S&P Global
Ratings

Research

Research Update:

Deutsche Lufthansa AG Upgraded To 'BBB-/A-3' On Strong Yields And Robust Air Travel Demand; Outlook Stable

December 4, 2023

Rating Action Overview

- We now expect Deutsche Lufthansa AG to generate S&P Global Ratings-adjusted EBITDA of €4.8 billion-€4.9 billion this year, compared with our April 2023 forecast of up to €4.5 billion, underpinned by stronger-than-expected yields amid robust passenger air travel demand and industrywide capacity constraints. We expect EBITDA to stay flat or rise moderately in 2024.
- We forecast that higher EBITDA will offset large capital expenditure for new aircraft and, supported by Lufthansa's commitment to deleverage, translate into sustained S&P Global Ratings-adjusted funds from operations (FFO) to debt of more than 45%, commensurate with a 'BBB-' rating.
- We therefore raised our long-term issuer credit and issue ratings on Lufthansa and its senior unsecured debt to 'BBB-' from 'BB+', our issue rating on its junior subordinated debt to 'BB' from 'B+', and our short-term issuer credit rating on the airline to 'A-3' from 'B'.
- The stable outlook reflects our expectation that economic or geopolitical conditions will not deteriorate unexpectedly or sharply, sustaining demand for air travel and ticket fares and translating into our weighted-average adjusted FFO to debt of above 45% over the next two years.

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Rating Action Rationale

Lufthansa's higher-than-expected yields, underpinned by uninterrupted robust demand for air travel and industrywide capacity constraints, translate into higher-than-forecast earnings this year. In the first nine months of 2023, the average unit revenue (passenger revenue divided by available seat kilometers [ASK]) in Lufthansa's Passenger Airlines business segment increased 11.5% year over year (after a 37.1% increase in 2022) and was therefore 23.8% above its pre-COVID-19 level in 2019. Strong air fares continue to benefit from continual robust leisure demand and lingering industrywide capacity constraints. This more than absorbed cost increases from a buildup in capacity and general inflationary pressures, fueling the expansion in Lufthansa's reported nine-month 2023 EBITDA to about €3.9 billion from €2.5 billion a year earlier. All passenger airlines increased their third-quarter year-on-year earnings; maintenance, repair, and overhaul (MRO) business achieved a new record EBIT for the first nine months of the year; and cargo segment continued to normalize. We expect Lufthansa's solid earnings performance to persist in the fourth quarter based on strong summer travel demand, which extended into October, and robust air traffic anticipated during the Christmas season. This led us to anticipate adjusted EBITDA of €4.8 billion-€4.9 billion this year--a marked improvement from €3.7 billion in 2022.

Based on Lufthansa's capacity guidance, we expect the group's revenue passenger kilometers (RPKs) to increase to 85%-86% of pre-pandemic levels in 2023 and then to 95%-96% in 2024 (from 70% in 2022). This reflects our view of persistent solid underlying demand for leisure travel across Lufthansa's European short-haul and international long-haul routes, so far largely resilient to the increased cost of living and interest rates. Also, the shift in consumer behavior has favored experience-based expenditure, and we anticipate the premium leisure segment--typically one of Lufthansa's most profitable segments--will continue to outperform others. Our forecast reflects a moderate pick up in corporate travel, which reached 60% of the pre-pandemic base (in terms of passenger numbers) at year-end 2022, albeit still significantly lagging leisure travel. Capacity constraints at Lufthansa's German hubs, due to labor shortages, limit upside for air traffic volumes beyond our 2023 base-case projection. However, as these bottlenecks are gradually resolved and Lufthansa deploys more aircraft, we expect its RPK to approach pre-pandemic levels in 2024.

We think that Lufthansa's air passenger fares will remain resilient in 2024 on steady air travel demand and lingering supply side constraints. We think industrywide capacity will remain tight due to delays in aircraft deliveries, shortage of jet engines and spare parts, Pratt & Whitney engine issues, and lack of workforce across the entire aviation network, and this should keep air fares largely flat. We also think yields will continue to benefit from robust demand for premium leisure travel, particularly considering that Lufthansa's major hubs are in wealthy catchment areas, such as Germany and Switzerland. That said, our yield-forecast hinges on rational capacity deployment upholding the sector's ability and willingness to recover cost inflation via air fares. Furthermore, we think that high yields should largely alleviate pressure from potentially elevated fuel prices and persistent inflationary pressure on Lufthansa's cost base, as per our assumptions for 2024, and curb potential downside to profitability should passenger demand unexpectedly dwindle.

