FINANCIAL STRATEGY AND VALUE-BASED MANAGEMENT

C06 FINANCIAL STRATEGY

	Sustainable increase of Company value		
	Return to value creation	**Generation of strong free cash flows**	**Maintain financial stability**
Focus	– Restructuring and transformation to adapt to changed market conditions – Improved return on capital – Continuous reduction of environmental impacts	– Increase in operating result – Working capital management – Value-adding capital expenditure	– Strategic liquidity reserve – Detachment of state stabilisation measures – Reduction in net indebtedness – Return to investment grade rating – Minimisation of financial risks
Targets	– Adjusted ROCE – Adjusted EBIT margin[1] – Specific CO_2 emissions	– Adjusted free cash flow[1]	– Adjusted net debt/Adjusted EBITDA

[1] Derivation ↗ **Earnings position, p. 40ff., Financial position, p. 44ff.**

Financial strategy aims to increase Company value

The financial strategy of the Lufthansa Group seeks to increase its Company value in a sustainable manner. It will concentrate on three dimensions: returning to value creation, generating strong free cash flows and maintaining financial stability. The successful implementation of the financial strategy aims to contribute to reducing the debt built up during the coronavirus pandemic and strengthening the Lufthansa Group balance sheet so that the Group can successfully overcome future crises.

Returning to value creation

Sustainable value creation in the Company

The Lufthansa Group applies a value-based system of management. At its centre is the return on capital. This is measured by the Adjusted Return on Capital Employed (Adjusted ROCE). If Adjusted ROCE exceeds the weighted average cost of capital (WACC), the Company is creating value. The Lufthansa Group has set the objective of generating an adjusted ROCE of at least 10% from 2024, not including cash and cash equivalents.

The Company's profitability is measured by Adjusted EBIT. The adjustments eliminate non-recurring, non-operating effects and thus improve the presentation of the Company's operating performance. Circumstances that justify an adjustment are listed in a catalogue. This includes gains and losses on the disposal of assets, impairment losses and earnings attributable to other periods in connection with pension obligations. Staff-related restructuring expenses and non-operating extraordinary expenses for legal procedures and company transactions not related to operating activities will also be included in the catalogue from 2022 onwards. From 2024, the Lufthansa Group aims to achieve an Adjusted EBIT margin of over 8%. ↗ **Forecast, p. 136ff, T022 Reconciliation of results, p. 43.**

The use of capital is also optimised by further improvements in working capital management and ensuring the value-creation of investments.

Finally the Lufthansa Group includes the specific CO_2 emissions in the control system in order to enable sustained value creation by reducing the environmental impacts. Information about the long-term goals for reducing carbon emissions can be found in the ↗ **Combined non-financial declaration/ Climate protection, p. 100ff.**

The Company's value creation was negative in 2021 due to the crisis. The Adjusted ROCE margin after tax was –7.5% (previous year: –16.7%), whereas WACC was unchanged year-on-year at 4.2%. Adjusted EBIT came to EUR –2,349m in 2021 (previous year: EUR –5,451m). The Adjusted EBIT margin, i.e. the ratio of Adjusted EBIT to revenue, was therefore –14.0% (previous year: –40.1%). ↗ **Earnings position, p. 40ff.** Specific CO_2 emissions per passenger-kilometre were 101.6 grammes in 2021, 3% lower than the previous year (previous year: 105.2 grammes). ↗ **Combined non-financial declaration/Climate protection, p. 100ff.**

