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Research Update:

Telecom Equipment Vendor Ericsson Upgraded To 'BBB-' Following Solid Free Cash Flow Improvement; Outlook Stable

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Rating Action Overview

- Sweden-based Telecom equipment vendor Ericsson has developed a competitive product portfolio, including in 5G technology, which has led to a global market share gain of about 1 percentage point for the mobile radio access network market (excluding China) to June 2020 from 2019, and a number of 5G contracts that could further support market share developments.
- At the same time, the company has executed its restructuring program, resulting in an impressive turnaround of the adjusted EBITDA margin, which we expect will reach 12%-13% in 2020, compared with 1% on average from 2016-2018.
- We expect Ericsson's annual reported free operating cash flow (FOCF) after lease payments will increase to about Swedish krona (SEK) 10 billion in 2020, compared with about SEK4 billion annually from 2016-2018.
- We are therefore raising our long-term issuer credit and issue ratings on Ericsson to 'BBB-' from 'BB+' and our regional scale rating to 'K-3' from 'K-4'; and affirming our 'A-3' short-term rating.
- The stable outlook reflects our expectation that in the next 24 months, Ericsson will post low-single digit revenue growth and maintain its adjusted EBITDA margin in the 12%-14% range, which we expect will result in annual reported FOCF after lease payments of SEK10 billion-SEK14 billion.

Rating Action Rationale

Ericsson has developed a competitive product portfolio. In our opinion, the company's competitive positioning benefits from the company's proven research and development (R&D) capabilities and continued R&D investments in previous years, which have resulted in an extensive intellectual property portfolio of currently more than 53,000 patents. Ericsson stepped up its R&D

investment to about 17% of sales in 2017-2020 from about 12% in 2016, although revenue was declining and the company was undergoing a significant cost-cutting plan. We believe this helped the company stabilize and increase its market share in several geographies, and has recently enabled it to take advantage of 5G spending and mobile equipment market growth, with 65 live 5G networks and 112 commercial agreements as of mid-November 2020. In North America the group increased its market share to 53% in second-quarter 2020 from 48% in 2018 and we expect that there could be further revenue growth opportunities following the completion of the T-Mobile and Sprint merger as well as the spectrum auctions planned in December 2020. Furthermore, Ericsson improved its market share in Europe, the Middle East, and Africa, a competitive region where all equipment providers are present, to 31% in second-quarter 2020 from 30% in 2018. We believe there could be further market share gain opportunities in this region if more countries, similar to the U.K., impose restrictions on Chinese vendors' activities in their respective countries, and as we see more operators switching from Chinese vendors. For example, BT Group PLC signed Ericsson and Nokia for its 5G and Telia in Lithuania selected Ericsson for 4G modernization and 5G (in both cases Huawei had been the vendor). We think security risks could have a positive impact on European vendors' share in Europe (including Ericsson) but offset by some near-term delays in 5G deployments in Europe, for example most recently in Sweden where the spectrum auction has been delayed, pending decision on whether Huawei can provide 5G equipment to operators.

Solid EBITDA margin improvement following a well-executed restructuring program led to a rebound in FOCF. Since 2017, Ericsson has implemented a comprehensive cost-cutting plan, which included a now-concluded headcount reduction of about 15% (compared with year-end 2016) and the termination of unprofitable customer contracts (of which seven out of 45 remains in the digital services segment). These measures have helped Ericsson's S&P Global Ratings-adjusted EBITDA margins to recover to about 13% over the past 12 months as of September 2020. The cost-cutting plan was accompanied with significant restructuring charges of about SEK8 billion annually during 2016-2018, hence a low point of about negative 4% in 2017, but the plan is completed. However, given the volatile nature of the industry, we expect recurrent restructuring charges, although at a significant lower level, of SEK2.0 billion-SEK2.5 billion annually from 2020, assuming no material drop in revenue. In addition, there is potential for further margin improvements, toward 14% in 2021, stemming from economies of scale following 5G momentum in several geographies and a turnaround to more software services within the digital services segment. As a result, we expect Ericsson's reported FOCF after lease payments to improve to about SEK10 billion in 2020 and toward SEK13 billion in 2021 (corresponding to S&P Global Ratings-adjusted FOCF of about SEK12 billion and SEK15 billion, respectively) compared with about SEK 4 billion annually in 2016-2018.

