Research Update:

Deutsche Lufthansa AG Upgraded To 'BB+' On Ongoing Air Traffic Recovery And Lower Financial Leverage; Outlook Positive

April 17, 2023

Rating Action Overview

- We think the recovery in air travel demand will continue this year and that resilient yields will offset inflationary pressures on Deutsche Lufthansa AG's (Lufthansa's) cost base and declining air freight rates in its cargo segment. This should boost S&P Global Ratings-adjusted EBITDA in 2023 to close to €4.5 billion, significantly above our previous base-case projection.
- These supporting factors should sustain Lufthansa's positive free operating cash flow (FOCF; after leases) and, on the back of the lower pension deficit, lead to S&P Global Ratings-adjusted funds from operations (FFO) to debt of 40%-45% (after 42% in 2022).
- We therefore raised our long-term issuer credit and issue ratings on Lufthansa and its senior unsecured debt to 'BB+' from 'BB' and our issue rating on its junior subordinated debt to 'B+' from 'B'. We affirmed the 'B' short-term issuer credit rating on Lufthansa.
- The positive outlook reflects at least a one-in-three likelihood that we may raise our ratings on Lufthansa in the next 12 months.

PRIMARY CREDIT ANALYST

Aliaksandra Vashkevich
Frankfurt
+ 49 693 399 9178
Aliaksandra.Vashkevich@spglobal.com

SECONDARY CONTACT

Izabela Listowska
Frankfurt
+ 49 693 399 9127
izabela.listowska@spglobal.com

Rating Action Rationale

We expect demand for Lufthansa's flights in 2023 to increase to up to 85% of pre-pandemic levels from 70% in 2022, based on revenue-passenger-kilometers (RPKs). This is at the higher end of our previous forecast of 75%-85% of 2019 levels (published in November 2022) and reflects the ongoing pick-up in air travel demand--so far largely inelastic to cost-of-living inflation and rising interest rates. According to the International Air Travel Association, in February this year, total global air passenger traffic (measured in RPKs) reached 84.9% of February 2019 levels and rose 55.5% compared with February 2022. This furthers the strong start of the year, when RPKs stood at 84.2% of January 2019 levels, marking 67% year-on-year growth. We think that this positive momentum will likely continue with increased contribution from the resilient demand for leisure destinations; business travel is picking up but still significantly lags the pre-pandemic levels, having stayed below 70% of pre-pandemic passenger numbers at end-2022. At the same time, capacity constraints at Lufthansa's German hubs (due to labor shortages) limit upside potential in air traffic volumes beyond our 2023 base-case projection. As these bottlenecks are gradually resolved and Lufthansa deploys more aircrafts, we expect its RPK in 2024 to approach its pre-pandemic levels.

We assume Lufthansa's 2023 revenue will surpass the €36.4 billion achieved in 2019, despite our forecast of RPK still below the pre-pandemic base. This follows an increase to €32.8 billion in 2022 from €16.8 billion in 2021 and reflects our expectation of an average air passenger yield above the already elevated level the previous year. In 2022, the average yield rose about 19.6% year on year and exceeded the pre-pandemic levels by about 15.6%. That said, it increased significantly toward the second half of the year, when pandemic-related restrictions weighed on air passenger travel less than during the first quarter. We also think that the positive yield momentum will benefit from the rising demand for premium leisure travel, particularly considering that Lufthansa's major hubs are in wealthy catchment areas, such as Germany and Switzerland. Our forecast hinges on steady air travel recovery and rational capacity deployment, underpinning the ability and willingness of the sector to pass through cost inflation to passengers through higher air fares, which are consistently above pre-pandemic levels.

We think high passenger yields will largely absorb cost-base inflation and high jet fuel prices, as capacity is ramping up. This should translate into adjusted EBITDA of up to €4.5 billion in 2023--compared with €3.7 billion in 2022 and our previous forecast of largely flat EBITDA year on year--and is just slightly shy of the €4.7 billion reported in 2019. We think that earnings recovery in 2023 will be increasingly carried by Lufthansa's passenger airline businesses, underpinned by the contribution from the non-passenger segment: maintenance repair and overhaul (MRO) and logistics (cargo freight), which we still expect to contribute more than it did before the pandemic. Still, we expect EBIT from cargo to drop significantly in 2023 and thereafter from the record-high of €1.6 billion in 2022 (segment's EBIT in 2019 dipped to negative €33 million from €263 million in 2018). This is because air freight rates are moderating, trailing decongestion in marine infrastructure, normalization in ocean freight rates and expansion in airline belly capacity (especially with the reopening of China, a key cargo market, at the start of this year). Nevertheless, in 2024, despite the anticipated ongoing decline of cargo's earnings, we expect Lufthansa's EBITDA, as adjusted by S&P Global Ratings, will surpass our 2023 forecasts, based on our assumption of steady recovery in demand for air travel.

