Maalot
S&P Global Ratings

Perion Network Ltd.

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Perion Network Ltd.

Affirmed Corporate Credit Rating	ilA-/Stable

Overview

Key Strengths	Key Risks
• Increased diversification through increase in digital advertising activity. • Low leverage. • Adequate liquidity. • Consistent free cash flow generation.	• Exposure to the risky, uncertain web search business. • Continued decrease in EBITDA margin with the increase in digital advertising activity, which is less profitable than the web search business. • High dependence on a major client (Bing) in the search business. • Uncertainty regarding Undertone's contribution to profitability.

Perion's revenues decreased in 2018, mainly due to a decrease in revenues from the advertising segment due to unavailability of high-quality advertising sites and a decrease in legacy product sales in the web search market.

We expect the Company to increase its revenues in the digital advertising segment, where potential for future growth is higher. However, this segment is less profitable than the search segment.

In the search segment, the Company is highly dependent on a major client (Bing), and discontinuation of this engagement could materially affect the Company's results.

In 2017 and 2018 Perion decreased its expenditures in order to mitigate the decrease in profitability. Among other things, the Company decreased its operating expenses, including general and administrative expenses, rent expenses, etc. However, we expect the Company to increase its development expenditures in 2019, an investment which, we believe, will only bear fruit in the medium term.

Perion's low leverage and continued generation of positive cash flows contribute to our assessment that debt maturities will be repaid as required and to the Company's adequate liquidity assessment.

Outlook: Stable

The stable outlook reflects our assessment that Perion Network's business risk profile will remain stable in the medium term, with no material decrease in its web search and advertising business. The stable outlook also reflects our assessment that the company's operating performance will support an adjusted debt to EBITDA ratio below 3.0x and continued positive operating cash flow generation.

Downside Scenario

We may consider a negative rating action if company fails to maintain the above mentioned coverage ratio or to generate consistently positive operating cash flow. We believe this could happen as a result of deterioration in market conditions in the web search industry, lower than expected contribution of the digital advertising business or the execution of leveraged acquisitions which will weaken its coverage ratios. A negative rating action would also be possible if the engagement with Bing is discontinued and the Company fails to secure an alternative engagement of similar magnitude.

Upside Scenario

We may raise the rating if Perion materially improves its business risk profile. This could happens if the Company strengthens its business position, improves its profitability and increases its business diversification. A positive rating action is also possible if Perion maintains an adjusted debt to EBITDA coverage ratio below 1.5x while generating stable operating cash flows by, among other things, improving its profitability.

Base Case Scenario

Key Assumption

- Decrease in GDP growth in North America (the region generating about 75% of the Company's revenues) to 1.7%-2.3% in 2019-2020.
- Decrease of about 8% in revenues in 2018 and slight decrease or stability in revenues in 2019-2020.
- Relative stability in adjusted EBITDA of about $35 million in 2018 and some decrease in 2019-2020 due to increase in less-profitable digital advertising activity and increase in R&D expenses.
- Low capital expenditures of $2 million - $3 million annually in 2019-2020.
- Low-scope acquisition of technology-supportive activity in 2019.

Key Metrics

	2017A	2018E	2019E	2020E
EBITDA margin	12.8%	14%	8%-11%	8%-11%
Debt/EBITDA	2.0x	1.4x	1.4x-2.2x	1.3x-2.2x
FFO/debt	35%	54%	45%-50%	35%-45%

A – Actual. E – Estimate. FFO – funds from operations.

Metrics are based on IFRS data and S&P Maalot adjustments.

Base Case Projections

Slight decrease, or at the most – stability, in Perion's revenues in 2019-2020 due to our assessment of competition in the Company's fields of operation as well as decreased revenues from the advertising segment.

Decrease in EBITDA margin in 2019-2020 as the Company expands its operation in the digital advertising segment which is less profitable than the web search activity. However, we view positively the expansion of digital advertising activity as its growth prospects are better than the web search activity's. We expect EBITDA margin to be 8%-11% in 2019 and 2020, compared to 13%-14% in 2018 (our assessment).

Company Description

Perion Network Ltd. is a global digital media company. Perion operates mainly in North America (75%) and Europe (20%) and provides advanced technology and various data solutions to digital advertisers. Perion generates revenues from its activity in the web search market and, since 2015 when it acquired Undertone, it also operates in the digital advertising market. In 2017, after a period of instability, the Company's management was replaced. Perion is a publically traded company founded in Israel in 1999 with dual listing in the Tel Aviv Stock Exchange and NASDAQ. About 45% of its shares are held by private shareholders (up to 15% per shareholder) and the remainder is held by the public.

Business Risk Profile

Perion's business risk profile is underpinned by the following factors:

- Maintenance of a balanced mix between web search activity and digital advertising. In 2018, revenues from web search activity and from digital advertising activity were largely the same, similarly to 2017. We believe that this distribution will remain stable in the next two years.
- Entry into tangent fields in digital advertising in order to expand the scope of activity, while potentially creating synergies with Undertone.

