Perion Network Ltd.

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Perion Network Ltd

Corporate Credit Rating	ilA-/Stable

Rationale

Business Risk	Financial Risk
• Material exposure to the risky, uncertain search industry. • Dependence on major client. • Experienced management team.	• "Adequate" liquidity. • Low leverage. • Expected slowdown in free cash flow generation in 2015 compared to 2014.

Outlook: Stable

The stable outlook reflects our assessment that Perion Network's business risk profile will not materially change in the short term, and that the company will maintain relative stability in its operating performance while maintaining an adjusted debt to EBITDA coverage ratio of less than 1.5x.

Downside Scenario

We may consider a negative rating action if we come to the conclusion that the company will fail to maintain the abovementioned coverage ratio. We believe this could happen as a result of a deterioration in the company's operating performance due to additional weakening in market conditions in the search industry; failing to renew agreements with large search engines (or a worsening in the terms of current agreements); and/or the implementation of an aggressive financial policy with regards to M&A or shareholders remuneration.

Upside Scenario

We think a rating upgrade in the short term is unlikely, in view of 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 coverage ratio of less than 1.5x while strengthening its business risk profile. We believe that this would entail a decrease in the company's dependence on BING, as well as development of income sources in non-web-search-related areas.

Standard & Poor's Base Case Scenario

In our base case scenario, we estimate that Perion Network will generate about $35-40 million of EBITDA in 2015, while maintaining a level of adjusted debt similar to that in 2014 and debt coverage ratio commensurate with the current rating.

Assumptions	Key Metrics*
• Revenues of ~$180 million in 2015-2016. • Adjusted EBITDA of about $ 35-40 million in 2015-2016. • Capital expenditures of up to $ 2 million in 2015-2016. • M&A activity at a higher level than before, funded by the company's internal sources and by debt.	(see metrics table below)

	2014A	2015E	2016E
EBITDA margin	30.3%	20%	20%
FFO/debt	167%	60%<	60%<
Debt/EBITDA	0.4X	0.5X-1.5X	0.5X-1.5X

A – Actual. E – Estimate.

* Coverage ratios are listed after an adjustment for long-term operational leasing, which increases debt, EBITDA, and financing expenses for 2014 by $ 14.5 million, $ 2 million, and $ 0.6 million, respectively, offsetting a $ 15 million stock-based payment from EBITDA as well as deduction of $ 10 million of excess cash, according to our definition, from financial det. Except for the amount of the stock-based payment, we do not foresee any material changes in these adjustments in 2015 and 2016.

Business Risk Profile

Material exposure to the web search market and to a major client

In our view, Perion has a highly risky business risk profile. We believe that the business risk profile is adversely impacted by two major factors. The first is the low revenue base, mostly stemming from the fast-changing web search market (a part of the on-line advertising market). The second is high dependence on a major client – search engine, BING. In 2014, 85% of Perion's revenues stemmed from web-search, and the remainder from advertising and product sales. In that year, 74% of the company's revenues stemmed from BING. We estimate that the company will continue to depend on BING in 2015, but that the share of revenues from BING is expected to decrease, mostly due to both a decline in both search-based revenues and stability in revenues from advertising and product sales. Going forward, we estimate that the company will generate up to 80% of its revenue from web-search in 2015, while the rest will stem from advertising and product sales.

In the web-search value chain, Perion is defined as a third party distributor for search engines, i.e. it directs web traffic to search engines and shares the revenue stemming from that traffic with the relevant search engine. Search-based revenues stem from web searches (on PCs – non-mobile) performed by internet users through Perion's platforms (e.g. toolbars) distributed by Perion's partners (application developers and publishers) and linked to search engines with which Perion is associated by agreement. If the search results in clicking a sponsored search result, and generates revenue for the search engine, this revenue is then shared with Perion. In the last five years, the non-mobile search market constituted about 40% of the on-line advertising market in the U.S., and in 2014 it constituted about 38% of this market, which was estimated at about $ 50 billion revenues that year.

As most of Perion's revenues stem from the U.S., we estimate that as long as the non-mobile search market maintains its current share of the on-line advertising market, search engines will be market-share-oriented and continue to use the services of companies such as Perion in order to increase their search volume. However, companies like Perion are exposed to changes in search engine and web browser policies, such as the change made by Google in 2014 regarding Chrome's extensions, which among others, reduced the value for users of Perion's platform and decreased adjusted EBITDA for 2014 (about $ 118 million) relative to the company's earlier projections. These changes are expected to continue to weigh on 2015 results, and we estimate that adjusted EBITDA will be about $ 35-40 million. We therefore estimate that Perion will try to diversify its revenue sources, whether through increasing its presence in the mobile advertising market (which has increased by 76% in 2014 and by 110% in 2013 in revenue terms), or through the acquisition of companies operating in internet advertising. While in the long run, acquisitions may contribute to the diversification of revenue sources and contribute to Perion's business position, we believe M&A activity entails high risks and significant operational challenges. We intend to examine the future effects of any such material acquisition on the company's credit rating.