According to our expectations, EBITDA in 2023 should underpin positive FOCF (after leases). In 2022, Lufthansa's FOCF (after leases), as adjusted by S&P Global Ratings, turned positive to €1.7 billion after a significantly negative value in 2021. This was due to about €1.7 billion working capital inflow pertaining to strong customer bookings and prepayments, underpinned by the record-high fares and generally more efficient working capital management, alongside the overall improvements in operating performance. Although it is difficult to precisely anticipate working capital swings, we expect them to remain positive, even if somewhat lower than in 2022. This, paired with an anticipated expansion in Lufthansa's EBITDA, should bolster operating cash flow to sufficiently cover an increase in net capital expenditure (capex) to €2.5 billion-€3.0 billion in 2023 from €2.3 billion in 2022.

After last year's significant decline in adjusted debt, we expect debt levels will remain largely stable, or increase slightly, in 2023. Adjusted debt at year-end 2022 stood near €7.2 billion, down from €12.4 billion at year-end 2021 and €10.8 billion before the pandemic. The decline stemmed from:

- Positive FOCF being used for debt reduction Lufthansa's financial debt (excluding leasing liabilities) declined by about €1.6 billion from the €14.3 billion reported at year-end 2021. That said, this is still significantly above the €7.2 billion reported at year-end 2019.
- A material reduction in our pension adjustment, which dropped to just €374 million from €3.6 billion in 2021 and €4.3 billion in 2019, largely due to the increased benchmark interest rate. Our adjustment represents the difference between the most recent estimated cumulated net plan assets and net plan liabilities under defined benefit schemes after tax.

We think that the higher net capex in 2023--largely, due to delays in the delivery of new aircraft in 2022--will constrain further deleveraging. We do not include potential proceeds from planned, but not yet contracted, disposals in our base case. In March 2023 Lufthansa ordered 22 new Airbus and Boeing wide-body aircrafts, with deliveries expected after 2025.

That said, we do not rule out the possibility of deleveraging help from recoveries in EBITDA and profitability. This could also help Lufthansa strengthen its credit measures, and increase financial flexibility for potential swings in operational performance and unforeseen setbacks. Under our base case, Lufthansa will maintain adjusted FFO to debt of 40%-45% in 2023-2024, compared with about 42% in 2022. This is close to our guideline of above 45% for the higher 'BBB-' rating. The consistent recovery of EBITDA margins to at least 15%, further structural debt reduction, stronger credit measures than in our current base case, and the resulting increased financial flexibility in the context of the highly volatile industry, in our view, are possible and critical for an upgrade.

Outlook

The positive outlook on Lufthansa reflects at least a one-in-three likelihood of an upgrade in the next 12 months.

Upside scenario

We could raise our ratings if Lufthansa improves adjusted FFO to debt to above 45% on a sustainable basis or recovers its profitability, such that its adjusted EBITDA margin increases to at least 15% (from 11.4% in 2022), the level commensurate with our satisfactory assessment of its business risk profile. This could occur if the recovery in air passenger demand continues despite sluggish economic growth and inflationary pressures, and if Lufthansa's proactive yield management curbs inflationary pressure on its cost base, while the company continues to prioritize deleveraging. Additionally, an upgrade, may follow if Lufthansa used potential cash proceeds from planned disposals of its business for leverage reduction, enabling an improvement in FFO to debt above 45%.

Downside scenario

We could revise the outlook to stable if we believe that adjusted FFO to debt will remain consistently between 30% and 45%, or Lufthansa is unable to improve its EBITDA margin to at least 15%, for example, because the strong recovery in leisure travel year to date loses steam or air passenger yields weaken. This may lead us to negatively reassessing its business risk profile to fair from the current satisfactory assessment.

Company Description

Lufthansa is the fourth-largest airline in the world, with operations out of main hubs in Frankfurt, Munich, Zurich, Vienna, and Brussels under the brands of Lufthansa German Airlines, SWISS, Austrian Airlines, and Brussels Airlines. In addition, the group's passenger business encompasses the point-to-point airlines within the Eurowings Group. Typically, Lufthansa generates 75%-80% of its EBIT from its passenger airline businesses, while its non-passenger business segments--such as MRO, airfreight, and catering--account for the remaining 20%-25%.

