

Perion Network Ltd.

February 15, 2018

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Perion Network Ltd.

Affirmed Corporate Credit Rating

iiA-/Stable

Rationale

Business Risk	Financial Risk
<ul style="list-style-type: none"> Exposure to the risky, uncertain web search business. This exposure is partly mitigated by an increase in digital advertising activity. Continued decrease in EBITDA margin with the increase in digital advertising activity which is less profitable than the web search business and considering the delay in benefits from the Undertone acquisition. High dependence on a major client in the search business. Limited visibility of business strategy due to the entry of a new management team. 	<ul style="list-style-type: none"> Low-to-medium leverage. Uncertainty regarding Undertone's contribution. To profitability. Adequate liquidity. Consistently positive free cash flow.

Outlook: Stable

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

Downside Scenario

We may consider a negative rating action if we predict that the company will fail to maintain the abovementioned coverage ratio or to generate negative operating cash flow over time. We believe this could happen as a result of further deterioration in market conditions in the web search industry, lower than expected contribution of the digital advertising business or the execution of leveraged acquisitions.

Upside Scenario

We may consider a positive rating action if the company materially improves its business position and profitability. A positive rating action is also possible if Perion maintains an adjusted debt to EBITDA ratio of less than 1.5x while generating stable operating cash flows.

Base Case Scenario

In our base case scenario we estimate that Perion's debt level will continue to decrease in the next two years, following the expected repayment of Series L bonds and bank loans used to finance the Undertone acquisition. On the other hand, we expect a continued decline in profitability due to entry into the digital advertising business which is characterized by relatively low profitability, and some decline in profitability of the web search business, partly mitigated by reorganization processes. Accordingly, in our base case scenario we assume a stable leverage level commensurate with the current rating.

Assumptions	Key Metrics*			
	2016A	2017E	2018E	
<ul style="list-style-type: none"> Decrease in revenues in 2017-2018 due to decline in EBITDA margin in the digital advertising business and delayed benefits from the Undertone acquisition. Adjusted EBITDA of about \$ 30 million in the medium term starting in 2017. Capital expenditures of about \$ 2.0 million – \$ 2.5 million per year in 2017-2018. 	EBITDA margin	12%	9%-10%	9%-10%
	Debt/EBITDA	2.1x	2.5x-3.0x	2.0x-2.5x
	FFO/debt	38%	25%-30%	25%-30%
	A – Actual. E – Estimate.			
	* Coverage and leverage ratios are listed after an adjustment for long-term operational leasing, which increases debt, EBITDA, and interest expense for 2016 by \$ 24 million, \$ 6 million, and \$ 2 million, respectively, and offsetting a \$ 7 million stock-based payment from EBITDA. Except for the amount of the stock-based payment, we do not foresee any material change in these adjustments in 2017.			

Business Risk Profile

Mitigated exposure to the web search market as company enters additional markets, decline in EBITDA margin

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

- Maintenance of a balanced mix between web search activity and digital advertising. In 2016 and in the first three quarters of 2017, revenues from web search activity constituted approximately 55% and 54% of total revenues, respectively, and digital advertising revenues constituted approximately 45% and 46%, respectively. We believe that this distribution will remain stable in the next two years.
- Entry into tangent fields in digital advertising in order to widen 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 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 drop from about 12% in 2016 9%-10% in 2017 and 2018. We note that non-recurring orders that did not materialize in 2017 significantly reduced the company's EBITDA. On the other hand, the company is reorganizing its manpower and focusing its development costs, which should improve its operating efficiency.
- Material dependence on major client, search provider Bing (owned by Microsoft Corporation (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 non exclusive, it increases the company's geographic diversification and allows it to operate in Belgium, Switzerland, Norway, Sweden, Austria, Denmark, etc.