The telecom equipment market remains very competitive. Ericsson had lost global market share in the mobile radio access network market, to about 26% during first-half 2020 from about 29% in 2018, primarily due to the relatively strong market growth in China compared with the rest of the world due to its strong 4G and 5G momentum. Although Ericsson won contracts in China in 2020, we still expect that the company's market share will remain low in the country, at 10%-11%, given the domestic vendors dominance. In addition, there could be additional pressure in some markets like the U.S., following operators' willingness to diversify their vendor base to non-European companies, including Samsung. As a result, we think price pressure will remain despite the market's relatively concentrated structure.

There is limited visibility of long-term top-line growth, due to volatile and cyclical demand for telecom equipment. We expect revenue growth in 2020 and 2021 to be primarily from the network segment, which benefits from the 5G momentum in North America and Asia, while we expect revenue growth in 2021 and 2022 will be further helped by a gradual turnaround to revenue growth in digital and managed services supported by the introduction of new products, such as Ericsson's 5G core and cloud native portfolio, solutions within artificial intelligence and automation, and, to a lesser extent, the Cradlepoint acquisition. However, we regard long-term growth prospects as uncertain, given the volatile and cyclical demand for telecom equipment. Regular major technology upgrades, such as from 4G to 5G, are pivotal drivers of Ericsson's core end-market. The staged and lumpy nature of these investments gives rise to pronounced cyclicality in equipment demand. For example, following the peak of 4G investment ending in 2015, the entire market contracted by about 15% over 2016 and 2017, according to Dell'Oro. In addition, the telecom equipment market is exposed to economic sensitivity and technology risks, such as open RAN solutions. We think these factors could continue to result in volatile topline, profitability and FOCF for telecom equipment vendors.

Outlook

The stable outlook reflects our expectation that Ericsson will post low-single digit revenue growth and maintain its adjusted EBITDA margin in the 12%-14% range, which we expect will result in annual reported FOCF after lease payments of SEK10 billion-SEK14 billion in 2021. In addition, we expect Ericsson will preserve adjusted debt to EBITDA of below 1.5x and funds from operations (FFO) to debt of above 60%.

Upside scenario

We could raise the rating if Ericsson's long-term revenue prospects improved, likely from a continued improved market position in the mobile RAN market or new revenue streams from the Internet of Things (IOT) applications. In absence of material restructuring costs, this should lead to EBITDA margins increasing to sustainably above 13% and annual reported FOCF after lease repayments of more than SEK15 billion. An upgrade would also require Ericsson to maintain adjusted debt to EBITDA of below 1.5x and FFO to debt of above 60%.

Downside scenario

We could lower the rating if the recovery of the mobile network equipment market stalled unexpectedly or if we observed materially worsening competitive conditions, or higher-than-expected nonrecurring costs. This would result in reported FOCF after lease payments below SEK9 billion and discretionary cash flow approaching break-even. Although unlikely, adjusted debt to EBITDA rising above 1.5x or FFO to debt decreasing below 60%, for instance following a large acquisition, could put pressure on the rating.

Company Description

Ericsson is the world's second-largest provider of wireless telecommunications network equipment and related software and services, with annual net sales of about SEK 230 billion. Its operations are organized in four segments:

- Networks (72% of first-nine-months 2020 revenue), which includes hardware, software, and related services for radio access and transport.
- Digital Services (15%), which includes software and services for business and operating support systems, and cloud-based solutions for telecom infrastructure and core networks.
- Managed Services (10%), which includes network and IT managed services, such as network design optimization and maintenance, for telecom operators.
- Emerging Business and Other (3%), which includes operations in three areas outside of Ericsson's core business, including Internet of Things (IoT), connected vehicle and interconnection solutions, as well as different media offerings.