Lufthansa is one of the largest global network carriers and one of two leading airline groups in Europe. It also has a No. 1 market position in Germany, and its regional brands are well established. Furthermore, Lufthansa maintains dominant market shares at its Frankfurt, Munich, Zurich, and Vienna hubs, notwithstanding fierce competition, while its wealthy catchment area (Germany and Switzerland, in particular) typically generates solid demand for travel.

Before the pandemic, the share of flights outside Europe for Lufthansa's Network Airlines accounted for about 70% as measured by RPK, of which half came from long-haul intercontinental flights to and from the Americas (mainly the U.S.).

Our Base-Case Scenario

Assumptions

- Lufthansa's RPK recovers to up to 85% of 2019 levels in 2022, compared with 70% in 2022 and just 30% in 2021, and approaches pre-pandemic levels in 2024. Demand for leisure travel, in particular, to drive the recovery in passenger volumes, with business traffic still lagging in terms of passenger volumes. Deployed capacity (available seat kilometers) will just slightly exceed passenger numbers. In 2023, we expect it to be constrained by significant staff shortages at Lufthansa's German hubs and potential delays in aircraft deliveries. Although we expect these issues to somewhat ease, but not completely disappear, in 2024.
- Revenue recovers to significantly above the pre-pandemic level of €36.4 billion in 2023, after €32.8 billion in 2022 and €16.8 billion in 2021, especially due to resilient leisure travel demand and air fares staying above the pre-pandemic levels. Lufthansa's revenue to increase further 2024, as the air passenger traffic approaches its pre-pandemic levels. We also think that Lufthansa will continue to proactively manage its yields in a way that largely absorbs jet fuel volatility and cost inflation.
- Fuel bill increasing to about €8.0 billion or slightly above, after €7.6 billion in 2022 compared with just €2.4 billion paid in 2021, as capacity increases and jet fuel prices remain elevated. We link our forecast to S&P Global Ratings' oil price assumptions of $90 per barrel (/bbl) in 2023 and $80/bbl in 2024. Our forecast also considers the recent fuel hedging positions with 76% of planned Brent crude oil consumption hedged in 2023 and 52% crack hedge ratio. We expect that Lufthansa will implement its hedging for 2024 guiding by the maximum hedge target ratio of 85% restored after the pandemic and in the context of major European competitors' hedging strategies.
- S&P Global Ratings-adjusted EBITDA increases to close to €4.5 billion in 2023 after €3.7 billion in 2022 and just break-even in 2021. We expect declining (albeit still elevated) EBITDA from the logistics/cargo segment and overall cost inflation to be absorbed by continuing air passenger

traffic growth and strong yields. In 2024, we expect EBITDA to increase further.

- Net capex forecast of €2.5 billion-€3.0 billion in 2023 and 2024, each, after €2.3 billion in 2022, following two years of low capex, with €1.3 billion in 2021 and €1.2 billion in 2020.
- Reintroduction of ordinary dividends with the payout ratio of 20%-40%, based on the previous year net income, with the first dividend payment expected in 2024.
- In 2023 and 2024 we carry forward the pension deficit adjustment of €374 million from 2022.
- We do not factor potential proceeds from the sale of the remaining part of the catering business (LSG Group) to Aurelius, which has been recently announced and is expected to close by the third quarter of this year, subject to various approvals. That said, we do not expect the transaction to have a material impact on our current base case. Likewise, the potential cash outflow for the planned acquisition of minority stake in ITA is not part of our base case.

Key metrics

- Adjusted FFO to debt improving to 40%-45% in 2023 and 2024, compared with about 42% in 2022 and a negative figure in 2021.
- Adjusted FOCF after leases in 2023 and 2024 likely declining from €1.7 billion generated in 2022, but remaining positive. That said, the extent of the decline hinges on working capital movements, which are currently difficult to predict.

Liquidity

We regard Lufthansa's liquidity profile as strong, versus adequate previously. The improvement stems from the airline's ample cash position and availability under its revolving credit facility (RCF), with the minimum liquid funds ratio raised by the group to €8 billion-€10 billion from the previous target of €6 billion-€8 billion. This should more than offset Lufthansa's short-term debt maturities. Our assessment is underpinned by Lufthansa's prudent risk management and sources covering uses even if EBITDA declines 50% under a stress scenario. In our base case, liquidity sources exceed uses by more than 2.0x in the 12 months started Jan. 1, 2023, and more than 1.5x in the ensuing 12 months.

