FINANCIAL STRATEGY AND VALUE-BASED MANAGEMENT

C05 FINANCIAL STRATEGY

	Sustainable increase of Company value		
	Return to value creation	**Generation of strong free cash flows**	**Maintain financial stability**
Focus	– Restructuring 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	– Reduction in net indebtedness – Return to investment grade rating – Minimisation of financial risks
Target	– Adjusted ROCE – Adjusted EBIT margin[1] – Specific CO_2 emissions	– Adjusted free cash flow	– Adjusted net debt/Adjusted EBITDA

[1] Derivation ↗ **Earnings position, p.38ff., Financial position, p. 42ff.**

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 free cash flows and maintaining financial stability. The successful implementation of the financial strategy should make it possible to repay the stabilisation funds and loans that the Company received to overcome the coronavirus pandemic.

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 indicator Adjusted Return on Capital Employed (Adjusted ROCE). If Adjusted ROCE exceeds the weighted average cost of capital (WACC), the Company is creating value.

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. Items that require adjustment are listed in a catalogue which has not been altered since 2015. They largely consist of the gains and losses on the disposal of assets and impairment losses and earnings attributable to other periods in connection with pension obligations. ↗ T021 **Reconciliation of results, p. 40.**

The use of capital is also optimised by strict working capital management and ensuring that capital expenditure adds value.

Finally, the Lufthansa Group factors specific carbon emissions into its management system in order to enable sustainable value creation that does not come at the expense of a higher environmental impact. In fact, the aim is to reduce specific carbon emissions continuously. Information about the long-term goals for reducing carbon emissions can be found in the ↗ **Combined non-financial declaration/Climate protection, p. 90ff.**

The Company's value creation was negative in 2020 due to the pandemic. The Adjusted ROCE margin after tax was −16.7% (previous year: 6.6%), whereas WACC was unchanged year-on-year at 4.2%. Adjusted EBIT came to EUR −5,451m in 2020 (previous year: EUR 2,026m). The Adjusted EBIT margin, i.e. the ratio of Adjusted EBIT to revenue, was therefore −40.1% (previous year: 5.6%). ↗ **Earnings position, p. 38ff.** Specific CO_2 emissions per passenger-kilometre (without wet leases) were 105.2 grammes in 2020, 14% higher than the previous year (previous year: 92.2 grammes). ↗ **Combined non-financial declaration/Climate protection, p. 90ff.**

T009 CALCULATION OF ADJUSTED ROCE AND COST OF CAPITAL[1]

in €m	2020	2019	Change in %
Revenue	13,589	36,424	−63
Other operating income	2,072	2,574	−20
Operating income	**15,661**	**38,998**	**−60**
Operating expenses	22,750	37,309	−39
Result from equity investments	−264	168	
EBIT	**−7,353**	**1,857**	
Adjusted EBIT	**−5,451**	**2,026**	
Interest on liquidity	84	79	6
Taxes (assumption 25% of EBIT + Interest on liquidity)	1,817	−484	
Cost of capital[1]	−1,011	−1,007	0
EACC	**−6,463**	**445**	
ROCE[2] in %	**−22.7**	**6.1**	**−28.8 pts**
Adjusted ROCE[3] in %	**−16.7**	**6.6**	**−23.3 pts**
Balance sheet total	39,484	42,659	−7
Non-interest bearing liabilities			
of which liabilities from unused flight documents	2,064	4,071	−49
of which trade payables, other financial liabilities, other provisions	3,856	5,868	−34
of which advance payments, deferred income, other non-financial liabilities	4,305	3,089	39
of which others	6,145	4,575	34
Capital employed	23,114	25,056	−8
Average capital employed[4]	**24,068**	**23,982**	**0**
WACC in %	4.2	4.2	0.0 pts

[1] WACC x Average capital employed.
[2] (EBIT + Interest on liquidity − 25% taxes)/Average capital employed.
[3] (Adjusted EBIT + Interest on liquidity − 25% taxes)/Average capital employed.
[4] Average capital employed in 2019 including IFRS 16 right-of-use assets as of 1 January 2019.

