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Research Update:

Lufthansa Upgraded To 'BBB/A-2' On Solid Financial Performance; Outlook Stable

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Rating Action Overview

- German airline Lufthansa continues to report strong operating performance, despite various operational headwinds and competitive challenges over the past two years.
- We believe Lufthansa will stabilize EBITDA at €4.5 billion-€5.0 billion, sustain its reduced net debt position, and generate sufficient free operating cash flow (FOCF) to improve its resilience against the next potential industry downturn, while keeping adjusted funds from operations (FFO) to debt above our 30% threshold for a 'BBB' rating.
- We are raising our issuer credit ratings on Lufthansa to 'BBB/A-2' from 'BBB-/A-3', our senior unsecured issue rating to 'BBB' from 'BBB-', and our junior subordinated issue rating to 'BB+' from 'BB'.
- The stable outlook reflects our view that Lufthansa will benefit from consistent passenger traffic growth, make capacity adjustments and nonfuel cost savings, and financially turn around Eurowings to counterbalance lower yields and higher fuel expenses.

Rating Action Rationale

We upgraded Lufthansa because of its continued strong operating performance, despite various operational headwinds and competitive challenges over the past two years. Lufthansa's solid reported EBITDA of about €5 billion in 2018 matches its highest EBITDA on record in 2017, resulting in credit metrics that are commensurate with our BBB rating.

Moreover, the airline was able to counterbalance the impact of higher fuel costs, nonrecurring expenses to integrate parts of former Air Berlin, the cost burden from irregularities and disruptions in flight operations, and overcapacity in the European short-haul network, thanks to its profitable growth (underpinned by solid demand for air travel), strongly performing long-haul network, and structural cost efficiencies.

Given Lufthansa's solid financial performance, our adjusted ratio of FFO to debt reached about 46% in 2018, compared with 47% in 2017, enhancing the airline's financial flexibility to tackle the next potential industry downturn.

Although the airline industry is tied to cyclical demand and supply conditions, and Lufthansa may not always be able to achieve the EBITDA generation it posted in 2017 and 2018, we believe that the company has the capacity to stabilize its EBITDA strength into lasting value of at least €4.5 billion-€5.0 billion in 2019-2020. In this way, Lufthansa will generate sufficient FOCF to fund capital expenditure (capex), including purchasing new planes, and maintain its reported net debt position at an average of €3.5 billion over 2019-2020. Such a financial performance should provide ample financial leeway for future external growth and accommodate potential fluctuations in pension liabilities, while allowing the airline to operate above our adjusted FFO-to-debt threshold for a 'BBB' rating of 30% over the next two years.

Our upgrade also takes into account the company's ability to continue lowering unit cost, as a measure to support its competitive position and help counterbalance industry volatility. This while protecting its strategic position in the profitable premium traffic and typically less-cyclical nonpassenger businesses: notably maintenance, repair, and overhaul (MRO), and catering.

Furthermore, given the inherent volatility of the airline industry and associated swings in earnings and cash flow, we consider that maintaining a continued prudent financial policy is a key credit factor. We believe that Lufthansa's financial discipline will support consistent and rating-commensurate financial leverage under normal operating and financial conditions. This means that the company will unlikely embark on any significant debt-financed external expansion and hold on to predictable shareholder distributions.

The company's policy is to ensure the adjusted net debt-to-EBITDA ratio remains below 3.5x (1.8x achieved in 2018) and a dividend payout of 10%-25% of EBIT while it continues to evaluate growth opportunities. This compares to our base case of adjusted debt to EBITDA for the company of below 2x over the next two years, incorporating our assumption for regular and annual dividend distribution, and the leverage guideline for the 'BBB' rating of below 3x. Accordingly, our forecast points to ample debt capacity headroom under the rating.

We forecast that Lufthansa's core credit measures, namely FFO to debt and debt to EBITDA, will continue performing better than our current intermediate financial profile assessment. That said, we expect that the airline's consistently high capex (8%-10% of revenue) over the next few years to modernize its aircraft fleet, which is essential to remain competitive, will weigh on its cash flow (as reflected in a relatively weak weighted-average ratio of adjusted FOCF to debt of 10%-11% in 2019-2020) and its overall creditworthiness.

