

Annual report on Ericsson Nikola Tesla Group performance

We are living in time of continuous and fast transformations. In 2017, digital transformation was a hot topic and will continue to be important in the years to come. Business and public sectors, as well as citizens, are becoming more aware that we need to change patterns, tools and ways of working, if we wish to catch up with the most developed societies and in that process ICT plays a key role. In the next couple of years, intelligent digital networks will connect billions of various devices worldwide, thus significantly impacting the habits, needs and the behavior of people in their business and private lives. We are talking about Industry 4.0, based on the upcoming implementation of the fifth generation of mobile technology (5G), Internet of Things (IoT), and the analysis of the large amount of data (Big Data).

As a company, we are committed to capturing of business opportunities and sustainability of our business performance. We are also aware of our increased responsibility, not only for our own business development, but for the impact on the society and the development of ICT industry as well. Our strategic understanding of the impact that technology has on business, people and the environment allows us to create solutions that improve business performance, increase quality of life, provide the tools and raise awareness of the need to be more responsible towards the environment.

The key to our success is the synergy of knowledge, innovativeness and striving for continuous progress combined with the trust of all stakeholders, our customers, partners, employees, shareholders and the society. We are proud of our long-term cooperation and strategic projects with the leading operators in Croatia and other markets. Our solutions in Industry & Society segment, such as digitization of healthcare, public administration, and smart cities contribute to the benefit of individuals and the society as a whole.

BUSINESS SITUATION IN MAJOR MARKETS

In 2017, we continued to work on the implementation of key projects, leaning on our technology leadership, employees' knowledge, and partnership with customers. We have made significant investments in new business opportunities to secure business sustainability in target areas and, at the same time, we have been implementing cost efficiency measures at all organizational levels. The year 2017 was also marked by increased investments in preparation for 5G mobile communication systems, in competence development of our experts and in testing systems.

The share of export in the Group's total sales revenue is around 70%, which makes us one of the largest Croatian ICT exporters, especially when it comes to export of knowledge.

In the domestic market, we record an increase in sales revenue. Operators are increasingly focusing on end-user demands, namely a faster mobile Internet access "anytime, anywhere, any device". In line with that, capital investments are focused on network infrastructure, capacity building and increase of speed in both fixed and mobile networks, creation of prerequisites for the introduction of 5G networks, service

quality and digital transformation. Vipnet selected our company for further development of their radio access network, thus allowing us to maintain the sole vendor position in this business segment. We extended cooperation with Hrvatski Telekom in Managed Services and are currently working on several strategic projects. I would like to highlight excellent results in the Industry & Society segment in the local market, where we contracted important projects during 2017, some of which were fully implemented. These projects are primarily related to digitization of healthcare, Joint Information System of Land Registry and Cadaster, and the building of the border surveillance system for the Republic of Croatia.

We continued successful cooperation with operators in neighboring countries, which resulted in signing of several contracts in 2017. Nevertheless, sales revenue decreased year-over-year due to postponement of some projects. In CIS market, sales revenues are significantly lower year-over-year, primarily due to the ramp-down of network modernization projects and unfavorable currency effects.

Services to Ericsson record a growth due to new responsibilities and competencies of our experts in R&D, as well as in the Solutions and Services Expert Centers. Ericsson Corporation recognized the quality, knowledge and innovativeness of our experts in various areas, from research and development to digital services and operations, convergent network solutions, professional services and managed services, all of which led to awarding us with an extension of responsibilities. Consequently, in 2017 we continued to hire experts, mainly in research and development, to match our extended responsibilities in the mobile networks segment. At the end of 2017, our R&D Center had 1,267 employees, thus representing the biggest concentration of R&D experts in Croatia, while Ericsson Nikola Tesla Group had a total of 3,060 employees.

Our daughter company, Ericsson Nikola Tesla Servisi d.o.o., continued to provide high quality services of monitoring, maintenance, and build of telecom network to Hrvatski Telekom. During the year, key projects in build of mobile broadband network were realized, as well as projects in optical networks design and build. Furthermore, the growth trend in the segment of providing services towards other operators in Europe continued.

