Research Update:

Lufthansa Downgraded To 'BB-' From 'BB' On Lower Air Traffic; Outlook Negative

November 19, 2020

Rating Action Overview

- We expect the recovery of global air traffic and business/corporate travel, in particular, will be slower than previously projected due to renewed travel restrictions in response to a spike in COVID-19 cases and increased substitution of face-to-face meetings with virtual gatherings.
- Deutsche Lufthansa AG (Lufthansa) continues to counter the plunge in its revenues by adjusting capacity, containing costs and capital investments, and safeguarding its liquidity position, but these measures will only partly offset the steep decline of up to 80% in air passenger traffic in 2020 (and up to 55% in 2021 versus 2019) and likely significant redundancy payments (subject to negotiations with unions). These developments result in a sharper-than-anticipated deterioration in Lufthansa's EBITDA and credit metrics under our revised base case.
- We are therefore lowering our ratings on Lufthansa and its senior unsecured debt to 'BB-' from 'BB', and our rating on the junior subordinated debt to 'CCC+' from 'B-'. We affirmed the short-term issuer credit rating at 'B'.
- The negative outlook reflects our view of persisting material uncertainties about the recovery of Lufthansa's financial metrics and risks of further weakening due to potentially slower-than-expected demand recovery for air passenger travel and insufficient cost-cuttings. We also consider the high uncertainty regarding the COVID-19-related impact on the economy, air traffic demand, and Lufthansa's financial position and liquidity.

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Rating Action Rationale

Air passenger demand and consumer confidence look bleak. There is considerable uncertainty regarding the overall outlook for air travel following a spike in COVID-19 cases and the resulting new round of lockdowns and travel restrictions. We now project that 2020 traffic as measured by revenue passenger kilometers (RPKs) and revenue are likely to be 65%-80% lower than in 2019, versus our previous estimate of 60%-70% lower. We see a weak recovery in 2021, with traffic and revenue still 40%-60% lower than in 2019 (compared with our previous estimate of 30%-40% lower). We also think the subdued demand will carry into 2022, leading us to forecast RPK and revenue 20%-30% lower than in 2019 (compared with 15%-20% previously). Our current estimates incorporate the recent consensus among health experts that a COVID-19 vaccine could be widely available by mid-2021.

Lufthansa cut its flight schedule in response to gloomy demand prospects for the next few quarters. The group lowered its planned capacity (available seat kilometres [ASK]) guidance for fourth-quarter 2020 to a maximum of 25% of its 2019 ASK, from 50%-55% in early June, resulting in a full-year ASK of at most 30% of 2019 levels. Since the onset of the pandemic, the group's load factors are well below the about 83% recorded in 2019, and we factor into our revised base case that its 2020 passenger numbers will likely be more depressed than we previously forecast. We note Lufthansa's strengthened performance between June and July following a nearly complete halt of air traffic in April-May. Although demand for long-haul flights has remained muted, improved demand for short-haul leisure travel across Europe translated to load factors of more than 65% in June and close to 70% in July. Since September, however, recovery has been side-lined by renewed travel restrictions. Traffic conditions are likely to be bumpy for at least the next few quarters, as local travel constraints, quarantine policies, and COVID-19 testing rules evolve. Furthermore, we anticipate a delayed and sluggish recovery of international long-haul bookings, for example to North America, as well as business and corporate traffic, which are typically Lufthansa's most profitable segments.

Lufthansa will report a marked OCF deficit and accumulate new debt in 2020. We therefore believe the group's credit metrics will continue to be under considerable pressure over the coming few quarters. We note that Lufthansa is cutting costs, executing operating-efficiency initiatives, and drastically reducing capacity, among other measures, and should benefit from a lower fuel bill (forecast by S&P Global Ratings at €2.5 billion-€2.7 billion in 2020 versus €6.7 billion in 2019). But we think the company will fall short of compensating for the collapse in revenue in 2020. Our fuel-cost forecast includes losses from ineffective fuel hedges (€764 million in the first nine months of 2020), which we treat as operating expenses and that were caused by lower fuel prices, and an over-hedged fuel position after a significant cut in capacity. Based on negative EBITDA (after exceptional items) of about €3 billion reported for the first nine months of 2020, we estimate that Lufthansa's adjusted EBITDA might deteriorate to between negative €3.6 billion and negative €3.8 billion this year, compared with a strong €4.7 billion in 2019. This dip, aggravated by working capital needs because of ticket refunds (€3.0 billion refunded in the first nine months of 2020 to bring the liability from unused flight documents down to a still significant €2.7 billion, which, however, includes only a small amount of open or unpaid refunds) and sluggish forward bookings, will result in materially negative OCF this year. We view positively the group's delays or cuts to capital expenditure (capex) for new planes and other discretionary projects (total spending to €1.3 billion in 2020 and up to €1.3 billion in 2021, from up to €3 billion annually scheduled before the pandemic) to restrain cash burn. Still, we forecast that Lufthansa's S&P Global Ratings-adjusted debt will rise significantly to about €15.0 billion by end-2020 (at constant pension liability versus end-2019) from about €10.8 billion in 2019.