Restructuring creates conditions for a return to profitable and sustainable growth

The restructuring and transformation programme ReNew will set the Company up for the changes in the market environment resulting from the crisis. The modifications it will make to the cost structures reflect the lower market volumes that are expected to persist for many years and create the conditions for a return to a positive operating result. The necessary measures are primarily being identified and implemented in the business segments. ↗ **Business segments, p. 51ff.** In addition, the ReNew programme provides for central steering and coordination of the activities.

Even once the pandemic is over, the aim is to increase structural profitability by continuously reducing unit costs, simplifying processes and structures and improving productivity.

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 and the stabilisation measures necessary because of it, the Company's net debt has risen significantly. One prerequisite for the prompt repayment of this funding is to generate strong free cash flows. As well as increasing the operating result, the main instruments for achieving this are strict working capital management and an investment focus on projects with the highest value creation.

Adjusted free cash flow in 2020 came to EUR −3,669m (previous year: EUR 203m). ↗ **Financial position, p. 42ff.**

Improvements in working capital management support cash flow generation

In strengthening and intensifying working capital management even once the acute crisis is past, the aim is to improve cash flow. The focus is on optimising the capital committed to the short-term operating business. Specifically, measures may include strict receivables management, improving or extending the payment targets for suppliers and optimising inventories. In view of the crisis, options such as requiring advance payments from customers or deferring payments may be examined and used in special cases.

Focused investing activities to maximise return on capital employed

As a rule, the Lufthansa Group endeavours to concentrate its capital expenditure on projects with the highest value creation. Investments planned in all segments for 2020 and 2021 have been reviewed and postponed – whenever possible and economically viable – in order to minimise short-term cash outflows. Capital expenditure was thus reduced in 2020 from the more than EUR 3bn originally planned to EUR 1.3bn.

Capital expenditure should remain lower than before the coronavirus pandemic. However, the Lufthansa Group will continue to invest in the renewal of its fleet, in-flight and ground products and infrastructure. The aircraft on order serve mainly to 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.

Gross capital expenditure (without expenditure on equity investments) fell by 64% to EUR 1,273m in 2020. This was primarily achieved by restructuring the payment plans for aircraft investments. Advance and final payments for aircraft and aircraft components along with aircraft and engine overhauls account for most of the capital expenditure. ↗ C12 **Primary, secondary and financial investments, p. 42.**

Reducing capital expenditure compared with the original budget made a major contribution to limiting the fall in free cash flow.

Free cash flow used to reduce debt

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. The crisis prompted the Annual General Meeting in 2020 to suspend the dividend for 2019, however.

In the long term, shareholders are expected to once again participate directly in the Company's success. However, the stabilisation measures of the Economic Stabilisation Fund (WSF) currently rule out the payment of dividends. This applies until the stabilisation measures come to a complete end, i.e. all loans and silent participations have been repaid, and the WSF has sold all its shares in the Company. Following successful repayment of the loans and silent participations, the WSF is obliged to sell the shares it still holds in Deutsche Lufthansa AG. The sale must take place no later than year-end 2023. If the silent participations are sold after this date, the obligation must be met directly. 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

Coronavirus crisis endangers the solvency of the Lufthansa Group and many competitors

The Company's financial strategy to date has been to protect itself against crises by holding minimum liquidity of EUR 2.3bn. Moreover, an investment grade rating and ownership of a largely unencumbered fleet were expected to allow new funds to be raised rapidly in the event of a crisis.

At the start of the coronavirus pandemic this was not possible, however, since the capital markets were no longer accessible for financing measures following the outbreak. The extent of the crisis far exceeded any other scenarios seen hitherto. The Lufthansa Group was therefore no longer able to cover its capital requirements by further borrowing on the market or with its existing liquidity.

