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Research Update:

Swedish Telecom Supplier Ericsson Outlook Revised To Stable On Profitability Improvement; 'BBB+/A-2' Ratings Affirmed

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Overview

- Ericsson's profitability has gradually improved since the end of 2013, and we expect the adjusted EBITDA margin to stabilize at 14%-15% in 2014-2015.
- We continue to assess Ericsson's business risk profile as satisfactory and its financial risk profile as minimal.
- We are revising our outlook on the company to stable from negative and affirming our 'BBB+/A-2' ratings.
- The stable outlook reflects our anticipation that Ericsson will post modest revenue and EBITDA growth and continued strong free operating cash flow over the next two years.

Rating Action

On Aug. 28, 2014, Standard & Poor's Ratings Services revised its outlook on Swedish telecommunications equipment supplier Ericsson (Telefonaktiebolaget L.M.) to stable from negative.

At the same time, we affirmed our 'BBB+' long-term and 'A-2' short-term corporate credit ratings on Ericsson.

Rationale

The outlook revision reflects the improvement in Ericsson's profitability over the past four quarters and our expectation that Ericsson's EBITDA margin will remain at 14%-15% in 2014-2015. This is supported by the company's completion of low-margin European modernization projects that weighed on margins until the end of 2013. In addition, we anticipate a more favorable revenue mix in the coming years, with more high-margin capacity projects and fewer low-margin coverage projects; as well as continuous cost-efficiency improvements and increasing royalty revenues. We think these factors will offset price pressure and further restructuring costs, which are ongoing features in the industry.

Our assessment of Ericsson's business risk profile is underpinned by its global leading position in mobile network technologies, with about 40% of the world's mobile traffic running through its networks. Ericsson also displays broad geographic diversity, with a focus on the largest telecom operators in each market; effective and continuous restructuring measures; and a strong research and development budget and patent portfolio. These strengths are partly offset by the volatility of the industry and fierce competition, with sustained price erosion and pressure on market share; Ericsson primarily competes with Huawei Technologies (which lacks a presence in the U.S., however), Nokia, Alcatel-Lucent, and ZTE Corp.

Our assessment of Ericsson's financial risk profile remains supported by the company's solid balance sheet, with large cash and investment balances that significantly exceed adjusted gross debt, and solid free operating cash flow (FOCF) generation. These strengths are moderated by a history of acquisitions and exposure to foreign exchange volatility. That said, we think future acquisitions are unlikely to affect our financial risk profile assessment, given the company's significant excess cash and our anticipation of positive discretionary cash flow.

Our comparable ratings analysis for Ericsson has resulted in a one-notch negative adjustment, based on our view of the company's position relative to other companies in the technology, hardware, and semiconductors industry. Specifically, we see that companies in the U.S. report significantly higher EBITDA margins and FOCF conversion than Ericsson, although they have similar business and financial risk profiles. We rate those companies higher than Ericsson, however.

In our base case, we assume:

- Flat or slightly lower revenues in 2014, including a 4% decline in the first six months of the year, followed by modest growth in 2015. We expect Ericsson to benefit from its strong position and diversified customer base as telecom carriers roll out their fourth-generation infrastructure around the world.
- Profitability will benefit from a rising share of higher-margin products, including software and royalty, although partly offset by continued restructuring activities and price pressure.
- A modest, negative change in working capital.
- Higher dividends than the Swedish krona (SEK) 9.8 billion paid in 2014.
- Some smaller acquisitions.

Based on these assumptions, we arrive at the following credit measures for Ericsson:

- An adjusted EBITDA margin of 14%-15% in 2014-2015 compared with 15.0% for the 12 months ended June 30, 2014, which includes a SEK4.2 billion payment from Samsung in the fourth quarter of 2013.
- FOCF of about SEK13 billion to SEK14 billion.
- Net reported cash of about SEK35 billion to SEK40 billion.

Liquidity

The short-term rating is 'A-2'. We have revised our assessment of Ericsson's liquidity to "exceptional" from "strong," as defined in our criteria, because we expect its sources of liquidity to amount to at least 2x uses over the next two years. Furthermore, we think the company has good relationships with its banks and a high standing in the credit markets.

Ericsson's principal liquidity sources include:

- Consolidated cash and equivalents of SEK68 billion on June 30, 2014;
- Funds from operations of SEK22 billion to SEK23 billion per year; and
- An undrawn revolving credit facility of $2.0 billion maturing in June 2020 that has no financial covenants.

The principal liquidity uses are:

- Annual capital expenditures of SEK7 billion;
- Our anticipation of significant intrayear peak working capital outflows; and
- Annual dividends of about SEK10 billion.

Outlook

The stable outlook reflects our view that over the next two years Ericsson will maintain its strong market share and balance sheet, an adjusted EBITDA margin of about 14%-15%, and its currently positive discretionary cash flow generation.

Upside scenario

We could raise the ratings if Ericsson's operating performance strengthened. This could be reflected in the adjusted EBITDA margin increasing to about 20% and revenues rising at least modestly. In addition, we would expect Ericsson to maintain a strong balance sheet.

Downside scenario

We could lower the ratings if Ericsson's strong balance sheet, including a significant net financial cash position, were to deteriorate, for example as a result of aggressive acquisitions or shareholder distributions that materially exceeded FOCF. We could also lower the ratings if we perceived a weakening of the company's business risk profile, for instance after a prolonged revenue decline, or if the EBITDA margin narrowed to 10%.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Stable/A-2

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Minimal

- Cash flow/Leverage: Minimal

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Negative (-1 notch)

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Technology Hardware And Semiconductors Industry , Nov. 19, 2013

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Ericsson (Telefonaktiebolaget L.M.)		
Corporate Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2
Nordic Regional Scale	--/--/K-1	--/--/K-1
Senior Unsecured	BBB+	BBB+

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