LUFTHANSA GROUP

Capital Markets Day Lufthansa Technik

Key Messages Q&A Session

Competition in M&A activities

Our main competitors in M&A transactions are Private Equity firms. They have been increasingly interested in the MRO market in recent years and they are driving consolidation through acquisition of smaller players in the US and Europe. However, in the US you also have other players, like HEICO, that aggressively pursue a buy & build strategy.

The role of defense

If you are a newcomer to the defense sector – as Lufthansa Technik is at least with regards to weapon carrying systems - you cannot easily push out the incumbents. Therefore, all the major campaigns that we are currently running, are campaigns for the German Air Force on future platforms. To put it into perspective, the individual military platform fleets are relatively small compared to the commercial market, therefore the addressable market is similarly small. It takes some time for newcomers to enter the market and thus the defense sector will be more relevant for Lufthansa Technik in the next decade than in the current one. Given all the current topics Lufthansa Technik has on its agenda, we cannot expect more than EUR 300 m turnover by 2030. For the next decade, we are convinced that the revenues as well as the EBIT contribution from defense will accelerate.

Global capacity growth in the MRO market

The assumption of a market-wide volume growth of 1-2% is based on the growth projection derived from global fleet developments. For Lufthansa Technik, the engine segment is the crucial segment for revenue growth. For this segment, the transition from legacy engines to new generation engines will be decisive. We expect that the capacity for new gen engines like the LEAP-1A and LEAP-1B will be scarce for years and as one of a few CBSA license holders on both the 1A & 1B we will be able to seize the growth opportunities there. The current delivery delays of new aircraft lead to a longer than planned usage and consequently additional shop visits for the legacy engines, which will result in a peak in the engine legacy MRO business by 2026 / 2027. All these capacity constraints combined make us optimistic that we will be able to reach or even outperform our revenue goals in the engine segment due to the favorable market conditions. Margin-wise the goals can be considered a bit more ambitious given the persistent cost inflation especially driven by the OEMs.

Differences between narrow- and widebody capacity on the engine side – *reference to slide 17 of the presentation*

The narrowbody engine market is by far the biggest market. Widebody engines only count for 20-25% of the market. It is a question of opportunities: The narrowbody engine market is more attractive for us and thus we focus on that.

Strategic rationale behind keeping 100% of Lufthansa Technik in our portfolio

In the past we have thoroughly discussed the opportunity to sell a minority stake of Lufthansa Technik and going through that exercise has provided significant benefit for us. The three aspects that were elaborated the most during these discussions were value creation, governance structure and above all: to what extent does a third party like an external private equity investor bring additional upside potential that we would not be able to realize on our own? It was a close call but eventually we came to the conclusion to keep 100% of Lufthansa Technik in our portfolio because we see that we are able to autonomously execute the “Ambition 2030” growth plan since we are well positioned from a capital allocation point of view as well as from a market expertise point of view.

Notes on MRO segment trends

The AMS segment is quite labor cost intensive and therefore we exclusively pursue base maintenance outside of Germany to exploit more favorable labor cost environments (e.g. in Hungary, Malta, the Philippines etc.) which support our margins now and in the future. Labor cost is addressed by choosing the right location.

The envisaged growth in our DGF business is based on scale effects of the Digital Ecosystem which is leveraging development cost with revenue growth at incremental cost. Profitability is driven by expansion of the business model, i.e. bring more aircraft on more modules of the Ecosystem.

Bringing further digitization like predictive maintenance to the MRO market (e. g. AVIATAR) usually comes with ramp-up cost but we are overcoming them right now and we are now entering the margin accretive phase.

Relationship between Lufthansa Technik and the OEMs

Our experience over the past decades makes us confident that we can grow despite the influence of OEMs on the size and access to the addressable market. There are a number of reasons for our confidence: Our size, market presence, large customer base and backing from the Lufthansa Group gives us good access to the OEMs. Lufthansa Technik represents the voice of a non-negligible portion of the airline industry when negotiating with the OEMs. With our engineering power we are able to develop repair procedures which are partly alternatives to the OEMs’ proposals and partly jointly developed with the OEMs. That illustrates that we can also function as valuable partners to the OEMs and thus do not exclusively consider them as competitors.

GTF engine issue impact on the business

Overall, it is a strong headwind for the Lufthansa Group in total. As Lufthansa Technik has a 50/50 joint venture with MTU in Poland (EME), which is the biggest GTF facility worldwide, we are part of the Pratt & Whitney GTF network. When we talk about quick turns, we benefit from the current situation thanks to additional demand but since our capacity is constrained by the scarce availability of repair material and spare parts our tailwind is limited. This is different when looking at the LEAP-1A and LEAP-1B engine teething: Here GE is capable of providing us with the necessary supplies and we can benefit from the accelerated demand.

