the near term Nokia faces integration challenges. Huawei consistently provides pricing tension, although is likely

to remain excluded from markets such as the US (Ericsson's North American revenues; 23.8% of total 9M15 sales). Fitch believes operators will always maintain at least two network supply relationships and that Ericsson's long established relationships, understanding of complex, changing and protracted industry cycles and focus on managed services and systems integration will continue to support a leading industry position.

Partnerships, M&A & Execution Risk

Ericsson's approach to M&A remains incremental rather than transformational with deals tending to be bolt-in in nature and funded from available cash. Its partnership with Cisco announced in November 2015 is intended to enhance its ability to offer complete network solutions, including Cisco's market-leading IP routing capabilities - an area where its own capabilities are relatively modest. This is increasingly important in light of the enlarged service offering envisaged by the Nokia-Alcatel Lucent merger and given Alcatel Lucent's strengths in this area. The Cisco partnership envisages incremental revenues for each partner, rising to USD1bn by 2018 as well as creating additional cost synergies for Ericsson.

Fitch believes execution risk exists, particularly in delivering the revenue potential of combined service offerings, and R&D synergies. The partnership's combined annual R&D spend, for instance, of USD11bn, compares with Huawei's approximate USD7.7bn. It will be important that the partners' respective managements are able to align research and sales objectives, and agree on how to deliver seamless solutions to their customers while pursuing their own strategic goals. At the same time we believe this approach offers lower execution risk than transformational M&A, where integration and cultural barriers, and the pursuit of synergy goals across different geographies and political sensibilities, may in the near term at least be more challenging to deliver.

IPR & Cost Synergies

Ericsson generated sales from intellectual property rights (IPR) of SEK9.9bn in 2014, and expects this to have risen to between SEK13bn and

SEK14bn in 2015 following agreement on outstanding patent litigation with Apple. At this level Fitch estimates Ericsson's patent revenues to be roughly twice the level of the pre-merger Nokia and that while Ericsson does not report the margin level of these revenues, Nokia's Technologies division's operating margins in the low 60s may be indicative of the high value of this revenue stream. Ericsson is also on track with its SEK9bn cost synergy target set to be achieved by 2017. FX headwinds have pushed management's estimated restructuring costs to SEK3.5bn-SEK4.5bn.

Fitch views both the existence of market-leading IPR in the revenue mix and the pursuit and delivery of cost efficiencies as supportive of the company's 'BBB+' rating.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Low single-digit revenue growth on a reported basis in 2016 and 2017.
- Margin expansion in 2016 and 2017, driven by the efficiency programme, lower restructuring costs and a higher-margin product mix.
- Capex around 3%-3.5% of revenues through to 2017, reflecting investment in new cost centres and new systems development.
- Recurring acquisition spend as the group further expands into its targeted growth areas.
- Maintenance of a strong net cash position despite continued dividend growth.

RATING SENSITIVITIES
Future developments that may, individually or collectively, lead to positive rating action include:
-improved operating profile evident in strengthened market position in key targeted areas, improved revenue mix and lower volatility of margins, despite what Fitch believes will continue to be tough competitive conditions;
-A consolidated operating margin in high single/low double digits;
-Pre-dividend FCF margin expected to be consistently in high single digits.

Future developments that may, individually or collectively, lead to negative

rating action include:
-A consolidated operating margin that fails to trend consistently to high single digits in the near- to medium-term, particularly if accompanied by weak cash flow generation, which will likely prompt a downgrade to 'BBB'.
-Pre-dividend FCF margin expected to be consistently below 5%.
-A change in financial policy leading to a balance sheet that is managed consistently on a net debt basis.

LIQUIDITY
Ericsson's liquidity is sound. At end-September 2015 Fitch estimates the company had unrestricted cash of around SEK20.4Bn (assuming restricted cash at similar levels to the SEK5.4Bn reported at YE14) and available undrawn committed bank lines of SEK17.5Bn. Debt maturities are well spread out with no significant repayments due before 2017. The average maturity of its debt is five years.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)

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ENDORSEMENT STATUS

Telefonaktiebolaget LM Ericsson EU Issued

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP/COUPON RATE	RATING TYPE
Telefonaktiebolaget LM Ericsson	-	Long Term Issuer Default Rati
Telefonaktiebolaget LM Ericsson EUR 500 mln 5.375% Notes 27 Jun 2017	XS0307504547	Long Term Rating
Telefonaktiebolaget LM Ericsson USD 1 bln 4.125% Notes 9 May 2022	US294829AA48	Long Term Rating
Telefonaktiebolaget LM Ericsson USD 5 bln Euro Medium	-	Long Term Rating

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