FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Ericsson to 'BBB-'; Outlook Negative

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Fitch Ratings-Moscow/London-21 July 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 Ericsson's warning on a weaker equipment market in 2017, implying heavier pressure on revenue and operating profit. We believe the market outlook is likely to remain challenging for 2018, in view of the lack of clear revenue drivers in the short-to medium-term.

We continue to see Ericsson as an investment-grade company. However, a significant financial recovery is unlikely before 2019 as we expect substantial restructuring charges to weigh on cash flow in both 2017 and 2018.The company's efforts to streamline operations and improve profitability involve considerable execution risks and visibility is limited on its post-restructuring operating profile in a competitive telecoms

equipment market.

KEY RATING DRIVERS

Weak Market Outlook: Ericsson is facing a negative market outlook for both 2017 and 2018, which will weigh on its revenue and margin and challenge its ongoing cost-restructuring programme. Visibility on the sector's market dynamics remains poor, while the lack of clear growth drivers makes a quick rebound unlikely.

Steeper RAN Revenue Decline Forecast: Ericsson changed its outlook for the radio access network (RAN) market to high single-digit percentage revenue decline in 2017 from an earlier estimate of between -2% and -6%. We believe this change suggests a downward revision of the company's 2017 revenue expectations. Lower sales may also have an impact on gross margins in the most important networks segment if high-margin revenue from network capacity upgrades and licensing fees comes under pressure. The company reported that its 2Q17 gross margin declined to 30% from 33% in 2Q16, and its networks division revenue declined 14% yoy on a like-for-like basis. Furthermore, the company expects that it will shed up to SEK10 billion of low-margin revenue by 2019, as announced at its 1Q17 results release.

Pressure on Cash Flow: We expect significant restructuring charges, planned short-term increases in R&D spending, but also impact from the announced contract revisions to weigh on the company's cash flow in both 2017 and 2018. The company accelerated its cost-cutting ambitions with a view to to cutting SEK10 billion of costs over the next 12 months. However, this is likely to be achieved at significant cash restructuring costs, which we estimate at SEK7 billion in both 2017 and 2018, given a SEK3 billion carry-over from 2016, and assuming at least SEK3 billion of additional restructuring costs in 2018.

Negative FCF Forecast: Also, the company estimates the cash impact from renegotiating some low profitable customer projects at up to SEK7.3 billion spread over a few years, but we believe the major portion of it will

likely be front-loaded. As a result, we expect pre-dividend free cash flow (FCF) to become negative in 2017, recovering to slightly positive in 2018. The announced change in the accounting treatment of some R&D expenses that will be expensed from now on rather than capitalised previously has no impact on cash flow and is neutral to the ratings.

Execution Risks: Ericsson's strategy to streamline operations, maintain technological leadership and double operating margin to above 12% after 2018 (6% in 2016) faces significant execution risks, in our view. The company has not yet reached a turn-around point in its financial and operating performance, which is reflected in the Negative Rating Outlook. Efforts to achieve positive momentum are likely to take time, so that Ericsson' credit profile is unlikely to become consistent with the mid-'BBB' rating for at least over the next 24 months.

Supportive Industry Structure: The highly concentrated structure of the RAN market protects Ericsson from excessive competition. Although this benefit has been diluted by weak demand for additional network capacity on the back of strong capex discipline exhibited by most telecoms operators, the industry remains consistent with investment-grade ratings.

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, reducing M&A risk. Ericsson is well-positioned in the mobile telecoms equipment market, and is likely to remain a key industry player, in our view. This backdrop is more consistent with an investment-grade rating.

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 create barriers to entry 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 to rapidly evolving customer demand.
Ericsson is less diversified and more focused on the mobile network segment than Huawei and Nokia Corporation (Nokia) (BB+/Positive). 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:
- Double-digit revenue decline in 2017, followed by a high-single-digit decline in 2018;
- Cash restructuring costs of SEK7 billion in 2017, and similar restructuring charges in 2018 reflective of carry-over effects;
- SEK3 billion of restructuring costs per annum viewed as likely recurring and treated before FFO in the medium-term, including in 2019 and 2020;
- 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 Outlook may be revised to Stable if the company's revenue and EBIT declines slow and the company's pre-dividend FCF turns positive on a sustained basis, while a substantial net cash position is being maintained on its balance sheet.

The industry fundamentals imply intrinsically volatile revenue and rapidly changing technology cycles, making an 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 above 5%;
- 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 negative.
- A change in financial policy leading to a balance sheet that is managed close to a net debt basis.

LIQUIDITY

Strong Liquidity Profile: Despite negative FCF forecast for 2017, Ericsson's liquidity is strong, with readily available cash of SEK50.1 billion (assuming SEK4.2 billion of restricted cash) at end-2Q17 comfortably covering SEK3.2 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)

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Telefonaktiebolaget LM Ericsson	EU Issued

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Telefonaktiebolaget LM Ericsson	-	Long Term Issuer Default Rating
Telefonaktiebolaget LM Ericsson EUR 500 mln 0.875% bond/note 01-Mar-2021	XS1571293171	Long Term Rating

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