Investor AB and AB Industrivärden, two Swedish investment holding companies, held about 38% of the voting rights associated with Ericsson's shares at the end of 2019.

Our Base-Case Scenario

Assumptions

- A global GDP decline of about 4% in 2020, before returning to growth of about 5% in 2021.
- Mobile telecom equipment market to post flat to single-digit growth in 2020-2022.
- Reported revenue growth of about 1% in 2020 and about 0%-3% annually in 2021 and 2022, on an adjusted currency basis and including the Cradlepoint acquisition.
- A relatively stable SEK-U.S. dollar exchange rate in 2021 and 2022, with limited impact on revenue and margins.
- S&P Global Ratings adjusted EBITDA margin of about 13% in 2020, potentially gradually improving towards 14% in 2021, compared with 12.3% in 2019 if restructuring charges remain at about 1% of sales (SEK2.0 billion-SEK2.5 billion annually), compared with SEK1 billion in 2019 and SEK8 billion annually in 2017-2018
- Cash taxes paid of SEK6.0 billion-SEK6.5 billion annually in 2021-2022.
- About SEK1 billion annually cash outflow from provisions relating to restructuring charges from previous years, in addition to current-year expenses.
- SEK3 billion cash out flow relating to pension fund in 2020, resulting in a decrease in pension liabilities with the same amount.
- Neutral net working capital in 2020, then about 1% of sales cash outflows thereafter.
- Gradual decline in capex to sales toward 2% of sales in 2022 from about 3% in 2020, of which we expect 20%-25% to be capitalized development costs.
- Gradual increase in dividends, from SEK 5 billion in 2020 to about SEK 10 billion in 2021 and 2022.
- Acquisition of Cradlepoint in 2020 of $1.1 billion (about SEK 10 billion), and additional small acquisitions of about 1% to 2% of sales in 2021-2022.

Ericsson (Telefonaktiebolaget L.M.) Key Metrics*

	--Fiscal year ended Dec. 31--			
(Bil. SEK)	2019a	2020e	2021e	2022e
Revenue (actual FX)	227	229-231	230-236	230-245
S&P Global Ratings-adjusted EBITDA margin (x)	12.3	13.0-13.5	13.0-14.0	> 13.0
Reported net cash	34.5	32-34	35-37	38-40
S&P Global Ratings-adjusted debt to EBITDA (x)	0.4	0.2-0.4	0.2-0.4	0.2-0.4
S&P Global Ratings-adjusted FOCF	20.3	12.0-13.0	13.0-16.0	> 15.0
Lease payments	2.9	2.5-3.0	2.5-3.0	2.5-3.0
Reported FOCF after lease payments	7.8	9.5-10.5	10.0-13.5	> 12
Reported DCF after lease payments	3.3	> 3.0	> 3.0	> 3.0

SEK--Swedish krona. FOCF--Free operating cash flow. DCF--Discretionary cash flow. A--Actual. E--Estimate.

Issue Ratings--Subordination Risk Analysis

Capital structure

Ericsson's debt primarily consists of SEK22.4 billion of capital market lending and SEK12 billion of term loans issued by parent company Telefonaktiebolaget LM Ericsson. There is minor debt outstanding of about SEK2 billion at subsidiary companies, primarily relating to working capital.

Analytical conclusions

The long-term issue rating on Ericsson's senior unsecured debt is 'BBB-', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure, given that there are no material secured liabilities and virtually all debt is located at the parent company.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/A-3

Business risk: Fair

- Country risk: Very Low
- Industry risk: Moderately High
- Competitive position: Fair

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Outlook Action

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Issuer Credit Rating	BBB-/Stable/A-3	BB+/Positive/A-3
Nordic Regional Scale	K-3	K-4
Senior Unsecured	BBB-	BB+
Recovery Rating	NR	3(60%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.