As a result, the Group agreed stabilisation measures with the governments of its home countries to ensure it remained solvent. The refinancing and repayment of this emergency funding is a key element of the future financial strategy. The Group will also examine what additional measures can be taken to ensure financial stability in a crisis, in the knowledge that it will never be possible to achieve protection against risks with a very low probability of occurrence and a very high level of loss, such as a global pandemic. ↗ **Opportunities and risk report, p. 71ff.**

Lufthansa Group returns successfully to the capital markets after agreement on stabilisation measures

Once the stabilisation measures were complete, the Lufthansa Group returned to capital markets successfully and on attractive conditions in the second half of the year. Total funds of approximately EUR 2bn were raised via a convertible bond, an unsecured euro bond and aircraft financing vehicles. Along with the bond for EUR 1.6bn issued in February 2021, the Lufthansa Group has therefore secured the refinancing of the EUR 2.6bn in financial liabilities due in 2021 and already repaid the KfW loan of EUR 1bn ahead of schedule in February 2021. ↗ **Events after the reporting period, p. 37.**

By the end of the financial year, the companies in the Lufthansa Group had utilised EUR 3.3bn of the stabilisation measures out of a total of EUR 9bn. This means that the Lufthansa Group can still draw on EUR 5.7bn of unused stabilisation measures.

As of year-end 2020, the Company therefore has around EUR 10.6bn of available liquidity. This includes the stabilisation measures that have not yet been drawn. ↗ **Financing, p. 43ff.**

Repayment of stabilisation measures and debt reduction are the main aims of the financial strategy

The Lufthansa Group has set itself the target of using as little of the stabilisation measures as possible. Drawn-down funding should be repaid as quickly as possible and overall debt reduced. Cash inflows from the operating business and proceeds from the disposal of non-core business segments are to contribute to reducing net debt. Net borrowing came to EUR 9,922m at year-end 2020, 49% more than in the previous year. ↗ **Net assets, p. 47f.**

Funding measures to finance financial liabilities as they fall due and to repay government stabilisation measures may consist of both debt and equity.

A mix of different instruments is to be used for borrowing, above all aircraft financing, bonds and borrower's note loans. Optimising the funding mix reduces financing costs, maintains a balanced maturity profile and diversifies the Lufthansa Group's portfolio of creditors. ↗ **C15 Maturity profile of borrowings, p. 45.**

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). The spread of the coronavirus and its impact caused both agencies to downgrade their rating, however. Standard & Poor's now rates the Lufthansa Group as BB– and Moody's as Ba2. Scope Ratings gives the Lufthansa Group a rating of BBB–, which continues to be investment grade.

T010 DEVELOPMENT OF RATINGS

Rating/outlook	**2020**	2019	2018	2017	2016
Standard & Poor's	BB–/ negative	BBB/ stable	BBB–/ positive	BBB–/ stable	BBB–/ negative
Moody's	Ba2/ negative	Baa3/ stable	Baa3/ stable	Baa3/ stable	Ba1/ stable
Scope Ratings	BBB–/ negative	BBB/ stable	BBB–/ positive	BBB–/ positive	BBB–/ stable

In the long term, the Group aims to receive an investment grade rating from all the main rating agencies. 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, lower net debt and a stronger equity base.

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.

At year-end 2020, the ratio was not applicable since EBITDA was negative. In the previous year the figure was 2.8.

T011 ADJUSTED NET DEBT/ADJUSTED EBITDA

	2020 in €m	2019 in €m	Change in %
Net indebtedness[1]	9,675	6,415	51
Pension provisions	9,531	6,659	43
Adjusted net debt	**19,206**	**13,074**	**47**
Adjusted EBIT	–5,451	2,026	
Depreciation and amortisation	2,561	2,692	–5
Adjusted EBITDA	**–2,890**	**4,718**	
Adjusted net debt/ Adjusted EBITDA	**not meaningful**	**2.8**	

[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. 48.**

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.

The significant fall in capacity in the reporting year meant that fuel was overhedged. A steep fall in the oil price caused hedging losses that could not be recouped by correspondingly lower fuel expenses. Since there were no hedged items, these losses were presented in the financial result. In response, the Lufthansa Group is considering adjusting its fuel hedging strategy. ↗ **Opportunities and risk report, p. 71ff., Notes to the consolidated financial statements, Note 45, p. 205ff.**