FINANCIAL STRATEGY AND VALUE-BASED MANAGEMENT

C07 FINANCIAL STRATEGY

Sustainable increase of Company value

	Increased value creation	Generation of strong free cash flows	Maintain financial stability
Focus	– Improved return on capital – Improved profitability – Continuous reduction of environmental impacts	– Increase in operating result – Working capital management – Focused investing activities	– Adequate liquidity – 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: increasing value creation, generating strong free cash flows and maintaining financial stability. The successful implementation of the financial strategy aims to further strengthen the Lufthansa Group balance sheet so that the Group can invest in future profitable growth and successfully overcome crises.

Finance Transformation Programme is intended to deliver improvements in the area of finance

The Lufthansa Group has successfully coped with the immediate impacts of the coronavirus crisis. Its financial management is thus now able to once again focus on the ongoing structural development of the Group's finance function. The Finance Transformation Programme was initiated in the reporting year in order to further improve the Lufthansa Group's finance function and thus support the Company's competitiveness and success.

The cornerstones of this programme are the review and improvement of financial steering, increased efficiency, the ongoing development of talent and employees as well as the modernisation of the finance IT landscape.

Increased 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 definition of Adjusted ROCE was revised in the 2022 financial year. The capital base is now adjusted for the Group's cash and cash equivalents. The new calculation method matches that of direct competitors and thereby enables a better comparison between the performance indicators. The Lufthansa Group has set itself the objective of generating an Adjusted ROCE of at least 10% from 2024.

The Company's profitability is measured by Adjusted EBIT and the Adjusted EBIT margin, i.e. the ratio of Adjusted EBIT to revenue. 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. These include gains and losses on the disposal of assets and impairment losses, reversals of impairment losses and earnings attributable to other periods in connection with pension obligations. Since the 2022 financial year, these adjustments have also included staff-related restructuring expenses and non-operating extraordinary expenses for legal procedures and company transactions. This change was made to ensure greater comparability with the reporting of other companies in the industry and to increase the transparency of non-recurring items. In the reporting year, the expenses for valuation allowances, depreciation and amortisation and impending compensation payments that were directly caused by the war in Ukraine, as well as impairment losses on goodwill in the Catering segment, are the key issues that were excluded from the Adjusted EBIT calculation. ↗ **T021 Reconciliation of results, p. 43.**

From 2024, the Lufthansa Group will seek to achieve an Adjusted EBIT margin of at least 8%. ↗ **Forecast, p. 149ff.**

T009 CALCULATION OF ADJUSTED ROCE

in €m	**2022**	2021	Change in %
Revenue	32,770	16,811	95
Other operating income	2,547	1,711	49
Operating income	**35,317**	**18,522**	**91**
Operating expenses	34,085	20,840	64
Result from equity investments	–1	2	
EBIT	**1,231**	**–2,316**	
Adjusted EBIT	**1,509**	**–1,666**	
Taxes (assumption 25% of EBIT)	–308	579	
ROCE[1] in %	**5.9**	**–10.3**	**16.2 pts**
Adjusted ROCE[2] in %	**7.3**	**–7.4**	**14.7 pts**
Balance sheet total	43,335	42,538	2
Non-interest bearing liabilities			
of which liabilities from unused flight documents	4,898	3,340	47
of which trade payables, other financial liabilities, other provisions	6,189	5,136	21
of which advance payments, deferred income, other non-financial liabilities	3,407	3,287	4
of which others	5,605	6,894	–19
of which liquid funds	8,301	7,666	
Capital employed	14,935	16,215	–8
Average capital employed	**15,574**	**16,927**	**–8**
WACC in %	7.2	4.2	3.0 pts

[1] (EBIT – 25% taxes)/Average capital employed.
[2] (Adjusted EBIT – 25% taxes)/Average capital employed.

Finally, the Lufthansa Group incorporates the specific CO_2 emissions into its management system to lower the associated costs of reducing environmental impacts and to enable sustainable value creation. Management remuneration is also aligned with this goal. Progress made in reducing emissions also influences funding terms. The revolving line of credit concluded in April 2022 with a volume of EUR 2.0bn also takes the specific CO_2 emissions into consideration. Achievement of the envisaged reduction path or a failure to do so would result in a lower or higher interest rate in the reporting year in question. Information about the long-term goals for reducing carbon emissions can be found in the ↗ **Combined non-financial report/Climate protection, p. 99ff.**