We continue to view Lufthansa's sizable (albeit structurally and significantly reduced in 2017) and volatile debt-like pension obligation, which makes up a substantial portion (about 35% at end-2018) of its total adjusted debt, as one of its main credit weakness. This is because an increase in net pension liabilities (if key assumptions around pension scheme change) would weigh on Lufthansa's financial leverage ratios. We understand that a 50-basis point change in the discount rate would equate to a net pension provision movement of about €1.8 billion as of Dec. 31, 2018. However, this assumes no change in the value of plan assets and/or inflation assumptions. We also acknowledge that the increase in the adjusted accounting pension provisions has no immediate material negative impact on the company's liquidity and cash flows, given the long-term nature of the obligations.

We view positively Lufthansa's proactive measures to lower the pension liability and the exposure to benchmark interest rates, and bolster the stability of its ratios. They included agreements with cabin crew and pilots on amendments to their pension arrangement realized in 2016-2017. These measures and the favorable performance of plan assets resulted in the company's pension deficit falling significantly to about €5.09 billion on Dec. 31, 2017, from about €8.35 billion a year earlier. This is marginally constrained by a fall in the long-term German- and corporate bond yields, which the company uses to measure its pension deficit under International Financial Reporting

Standards (IFRS).

Lufthansa enjoys an excellent competitive position based on the leading positions it has at its main hubs in Frankfurt, Munich, Zurich, and Vienna, the continued strong demand from its economically strong outbound markets, the diversity in its operations, and its good exposure to high-yield premium traffic. Our view is somewhat tempered by the fundamental characteristics of the airline industry, such as Lufthansa's susceptibility to European and global economic cycles, oil price fluctuations, high capital intensity, and unforeseen geopolitical and security events, including global terrorism and disease outbreaks.

Good geographic diversification reduces Lufthansa's dependency on local economies and forms a buffer against localized event risks. Furthermore, the airline's leading market position in aircraft MRO as well as catering adds stability to group earnings through the lower and different-stage cyclicality of these operations. Lufthansa's cost position is a competitive disadvantage, however, which could lead to changes in our analysis if the company's positive trend in lowering its unit cost is interrupted.

Outlook

The stable outlook reflects our view that Lufthansa will be able to maintain adjusted FFO to debt of more than 30% in 2019-2020. This is based on our expectation that 2019 and 2020 will likely be solid years for the airline's EBITDA thanks to consistent passenger traffic growth, timely capacity adjustments and nonfuel cost savings, and the financial turnaround of Eurowings. These will counterbalance the burden from lower yields and higher fuel expenses, in our view. Accordingly, we consider that the company will realize a sustained benefit from ongoing strategic and efficiency initiatives, while gradually reducing its unit cost and thereby protecting its profitability and business profile.

Downside scenario

We would lower the rating if Lufthansa's earnings weakened, such that the ratio of adjusted FFO to debt deteriorated to less than 30%, with limited prospects of improvement in the next 12 to 18 months. This could occur due to, for example, lower growth in passenger volumes than we anticipate, a greater fall in ticket fares than in our base case, or a larger surge in fuel prices beyond what we factor into our forecast, which Lufthansa was unable to pass on via higher ticket fares or counterbalance by cost savings. A downgrade would also be likely if we noted any deviations in terms of financial policy decisions that would prevent credit measures remaining consistent with the 'BBB' rating.

Upside scenario

Although unlikely in the next 12 months, we could raise the rating if we considered that Lufthansa would achieve and keep its reported EBITDA in excess of €5.5 billion (excluding the impact of IFRS 16). Such an improvement could stem from a combination of structurally improved competitive environment allowing for more timely and efficient pass through of fuel price inflation through higher ticket fares and continuing cost-cutting by Lufthansa. This earnings performance would need to be complemented by the airline's solid FOCF generation and reduced debt, such that adjusted FFO to debt improved and consistently stayed well above 50%. Furthermore, an upgrade would hinge on Lufthansa's commitment to aligning its financial policy to ensure that such a ratio is sustainable.