T010 CALCULATION OF ADJUSTED ROCE

in €m	2021	2020	Change in %
Revenue	16,811	13,589	24
Other operating income	1,711	2,072	-17
Operating income	**18,522**	**15,661**	**18**
Operating expenses	20,840	22,750	-8
Result from equity investments	2	-264	
EBIT	**-2,316**	**-7,353**	**69**
Adjusted EBIT	**-2,349**	**-5,451**	**57**
Interest on liquidity	-6	84	
Taxes (assumption 25% of EBIT + Interest on liquidity)	581	1,817	-68
ROCE[1] in %	**-7.4**	**-22.7**	**15.3 pts**
Adjusted ROCE[2] in %	**-7.5**	**-16.7**	**9.2 pts**
Balance sheet total	42,538	39,484	8
Non-interest bearing liabilities			
of which liabilities from unused flight documents	3,340	2,064	62
of which trade payables, other financial liabilities, other provisions	5,136	3,856	33
of which advance payments, deferred income, other non-financial liabilities	3,287	4,305	-24
of which others	6,865	6,145	12
Capital employed	23,910	23,114	3
of which liquid funds	7,666	5,460	40
Average capital employed	**23,491**	**24,068**	**-2**
WACC in %	4.2	4.2	–

[1] (EBIT + Interest on liquidity -25% taxes)/Average capital employed.
[2] (Adjusted EBIT + Interest on liquidity -25% taxes)/Average capital employed.

Restructuring forms basis for a return to profitable and sustainable growth

With a restructuring and transformation programme implemented throughout the Group, the Company has aligned itself with the modified market environment as a result of the crisis. The modifications it will make to the cost structures reflect the lower market volumes and create the conditions for a return to a positive operating result. Necessary measures to generate the planned structural cost savings of EUR 3.5bn annually by 2024 have been identified both in business segments and top-down. These include measures to reduce staff costs by a total of EUR 1.8bn. In addition to reducing headcounts, the focus is on permanently increasing productivity. Measures relating to the reduction in organisational and operational complexity as well as standardising and modernising the Group fleet should generate cost savings of around EUR 1.7bn. By the end of the 2021 financial year, over three quarters of the measures had been implemented, sustainably reducing annual costs by around EUR 2.7bn. ↗ **Business segments, p. 53ff.**

Generation of strong free cash flows

Generation of strong free cash flows is a principal goal of financial management

As a result of the coronavirus pandemic, the Company's net debt has increased. Thanks to strict liquidity management and successful financing measures, particularly the capital increase carried out in October 2021, the stabilisation measures in Germany could be repaid significantly earlier than originally planned. Nevertheless, indebtedness is significantly above the pre-crisis level. To further reduce debt, including the repayment of the additional state-guaranteed loans in Switzerland, Austria and Belgium drawn at the end of 2021, generating strong free cash flows is essential. In addition to increasing the operating result, the key levers for this are strict working capital management and disciplined investing activities. Through this, the Lufthansa Group plans to generate Adjusted free cash flow of around EUR 2bn each in 2023 and 2024.

Adjusted free cash flow in 2021 came to EUR -855m (previous year: EUR -3,669m). ↗ **Financial position, p. 44ff.**

Improvements in working capital management support cash flow generation

Working capital management will be intensified even beyond the acute crisis. This will include such measures as strict receivables management, improving payment terms with suppliers, process improvements in procurement and optimising inventories, in particular at Lufthansa Technik. In performance dialogues with business entities, cash flow plays an important role such that the organisation is continuously sensitised to its influence on company value.

Focused investing activities to maximise return on capital employed

Capital expenditure planned in all segments in 2020 and 2021 has been reviewed and postponed – whenever possible and economically viable – in order to minimise short-term cash outflows. In the coming years, the Group will increase its capital expenditure again in order to secure long-term profitable growth. As a matter of principle capital expenditure should not exceed the value of the depreciation and amortisation.

The Lufthansa Group will also invest further in the modernisation of the fleet, the on-board and ground product as well as infrastructure. Additional aircraft will mainly replace older, less efficient models. The allocation of new aircraft to the different airlines and bases is constantly optimised according to value-based criteria. This makes the investment profile more balanced and increases focus on the deployment of capital. The increased use of leasing will further limit capital usage. This will take the proportion of leasing above its current level of 12%.