Financial Risk Profile

Strong debt coverage ratios and low debt burden tempered by expected decline in cash flow from operations

We think that Perion's financial risk is low given a very low debt burden and robust debt coverage ratios, as reflected by our operating base case scenario. We estimate that in the medium term, the company's debt to adjusted EBITDA ratio will be less than 1.5x, including M&A activity. Our opinion on Perion's financial risk profile estimate is also supported by the financial characteristics of the company's activity, low operating leverage and positive free cash flow generation in light of low investment in working capital. On the other hand, the company's financial risk profile is adversely impacted by the lack of a clear financial policy. However, we believe the financial policy that will be implemented will not lead to a deviation from coverage ratios commensurate with the current rating. We believe that in the medium term, and in accordance with management declarations, the company will channel its internal sources towards growth and will not engage in material dividend distribution or share buybacks. In addition, we estimate that any acquisitions in the short term will be financed by the company's cash balances, and perhaps also by equity issuance, but these are unlikely to cause a deviation from the coverage ratios we have determined to be commensurate with the current rating.

Table 1

Perion Network Ltd. -- Financial Summary

Industry Sector: Software & Services

(Mil. $)	**--Fiscal year ended Dec. 31, 2014--**
Revenues	388.7
EBITDA	117.7
Funds from operations (FFO)	91.9
Net income from continuing operations	42.8
Cash flow from operations	73.4
Capital expenditures	10.9
Free operating cash flow	62.5
Discretionary cash flow	62.5
Cash and short-term investments	106.2
Debt	42.5
Equity	246.0
Adjusted ratios	
EBITDA margin (%)	30.3
Return on capital (%)	31.7
EBITDA interest coverage (x)	49.5
FFO cash int. cov. (x)	362.7
Debt/EBITDA (x)	0.4
FFO/debt (%)	216.1
Cash flow from operations/debt (%)	172.5
Free operating cash flow/debt (%)	146.9
Discretionary cash flow/debt (%)	146.9

N.M. - Not Meaningful.

Reconciliation Of Reported Figures

In order to create a basis for comparison with other rated companies, we adjust the data reported in the company's financial statements in order to calculate the company's credit metrics. The main adjustments to Perion Network's consolidated financial data for 2014 are as follows:

- Deducting surplus cash, as per our definition, 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.

Table 2.

Reconciliation Of Perion Network Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. $)

	--Fiscal year ended Dec. 31, 2014--					
Perion Network Ltd. reported amounts						
	Debt	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**
Reported	38.1	100.6	55.3	1.8	100.6	72.0
Standard & Poor's adjustments						
Interest expense (reported)	--	--	--	--	(1.8)	--
Interest income (reported)	--	--	--	--	0.0	--
Current tax expense (reported)	--	--	--	--	(23.4)	--
Operating leases	14.5	1.9	0.6	0.6	1.3	1.3
Surplus cash	(10.0)	--	--	--	--	--
Share-based compensation expense	--	15.1	--	--	15.1	--
Non-operating income (expense)	--	--	0.1	--	--	--
Total adjustments	4.5	17.0	0.7	0.6	(8.7)	1.3
Standard & Poor's adjusted amounts						
	Debt	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
Adjusted	42.5	117.7	56.0	2.4	91.9	73.4

Liquidity: Adequate

According to our criteria, Perion Network's liquidity is "adequate". Our assessment is mostly based on the company's existing cash balances, limited debt maturities in the next two years, and our forecast for cash flow generation and M&A activity which will mostly be financed through debt and equity.

Principal Liquidity Sources	Principal Liquidity Uses
• About $ 20 million in cash and cash equivalent (as of the end of Q1- 2015); • About $ 40 million in operating cash flow until the end of 2016.	• $ 11 million in maturities until the end of 2016; • Up to $ 2 million in capital expenditures per year.

Modifiers

Diversification portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Negative

Management/Governance: Neutral

Comparable ratings analysis: Neutral

Related Criteria And Research

- National And Regional Scale Credit Ratings, September 22, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Standard & Poor's National & Regional Scale Mapping Tables, September 30, 2014
- Corporate Methodology, November 19, 2013
- Key Credit Factors For The Technology Software And Services Industry

Rating Details (As of June 18, 2015)	
Perion	
Corporate Credit Rating	ilA-/Stable
Senior Unsecured Debt	
12	ilA-
Corporate Credit Rating History	
03-March-2013	ilA-/Stable