Our innovation capacity is our main advantage and we further strengthen it through various projects. Among other, our focus is on the technology incubator *Ericsson Garage Croatia*, which serves as a place for development and testing of new technologies and solutions. The innovations which are being developed within *Ericsson Garage Croatia* are the result of cooperation with scientific and research institutions, customers and partners. I would also like to mention Ericsson Nikola Tesla Summer Camp, which represents a synergy of business and science. In the past seventeen years, in cooperation with the Faculty of Electrical Engineering and Computing (Zagreb), the Faculty of Electrical Engineering, Mechanical Engineering and Naval Architecture (Split), as well as many other scientific institutions from Croatia and abroad, we hosted more than 800 top students, mostly from STEM fields, who created prototypes, analysis and solutions related to current ICT trends. These activities reinforce Ericsson Nikola Tesla's important role in Ericsson's innovations, and at the same time encourage young people to focus their professional development on the ICT industry.

Given the demanding market environment, business risks that marked previous years are still present. Those risks include:

- Impacts of the challenging economic environment and political uncertainties on demand and prices of our products and services
- Reduction and slowdown in operators' capital investments, as well as postponement of strategic investments in the public and private sector
- Industry convergence and consolidation among suppliers of equipment and services
- Increased competition and new IT companies entering telecommunication market
- Business mix impact on gross margin
- Increased credit and commercial risk exposure should our customers face adverse financial conditions
- Increased demand for customer financing
- Negative foreign exchange impact on business results given the greater part of our revenue is generated in EUR and USD
- Retaining of highly qualified / top performing employees to stay competitive.

KEY PERFORMANCE INDICATORS

In 2017, Ericsson Nikola Tesla Group sales revenue amounted to MHRK 1,481.6, down by 6.9% year-over-year. Gross margin declined to 10.2% (2016: 11.9%). Namely, due to the complexities of a large strategic project in CIS market, provisions and project adjustments were made, which greatly impacted profitability. The perceptual return on sales is higher when compared to the previous year, if currency effects and provisions are excluded.

The operating profit amounted to MHRK 75.7 while net profit amounted to MHRK 67.9. A solid cash flow from operating activities was achieved, amounting to MHRK 108.2. Total cash and cash equivalents, including short term financial assets, at the end of the year amounted to MHRK 243.8. Working capital efficiency, expressed in Working Capital Days (WCD), was 31. Cash conversion was at 68%.

There were no tax incentives for R&D in 2017, however, we hope that in 2018, after the State Aid Act for R&D Projects comes into force, we will be able to use these incentives.

STRATEGIC DIRECTION

We are approaching the new business cycle aware of the complexity and the dynamics of ICT industry trends.

The strategy of Ericsson Nikola Tesla Group in 2018 is focused on market share strengthening, gaining new responsibilities, and development and expansion of solutions, products and high value services portfolio. In order to meet our strategic targets, we need technology leadership, development of new business models, new knowledge and further development of our innovative organizational culture combined with a strong focus on cost and operational efficiencies and strategic risks management.

Therefore, by implementing strategic initiatives/ transformation programs, we continue to strengthen our position in strategic areas: 4G/5G, OSS/BSS and Digital Transformation, Managed Services, and IoT, by using the latest technology and business models and concepts, such as cloud solutions, Network Functions Virtualization (NFV), Software-Defined Networking (SDN), X as a service model (XaaS), etc. In Ericsson internal market, our aim is to maintain the existing responsibilities and expand our activities in new areas, while maintaining a high quality of delivered services. The strong focus remains on cost and operating efficiency, as well as strategic risk management.

Our long-term strategy remains focused on the mentioned strategic initiatives with the aim to achieve excellence and support our customers on their transformation journeys.

All other data comprising the annual company report pursuant to Article 250a of the Companies Act can be found in the enclosed 2017 Annual Report, consisting of the General Report, the Non-financial Report and Consolidated and Non-consolidated Financial Statements as at December 31, 2017.

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