The Lufthansa Group has reduced capital expenditure since the outbreak of the coronavirus crisis, in particular by delaying aircraft deliveries. In the reporting year, capital expenditure remains significantly below the pre-crisis level. Compared with the previous year, gross capital expenditure (excluding the purchase of shares) rose by 4% to EUR 1,329m (previous year: EUR 1,273m). Advance and final payments for aircraft and aircraft components along with aircraft and engine overhauls account for most of this. The increase compared with the previous year mainly resulted from higher advance payments for future aircraft deliveries. ↗ C13 **Primary, secondary and financial capital expenditure, p. 44**

Resumption of dividend payments targeted in the long-term

Shareholders are to again directly participate in the Company's success as soon as the Group's long-term financial stability has been restored. Before the coronavirus pandemic, the Lufthansa Group's dividend policy was to distribute to shareholders 20% to 40% of net profit, adjusted for non-recurring gains and losses.

However, the contractual terms of the Economic Stabilisation Fund's (ESF) stabilisation measures still rule out the payment of dividends. This applies until the complete sale of the shareholding of WSF (31 December 2021: 14.09%), which has been agreed to take place by October 2023.

On condition that the net profit for the year in the individual financial statements prepared in line with German commercial law for Deutsche Lufthansa AG permits a distribution of this amount, dividend payments would again be possible in the year following the end of the stabilisation measures. Until then, the Group will use its free cash flow primarily for repaying its financial liabilities, including the state stabilisation measures.

Maintaining financial stability

Liquidity should be permanently between EUR 6bn and EUR 8bn

The Lufthansa Group has decided to permanently hold liquidity of between EUR 6bn and EUR 8bn to protect against crises. This represents a significant increase compared to the pre-crisis level. For capital efficiency reasons, a material part of the strategic liquidity reserve will be held in the form of a revolving loan facility that will be financed by a consortium of banks.

Lufthansa Group benefits from good capital market access

In the 2021 financial year, the Lufthansa Group refinanced itself successfully and to a significant extent in the capital market. By placing several bonds, issuing borrower's note loans, aircraft financings and other external financing, a total of EUR 6.1bn of debt was raised. In addition, by means of a capital increase in October 2021 a further EUR 2.2bn was raised through the issuance of around 598 million new shares. ↗ **Financing, p. 46f.**

State stabilisation measures in Germany repaid ahead of time

The successful financial measures formed the basis for the early repayment of stabilisation measures in Germany.

After the successful issuance of a bond, the EUR 1bn loan from the Kreditanstalt für Wiederaufbau (KfW) was repaid as early as February 2021. After the completion of the capital increase, the Company was able to repay the funds obtained from the Silent Participation I from WSF totalling EUR 1.5bn in October 2021 and therefore significantly earlier than planned. The Silent Participation II totalling EUR 1.0bn was repaid in November 2021 and the unused part of the Silent Participation I was terminated. Therefore the Lufthansa Group repaid or terminated all loans and silent participations provided by the Federal Republic of Germany.

By the end of the 2021 financial year, the companies in the Lufthansa Group had received around EUR 5.0bn of the stabilisation measures out of an original total of EUR 9.0bn. EUR 3.6bn of the total has already been repaid or included as part of the capital increase. At the end of the 2021 financial year, loans totalling EUR 1.0bn were available for drawdown in Switzerland. Other unused funds in Germany were terminated.

As of year-end 2021, the Company therefore had around EUR 9.4bn of available liquidity. This includes the stabilisation measures in Switzerland that have not yet been drawn and available credit lines. ↗ **Financing, p. 46f.**

Reducing debt as the core goal of financial strategy

After repaying the stabilisation measures in Germany, the focus is now on the long-term reduction in the level of indebtedness. Cash inflows from the operating business and proceeds from the disposal of non-core business segments are to contribute to reducing net debt.

