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Research Update:

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

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Overview

- Swedish Telecom Supplier Ericsson reported weaker-than-expected revenue and profitability performance in the first half of 2016, and we forecast that this trend will continue for the rest of the year.
- As a result, we have lowered our base case, which previously assumed revenue growth and increasing margins in 2016. We now forecast declining revenues and an S&P Global Ratings-adjusted EBITDA margin of about 9%-10% in 2016, but improving margins and stabilizing revenues in 2017.
- We are therefore affirming our 'BBB+' long-term corporate credit rating on Ericsson, but revising the outlook to negative from stable.
- The negative outlook reflects the possibility of a downgrade in the next 12 months if we think that currently negative revenue growth and weak profitability will prevail for a prolonged period.

Rating Action

On July 25, 2016, S&P Global Ratings revised its outlook on Swedish Telecom Supplier Ericsson (Telefonaktiebolaget L.M.) to negative from stable. At the same time, we affirmed our long-term corporate credit and issue ratings on the company at 'BBB+' and our short-term rating at 'A-2'.

Rationale

The outlook revision primarily reflects Ericsson's weaker-than-expected revenue and profitability performance in the first half of 2016, and our view that revenues and margins are unlikely to materially rebound in the second half of 2016. As a result, we have materially revised our EBITDA margin expectations for 2016 to about 9%-10% from about 15% before. Nevertheless, we do expect a gradual recovery in margins in 2017 and 2018, primarily due to improving industry demand and significant cost cutting.

The negative outlook also reflects the possibility that we could revise downward our assessment of Ericsson's business risk, which in turn could result in a downgrade, if the group's revenues grow below the industry average or if we think that adjusted EBITDA margins will only remain at about 10%, despite the ongoing restructuring program.

Ericsson reported an 11% year-on-year decline in revenues in the second

quarter of 2016, following a 2% year-on-year decline in the first quarter, primarily due to lower mobile broadband sales in some emerging markets with weak macroeconomic conditions. In our previous base case, we had assumed about 2%-4% revenue growth in 2016. In addition, the reported gross margin declined to 32.8% and our adjusted EBITDA margin declined to 9.3% in the first half of 2016, compared with 34.2% and 10% in the first half of 2015, respectively.

Ericsson announced a cost cutting program in 2014, targeting Swedish krona (SEK) 9 billion annual run-rate savings in 2017. In addition, the company announced a reorganization and further cost reduction initiatives in April 2016. We understand that the original savings target has been increased by 50%, and that management aims to achieve total annual run-rate in the second half of 2017. We expect 2016 to be a tough year for Ericsson, but at this stage we view the challenges as short term and not fundamental.

The ratings on Ericsson continue to be supported by a strong balance sheet with a meaningful reported net cash position and well-spread debt maturities.

Our base case assumes:

- Revenues to decline in the Networks and Global Services segments by high-single-digit percentages in 2016. This is due to the weak macroeconomic situation in some emerging markets and overall challenging market conditions in the wireless infrastructure market following the peak in fourth-generation (4G) wireless rollouts in 2015. We expect the market to stabilize in 2017, but revenues are still likely to decline slightly given the absence of meaningful growth triggers in the short term.
- Restructuring cost of SEK4 billion-SEK5 billion in 2016, decreasing slightly in 2017, compared with SEK5 billion in 2015.
- Reported gross margin of about 33% in 2016, improving in 2017, compared with 34.8% in 2015. Decline in 2016 due to a larger share of coverage projects and services business, and challenges in the Global Services segment. Increase in 2017 thanks to cost cutting measures and expected improvement in business mix.
- About SEK4 billion-SEK5 billion in operating cost savings in 2016, increasing to about SEK5.5 billion-SEK6.5 billion in 2017.
- Annual capital expenditures (capex) of about 2.5%-3.0% of revenues and some bolt-on acquisitions.
- Constant annual dividend of SEK3.70 per share.
- Increase in adjusted gross debt, primarily due to an increase in postretirement obligations as a result of low interest rates. We consider cash reserves above about SEK5 billion as surplus and deduct them from gross debt.

Based on these assumptions, we arrive at the following adjusted credit measures for 2016-2018:

- Adjusted EBITDA margin of 9%-10% in 2016, improving to above 11% in 2017, compared with 12.7% in 2015.
- Reported free operating cash flow (FOCF) of about SEK3 billion-SEK4.5

billion in 2016 and about SEK10 billion-SEK12 billion in 2017, compared with SEK9 billion in 2015.

- Funds from operations (FFO) to debt above 100% in 2016-2017.
- Adjusted debt to EBITDA of about 0.5x in 2016-2017.
- Reported net cash position of about SEK30 billion at the end of 2016 and about SEK25 billion-SEK27 billion at the end of 2017.

Liquidity

The short-term rating is 'A-2'. We consider Ericsson's liquidity to be exceptional because we expect its sources of liquidity to amount to at least 2x uses in the two years from June 30, 2016. Furthermore, we think the company has good relationships with its banks and a high standing in the credit markets.

We anticipate the following primary liquidity sources over the next 24 months:

- Consolidated cash and equivalents of SEK49 billion as of June 30, 2016.
- Annual FFO of above SEK16 billion.
- An undrawn revolving credit facility of \$2.0 billion maturing in 2021 that has no financial covenants.

We anticipate the following primary liquidity uses over the same period:

- Annual capex, including capitalized development costs, of SEK10 billion-SEK12 billion.
- Our anticipation of significant intrayear peak working capital outflows.
- Annual dividends of about SEK12 billion-SEK13 billion in 2017 and 2018.
- Short-term debt of about SEK10 billion as of June 30, 2016, including €500 million notes maturing in 2017.

Outlook

The negative outlook on Ericsson reflects the potential for a downgrade in the next 12 months, if the company is not able to stabilize its revenues and materially improve its profitability in 2017.

Downside scenario

We could lower the ratings if Ericsson's revenues grow less than the industry average for a prolonged period or if we thought that EBITDA margins would only remain at about 10%, despite the ongoing restructuring. We think this could happen because of increasing competition, loss of market shares, or inadequate cost reductions. We could also consider a downgrade if Ericsson's strong balance sheet were to deteriorate, for example, as a result of aggressive acquisitions or continuous shareholder distributions that materially exceed FOCF.

Upside scenario

We could revise the outlook back to stable if Ericsson's operating performance strengthened sustainably. This could be reflected in the adjusted EBITDA margin increasing to about 14%-16% and revenue growth at least in line with

the industry average. In addition, we would expect Ericsson to maintain a strong balance sheet, including a solid net cash position and at least break-even discretionary cash flow generation.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Negative/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 Rating Analysis: Negative (-1 notch)

Related Criteria And Research

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Ericsson (Telefonaktiebolaget L.M.) Corporate Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2

Ratings Affirmed

Ericsson (Telefonaktiebolaget L.M.) Nordic Regional Scale Senior Unsecured	--/--/K-1 BBB+
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