The Company's value creation was positive again in the 2022 financial year. The Adjusted ROCE after tax was 7.3% (previous year: –7.4%), while the WACC rose by 3.0 percentage points year-on-year to 7.2% (previous year: 4.2%). Adjusted EBIT amounted to EUR 1,509m in the 2022 financial year (previous year: EUR –1,666m). The Adjusted EBIT margin was therefore 4.6% (previous year: –9.9%). ↗ **Earnings position, p. 40ff.** Specific CO_2 emissions per passenger-kilometre were 90.0 grammes in 2022, 11% lower than in the previous year (previous year: 101.6 grammes). ↗ **Combined non-financial declaration/Climate protection, p. 99ff.**

Restructuring forms basis for Lufthansa Group's return to profitable and sustainable growth

The Lufthansa Group has now almost completed its Group-wide restructuring and transformation programme. The programme has allowed the Company to align itself with the changes in the market environment created by the crisis. The modifications it made to the cost structures, particularly the reduction in fixed costs, reflected the lower market volumes and created the conditions for its return to a positive operating result.

Structural cost savings of EUR 3.5bn per year are to be achieved as a result of the restructuring by 2024. This includes measures to reduce staff costs with a volume of around EUR 1.4bn as well as further measures which are intended to achieve a permanent improvement in productivity, with a volume of roughly EUR 2.1bn. The latter include measures designed to reduce the level of organisational and operational complexity and to standardise and modernise the Group fleet.

By the end of the 2022 financial year, more than 90% of the measures had already been implemented and the cost base had thus been structurally reduced by around EUR 3.2bn per year. ↗ **Business segments, p. 52ff.**

Generation of strong free cash flows

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

The Company's net debt rose during the coronavirus pandemic. Thanks to strict liquidity management and successful financing measures, including the capital increase carried out in October 2021, the stabilisation measures were repaid in full, significantly earlier than originally planned. The generation of strong free cash flows is essential in order to further reduce debt and to safeguard the Company's long-term investment capability. In addition to increasing the operating result, the key levers for this are strict working capital management and focused investing activities. Through this, the Lufthansa Group plans to generate significantly positive Adjusted free cash flow in 2023 and 2024.

The definition of Adjusted free cash flow was amended in the 2022 financial year so that cash inflows and outflows from the sale and acquisition of companies or individual business units which are allocated to investing activities are no longer recognised. Moreover, since the 2022 financial year all cash flows that are related to pensions – including allocations to the pension funds and dividends paid out of them – have been shown as part of operating cash flow.

In the 2022 financial year, Adjusted free cash flow benefited in particular from the strong increase in bookings and related advance payments as well as improvements to working capital. It thus reached a record level of EUR 2,526m (previous year: EUR –1,049m). ↗ Financial position, p. 44ff.

Improvements in working capital management support cash flow generation

Working capital management is to be further intensified. Targeted measures such as strict receivables management, improving payment terms with suppliers, improvements to procurement processes and maintenance of inventories, in particular at Lufthansa Technik, are additional areas of optimisation. Free cash flow also plays a major role for managers' variable remuneration and in the performance dialogues with the business entities. The organisation is continuously made aware of its influence on Company value and incentives are established to increase the level of free cash flow.

Focused investing activities to maximise return on capital employed

The Lufthansa Group is making extensive investments in the modernisation of its fleet, on-board and ground products as well as infrastructure in order to ensure profitable long-term growth. However, the net investments should not exceed the value of the depreciation and amortisation at least up to and including 2024, thus within the period of the medium-term planning presented in the summer of 2021.

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. Greater use of leasing is intended to increase the level of flexibility for long-term fleet planning and to limit the use of capital. In the medium term, this will take the proportion of leasing above its current level of around 10%.

Following the strong reduction in investment spending due to the coronavirus pandemic, the Lufthansa Group significantly increased its volume of investment in the reporting year. The investment volume remained significantly lower than its pre-crisis level in 2019. However, compared with the previous year, net capital expenditure rose by 104% to EUR 2,286m (previous year: EUR 1,119m). Advance and final payments for aircraft and aircraft components along with aircraft and engine overhauls account for most of this. ↗ C14 Primary, secondary and financial investments, p. 44.

Now that the coronavirus crisis has been overcome, the goal is to resume dividend payments

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 crisis, the Lufthansa Group's dividend policy was to distribute to shareholders 20% to 40% of net profit, adjusted for non-recurring gains and losses. One condition for the payment of a dividend is that a distribution of the relevant amount is permitted by the net profit for the year as shown in the individual financial statements of Deutsche Lufthansa AG that are drawn up under German commercial law. For the 2023 financial year, the Group intends to return to its original dividend policy, provided that the economic recovery continues as forecast for the 2023 financial year.

