

# Perion Network Ltd.

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February 9, 2017

**Primary Credit Analyst**

Tamar Stein, 972-3-7539721 [tamar.stein@spglobal.com](mailto:tamar.stein@spglobal.com)

**Secondary Credit Analyst**

Matan Benjamin, 972-3-7539731 [matan.benjamin@spglobal.com](mailto:matan.benjamin@spglobal.com)

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# Perion Network Ltd.

**Affirmed Corporate Credit Rating**

**iiA-/Stable**

## Rationale

| Business Risk  | Financial Risk   |
|--|--|
| <ul style="list-style-type: none"> <li>• High dependence on major client</li> <li>• Exposure to the risky, uncertain web search business. This exposure is mitigated by an increase in digital advertising activity.</li> <li>• Decrease in EBITDA margin with the increase in digital advertising activity which is less profitable than the web search business.</li> <li>• Uncertainty regarding new management's expected moves and long-term strategy.</li> </ul> | <ul style="list-style-type: none"> <li>• Low leverage.</li> <li>• Uncertainty regarding Undertone's long-term contribution. However, we note that it is not a financial burden on the company.</li> <li>• Adequate liquidity.</li> <li>• Stable free cash flow generation.</li> <li>• Lack of formal financial policy regarding acquisitions, although the company consistently maintains high cash reserves.</li> </ul> |

## 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 will occur 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 above mentioned coverage ratio or to generate positive 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, failure to renew the agreement with Bing (or a worsening in the terms of the agreement), 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 coverage ratio of less than 1.5x while generating stable operating cash flows.

## Standard & Poor's Base Case Scenario

In our base case scenario we estimate that Perion's debt levels will remain stable in the next two years but still significantly higher than in 2014 (mainly because of the Undertone acquisition in late 2015). We also expect deterioration in profitability due to entry into the digital advertising business which is characterized by relatively low profitability, and continued deterioration in profitability of the web search business. Accordingly, in our base case scenario we assume that leverage levels will be stable and commensurate with the current rating.

| Assumptions  | Key Metrics*   |              |              |           |
|--|--|--------------|--------------|-----------|
| <ul style="list-style-type: none"> <li>Moderate growth in revenues in 2017-2018 mainly due to advertising activity which will mitigate the expected decrease in web search activity.</li> <li>Adjusted EBITDA of about \$ 45 million in the medium term starting in 2016.</li> <li>Capital expenditures of about \$ 5 million per year in 2017-2018.</li> <li>Smaller cash reserves in 2016, mostly as a result of a \$ 22 million payment made in August 2016, according to the acquisition agreement. This payment replaces the company's \$ 36 million obligation in respect of the Undertone acquisition, which was therefore erased.</li> </ul> | <b>2015A</b>   | <b>2016E</b> | <b>2017E</b> |           |
|  | <b>EBITDA margin</b>   | 26%          | 16%-17%      | 15%-16%   |
|  | <b>Debt/EBITDA</b>   | 2.1x         | 2.0x-2.2x    | 2.0x-2.3x |
|  | <b>FFO/debt</b>  | 37%          | 30%-35%      | 30%-35%   |
|  | 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 2015 by \$ 29 million, \$ 4 million, and \$ 1.5 million, respectively, offsetting a \$ 7 million stock-based payment from EBITDA as well as deducting \$ 10 million of excess cash, according to our definition, from financial debt. Except for the amount of the stock-based payment, we do not foresee any material change in these adjustments in 2016 and 2017. |              |              |           |

## Business Risk Profile

### Mitigated exposure to the web search market as company enters new markets, material exposure to a major client

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

- Decreased exposure to web search activity and expected increase in revenues from digital advertising. In 2015, approximately 79% of the company's revenues stemmed from web search activity, 11% from advertising and the remainder from product sales. We estimate that in 2016, revenues from web search activity will constitute approximately 51% of total revenues and digital advertising revenues will increase to approximately 41%. We believe that this distribution will remain stable in the next two years.
- Maintaining a prominent position in the web search market with 17% market share in Q1 2016 (according to the company, market leader IAC has a 69% market share, followed by Blucora (formerly Infospace) with 14%).

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

- Exposure to web search activity (part of the digital advertising market) 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 its 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.

- Material dependence on major client, search provider Bing (owned by Microsoft (AAA/Stable)). In 2015, approximately 80% of Perion's revenues originated from search provider Bing. We believe Perion will continue to be dependent on Bing in the next two years, but to a lesser extent due to the expected decrease in search revenues and relative stability in revenues from advertising and products. We note that the company's engagement with Bing is subject to a contract which is due to expire in January 2018 and there is no guarantee that it will be renewed. We believe that Perion's revenues will be materially jeopardized if Bing decides to discontinue their engagement.
- Decrease in total EBITDA margin as a result of the increase in digital advertising activity which is less profitable than web search activity. We estimate that Perion's adjusted EBITDA margin will drop from 30% in 2014 to 16%-17% in the next two years.

