Research Update:

Lufthansa Rating Lowered To 'BB' On Increased Leverage; Outlook Negative

July 1, 2020

Rating Action Overview

- Lufthansa's shareholders and the European Commission have approved a €9.0 billion state aid package that we believe will significantly boost Lufthansa's liquidity but result in weaker credit metrics than commensurate with the ‘BB+’ rating, since we regard most of the state aid package as debt.

- Furthermore, we expect a steeper drop in Lufthansa's EBITDA and a higher cash flow deficit in 2020 because of a likely slower rebound in long-haul passenger traffic, expected sluggish corporate and business travel, and weakened demand for the airline's maintenance, repair, and overhaul (MRO) services.

- We are therefore lowering our ratings on Lufthansa and its senior unsecured debt to 'BB' from 'BB+' and our ratings on the junior subordinated debt to 'B-' from 'B'. The 'B' short-term issue credit rating is unchanged. We removed the ratings from CreditWatch negative, where we placed them on March 20, 2020.

- The negative outlook reflects our view that Lufthansa's financial metrics will remain under considerable pressure in the next few quarters amid the extremely difficult trading environment. Furthermore, there is still high uncertainty regarding the COVID-19 pandemic and economic recession, and their adverse impact on air traffic demand and Lufthansa's financial position and liquidity.

Rating Action Rationale

Lufthansa's shareholders and the European Commission approved the €9 billion state aid package under the Federal Economic Stabilization Fund. The stabilization package is composed of €5.7 billion in silent participation and a €3.0 billion state-guaranteed loan. The package also includes the German government acquiring a 20% stake in Lufthansa's share capital at a share price of €2.56, which is equivalent to a €300 million cash injection. After our review of the relevant legal framework agreement, we now regard the €5.7 billion silent participation as akin to debt, according to our hybrid criteria. This is because we believe that Lufthansa has a material incentive to redeem the silent participation given that the hybrid's documentation includes multiple coupon...
step-ups up until 2023. Furthermore, based on Lufthansa's public communication, we understand that the airline intends to redeem the hybrid instrument as soon as practicable. Accordingly, we now expect Lufthansa's adjusted debt to rise to as much as €18.0 billion in 2020 compared with €10.8 billion in 2019, which will result in much weaker credit measures than we previously forecast and a highly leveraged financial risk profile versus aggressive previously. In our view, certain benefits of the silent participation differentiates it from traditional debt, which we capture in our credit rating by applying one notch of uplift to the anchor to arrive at Lufthansa's stand-alone credit profile (SACP) of 'bb-'. We note that the silent participation does not have an effective maturity date and includes optionally deferrable coupon features. This provides important flexibility to the airline's capital structure.

We expect a steeper drop in Lufthansa's EBITDA and higher cash flow deficit in 2020 than in our previous base case. This is because of a likely slower rebound in the airline's long-haul passenger traffic, expected sluggish corporate and business travel, and weakened demand for its MRO services. In light of Lufthansa's plan to increase its capacity in July to only about 40% of its original schedule from just 3% in May, we expect a severely constrained summer season, which is typically the strongest in terms of revenue generation. The uncertainty of timing over lifting entry bans and quarantine requirements for countries outside the EU curbs the recovery in the high-margin long-haul passenger segment, especially for the North American destinations. Additionally, we expect the demand for MRO services, which historically contributed to close to 20% of Lufthansa’s EBITDA, to remain sluggish given the airline sector’s reduced activity globally. Although Lufthansa is taking steps to mitigate the collapse in air travel demand, we now forecast a significantly negative adjusted EBITDA this year. This, aggravated by working capital requirements, which could be material because of, for example, ticket refunds or sluggish bookings, and partly offset by deferral of capital expenditure (capex) for new planes and maintenance, and suspension of dividends, will result in negative free operation cash flow (FOCF) of €7.5 billion–€8.0 billion in 2020.

Lufthansa's depressed financial metrics for 2020 are less meaningful to our assessment of financial risk. That said we factor into our analysis expected financial results for 2020, particularly regarding the capital structure, accumulation of debt, and liquidity. Because we believe that the state aid package will substantially enhance the airline’s capacity to navigate through this difficult year, we focus mostly on expected 2021 credit ratios. This approach best reflects the airline's cash flow/leverage profile in our analytical judgment, assuming that air travel starts to recover late in 2020.