Our estimate of Lufthansa's principal liquidity sources for 2023 comprises:

- Nonrestricted cash, cash equivalents, and liquid securities of €8.3 billion;
- Available funds under the committed RCF maturing beyond 12 months of about €2.1 billion; and
- Our FFO projection of €2.5 billion-€3.0 billion.

Our estimate of principal liquidity uses for the same period comprises:

- Short-term financial debt of about €1.4 billion;
- Intra-year working capital outflows of €1.5 billion; and
- Net capex of €2.5 billion-€3.0 billion.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-4, G-2

Social factors are a negative consideration in our credit rating analysis. This reflects the correlation of air passenger traffic and Lufthansa's operating performance with health and safety risk. In general, Lufthansa was hard hit by the pandemic, a health and safety risk, and we lowered its rating by four notches. Following the lift of pandemic-related travel restrictions it has been seeing a significant recovery in domestic and European short-haul leisure, in particular, while business and some international flying is taking longer to return. In 2022, demand for Lufthansa's flights (as measured in RPKs) recovered to about 70% of 2019 levels from just 30% in 2021. In 2023, we expect the recovery to continue, but still forecast RPKs up to 15% below pre-pandemic levels.

Environmental factors are a moderately negative consideration, like the broader airline industry, reflecting pressures to reduce greenhouse gas emissions. Therefore, Lufthansa will continue upgrading its fleet, which is about 13.1 years old, with more fuel-efficient aircraft. This will lead to a moderate increase in capex above deflated pandemic levels, which we expect to be largely in line with the fleet's annual depreciation.

Hybrid

Our issue rating on Lufthansa's junior subordinated debt (hybrid bond) is 'B+'. This takes into account a three-notch deduction (including one for deferral risk) from the issuer credit rating.

We treat the hybrid bond as having 50% equity content. This is supported by the residual time until the effective maturity exceeding 15 years. We view February 2041 as the hybrid bond's effective maturity, when its coupon steps up above 25 basis points by further 75 basis points, representing an incentive to call.

Issue Ratings - Recovery Analysis

Key analytical factors

- Our issue rating on Lufthansa's senior unsecured debt is 'BB+'. The '3' recovery rating indicates our expectation that lenders would receive meaningful recovery (50%-70%; rounded estimate: 65%) of the principal in the event of a payment default.
- As per our criteria, we cap the recovery rating at '3' given the unsecured nature of the debt. The recovery rating benefits from the estimated residual at-default value of the company's assets after satisfying the prior ranking and secured creditors ranking ahead of the unsecured claims.
- Under our simulated default scenario, we assume a default in 2028 triggered by adverse industry conditions combined with a recession or external shock, such as a major global pandemic or terrorist attack. We expect that Lufthansa would seek to reorganize and assume it would emerge from bankruptcy as a going concern.
- We have valued the company on a discrete-asset basis. Our valuations reflect our estimate of the value of the various assets at default based on net book value for current assets and

appraisals for aircraft after adjusting for expected realizations rates in a distressed scenario.

Simulated default assumptions

- Year of default: 2028
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value: €13.7 billion
- Net enterprise value (after 5% admin. costs): €13.0 billion
- Total secured debt claims: €4.5 billion
- Total value available to unsecured claims: €8.5 billion
- Senior unsecured debt: €9.7 billion*
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

Note: All debt amounts include six months of prepetition interest. *We believe that in a distressed scenario, 85% of the outstanding RCF will be drawn.

Ratings Score Snapshot

Issuer Credit Rating	**BB+/Positive/B**
Business risk:	Satisfactory
Country risk	Low
Industry risk	High
Competitive position	Excellent
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile	bb+

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions , March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- General Criteria: Group Rating Methodology , July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments , April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings , March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers , Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments , Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers , Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions , Nov. 19, 2013
- General Criteria: Methodology: Industry Risk , Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology , Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities , Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating , Oct. 1, 2010

Related Research

- Deutsche Lufthansa AG Upgraded To 'BB' On Air Traffic Recovery And Reduced Financial Leverage; Outlook Positive, Nov. 30, 2022.

Ratings List

Upgraded; Ratings Affirmed

	To	From
Deutsche Lufthansa AG		
Issuer Credit Rating	BB+/Positive/B	BB/Positive/B
Junior Subordinated	B+	B
Senior Unsecured	BB+	BB
Recovery Rating	3(65%)	3(65%)