FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Ericsson to 'BBB', Outlook Negative

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Fitch Ratings-Moscow-28 April 2017: Fitch Ratings has downgraded Telefonaktiebolaget LM Ericsson's Long-Term Issuer Default Rating (IDR) and senior unsecured rating to 'BBB' from 'BBB+'. The Outlook on the IDR is Negative.

The downgrade and the Negative Outlook reflect operating and financial challenges facing Ericsson, at least over the next 18-24 months. Significant revenue pressure in the core networks segment and a re-sizing of the media and IT/cloud segments, and continued R&D expenditure are likely to weigh on operating profit. In addition, significant restructuring costs are likely to lead to negative free cash flow in 2017.

We continue to see Ericsson as an investment-grade company. However, its efforts to streamline operations and improve profitability involve considerable execution risks and there is limited visibility on its post-restructuring operating profile in a competitive telecoms equipment market.

KEY RATING DRIVERS

Challenging Market Conditions: We believe difficult conditions in the telecoms equipment market are likely to pose significant challenges to the company's aim to improve profitability. There are no potential drivers, in our view, that may support strong market recovery in the next two years, and there is significant uncertainty on how the market will develop in the long run.

Ericsson's core market of mobile radio equipment and services remains weak and highly competitive, as the roll-out of 4G networks coverage is largely complete in the developed world. Ericsson is guiding for a 2% to 6% decline in the global mobile radio networks markets in 2017. A significant deployment of 5G networks is unlikely over the next two to three years, with low visibility on telecoms operators' propensity to spend on new 5G solutions.

Revenue Underperformance: We believe Ericsson's revenue is likely to underperform the broader mobile equipment market in 2017. Pressures result from a sharp drop in intellectual property rights revenue, renegotiation of some large service contracts, with a lingering negative impact throughout 2017, and potentially 2018, and weak performance of smaller IT/cloud and media segments. In the medium term, the company guided that optimisation of some low-performing service and network roll-out contracts would shave off up to SEK10 billion of revenues in 2019, equal to 5% of last-12-months revenue to 1Q17.

Restructuring Strategy Brings Execution Risks: The company's target of doubling its 2016 operating margin (to an implied 12%) after 2018 faces significant execution risks, in our view. Ericsson is likely to become a leaner and more profitable company if the strategy is successfully implemented, but with a narrower focus on the radio access network market. The size of this market remains significant but it is intrinsically volatile, with limited visibility on longer-term growth prospects and technological risks due to increasing commoditisation of network architecture. This backdrop is more consistent with a low-to-mid 'BBB' rating, at least over the next few years.

Ericsson's cost-cutting initiatives entail substantial restructuring costs that are likely to turn its free cash flow negative in 2017, by our estimates. The company guided for SEK6 billion-8 billion of restructuring costs in 2017, while the additional cash impact of provisions related to the revision of some large customer contracts was estimated at SEK5.8 billion spread over a few years (we assume half of these cash costs will be taken in 2017).

Strong Industry Positions: Ericsson is well positioned in the mobile telecoms equipment market share, and is likely to remain a key industry player, in our view. The industry has consolidated to three main companies, with a limited threat of new entrants in the network equipment segment over the medium term. Fitch believes many telecoms operators would want to maintain at least two network supplier relationships. With some key regions effectively closed except to selected operators, further industry consolidation is unlikely, which reduces M&A risk.

Weak Short-Term Cash Flow: We expect Ericsson to generate negative cash flow in 2017, driven by declining revenues and significant restructuring costs. We believe cost-cutting efforts may allow it to improve profitability and turn FCF positive in 2018. The company is likely to need to maintain strong dividend discipline to put it in a position to start growing its net cash position.

DERIVATION SUMMARY

Ericsson is an established telecoms equipment manufacturer, with strong positions in mobile networks - a segment with three main companies with comparable market shares. A significant level of 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 the company withstand short-term pressures and adjust the business for rapidly evolving customer demand. Ericsson is less diversified and more focused on the mobile network segment than Huawei and Nokia. It lags behind Nokia in cost-cutting, which started an ambitious restructuring programme following its merger with Alcatel.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- high-single-digit revenue decline in 2017, followed by a milder low-single-digit decline in 2018, recovering to neutral to 1% growth in 2019 and 2020;
- cash restructuring costs of SEK8 billion in 2017;
- a SEK3 billion negative cash impact in 2017 from provisions relating to the revision of some customer projects with a further impact of SEK2 billion in 2018 and SEK0.8 billion in 2019;
- strong dividend discipline, in view of significant strategic challenges;
- maintenance of a healthy net cash position.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

The industry fundamentals imply intrinsically volatile revenues and rapidly changing technology cycles, which makes a potential upgrade to 'BBB+' unlikely in the medium term and dependent on developments such as:

- strong market positions in key targeted segments together with improved visibility of revenue and profitability of the global telecoms equipment market;
- pre-dividend FCF margin consistently in high single digits;
- maintenance of a strong net cash balance sufficient to withstand short- to medium-term revenue pressures.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Deteriorating market share and increased industry competition, leading to further pressure on Ericsson's revenue and cash flow generation
- Pre-dividend FCF margin expected to be consistently in low single digits
- 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 SEK61.4 billion (this excludes an estimated SEK4.2 billion of restricted cash and includes SEK32.6 billion of high-quality, liquid interest-bearing assets) at end-1Q17 comfortably covering SEK9.5 billion of current debt redemptions.

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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
Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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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 Defau Rating
Telefonaktiebolaget LM Ericsson EUR 500 mln 5.375% Notes 27 Jun 2017	XS0307504547	Long Term Rating
Telefonaktiebolaget LM Ericsson EUR 500 mln 0.875% bond/note 01-Mar-2021	XS1571293171	Long Term Rating
Telefonaktiebolaget LM Ericsson USD 1 bln 4.125% Notes 9 May	US294829AA48	Long Term Rating

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