Financial Risk Profile

Low-to-average leverage

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

- Low-moderate leverage reflected in a debt to adjusted EBITDA ratio consistently below 2.7x, 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. In 2019, the company may use its cash reserves to repay large maturities due that year.
- Consistently positive free cash flow generation in light of low investment in working capital.

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

- Uncertainty regarding the scope of Undertone's contribution to profitability. We estimate that benefits from the Undertone acquisition will be reflected in Perion's financial results in 2019.
- Uncertainty regarding future financial strategy that the company will implement in light of the strong competition in the web search and digital advertising sectors.

Liquidity: Adequate

Relatively high cash reserves and consistently positive cash flow generation

The company's liquidity profile is 'adequate', according to our criteria. We estimate that the ratio of Perion's sources to uses will exceed 1.2x in the 12 months starting January 1, 2018. This assessment is underpinned by existing cash reserves, a manageable amortization schedule, and our forecasted operating cash flow.

In our base-case scenario we estimate that the company's major sources and uses in the 12 months starting January 1, 2018, will be as follows:

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> • Cash and cash equivalent of approximately \$ 38 million. • Operating cash flow of approximately \$ 18 million - \$ 24 million. • Committed bank facility for over 12 months of approximately \$ 12.5 million. 	<ul style="list-style-type: none"> • Long term debt maturities of approximately \$ 15 million. • Capital expenditure of approximately \$ 2.5 million.

Covenant Analysis

As of September 30, 2017, the company maintains sufficient headroom on its financial covenants.

Modifiers

Diversification portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management/Governance: Neutral

Comparable ratings analysis: Neutral

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 2016 are:

- Discounting long-term operating leasing contracts and adding them to reported debt.
- Offsetting the effect of stock-based payments on EBITDA.

Reconciliation Of Perion Network Ltd. Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. \$)

--Fiscal year ended Dec. 31, 2016--

Perion Network Ltd. reported amounts

	Debt	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	77.7	37.3	11.3	5.7	37.3	33.8
S&P Global Ratings adjustments						
Interest expense (reported)	--	--	--	--	(5.7)	--
Interest income (reported)	--	--	--	--	0.2	--
Current tax expense (reported)	--	--	--	--	(3.5)	--
Operating leases	24.3	6.1	1.9	1.9	4.2	4.2
Share-based compensation expense	--	6.8	--	--	6.8	--
Non-operating income (expense)	--	--	0.2	--	--	--
Debt - Issuance cost	1.3	--	--	--	--	--
Total adjustments	25.7	13.0	2.1	1.9	2.1	4.2
S&P Global Ratings adjusted						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	103.4	50.3	13.4	7.5	39.5	38.0

Related Criteria And Research

- [Standard & Poor's Maalot \(Israel\) National Scale: Methodology For Nonfinancial Corporate Issue Ratings](#), September 22, 2014
- [National And Regional Scale Credit Ratings](#), September 22, 2014
- [S&P Global Ratings' National And Regional Scale Mapping Tables](#), August 14, 2017
- [S&P Global Ratings Definitions](#), August 18, 2016
- [Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings](#), October 24, 2013
- [Corporate Methodology](#), November 19, 2013
- [Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers](#), December 16, 2014
- [Corporate Methodology: Ratios And Adjustments](#), November 19, 2013
- [Group Rating Methodology](#), November 19, 2013
- [Use Of CreditWatch And Outlooks](#), September 14, 2009
- [Methodology: Industry Risk](#), November 19, 2013
- [Country Risk Assessment Methodology And Assumptions](#), November 19, 2013
- [Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers](#), November 13, 2012
- [Key Credit Factors For The Technology Software And Services Industry](#), November 19, 2013

Rating Details (As of 15-Feb-2018)**Perion Network Ltd****Issuer rating(s)**

Local Currency LT ilA-/Stable

Issue rating(s)Senior Unsecured Debt

Series 12 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 15/02/2018 16:03

Time when the analyst first learned of the event 15/02/2018 16:03

Rating requested by Issuer

Credit Rating Surveillance

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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