Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades Lufthansa's CFR to Ba2, outlook negative

02 Jul 2020

Frankfurt am Main, July 02, 2020 -- Moody's Investors Service, ("Moody's") has today downgraded the corporate family and probability of default ratings of Deutsche Lufthansa Aktiengesellschaft (`Lufthansa´) to Ba2 / Ba2-PD from Ba1 / Ba1-PD respectively. Concurrently the agency has downgraded the senior unsecured rating of Lufthansa to Ba2 from Ba1, the senior unsecured MTN to (P)Ba2 from (P)Ba1 and has assigned a ba3 Baseline Credit Assessment (BCA). The outlook changed to negative from ratings under review.

Today's rating action concludes the review for downgrade initiated on 17th March 2020.

Today's rating actions reflect:

-The increasing duration and severity of the coronavirus outbreak

-Moody's expectation that the airline industry will remain deeply constrained in 2020 and 2021 and will not recover 2019 passenger volumes until 2023 at the earliest

-The risk that the company will incur substantially increased debt during the coronavirus pandemic, and might be challenged to repair its balance sheet in the next two to three years

-The liquidity relief from the support package offered by the German, Austrian and Swiss government

-Lufthansa's scale, strong market position and strategic importance but also its weak structural profitability

RATINGS RATIONALE

The rapid spread of the coronavirus outbreak, deteriorating global economic outlook, low oil prices and high asset price volatility have created an unprecedented credit shock across a range of sectors and regions. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. Today's action reflects the impact on Deutsche Lufthansa Aktiengesellschaft and the deterioration in credit quality it has triggered, given its exposure to the global airline industry, which has left it vulnerable to travel restrictions and sensitivity to consumer demand and sentiment.

Lufthansa was hit amongst the first European airlines by the coronavirus outbreak due to its material exposure to China and the APAC region. The company had to reduce its capacity to APAC already in February and early March with restrictions on flights to and from China and other Asian countries. As the outbreak spread the company reduced its capacity by 95% in April and May.

Moody's expects flight activity to resume over Q3 and Q4 of 2020, but remaining severely depressed, with domestic flights recovering earlier and a slower return for international and long haul flights. With around 70% of its network airlines capacity outside Europe and a high exposure to business travel and premium leisure, Moody's expects that as flights resume Lufthansa will see a slower recovery profile than the industry as a whole.

The International Air Transport Association (IATA) currently forecasts that 2020 global passenger numbers will be 48% down year-on-year, with 2021 volumes around 30% below 2019, and only recovering to 2019 levels by 2023. Given high levels of uncertainty of the trajectory of the pandemic there are a wide range of possible outcomes and Moody's credit assessment considers deeper downside scenarios incorporating the risks of a slower recovery. In particular Moody's considers that 2021 is likely to remain a severely depressed year for the industry, with continued travel restrictions, health screening and social distancing, consumer concerns over travel, a weak economic environment and threats of further coronavirus outbreaks. This is likely to be partially mitigated by better preparedness by governments and healthcare systems, international coordination, pent-up consumer demand and the economic importance of resuming air travel. The timing and profile of a recovery beyond 2021 also remains highly uncertain.

The sharp decline in passenger traffic has led to a rapid erosion of Lufthansa's liquidity reserves. The issuer has indicated publicly that it currently consumes approximately €800 million per month at the operating cash flow level before working capital. In addition Lufthansa faces high potential cash outflows from the reimbursement of canceled tickets. Whilst the company has raised approximately €1.5 billion in funding since the start of the outbreak its liquidity position has become unsustainable forcing Lufthansa to engage with the German government to negotiate a comprehensive support package.

Moody's expects that Lufthansa will incur substantial additional debt to support its liquidity and cash consumption during the coronavirus outbreak, and that cash generation is unlikely to be sufficient thereafter to restore balance sheet metrics by 2023.

On 25th June 2020, Lufthansa has secured the shareholders' approval for a comprehensive support programme from the German government. Lufthansa will receive €6 billion in funding through a combination of subordinated capital and common equity from the German government and €3 billion of senior secured funding through a private bank consortium with ca. 75% of the total loan amount provided by State-owned bank KFW. While the support package is approved under a temporary framework and there is a financial incentive to repay it as soon as possible, it provides a material liquidity injection at a cost that is below the current funding cost of other airline peers at least for the next two years. The government of Austria and Switzerland have also pledged €2 billion of support for Austrian Airlines and SWISS.

We will treat the silent participation 1 and 2 under the German support package as debt for the calculation of our credit metrics but have applied the Government Related Issuers methodology following the shareholder's approval of a €300 million rights issue that will give the German government a 20% stake in Deutsche Lufthansa Aktiengesellschaft. We have applied a moderate support assumption under our GRI methodology reflecting the materiality of the support package but also the temporary nature of the support package.

At the same time the rating reflects Moody's expectation that Lufthansa will remain a leading operator in the industry as a key network carrier for all German speaking European countries. This is supported by its large scale, strong brands, extensive and diversified global network, and strong market positions on certain routes, including highly profitable transatlantic routes, and at sought after airports. The combined support package of up to €11 billion from three governments underpins the strategic importance of Lufthansa for the connectivity of Germany, Austria and Switzerland. The rating remains constrained by the issuer's weak structural profitability as evidenced by a high Cost per Available Seat Kilometer. The restructuring of Lufthansa's workforce is seen as key in the ability of the issuer to redeem the various instruments of the support packages and to ensure its long term solvency.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Moody's regards the coronavirus outbreak as a social risk under its ESG framework, given the substantial implications for public health and safety.

The support package from the German government includes commitments from Lufthansa to reduce its CO2 emissions. Lufthansa should invest into 80 new aircraft from 2021 to 2023 to modernize the fleet and reduce its emissions. In addition the issuer should expand strategic cooperation on aircraft fuels from environmentally friendly sources.

OUTLOOK

The negative outlook reflects the continued uncertain prospects for the airline industry, with risks of extended disruption to travel causing further strain on the company's balance sheet and liquidity. Furthermore, Moody's notes execution challenges linked to efficiency and cost structure improvements. A delayed recovery of operating performance and cash flow generation could result in further negative rating pressure over the next quarters.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The ratings are unlikely to be upgraded in the short term. Positive rating pressure would not arise until the coronavirus outbreak is brought under control, travel restrictions are lifted, and passenger volumes return to more normal levels. At this point Moody's would evaluate the balance sheet and liquidity strength of the company and positive rating pressure would require evidence that the company is capable of substantially recovering its financial metrics and restoring liquidity headroom within a 1-2 year time horizon.

Moody's could downgrade Lufthansa if:

-There are expectations of deeper and longer declines in passenger volumes extending materially into 2021

-There are concerns over the adequacy of liquidity driven by extended groundings in 2021

-There are clear expectations that the company will not be able to maintain financial metrics compatible with a ba3 BCA following the coronavirus outbreak, in particular if:

- Gross adjusted leverage is expected to be sustainably above 5x

- Moody's adjusted EBIT margin were to fall substantially below 7%

- Retained cash flow to debt drops sustainably below 15%

PRINCIPAL METHODOLOGIES

The methodologies used in these ratings were Passenger Airline Industry published in April 2018 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1091811 , and Government-Related Issuers Methodology published in February 2020 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1186207 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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