The projected recovery of credit metrics in 2021 is limited by Lufthansa's high debt and is susceptible to risks. Although we expect Lufthansa's operating performance to improve in 2021, with adjusted EBITDA rising to €2.5 billion–€3.0 billion, its ratio of funds from operations (FFO) to debt will only recover to be consistent with the higher end of our highly leveraged financial profile category from the negative territory we forecast in 2020, while we expect the airline's FOCF to break even. For these forecasts, we assume passenger traffic will start recovering later this year, and benefits from structural cost-cutting measures and lower jet fuel price will feed through. Nevertheless, low visibility on the evolution of the COVID-19 pandemic and recessionary trends mean our forecasts are subject to significant risks.

We consider Lufthansa a government-related entity. We see a moderate likelihood that Lufthansa would receive extraordinary support from the German government under a stress scenario, beyond the recently approved stabilization package. This translates into one notch of
uplift from the airline's SACP of ‘bb-’. We base our view on our assessment of Lufthansa's important role for, and limited link with, the German government.

Environmental, social, and governance (ESG) credit factors for this credit rating change:
- Health and safety

Outlook
The negative outlook reflects our view that Lufthansa's financial metrics will remain under considerable pressure in the next few quarters amid the difficult trading environment. Furthermore, there is high uncertainty regarding the COVID-19 pandemic and economic recession, and their adverse impact on air traffic demand and Lufthansa's financial position and liquidity.

Downside scenario
A downgrade would likely follow if we expect that adjusted FFO to debt won't recover to above 6% over 2021. This could occur if the COVID-19 pandemic cannot be contained, resulting in prolonged lockdowns and travel restrictions, or if passengers remain reluctant to book flights. We could also lower the rating if industry fundamentals weaken significantly and for a sustained period, impairing Lufthansa's competitive position and profitability. While we currently don't see liquidity as a near-term risk, we would lower the rating by at least one notch if air traffic does not recover in line with our expectations and management's proactive actions to adjust operating costs and capital investments are insufficient to preserve at least adequate liquidity, such that sources exceed uses by more than 1.2x in the coming 12 months, in the absence of extraordinary government support.

Upside scenario
To revise the outlook to stable, we would need to be confident that demand conditions are normalizing and the recovery is robust enough to enable Lufthansa to partly restore its financial strength, such as adjusted FFO to debt increasing sustainably to 6%-12%, alongside a stable liquidity position. We would expect this to be further underpinned by prudent financial policy.

Liquidity
Factoring in the €9 billion state aid package from the German government, we expect Lufthansa's liquidity to remain adequate, with liquidity sources exceeding uses by more than 1.2x in the 12 months started March 31, 2020. As of that date, Lufthansa and its subsidiaries had cash/cash equivalents and liquid securities of about €5.1 billion, including fully drawn credit lines. This compared with short-term debt of about €2.2 billion (including finance leases), capex needs below €2.0 billion, and negative operating cash flow after operating lease payments that we forecast at €5.0 billion-€5.5 billion, assuming large working capital requirements to--among other things--potentially cover a portion of outstanding liabilities from unused flight documents that amounted to €4.49 billion as of March 31, 2020.

Lufthansa has no maintenance financial covenants in the documentation for its outstanding debt.
Issue Ratings--Recovery Analysis

Key analytical factors

- Our issue rating on Lufthansa's senior unsecured debt is 'BB'. The recovery rating remains at '3' indicating 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 prior ranking debt and secured creditors ranking ahead of the unsecured claims.

- Our simulated default scenario assumes a default in 2025 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.

Simplified waterfall

- Gross enterprise value: €13.1 billion
- Net enterprise value (after 5% admin. costs): €12.4 billion
- Total secured debt claims (including priority liabilities): €6.0 billion
- Total value available to unsecured claims: €6.4 billion
- Senior unsecured debt: €2.1 billion
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

Notes: All debt amounts include six months of prepetition interest.

Hybrid Debt

Our issue rating on Lufthansa's junior subordinated debt (hybrid bond) is now 'B-'. This takes into account a three-notch deduction (including one for deferral risk) from the SACP. We are notching down from the SACP instead of from the issuer credit rating, since we view the potential government support as unlikely to apply to the hybrid.

Ratings Score Snapshot

Issuer Credit Rating: BB/Negative/B
Business risk: Satisfactory
- Country risk: Low
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- Industry risk: High
- Competitive position: Excellent

Financial risk:
- Cash flow/Leverage: Highly leveraged

Anchor: b+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bb-
- Sovereign rating: AAA
- Likelihood of government support: Moderate (+1 notch)

Related Criteria
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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 | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
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- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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<tr>
<td>Issuer Credit Rating</td>
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<td>BB+/Watch Neg/B</td>
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<td>BB</td>
<td>BB+ /Watch Neg</td>
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<tr>
<td>Recovery Rating</td>
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.
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