We project that a COVID-19 vaccine, if widely available by mid-2021, could help to restore air traffic demand and contribute to the group's financial recovery in 2021. We envisage Lufthansa's operating performance improving in 2021, albeit at a slower pace than we projected in June. This is because of a more severe decline in air traffic volumes than we previously forecast, aggravated by the likely large redundancy payments due to the envisaged drastic cutbacks in the airline's global workforce. We now anticipate Lufthansa's EBITDA, as adjusted by S&P Global Ratings, will rebound in 2021 but remain significantly below the €2.5 billion-€3.0 billion we projected previously. In our base case we assume a substantial recovery in air traffic in second-half 2021, underpinned by our current view that an effective vaccine for COVID-19 will become widely available by the middle of next year, easing or lifting of travel restrictions and restoring passenger confidence in air travel. Our revised base case indicates a weaker recovery in the group's credit metrics. We no longer think that adjusted FFO to debt will recover to above 6% in 2021 (versus our earlier forecasts of 6%-12%). Furthermore, low visibility regarding the pandemic's duration, as well as recessionary trends and their impact on passenger volumes, add a significant degree of uncertainty to our base case.

The €9 billion state aid package under the Federal Economic Stabilization Fund strengthened Lufthansa's capital structure and liquidity position. The stabilization package comprised €5.7 billion in silent participation and a €3.0 billion state-guaranteed loans. The package also included a 20% stake in Lufthansa's share capital by the German government that was acquired for €306 million cash (at a share price of €2.56) in third-quarter 2020. We regard the €5.7 billion silent participation as akin to debt. This is because we believe that Lufthansa has a material and strong incentive to redeem the silent participation given that the hybrid's documentation includes multiple coupon step-ups until 2027. Furthermore, based on Lufthansa's public communication, we understand that the airline intends to redeem the hybrid instrument as soon as practical. In our view, certain benefits of silent participation, such as no effective maturity date and optionally deferrable coupon features, differentiate it from traditional debt and provide important flexibility to Lufthansa's capital structure. This comparative strength, however, is now offset by our view that the group's actual and forecasted credit metrics are at the weaker end of the highly leveraged financial profile range, combined with our assessment of the business profile remaining at the lower end of satisfactory range because of depressed profitability. Therefore, we removed the one-notch uplift to the anchor to arrive at Lufthansa's stand-alone credit profile (SACP) of 'b+'.

The sizable government support package abated near-term liquidity concerns. As of Sept. 30, 2020, the group's total liquidity was €10.5 billion, comprising €4.2 billion of cash, cash equivalents, and liquid securities, as well as €6.3 billion of available funds under the €9.0 billion state aid package under the Federal Economic Stabilization Fund. Liquidity was further augmented by €600 million in cash from the convertible bond issue completed in November 2020, to a pro forma total liquidity position of about €11.1 billion. Moreover, we acknowledge Lufthansa's determination and flexibility to defer capex for new planes and suspend dividends, with a focus on preserving cash and restoring its credit measures.

Our view of Lufthansa as a government-related entity supports the group's creditworthiness. We see a moderate likelihood that, beyond the stabilization package, Lufthansa would receive extraordinary support from the German government under a stress scenario. 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 extremely difficult trading environment. Furthermore, there is elevated uncertainty regarding the COVID-19 pandemic and economic recession, and the repercussions for air traffic demand and Lufthansa's financial position and liquidity.

Downside scenario

We could lower the rating over the next 12 months if we believe the recovery will be more prolonged or weaker than expected, resulting in continued high cash flow burn, thus leading to very weak or even negative FFO generation in 2021. This could occur if COVID-19 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 prolonged 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

A stable outlook would hinge on greater visibility on more normal demand conditions and that the recovery is robust enough to enable Lufthansa to partly restore its financial strength, such as adjusted FFO to debt recovering to at least 6% over 2021, alongside a stable liquidity position.

Company Description

Lufthansa carried around 145 million passengers in 2019, making it the fourth-largest airline in the world. The airline operates out of its main hubs in Frankfurt, Munich, Zurich, and Vienna under the brands of Lufthansa German Airlines, SWISS, and Austrian 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 nonpassenger 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 its 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.