Company Description

Lufthansa carried around 142 million passengers in 2018 and was the fourth-largest airline in the world by number of passengers carried. The airline has a fleet of 763 aircraft and operates out of its main hubs in Frankfurt, Munich, Zurich, and Vienna under the brands of Lufthansa German Airlines, SWISS, and Austrian Airlines. Besides these network airlines, the passenger business encompasses the point-to-point airlines within the Eurowings Group. Typically, Lufthansa generates 70%-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%-30%.

Lufthansa is one of the largest global network carriers and one of two leading airline groups in Europe. It also has a leading domestic 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) generates solid demand for travel. The company also offers one of the world's largest route networks and has balanced exposure to high-yielding, premium, long-haul traffic across its route portfolio.

Our Base-Case Scenario

In our base-case scenario, we assume:

- Global air traffic remaining strong and expanding at rates in excess of our forecast long-term average of around 5% as well as global GDP growth of 3.4% in 2019 and 3.6% in 2020 (from 3.7% in 2018). This solid expansion is being fueled by good, albeit moderating, overall economic conditions, the long-term growth of the global middle class--particularly in Asia--and low fares from the proliferation of low-cost airlines.
- GDP growth of all major contributors to worldwide passenger volumes, including the eurozone at 1.1% in 2019 and 1.4% in 2020 (from 1.8% in 2018); the U.S. at 2.2% in 2019 and 1.7% in 2020 (from 2.9% in 2018); China at 6.2% in 2019 and 6.2% in 2020 (from 6.6% in 2018); Asia-Pacific at 5.2% in 2019 and 5.3% in 2020 (from 5.5% in 2018). Despite an anticipated economic slowdown in Germany with our forecast GDP growth of 0.5% in 2019 and 1.3% in 2020 (from 1.5% in 2018), we expect Lufthansa's largest market in terms of traffic revenue will hold up fairly well and deliver growth in passenger numbers on the back of the country's modern, highly diversified, and competitive economy, and its demonstrated ability to absorb large economic and financial shocks.
- Lufthansa's capacity, measured as available seat-kilometers (ASK) to increase by 4% in 2019 and 4% in 2020, largely aligned with management's guidance indicating 4% growth for its network airlines and 2% for Eurowings. The main organic capacity growth driver will be more seats per aircraft, helped by upgrading seats on the short-haul fleet, the introduction of new aircraft with more seats than the planes they have replaced, and longer flight distances.
- Ticket sales, as measured by revenue per passenger kilometers, to increase moderately above the capacity growth in 2019-2020, resulting in slightly higher load factors. In general, we believe that Lufthansa will pursue its disciplined capacity management and focus on selling new capacity at the expense of average ticket prices to fill seats.
- Pressure on average yields increasing in 2019 and diminishing in 2020. The lower oil price environment in general, combined with overcapacities in the European short-haul at least in first-half 2019, will likely constrain air fares. Air fares will likely recover somewhat into 2020 on

the announced capacity withdrawals from second-half 2019, but competition will remain fierce. Accordingly, we forecast a drop in average ticket prices by 2.5% in 2019 and 1.5% in 2020.