Main risks for our ambitions

The cost inflation is our main concern especially regarding material as well as labor cost. But we have mitigation measures in place: The new site in Portugal will provide a more favorable labor cost environment and additional capacity. Also, we have the key levers at hand to address the material cost increases as well, i.e. long-term OEM relationships and contracts, repair capability, access to USM (used serviceable material) and inflation clauses in customer contracts.

Market share distribution

There are only five CBSA license holders worldwide who have the full-blown license to work on the LEAP-1A and LEAP-1B engines. With the ongoing fleet rollover from existing technologies to the new engine types, the providers which are less well equipped with access to new engine type IP will most probably lose market share over time and Lufthansa Technik is well positioned to take these shares and thus grow.

Cash Conversion Target >50%

This target is derived from the discussions we had until last year with Private Equity investors and is considered to be above the industry standard. In a business that has still the ambition to grow and which is investing in its growth (be it in infrastructure, expansion and innovation) a higher target appears not realistic – especially since we plan to grow in the component segment to further exploit opportunities of taking double digit returns. Overall, the target of >50% Cash Conversion rate can be viewed as reasonable, and it is thus a target that both, Lufthansa Group as a shareholder as well as Lufthansa Technik itself, feel comfortable with. *Reminder: LHT definition of CCR is "Adj. FCF/Adj. EBIT".*

Margins at LH Airlines vs. margins at third party customers

Lufthansa Technik has a 70% third-party revenue share outside of Lufthansa Group. There is an arm's length relationship between Lufthansa Technik and the rest of Lufthansa Group in place. Please note that a significant volume of our business is effectively tendered. Hence, all our offers are market-tested. Accordingly, contracts with Group Airlines follow the framework agreement standard that is also used for LHT's external customers. Nevertheless, the Lufthansa Group airlines are Lufthansa Technik's largest customer and thus some other conditions might be applied.

Supply-chain disruptions at the OEMs

Compared to the situation during and directly after COVID, the OEMs have increasingly reduced their supply chain issues and they will eventually be able to fix them completely. Regarding the question on OEM repair capacity for the aftermarket, we see various OEM strategies, but they too must balance their capital allocation between manufacturing and repair and the return profile on material vs labor.

Contract structures

We have all kinds of different customer contracts in place, starting with a single repair order to a multi-year contract of up to 12 years for Total Component Support. Therefore, we have all sorts of mechanisms in place as well, including a protection against hyperinflation clause. Also, we typically incorporate price escalations for labor and material cost.

Material procurement

We secure material price increases through long-term contracts with our suppliers on an ongoing basis. Wherever possible and based on these contracts we calculate the market offers that we place.

Cash Conversion and CAPEX

The development of cash conversion over the next years will not be in a straight line because infrastructure investments are front loaded. Hence, Cash Conversion is expected to decline short-term and to recover towards the end of the decade due to high capex demand, i.a. our new facility in Santa Maria da Feira, Portugal, investments into our facility in Hamburg and the new Mobile Engine Services facility in North America. However, all the measures are in place or being implemented to drive this going forward. Over the years LHT has always delivered cash to the group, but pre pandemic we spent a lot of money on building up capacity that we are using and scaling up today. Management is incentivized based on Cash Flow targets.

The ramp up of new engine types is a cash burden in the beginning because we need to qualify people and the tooling is very expensive.

Advantages of Airlines and LHT under one umbrella

Absolutely. The first advantage is the baseload that LHT receives from the airlines. LHT also benefits from the fleet campaigns. Thirdly, LHT strongly benefits from the operational and flight data that they receive from Lufthansa Group as the fourth biggest operator in the world which they can use to e.g. to improve their digital tech-ops ecosystem.

Growth markets in India and China

We are happy to have founded Lufthansa Technik Shenzhen already many years ago in which we hold an 80% equity stake. In addition, LHT has a subsidiary in Hongkong. Hence, we are well placed to serve the Chinese market from those locations.

We are also looking carefully at the fast-growing market of India and take a positive view on the recent stabilization of the aviation market. We want to engage here and are also looking at production sites/logistic hubs or other possibilities like JVs with local entities.

On the customer side we are very successful and have just announced further business with Air India, which is very interesting due to the new ownership structure.

Top Customers and future disclosure

Effectively, we are in close contact with every major airline in the world due to the sheer market size we have. Lufthansa Group is of course the biggest customer under contract but in total close to 5000 aircraft are under component contracts, which speaks for itself. The roll out of the growth plan in North America will bring us closer to the big four airlines in the United States.

We as Lufthansa Group do have a segment disclosure in place, which we will keep in place as is. However, we would like to give more color and visibility going forward on the execution of the Ambition 2030 plan.

Effect of tariff increases on operations

The current situation is rather unpredictable. Before we opened a shop in the US / Canada we looked into this question and did our due diligence. The current discussion on tariff increases mostly focuses on production [industries] and not so much on material for aircraft or repair processes. We will closely monitor the developments. Remark: Aircraft parts often benefit from tariff exemptions.