

Rating Action: Moody's changes outlook on Ericsson's Ba1 ratings to stable from positive following acquisition of Vonage

23 Nov 2021

Milan, November 23, 2021 -- Moody's Investors Service ("Moody's") has today changed to stable from positive the outlook on the ratings of Telefonaktiebolaget LM Ericsson (Ericsson), a leading global provider of telecommunications equipment and related services to mobile and fixed network operators. Concurrently, Moody's has affirmed the company's Ba1 corporate family rating (CFR), its Ba1-PD probability of default rating (PDR), and the Ba1 senior unsecured long-term debt ratings.

On 22 November, Ericsson announced [1] the agreement to acquire Vonage Holdings Corp (Vonage). With around \$1.4 billion revenue and \$200 million EBITDA expected in 2021, Vonage is a global communications platform which provides communication services through cloud-connected devices.

Ericsson has offered \$21 per Vonage's share, implying a total acquisition price of approximately \$6.2 billion (Enterprise Value), or an EV / EBITDA multiple close to 30x (based on 2021 expected EBITDA). The transaction will be funded with a combination of existing cash and cash equivalent investments. The acquisition received the unanimous approval of Vonage's Board of Directors and is expected to close in the first half of 2022, subject to shareholder and regulatory approvals.

"We have changed the outlook on Ericsson's ratings to stable from positive given that following the cash-funded acquisition of Vonage, it will take the company longer than previously expected to reach a net cash positive position. The transaction is fully priced, and there is execution risk associated with Ericsson's ability to scale up the acquired business and the ability to generate revenue synergies," says Ernesto Bisagno, a Moody's Vice President - Senior Credit Officer and lead analyst for Ericsson.

"However, we also recognize that Vonage's acquisition will give Ericsson access to a global communication platform in a high growth market and will enhance its enterprise business," adds Mr Bisagno.

A full list of affected ratings can be found at the end of this press release.

RATINGS RATIONALE

The outlook change to stable from positive factors in that the acquisition of Vonage will delay the potential for Ericsson to achieve a Moody's adjusted net cash position beyond 2023 and initially dilute Ericsson's operating margins by 20-30 basis points (or 110 basis points including higher amortization on acquired intangible assets), owing to the lower margins of the target. The transaction is fully priced, and there is execution risk associated with Ericsson's ability to scale up the acquired business and the ability to generate revenue synergies. While the contribution from Vonage can mitigate the cyclical nature of Ericsson's business in a downturn, this contribution remains fairly small at this stage.

This is partially offset by the potential for Ericsson to accelerate revenue growth, given that Vonage operates in a high-growth market. The acquisition will also give Ericsson access to a global communications platform which, combined with Ericsson's strong position in 5G mobile networks, should accelerate its enterprise business and generate revenue synergies of around \$0.4 billion by 2025. Ericsson guided that the transaction will be EPS and free cash flow (before M&A) accretive from 2024 onwards.

In 2022, Moody's expects stronger revenue growth in the high-single-digit range reflecting the contribution from Vonage and lower headwinds from China. The rating agency also expects Ericsson to maintain operating margins within its 12%-14% EBIT margin guidance (excluding Vonage), driven by a reduction of the operating loss in the DS segment. However, the acquisition of Vonage will have a modest negative impact on 2022 operating margin of around 20-30 basis points (or 110 basis points including higher amortization on the acquired intangible assets).

Assuming increased dividends over 2021-22, reflecting improved earnings and some volatility in working capital cash management, Ericsson would generate an average Moody's-adjusted FCF of SEK17 billion each year. As a result, Moody's anticipates additional improvements in Ericsson's credit metrics, with Moody's-

adjusted gross debt/EBITDA trending towards 1.7x in 2022.

Assuming Vonage's acquisition will complete in H1 2022, Moody's-adjusted net debt/ EBITDA will increase towards 1.1x in 2022 (0.4x in September 2021), which is higher than the previous estimate of 0.2x prior to the Vonage acquisition.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS

Moody's has factored into its decision to change the outlook the governance considerations associated with the company's financial strategy and risk management. This deal is the largest acquisition in Ericsson's history and it is entirely cash funded. While the acquisition will not have impact on Moody's gross leverage, it will reduce cash on balance sheet and delay the potential for Ericsson to achieve a net cash position.