However, Perion's business risk profile is constrained, in our opinion, by the following factors:

- Exposure to web search activity, which is characterized by material shifts and high volatility. As most of Perion's revenues originate in the U.S., we estimate that as long as the non-mobile search market maintains a stable share of the U.S. digital advertising market, search engines will be market-share-oriented and continue to rely on the services of companies such as Perion to increase their search volume. Nevertheless, such companies are exposed to changes in search engine and browser policies.
- Continued decrease in total EBITDA margin as a result of the increase in the share of digital advertising activity which is less profitable than web search activity, and the delay in benefits from the Undertone acquisition. We estimate that Perion's adjusted EBITDA margin will decrease from 13%-14% in 2018 to 8%-11% in 2019 and 2020. However, the Company is reorganizing its manpower and focusing its development costs, which should improve its operating efficiency, although it intends to increase its R&D budget to expand its activity.
- Material dependence on a major client, search provider Bing (owned by Microsoft (AAA/Stable/A-1+)). In October 2017, the company's engagement with Bing was renewed for a period of three years. Although this engagement is not exclusive, it increases the company's geographic diversification and allows it to operate in Belgium, Switzerland, Norway, Sweden, Austria, Denmark, etc. Discontinuation of this engagement could materially hurt the Company's result unless it finds an alternative engagement of the same magnitude.

Financial Risk Profile

Perion's financial risk profile is underpinned, in our opinion, by the following factors:

- Low leverage reflected in an average debt to adjusted EBITDA ratio of about 2.0x, commensurate with the current rating and peers. We believe the company will continue to regularly serve its ongoing debt maturities and maintain adequate cash reserves.
- Consistently positive, albeit decreasing, free cash flows in light of low investment in working capital.

These supporting factors are somewhat mitigated, in our opinion, by the following constraints:

- Expected decrease in operating cash flows as the Company expands its activity in the digital advertising segment which is less profitable than web search activity and due to an increase in R&D expenses.
- Uncertainty regarding the scope of Undertone's contribution to profitability. We estimate that a substantial contribution will only be reflected in Company results in 2019-2020.

Table 1.

Perion Network Ltd. – Financial Summary (Mil. $)

Industry Sector: Software & Services

	2017	**2016**	**2015**	**2014**	**2013**
Revenues	274.0	312.8	218.7	388.7	87.1
EBITDA	35.0	50.3	57.4	117.7	17.3
FFO	28.6	39.5	44.1	91.9	14.4
Net income from continuing operations	(72.8)	2.8	(68.7)	42.8	0.3
Cash flow from operations	40.8	38.0	20.3	73.4	17.0
Capital expenditures	1.6	1.5	6.0	10.9	2.3
Free operating cash flow	39.2	36.5	14.3	62.5	14.7
Discretionary cash flow	39.2	36.5	14.3	62.5	14.7
Debt	70.9	98.2	118.4	42.5	8.3
Equity	138.3	208.1	199.8	246.0	56.6
Adjusted ratios					
Annual revenue growth (%)	(12.4)	43.0	(43.7)	346.1	44.7
EBITDA margin (%)	12.8	16.1	26.2	30.3	19.9
Return on capital (%)	4.5	4.1	(15.9)	31.7	6.6
EBITDA interest coverage (x)	5.3	6.7	13.8	49.5	33.7
FFO cash interest coverage (x)	7.6	8.3	21.4	362.7	41.2
Debt/EBITDA (x)	2.0	2.0	2.1	0.4	0.5
FFO/debt (%)	40.3	40.2	37.3	216.1	174.2
Cash flow from operations/debt (%)	57.5	38.7	17.1	172.5	204.5
Free operating cash flow/debt (%)	55.2	37.2	12.0	146.9	176.8
Discretionary cash flow/EBITDA (%)	111.8	72.6	24.8	53.1	84.6

Liquidity: Adequate

We estimate Perion's liquidity as 'adequate', based on our assessment that the ratio of Perion's sources to uses will exceed 1.2x in the 12 months starting January 1, 2019. This assessment is underpinned by existing cash reserves, the amortization schedule, and operating cash flow generation capability.

In our base-case scenario, we estimate that the company's major sources and uses in the 12 months starting January 1, 2019, will be as follows:

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and cash equivalent of approximately $ 43 million. • Operating cash flow of approximately $15 million - $20 million.	• Long term debt maturities of approximately $16 million. • Maintenance capital expenditure of approximately $1-$2 million.

Debt Maturities					
Year	2019	2020	2021	2022	2023 and later
Maturities (Mil $)	16	16	8	0	0

Covenant Analysis

Compliance Expectations

We expect the Company to maintain sufficient headroom (over 15%) on all of its financial covenants in the short term.

Requirements

According to the terms of the Company's bonds and loans, it must maintain the following covenants: minimum equity of $120 million, net debt to EBITDA of up to 2.5x, EBITDA of at least $11 million and cash balance of at least $10 million

Modifiers

Diversification portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management/Governance: Neutral

Comparable ratings analysis: Neutral

Recovery Analysis

Key analytical factors

- We are approving our 'ilA-' issue rating, identical to the issuer rating, on Perion Network Ltd.'s unsecured bond series L. The recovery rating for this series is '3', reflecting our assessment that in the case of default, the recovery rate would be 50%-70% (at the lower end of this range).

