Perion Network Ltd.

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March 6, 2014

Research Update:

Perion Network Ltd. Assigned 'ilA-' Rating; Outlook Is Stable

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Research Update:

Perion Network Ltd Assigned 'ilA-' rating; Outlook Is Stable

Overview

- Perion’s Issuer rating is based on our assessment that it has a low-risk financial profile on the one hand, but a high-risk business profile on the other hand, mostly stemming from its over reliance on major clients, with emphasis on Bing Search Engine, and due to its business model which is mainly based on search-related revenues.
- We believe that Perion’s merger with "ClientConnect" strengthened the company’s competitive position as well as its debt servicing capabilities. However, the company is still exposed to the inherent risks of the search sector and is expected to remain so over the intermediate term.
- We assign a rating of "ilA-" (Israel National Scale Rating) to Perion Network Ltd., which operates in the sectors of software development, marketing and advanced services for developers, distributers and E-mail users.
- The stable outlook reflects our expectation that the operational performance of the company will remain stable in the near term, while maintaining an adjusted debt-to-EBITDA coverage ratio of less than 1.5x.

Rating Action

On March 6, 2014, Standard & Poors Maalot assigned a rating of "ilA-" to Perion Network Ltd., which operates in the field of software development, marketing and advanced services for developers, distributers and E-mail users. The outlook is stable.

Rationale

The rating of Perion Network Ltd (hereafter: "Perion") is mainly supported by a low-risk financial risk profile as reflected by strong debt coverage ratios. As of today, the company carries a very low debt level in comparison to its debt service capabilities. Conversely, the rating is negatively impacted by a relatively high-risk business risk profile, in our view, as a result of dependency upon major customers, especially the Bing Search Engine, and due to the company's business model which is mainly based on search-related revenues.

We believe that the merger of Perion with "ClientConnect" has synergetic advantages, but currently, these are not evident. In absolute terms, the company's extent of operations and debt repayment capabilities have improved, along with an enhancement in the group’s business position, mainly as a result of greater economies of scale. However, the company is still exposed to the inherent risks of the internet search sector and is expected to remain exposed over the intermediate term, without significant costumer diversification.

In our opinion, Perion's level of financial risk is low given its low debt burden and forecasted debt coverage ratios under our operating base case scenario, over the next two years. We estimate that the company's adjusted debt to EBITDA ratio will be lower than 1.5x over the intermediate term, including M&A activities. Our financial risk profile assessment is also supported by the operations of the company, which generally generate positive free cash flows supporting its debt service capabilities. On the other hand, the financial profile is negatively impacted by a lack of a clear financial policy. However, we believe that the financial policy which would be implemented, de facto, will not lead to a breach of the coverage ratios which are commensurate with the current rating. In our view, over the intermediate term, the company will direct its internal resources to growth initiatives and will not execute material dividend distribution/buybacks. In addition, we estimate that acquisitions over the near term (up to 1 year), if any, will be funded through debt, and possibly also with an equity component. As previously indicated, we do not expect such acquisition activity to lead to a breach of the coverage ratios which we view as commensurate with the current rating.

We believe that Perion's business profile carries a relatively high level of risk. In our view, the business risk profile is negatively affected by two main factors: over dependency on major clients, especially the search provider Bing, and a narrow revenue base which is geared towards revenues from the search market, which is characterized by dynamic fast changes. As of July 2013, ClientConnect's (prior to the merger with Perion) portion of revenues from the search providers Bing and Google amounted to 56% and 30%, respectively. We estimate that the consolidated entity's (Perion and ClientConnect) share of revenues from Bing will grow further in 2014. Perion's contract with Bing is expected to end on December 2014 and there are no guarantees that it will renewed. The company's revenue base is therefore materially exposed to a non-renewal of the aforementioned commitment. However, and according to the company's management, we estimate that the contract will be renewed in light of Perion's share of Bing's total number of searches in the US (~10%). As mentioned above, the company's revenue base is mainly compreised from the internet search sector. We estimate that search activity will contribute about 80% of the group's revenue in 2014, with the remainder coming from internet advertising as well as from product sales.