Our Base-Case Scenario

Assumptions

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Our current base-case scenario for Lufthansa factors in the following:

- Global air passenger traffic falling by up to 80% in 2020 versus 2019; and passenger volumes being 40%-60% lower in 2021 and 20%-30% lower in 2022 as compared with the 2019 base, then recovering very gradually to pre-pandemic levels by 2024.
- Lufthansa's revenue passenger kilometers (RPK; a measure of passenger demand) declining by 75%-80% in 2020 versus 2019 and recovering in 2021 from a very low level but staying 55%-60% below the 2019 base. Capacity (available seat kilometers; ASK) will decrease less than passenger numbers, because it is difficult for Lufthansa to align flights with the lower traffic levels while maintaining a viable flight schedule. We forecast ASK to decline 70% in 2020 versus 2019, which is in line with the group's guidance, and 45%-50% in 2021 versus 2019. We expect the European domestic and short-haul bookings will recover faster while intercontinental and corporate traffic--both very important for restoring the group's profitability--are likely to take some time to reopen, given severe border restrictions.
- Revenue dropping by about 65% in 2020 to €12.0 billion-€13.0 billion, supported by solid growth in cargo revenue expected to reach €2.0 billion-€2.5 billion in 2020, and recovering to as much as €18.0 billion-€19.0 billion in 2021, trailing the evolution of passenger traffic at low-single digit annual drop in ticket fares due to expected competitive pressures and overcapacity on European short-haul routes, in particular.
- A significantly lower fuel bill for Lufthansa in 2020-2021, compared with 2019, even if we incorporate an ineffective fuel-hedging loss of €1 billion in 2020 (€764 million in the first nine months of 2020), as forecast by S&P Global Ratings. We link our forecast to S&P Global Ratings' oil price assumptions of $50 per barrel (/bbl) in 2021 and $50/bbl in 2022, Lufthansa's hedged position, and our ASK forecast.
- The revenue shortfall only being partly offset by cost-containment measures and lower jet fuel costs. We estimate that adjusted EBITDA will be significantly negative in 2020, then recover in 2021 but remain significantly below the €2.5 billion-€3.0 billion we projected in our June review. We assume a vaccine or effective treatment could be widely available and passenger demand recovers strongly from about mid-2021, which will be to some extent offset by the potentially large redundancy payments.
- A significant reduction in capex somewhat mitigating the working capital requirements, which could be material because of possibly cautious forward bookings or continued ticket refunds. We assume €1.3 billion in capex in 2020 compares with about €3.7 billion spent in 2019. We assume up to €1.3 billion in capex in 2021.
- No dividends in 2020 and 2021.

Liquidity

In our view, Lufthansa has adequate liquidity thanks to the significant state aid package. We factor in the €9 billion state aid package and November-convertible bond issue of €600 million, as well as the expected significantly negative free operating cash flow (OCF after capex and lease payments) in 2020. In our base case, liquidity sources exceed uses by about 2.0x in the 12 months started Sept. 30, 2020, and above 1.5x in the following 12 months.

Our estimate of Lufthansa's principal liquidity sources for the 12 months started Sept. 30, 2020, comprise:

- Cash, cash equivalents, and liquid securities of €4.2 billion;
- Available funds under the committed state aid package of €6.3 billion; and
- Cash proceeds of €600 million from the convertible bond issue completed in November 2020.

Principal liquidity uses for the same period consist of:

- Short-term debt of about €2.5 billion, excluding the €500 million hybrid bond, which has an optional call in 2021, but not a mandatory maturity;
- Our projection of negative FFO of up to €1 billion;
- Working capital use of up to €1.0 billion, according to our base case, pertaining to our assumption of, for example, potential refunds under the outstanding liabilities from unused flight documents that amounted to €2.7 billion as of end-September (of which open or unpaid refunds accounted for only a small amount) and subdued forward bookings;
- Capex of up to €1.3 billion; and
- No shareholder remuneration because we do not anticipate distributions in a stress scenario.

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 debt. The recovery rating benefit 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 2024 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: €13.2 billion
- Net enterprise value (after 5% admin. costs): €12.5 billion
- Total secured debt claims: €5.4 billion

- Total value available to unsecured claims: €7.1 billion
- Senior unsecured debt: €5.1 billion
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

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

Hybrid debt

Our issue rating on Lufthansa's junior subordinated debt (hybrid bond) is 'CCC+'. 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

Deutsche Lufthansa AG

Issuer Credit Rating:	BB-/Negative/B
Business risk:	Satisfactory
Country risk:	Low
Industry risk:	High
Competitive position:	Excellent
Financial risk:	Highly leveraged
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:	Neutral (no impact)
Stand-alone credit profile:	b+
Sovereign rating:	AAA
Likelihood of government support:	Moderate (+1 notch)

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 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

- Lufthansa Rating Lowered To 'BB' On Increased Leverage; Outlook Negative, July 1, 2020

Ratings List

Downgraded; Short-Term Rating Affirmed

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

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