- Burden from the increased fuel expenses. We forecast oil prices will decrease to an average of $60 per barrel (/bbl) in 2019, followed by a flat $60/bbl in 2020, from around $70/bbl in 2018. This, combined with the increasingly fuel-efficient fleet, will not be sufficient to counterbalance the impact from Lufthansa's unfavorable fuel hedge position, however, and so we forecast Lufthansa's fuel bill at about €600 million higher than last year. In 2020, we forecast only slightly higher (by €150 million-€200 million) fuel cost year on year, based on flat oil prices, but higher consumption reflecting the growth in ASK.
- A slight reduction of nonfuel unit cost per available seat kilometer (CASK) over 2019-2021 (excluding disruption-related costs), as a continuation of the underlying positive trend over the past few years, as highlighted by the currency-adjusted CASK decline of 1.7% in 2018. A sustained gradual unit cost reduction is due to Lufthansa's reorganization program and crew productivity improvements; modernization and harmonization of its aircraft fleet; increased number of seats per aircraft; renegotiation of infrastructure contracts; a turnaround of the low-cost airline Eurowings' EBIT from 2019 (after the phase-out of one-off Air Berlin integration costs and the fine-tuning of flight schedules).
- No major change in combined EBITDA contribution from nonpassenger businesses comprising the MRO, logistics, and catering segments.
- Average annual capex of €3.6 billion-€3.7 billion in 2019 and 2020, mainly to accommodate Lufthansa's fleet renewal program and consistent with management's guidance of investments consistent with 8%-10% of revenue.
- Dividends paid in 2019 to be €380 million (€349 million paid in 2018) followed by a similar EBIT payout consistent with the company's publicly stated dividend policy of 10%-25%.
- No acquisitions and only immaterial asset disposals, consistent with historical averages. These are recurring disposals of old aircrafts and related equipment.
- No changes to the pension deficit, accordingly we carried forward the 2018 adjustments, although this will ultimately depend on the evolution of discount rates and other assumptions.
- Largely stable reported average net debt over 2019-2020 as compared with year-end 2018 because the company generates sufficient FOCF to absorb capex and dividend distributions.
- Lower adjusted debt under IFRS 16 accounting, because Lufthansa will record a debt-like lease liability of €2.4 billion in 2019, which we will include in our ratio calculation, and which is €0.9 billion lower than our operating lease adjustment to debt at year-end 2018.

Based on our base-case assumptions, we arrive at the following credit measures:

- A weighted-average ratio of adjusted FFO to debt of 48%-50%, an improvement from about 46% in 2018.
- A weighted-average ratio of adjusted debt to EBITDA of 1.6x-1.7x in 2019-2020, better than the 1.8x in 2018.
- A weighted-average ratio of adjusted FOCF to debt of 10%-11% in 2019-2020, up from about 4% in 2018.

Liquidity

We view Lufthansa's liquidity as strong. We project Lufthansa's sources of liquidity will exceed its uses by about 1.7x in the 12 months started Jan. 1, 2019, and by about 1.9x over the subsequent 12-month period. We also expect the company's liquidity sources to exceed uses in 2019 even if its EBITDA declines by 50%. Furthermore, we believe that Lufthansa has well-established, solid relationships with banks; a generally high standing in credit markets; and generally prudent risk management. There are no covenants in the bank documentation.

Liquidity sources for 12 months started Jan. 1, 2019, consisted of:

- About €4.08 billion of available cash.
- €849 million of committed credit line availability with maturity beyond 12 months.
- About €4.1 billion of cash FFO under our base-case scenario.

Liquidity needs over the same period will mainly include:

- €1.09 billion in short-term maturities.
- About €3.9 billion in capex.
- Declared cash dividends of €380 million to be paid in 2019. We do not include further dividends in our liquidity analysis because we do not foresee any distributions under stress, although we expect annual dividend distribution according to the stated dividend policy under normal industry conditions.

Issue Ratings - Subordination Risk Analysis

Capital structure

On Dec. 31, 2018, Lufthansa's capital structure consisted of €6.685 billion of total borrowings, of which €2.889 billion was unsecured debt (bank loans and bonds), €75 million was secured bank debt, and €3.721 billion was finance leases and secured financing akin to leasing.

Analytical conclusions

We rate Lufthansa's unsecured notes 'BBB', the same as the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

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: Strong (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria

- 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 And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria | Financial Institutions | General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

- Criteria | Insurance | General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Upgraded

	To	From
Deutsche Lufthansa AG		
Issuer Credit Rating	BBB/Stable/A-2	BBB-/Positive/A-3
Senior Unsecured	BBB	BBB-
Junior Subordinated	BB+	BB