In the search sector's value chain , Perion is defined as a third party distributer of search engines, meaning, it diverts surfers' traffic to the search engine and shares the revenues which were generated by this traffic with the relevant search engine. Search revenues are generated by searches by internet users through Perion's platforms (such as toolbars) which are distributed by Perion's affiliates (application developers, publishers) and are linked to the search engines which have an agreement with Perion. If a search leads to a click on a sponsored link and generates revenues for the search engine, the search engine shares this revenue with Perion. Over the past five years, the search market accounted for over 40% of the total online advertising market in the U.S. As of 2012, the search market accounted for 46% of the total online advertising market in the U.S., which is estimated at about 37 billion dollar for that year. Due to the fact that most of Perion's revenues are generated in the U.S., we think that as long as the search market enjoys growth rates which are similar to the growth rates in previous years (14.5% in 2012, 27% in 2011, 12% in 2010), the search engines will focus on their market shares and continue to rely on the services of companies such as Perion in order to increase their search volume. Nevertheless, companies such as Perion are exposed to changes in the policies of the search engines and do not currently benefit from a positive reputation among web surfers. Therefore, we believe that Perion will attempt to diversify its sources of revenues, whether via expanding its presence in the mobile advertising sector, which showed triple digit growth rates over the last two years, or through purchasing internet advertising companies. While acquisitions can potentially increase revenue diversification and improve the company's business position over the long term, we believe that such a policy carries high risks and substantial operational challenges. We intend to review the effects of every material acquisition on the credit standing of the company.

Perion's business risk profile also includes our assessment of the industry risk of the technological services and software industry, which we see as "intermediate". The business risk profile also addressed country risk, which we see as low in light of the fact that most of the company's revenues are generated in countries which are defined as low-risk countries.

Our base case operating scenario incorporates the following major assumptions and expectations:

- 2.6% growth in the GDP of the U.S. in 2014.
- Stable operational profitability which will be expressed as an adjusted EBITDA to revenues ratio of about 25% in 2014 and 2015.
- Adjusted EBITDA of approximately 125 million dollars in 2014.
- Capital expenditures of about 12 million dollars in 2014 and 5 million dollars from 2015 onward.
- M&A activity on a bigger scale than in the past, in our view, which will be funded by internal resources and new debt.

Under our base case scenario, the projected debt coverage ratios are as follows:

- Adjusted debt-to-EBITDA ratio of less than 1.5x in 2014 and 2015.
- Adjusted FFO-to-debt ratio of more than 50% in 2014 and 2015.

Liquidity

We estimate the company's liquidity profile as "Adequate", according to our criteria guidelines. This assessment is supported mainly by existing cash reserves, limited debt repayments over the next two years, our cash flow projections and our estimates regarding the scope of M&A activity, which will be funded mainly through debt.

We assess that the sources to uses ratio of the company will exceed 1.2x in 2014.

Under our base case scenario, we assume that the company will have the following sources over the next 12 months:

- Cash and equivalent of 23 million dollars;

- Operating cash flow of 60 million dollars.

We assume that the company's uses over the next 12 months will be:

- Debt repayments amounting to approximately 2 million dollars;
- Capital expenditures amounting to approximately 12 million dollars.

Outlook

The stable rating outlook reflects our opinion that Perion's business risk profile will not materially change in the near term and that the company will maintain relatively stable operational performance while maintaining an adjusted debt-to-EBITDA coverage ratio of less than 1.5x.

Downside scenario

We could take a negative rating action if the company does not meet the aforementioned coverage ratio. This could result from a deterioration in operating performance due to non-renewal of the agreements with the major search engines (or a deterioration in the existing terms) and/or the implementation of an aggressive M&A and dividend/buybacks policy.

Upside scenario

Rating upgrade seems unlikely in the near term due to our assessment of the company's business risk profile. However, we may consider a positive rating action if the company maintains an adjusted debt-to-EBITDA ratio of less than 1.5x while strengthening its business risk profile. In our view, this would correspond to reducing its dependency on large search providers and diversifying its revenue base to more stable non-search revenues.

Rating Score Snapshot

Diversification: Neutral (no impact)

Capital Structure: Neutral (no impact)

Liquidity: Neutral (no impact)

Financial Policy: Negative impact

Management and Governance: Neutral (no impact)

Comparable rating analysis: Neutral (no impact)

Ratings list

General details (as of March 6, 2014)	
Perion	
Issuer credit ranking	IlA-/Stable
Issuer ranking history	
March 6, 2014	IlA-/Stable