Maintaining financial stability

Liquidity should be between EUR 8bn and EUR 10bn in future

The Lufthansa Group has decided to hold liquid funds of between EUR 8bn and EUR 10bn in future to protect against possible crises. The minimum liquidity level was increased again in view of the significant expansion of business activity. For capital efficiency reasons, part of the strategic liquidity reserve is held in the form of a revolving line of credit. An appropriate line of credit with a volume of EUR 2.0bn was agreed with a broad consortium of international banks in April 2022, replacing non-utilised bilateral lines of credit with a volume of around EUR 0.7bn. The Lufthansa Group's available liquidity thus increased by around EUR 1.3bn. At the end of the reporting year, it amounted to EUR 10.4bn (previous year: EUR 9.4bn). ↗ Financial position, p. 44ff.

Lufthansa Group benefits from good capital market access

The Lufthansa Group successfully refinanced itself on the capital market in the 2022 financial year. A total of EUR 786m of debt was raised through the issue of two borrower's note loans and by means of aircraft finance and other external financing. Together with the cash inflows from operating business, expiring liabilities were thus refinanced and the remaining stabilisation funds in Switzerland, Austria and Belgium were paid back early and in full. ↗ Financing, p. 46f.

Further reduction of debt as the core goal of financial strategy

The long-term financial strategy continues to focus on reducing the level of gearing. The generation of strong free cash flows in particular is intended to help reduce the volume of net debt. Income from the sale of business units which are to be sold off in whole or in part for strategic reasons may also potentially contribute to a reduction in the volume of debt.

At the end of the 2022 financial year, net indebtedness was EUR 6,871m. It was therefore 24% lower than the previous year (previous year: EUR 9,023m) and only slightly higher than the pre-crisis level at year-end 2019 (EUR 6,662m). ↗ Net assets, p. 48f.

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 funding mix should reduce financing costs, maintain a balanced maturity profile and diversify the Lufthansa Group's portfolio of creditors. In principle, newly raised funds should be subject to fixed interest rates. The volume of floating-rate liabilities should not exceed the volume of funds invested at a floating interest rate. Net debt is thus subject to a fixed interest rate and market-wide interest-rate changes do not have any material impact on the Group's interest burden. ↗ C17 Maturity profile of borrowings, p. 46.

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 "Baa3"). As a result of the coronavirus crisis and its impact, both agencies downgraded their ratings. However, in late November 2022 Standard & Poor's raised its rating to BB with a positive outlook. Moody's has given the Lufthansa Group a "Ba2" rating and raised its outlook to "stable" in early December 2022. Scope Ratings graded the Lufthansa Group at "BBB–" and therefore still in the investment grade range. Moreover, in July 2022 Scope Ratings raised its outlook to "stable".

T010 DEVELOPMENT OF RATINGS

Rating/outlook	**2022**	2021	2020	2019	2018
Standard & Poor's	BB/ positive	BB–/ stable	BB–/ negative	BBB/ stable	BBB–/ positive
Moody's	Ba2/ stable	Ba2/ negative	Ba2/ negative	Baa3/ stable	Baa3/ stable
Scope Ratings	BBB–/ stable	BBB–/ negative	BBB–/ negative	BBB/ stable	BBB–/ positive

The Group aims to restore its investment grade rating with all of the significant rating agencies. Investment grade ratings for the Company's debt ensure good access to the capital markets and low funding costs and thus financial flexibility. Conditions for an investment grade rating are further improvement in the operating result and a reduction of debt, among other things.

Gearing, measured by the ratio of Adjusted net debt to Adjusted EBITDA, should be limited to a figure of less than 3.5. With Adjusted net debt, the ratio takes into account both net indebtedness (including the financial obligations arising from Group leases, primarily for property and aircraft) and net pension obligations. Due to the market-wide increase in interest-rate levels in the reporting year, these decreased significantly to EUR 2.0bn (previous year: EUR 6.5bn).

In late 2022, the ratio of Adjusted net debt/Adjusted EBITDA was 2.3 (previous year: 25.8).

T011 ADJUSTED NET DEBT/ADJUSTED EBITDA

	2022 in €m	2021 in €m	Change in %
Net indebtedness[1]	6,624	8,776	-25
Net pension obligations	1,993	6,540	-70
Adjusted net debt	**8,617**	**15,316**	**-44**
Adjusted EBIT	1,509	-1,666	
Depreciation and amortisation	2,277	2,259	1
Adjusted EBITDA	**3,786**	**593**	**538**
Adjusted net debt/ Adjusted EBITDA	**2.3x**	**25.8x**	**-91**

[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. 49.

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 can therefore be taken into account in pricing at an early stage. ↗ Opportunities and risk report, p. 75ff., Notes to the consolidated financial statements, Note 45, p. 235ff.