FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Ericsson's Outlook to Stable; Affirms at 'BBB-'

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Fitch Ratings-Moscow-27 July 2018: Fitch Ratings has revised Telefonaktiebolaget LM Ericsson's (Ericsson) Outlook to Stable from Negative. The telecom equipment company's Long-Term Issuer Default Rating (IDR) and senior unsecured rating have been affirmed at 'BBB-'.

Ericsson is an established telecoms equipment manufacturer, with strong positions in mobile networks - a segment in which the group is one of three main companies with comparable market positions. 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.

KEY RATING DRIVERS

Stabilising Market: The global mobile infrastructure market has demonstrated clear signs of stabilisation with revenue decline easing to low single-digit territory in 1Q18, according to Dell'Oro Group, an industry consultant. We believe a significant increase in market pressure is unlikely in the medium-term, with key vendors expecting modest revenue contraction in 2018 before seeing muted growth. A positive market outlook is helped by accelerated 5G roll-out plans in many regions including, most importantly, the US.

Ericsson's planning assumptions envisage a 2% decline in the radio access network (RAN) equipment market in 2018, but an estimated CAGR growth over 2017-2022 of 2%, suggesting a market recovery in 2019-2022. Nokia expects approximately 1% to 3% decline in its networks addressable market in 2018, followed by growth in 2019 and 2020.

Improving Performance: Ericsson's financial performance has improved in all segments, including the most important networks division where 2Q18 revenue growth was up 2% yoy, adjusted for currency impact. We view Ericsson's gross margin improvement as sustainable, with the group expecting a stronger positive impact from cost reductions in 2H18 (2Q18 improvement was 5.8pp yoy).

Although revenue from digital and managed services continue to shrink in yoy terms, this is partly a result of restructuring whereby Ericsson is renegotiating or exiting unprofitable contracts. The positive impact of restructuring is clearly visible in the improving gross and operating margins across all non-networks segments.

R&D Important: Ericsson's increased R&D expenditure should help the group to maintain its competitiveness. It remains committed to significant R&D investments with an aim to safeguard its leading product portfolio. We believe an improving gross margin should allow Ericsson to finance R&D expenditure with internal cash flows. A structural shift in the cost base, with higher R&D accompanied by other operating cost savings, is credit-positive, in our view, even if it does not lead to a higher operating margin.

On-Going Cost Cutting: Ericsson's on-going focus on cost cutting and more efficiency will lead to further gross and operating margin improvements, by our estimates. Its strategy initiated in early 2017 is targeted to improve Ericsson's operating margin to above 10% by end-2020 in a scenario of no revenue growth. A revenue increase, particularly in a higher-margin network segment, which we view as likely, would imply an upside to these plans.

While Ericsson does not intend to pursue any self-imposed cost-cutting goals after its SEK10 billion programme was successfully completed at end-2Q18, strict cost discipline is set to continue. We expect cost benefits to significantly exceed the restructuring costs, which we assume at up to 2% of revenue per annum in the medium-term.

Consolidated Industry Structure: The highly concentrated structure of the radio access network market protects Ericsson from excessive competition. The industry remains dominated by three vendors, Huawei, Ericsson and Nokia, with comparable competitive positions. The three vendors share among themselves more than 80% of RAN revenue, by Dell'Oro estimates. We view the industry as consistent with investment-grade ratings.

Telecoms operators value long-term uninterrupted vendor support, which creates significant barriers for entry for new smaller players. The US tensions with ZTE, the fourth-largest and most disruptive vendor, jeopardised its ability to provide maintenance support for its equipment. We believe telecoms operators will remain alert to diversifying their vendor dependence and will be keen to maintain relationships with at least two equipment suppliers, which would mitigate competitive intensity for vendors.

Cash Flow Turning Positive: We expect Ericsson to generate marginally positive free cash flow (FCF) in 2018, with a pre-dividend FCF margin in the low single-digit territory. Substantial restructuring costs guided by Ericsson at SEK5 billion-SEK7 billion in 2018 will be a significant drag.

However, these are likely to be at least partially compensated by positive working capital movements, in view of the group's efforts to improve service delivery and manage inventory more efficiently.

We project Ericsson to remain FCF-positive in the medium-term, with cash flow generation helped by gradual margin improvement, albeit with less working capital benefits.

Strong Balance Sheet: Ericsson's strong balance sheet with SEK33.1 billion net cash at end-2Q18 helps the group manage significant revenue and cash flow volatility. With Ericsson's cash flow only starting to recover, there is not much capacity for more generous shareholder distributions without a negative impact on the balance sheet.

DERIVATION SUMMARY

Ericsson is less diversified and more focused on the mobile network segment than Huawei and Nokia Corporation (BB+/Positive). Its significant R&D investments into both network core and radio segments make Ericsson's products and services competitive in spite of Huawei's total R&D spend being more than 10x higher. Ericsson somewhat lags behind Nokia in cost-cutting, which started an ambitious restructuring programme following its merger with Alcatel. A substantial net cash position helps Ericsson withstand short-term pressures and adjust its business to rapidly evolving customer demand.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer
- Revenue to decline by low single-digits in 2018, before stabilising;
- EBITDA margin gradually improving to approximately 12% in 2020-2021;
- Cash restructuring costs of SEK7.5 billion in 2018, reflecting carry-over impact;
- SEK4 billion of restructuring costs per annum viewed as likely recurring and treated as an item before FFO in the medium-term;

- Strong dividend discipline, reflecting significant strategic challenges; and
- Maintenance of a healthy net cash position.

RATING SENSITIVITIES

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

The industry fundamentals imply intrinsically volatile revenue 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 above 5%, along with maintenance of a strong net cash balance sufficient to withstand short- to medium-term revenue pressures.
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 trending to break-even or negative
-A change in financial policy leading to a balance sheet that is being managed close to a net debt basis

LIQUIDITY

Strong Liquidity Profile: Ericsson's liquidity is strong, with readily available cash of SEK63.8 billion (assuming SEK3.1 billion of restricted cash) at end-2Q18, supported by a recent EUR250 million five-year facility from European Investment Bank. Short-term borrowings were modest at SEK2.6 billion, and overall Ericsson had a net cash position of SEK30 billion (adjusted for restricted cash) at end-2Q18. Well-distributed debt maturities provide additional support to Ericsson's liquidity profile.

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Applicable Criteria

Corporate Rating Criteria - Effective from 23 March 2018 to 19 February 2019 (pub. 23 Mar 2018)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Sector Navigators (pub. 23 Mar 2018)

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Telefonaktiebolaget LM Ericsson	EU Issued

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