## Financial Risk Profile

### Leverage commensurate with the rating, lack of formal financial policy

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

- Low-moderate leverage compared to peers, as reflected in a debt to EBITDA ratio consistently below 2.5x. Leverage increased in 2015 compared to 2014, as debt levels rose following the Undertone acquisition, but we assume that the company will not increase its debt further and will maintain the current leverage level over time.
- 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:

- Lack of a clear financial policy, although we believe the actual financial policy will not lead to a deviation from coverage ratios commensurate with the current rating. According to management, the company will use its internal sources for growth and will not distribute dividends or make material acquisitions, but we are uncertain about whether these principles will be maintained in light of the changing CEO and current uncertainty about the company's future strategy.

## Liquidity: Adequate

### 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, 2017. This assessment is underpinned by existing cash reserves, a flat amortization schedule, and our forecasted operating cash flow.

In our base-case scenario we estimate that the company's major sources and uses from January 1, 2017 until year end 2017 are:

| Principal Liquidity Sources   | Principal Liquidity Uses   |
|---|--|
| <ul style="list-style-type: none"> <li>Cash and cash equivalent of approximately \$ 32 million.</li> <li>Operating cash flow of approximately \$ 30 million.</li> </ul> | <ul style="list-style-type: none"> <li>Short term debt maturities of approximately \$ 19 million.</li> <li>Capital expenditure of approximately \$ 5 million.</li> </ul> |

## Covenant Analysis

As of September 30, 2016, 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 2015 are:

- Deducting \$ 10 million of surplus cash earmarked for bond repayment from reported financial debt.
- Discounting long-term operating leasing contracts and adding them to reported debt.
- Offsetting the effect of stock-based payments on EBITDA.

**Reconciliation Of Shufersal Ltd Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. NIS)**

--Fiscal year ended Dec. 31, 2015--

| Perion Network Ltd. reported amounts |             |              |             |                  |                  |                       |                           |
|--------------------------------------|-------------|--------------|-------------|------------------|------------------|-----------------------|---------------------------|
|                                      | Debt        | Revenues     | EBITDA      | Operating income | Interest expense | EBITDA                | Cash flow from operations |
| Reported                             | 99.0        | 221.0        | 38.3        | (66.0)           | 2.6              | 38.3                  | 17.6                      |
| Standard & Poor's adjustments        |             |              |             |                  |                  |                       |                           |
| Interest expense (reported)          | --          | --           | --          | --               | --               | (2.6)                 | --                        |
| Interest income (reported)           | --          | --           | --          | --               | --               | 0.6                   | --                        |
| Current tax expense (reported)       | --          | --           | --          | --               | --               | (9.7)                 | --                        |
| Operating leases                     | 29.3        | --           | 4.3         | 1.5              | 1.5              | 2.7                   | 2.7                       |
| Surplus cash                         | (10.0)      | --           | --          | --               | --               | --                    | --                        |
| Share-based compensation expense     | --          | --           | 7.4         | --               | --               | 7.4                   | --                        |
| Non-operating income (expense)       | --          | --           | --          | 0.6              | --               | --                    | --                        |
| Revenues - Other                     | --          | (2.3)        | (2.3)       | (2.3)            | --               | (2.3)                 | --                        |
| EBITDA - Other                       | --          | --           | 9.7         | 9.7              | --               | 9.7                   | --                        |
| D&A - Other                          | --          | --           | --          | 6.6              | --               | --                    | --                        |
| <b>Total adjustments</b>             | <b>19.4</b> | <b>(2.3)</b> | <b>19.1</b> | <b>16.0</b>      | <b>1.5</b>       | <b>5.8</b>            | <b>2.7</b>                |
| Standard & Poor's adjusted amounts   |             |              |             |                  |                  |                       |                           |
|                                      | Debt        | Revenues     | EBITDA      | EBIT             | Interest expense | Funds from operations | Cash flow from operations |
| Adjusted                             | 118.4       | 218.7        | 57.4        | (49.9)           | 4.2              | 44.1                  | 20.3                      |

**Related Criteria And Research**

- [Group Rating Methodology](#), November 19, 2013
- [S&P Global Ratings' National And Regional Scale Mapping Tables](#), June 1, 2016
- [National And Regional Scale Credit Ratings](#), September 22, 2014
- [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
- [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
- [Key Credit Factors For The Technology Software And Services Industry](#), November 19, 2013
- [Use Of CreditWatch And Outlooks](#), September 14, 2009

**Rating Details (As of 09-Feb-2017)****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 09/02/2017 13:03

Time when the analyst first learned of the event 09/02/2017 13:03

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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