Simulated default assumptions

- Year of default: 2022
- A deep recession in the countries of operation will lead, among other things, to a sharp drop in demand for the Company's products. Simultaneously, the Company will lose a material client (Microsoft Bing). These developments will lead to a significant drop in the Company's revenues and to a deterioration in its operating performance.
- The company will continue to operate as a going concern and undergo reorganization. For this reason, we are using the EBITDA multiple method to evaluate the Company's value at the time of hypothetical default.

Simplified waterfall at emergence

- EBITDA at emergence: $3 million
- EBITDA multiple: 5.0x (considering company characteristics and in comparison with similar companies)
- Enterprise value at emergence: $15 million
- Administrative costs: 5%
- Net Enterprise value available to unsecured debt: $14 million
- Total unsecured debt: $25 million (considering amortization schedule during hypothetical deterioration)
- Recovery expectation for unsecured debt (Series L): 50%-70% (at the lower end of this range)
- Recovery rating for unsecured debt (Series L) (1 to 6): 3

All debt amounts include six months' prepetition interest.

Mapping Recovery Percentages To Recovery Ratings - Group A Jurisdiction

For issuers with a speculative-grade issuer credit rating

		Nominal recovery expectations		
Recovery rating*	**Recovery description**	**Greater than or equal to**	**Less than**	**Issue rating notches relative to ICR**
1+	Highest expectation, full recovery	100%	N/A	+3 notches
1	Very high recovery	90%	100%	+2 notches
2	Substantial recovery	70%	90%	+1 notch
3	Meaningful recovery	50%	70%	0 notches
4	Average recovery	30%	50%	0 notches
5	Modest recovery	10%	30%	-1 notch
6	Negligible recovery	0%	10%	-2 notch

Recovery ratings are capped in certain countries to adjust for reduced creditor recovery prospects in these jurisdictions. Recovery ratings on unsecured debt issues are generally also subject to caps (see Step 6, paragraphs 90-98 of Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016, for further detail). ICR--Issuer credit rating.

Reconciliation

In order to create a basis for comparison with other rated companies, we adjust the data reported in the company's financial statements which we use to calculate coverage ratios. The main adjustments we made on Perion Network Ltd.'s consolidated data for 2017 are:

- Discounting long-term operating leasing contracts and adding them to reported debt.
- Offsetting the effect of stock-based payments on EBITDA.
- Deducting $10 million of cash from debt in accordance with the bond indenture.

Table 2.

Reconciliation Of Perion Network Ltd. Reported Amounts with S&P Global Ratings Adjusted Amounts (Mil. $) for the Fiscal Year Ended Dec 31, 2017

Perion Network Ltd. reported amounts

	Debt	EBITDA	Interest expense	EBITDA	Cash flow from operations
Reported	60.7	26.6	5.0	26.6	36.0
S&P Global Ratings adjustments					
Interest expense (reported)	--	--	--	(5.0)	--
Interest income (reported)	--	--	--	0.1	--
Current tax expense (reported)	--	--	--	(0.0)	--
Operating leases	20.2	6.3	1.6	4.8	4.8
Surplus cash	(10.0)	--	--	--	--
Share-based compensation expense	--	2.1	--	2.1	--
Non-operating income (expense)	--	--	--	--	--
D&A - Impairment charges/(reversals)	--	--	--	--	--
Total adjustments	**10.2**	**8.4**	**1.6**	**2.0**	**4.8**

S&P Global Ratings adjusted amounts

	Debt	EBITDA	Interest expense	Funds from operations	Cash flow from operations
Adjusted	70.9	35.0	6.6	28.6	40.8

Related Criteria And Research

- Use Of CreditWatch And Outlooks, September 14, 2009
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, November 13, 2012
- Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, October 24, 2013
- Key Credit Factors For The Technology Software And Services Industry, November 19, 2013
- Group Rating Methodology, November 19, 2013
- Corporate Methodology: Ratios And Adjustments, November 19, 2013
- Corporate Methodology, November 19, 2013
- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Methodology: Industry Risk, November 19, 2013

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- S&P Global Ratings Definitions, October 31, 2018

Rating Details (As of 07-Feb-2018)	
Perion Network Ltd	
Issuer rating(s)	
Local Currency LT	ilA-/Stable
Issue rating(s)	
Senior Unsecured Debt	
Series L	ilA-
Issuer Rating history	
Local Currency LT	
02-Feb-2016	ilA-/Stable
02-Dec-2015	ilA-/Watch Dev
03-March-2014	ilA-/Stable
Other Details	
Time of the event	28/02/2019 17:38
Time when the analyst first learned of the event	28/02/2019 17:38
Rating requested by	Issuer

Credit Rating Surveillance

S&P Maalot is the commercial name of S&P Global Ratings Maalot Ltd. S&P Maalot conducts surveillance activities on developments which may affect the creditworthiness of issuers and specific bond series which it rates, on an ongoing basis. The purpose of such surveillance is to identify parameters which may lead to a change in the rating.

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