At the end of the 2021 financial year, net debt amounted to EUR 9,023m. It was therefore 9% lower than in the previous year (previous year: EUR 9,922m). Compared with the end of the 2019 financial year, net debt has increased by EUR 2.4bn. ↗ **Net assets, p. 49f.**

Use of diversified finance sources

A mix of different instruments is to be used for future borrowing, above all aircraft financing, bonds and borrower's note loans. Optimising the financing mix should reduce financing costs, maintain a balanced maturity profile and diversify the Lufthansa Group's portfolio of creditors. ↗ **C16 Maturity profile of borrowings, p. 47.**

Aim is to return to investment grade rating

Before the coronavirus crisis, the rating agencies Standard & Poor's and Moody's both rated the Lufthansa Group as investment grade (31 December 2019: Standard & Poor's: "BBB", Moody's: "Baa"3). As a result of the coronavirus crisis and its impact, both agencies downgraded their rating. At the end of the reporting year, Standard & Poor's rated the Lufthansa Group as "BB –" and Moody's as "Ba2". Scope Ratings rated the Lufthansa Group at "BBB –" and therefore again in the investment grade range. The outlook from Moody's ratings and Scope continues to be "negative" and Standard & Poor's raised its outlook to "stable "in November 2021.

T011 DEVELOPMENT OF RATINGS

Rating/outlook	**2021**	2020	2019	2018	2017
Standard & Poor's	BB–/ stable	BB–/ negative	BBB/ stable	BBB–/ positive	BBB–/ stable
Moody's	Ba2/ negative	Ba2/ negative	Baa3/ stable	Baa3/ stable	Baa3/ stable
Scope Ratings	BBB–/ negative	BBB–/ negative	BBB/ stable	BBB–/ positive	BBB–/ positive

The Group aims to restore its investment grade rating with all of the significant rating agencies by 2024. Investment grade ratings for the Company's debt ensure low funding costs and financial flexibility as a result. The conditions for an investment grade rating are a return to a positive operating result and a further reduction in net indebtedness.

Gearing, measured by the ratio of Adjusted net debt to Adjusted EBITDA, should be reduced to a figure of less than 3.5. With Adjusted net debt, the ratio takes into account both traditional net debt (including the financial obligations arising from Group leases, primarily for property and aircraft) and pension provisions. The Group assumes that this will decrease in the long-term due to the ongoing strong income from pension assets. It therefore intends to keep the additions to pension assets as low as possible and to mainly limit them to the regular additions to ongoing defined benefit obligations (DBO).

At the end of 2021 the Adjusted net debt/Adjusted EBITDA indicator was not meaningful as a result of the negative EBITDA.

T012 ADJUSTED NET DEBT/ADJUSTED EBITDA

	2021 in €m	2020 in €m	Change in %
Net indebtedness[1]	8,776	9,675	-9
Pension provisions	6,676	9,531	-30
Adjusted net debt	**15,452**	**19,206**	**-20**
Adjusted EBIT	-2,349	-5,451	57
Depreciation and amortisation	2,259	2,561	-12
Adjusted EBITDA	**-90**	**-2,890**	**97**
Adjusted net debt/ Adjusted EBITDA	**not meaningful**	**not meaningful**	**–**

[1] In order to calculate net indebtedness, here 50% of the hybrid bond issued in 2015 (EUR 247m) has been discounted. Calculation of net indebtedness ↗ **p. 50.**

Structured risk management minimises finance risks

The Group's financial stability is also ensured by means of integrated risk management. Hedging fuel, exchange rate and interest rate risks minimises the short-term financial risks for the Lufthansa Group. The hedges smooth price fluctuations by means of rule-based processes. Changes in fuel costs could therefore be taken into account in pricing at an early stage.

At the start of the reporting year, fuel hedging for 2022 and the subsequent years was restarted after it had been paused temporarily due to the outbreak of the coronavirus pandemic. 65% of the planned fuel requirements were hedged over a period of 24 months. ↗ **Opportunities and risk report, p. 76ff., Note 45 to the consolidated financial statements, p. 225ff.**