LIQUIDITY

The acquisition of Vonage will reduce existing cash and investments by around SEK56 billion. Ericsson's liquidity will remain good, reflecting (1) its cash and cash equivalents balance of SEK46 billion as of September 2021, in addition to SEK15 billion of short-term fixed-income investments, and another SEK26.7 billion in long-term investments; (2) \$2.0 billion revolving credit facility (fully undrawn as of September 2021), maturing in June 2028 (renewed in September 2021 and which includes an interest margin linked to sustainability targets), with no financial covenants or significant adverse change conditions for drawdowns; (3) positive FCF generation after dividends; and (4) limited short-term debt maturities.

Ericsson made significant debt repayments in the last quarters including a \$684 million bilateral loan repaid in Q4 2020 and a €500 million bond in Q1 2021. Short-term maturities mainly include the \$1 billion bond due in May 2022.

STRUCTURAL CONSIDERATIONS

Ericsson's probability of default rating of Ba1-PD incorporates the use of a 50% family recovery rate assumption, reflecting a capital structure comprising both bank debt and bonds. All of Ericsson's debt instruments, including its \$2.0 billion revolving credit facility, are senior unsecured, have investment-grade style documentation and have no financial covenants. All of Ericsson's rated bonds have a Ba1 rating, at the same level as Ericsson's Ba1 corporate family rating.

RATIONALE FOR STABLE OUTLOOK

Despite the expected increase in Moody's adjusted net debt in 2022, the stable outlook reflects Moody's expectations that Ericsson's operating performance will continue to improve driven by a combination of positive organic growth in revenue, additional improvements in the DS segment, and increased contribution from 5G contracts.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Upward pressure on the rating could develop if Ericsson makes progress in the turn-around of the DS segment, successfully scales up the Vonage business, and maintains a sustainably robust competitive position and technological leadership despite the loss of market shares in China. Quantitatively, an upgrade would require operating margins (Moody's-adjusted) to increase towards 15%, strong FCF generation after shareholder distributions, and a sustained solid liquidity profile and a strong balance sheet with a net cash position (on a Moody's-adjusted basis).

Downward rating pressure could develop if there is a deterioration in operating performance or large debt-financed acquisitions, such that its Moody's-adjusted operating margin drops below 8%, its Moody's-adjusted debt/EBITDA increases sustainably above 2.5x, or its FCF turns negative and liquidity deteriorates.

LIST OF AFFECTED RATINGS

Affirmations:

..Issuer: Telefonaktiebolaget LM Ericsson

.... Probability of Default Rating, Affirmed Ba1-PD

.... LT Corporate Family Rating, Affirmed Ba1

...Senior Unsecured Regular Bond/Debenture, Affirmed Ba1

Outlook Actions:

..Issuer: Telefonaktiebolaget LM Ericsson

....Outlook, Changed To Stable From Positive

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Diversified Technology published in August 2018 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1130737 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

COMPANY PROFILE

With net sales of SEK231 billion and Moody's-adjusted EBITDA for the 12 months ended 30 September 2021 of SEK40.2 billion, Ericsson is a leading provider of telecommunications equipment and related services to telecom operators globally. Its equipment is used in more than 180 countries, and around 40% of the global mobile traffic passes through its systems. In 2020, Ericsson's Networks division contributed 71% of the group's net sales, followed by DS at 16%, Managed Services at 10% and its Emerging Business and Other segment at 3%.

The largest shareholders are Investor AB (Aa3 stable) with 22.8% of voting rights and AB Industrivärden with 19.3%.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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REFERENCES/CITATIONS

[1] Announcement published on Ericsson's website 22-Nov-2021. <https://www.ericsson.com/en/press-releases/2021/11/ericsson-to-acquire-vonage-for-usd-6.2-billion-to-spearhead-the-creation-of-a-global-network-and-communication-platform-for-open-innovation> .

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