We forecast flat-to-moderately higher adjusted EBITDA in 2024. The earnings performance will be increasingly carried by Lufthansa's passenger airline businesses, underpinned by the contribution from the MRO segment, which we expect to earn more than before the pandemic. We also expect EBIT from the cargo business to stay above the 2019 base, but to fall below the anticipated 2023 level. This is mainly because air freight rates are moderating, trailing the low ocean freight rates and expansion in airline cargo hold capacity, especially with the reopening of China, a key cargo market, at the start of this year. Nevertheless, we recognize that low revenue visibility beyond the next few months and pressure on consumers' disposable incomes could alter our assumptions for 2024. Currently, ticket prices across the industry are particularly high and demand is robust following years of challenging travel conditions due to COVID-19. Consumers are prioritizing spending on holidays despite cost-of-living pressure. However, if real disposable incomes fall further and unemployment rises, we think this could stress ticket prices.

EBITDA strength results in a clearly positive free operating cash flow (FOCF) and stronger credit metrics in 2023, but large fleet renewal program will delay further deleveraging in our view. We expect earnings expansion and solid EBITDA-to-operating cash flow conversion will more than offset the accelerating investment in fleet renewal and result in adjusted FFO to debt of 53%-55% in 2023, as compared with 42% in 2022. This is consistent with our threshold for the 'BBB-' rating on Lufthansa of more than 45%. We now forecast Lufthansa's debt will decrease to €6.8 billion-€6.9 billion, as adjusted by S&P Global Ratings, in 2023 (from an adjusted €7.2 billion in 2022, €12.4 billion at end-2021, and €10.8 billion before the pandemic). That said, upcoming deliveries of new aircraft will constrain further balance-sheet deleveraging in 2024 and 2025 (and might even result in a moderate buildup of adjusted debt), while reducing the fleet's running cost and environmental impact over time. Consequently, the resilience of Lufthansa's credit metrics for the current rating level hinges largely on the lasting strength of EBITDA and operating cash flows, in line with our 2024-2025 base case.

Outlook

The stable outlook reflects our expectation that economic or geopolitical conditions will not deteriorate unexpectedly or sharply, supporting resilient demand for air travel and ticket fares and translating into weighted-average adjusted FFO to debt of above 45% over the next two years.

Upside scenario

We could raise our ratings if Lufthansa improves adjusted FFO to debt to about 60% on a sustainable basis or recovers its profitability, such that its adjusted EBITDA margin increases and stays at least 15% (from about 13% we anticipate in 2023), the level commensurate with our satisfactory assessment of its business risk profile. This could happen if the group's earnings and operating cash flow exceed our base-case scenario and are sufficient to absorb Lufthansa's high capital expenditure (capex). We would expect this to be underpinned by a prudent financial policy that prioritizes the sustainability of improved ratios over shareholder remuneration.

Downside scenario

We would lower the rating if passenger demand, yield levels, and consequently Lufthansa's EBITDA fall short of our expectations, such that adjusted FFO to debt deteriorates below 45% with limited prospects of improvement. This could occur if inflationary pressures curb consumer confidence and travel affordability or if geopolitical tensions escalate dampening travel demand. A large debt-funded acquisition resulting in credit measures falling short of our guidelines for a prolonged period might also trigger a downgrade. We could also lower the rating if Lufthansa is unable to preserve its EBITDA margin at about 13%. This may lead us to reassessing its business risk profile to fair from satisfactory currently.

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 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. Lufthansa generates about 80% of its EBIT from its passenger airline businesses, while its nonpassenger business segments--such as MRO and airfreight/cargo--account for the remaining 20%.

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.).

As of Sept. 30, 2023, Lufthansa's fleet comprised a total of 714 aircraft (versus 710 aircraft at end-2022), about three-fourth of which were unencumbered. As of Dec. 31, 2022, the average age of the aircraft in the fleet was 13.1 years (previous year: 12.7 years). The airline continues to modernize its fleet with 174 aircraft on order and purchase options for an additional 58 at year-end 2022. Subsequently in March 2023, Lufthansa ordered 22 new Airbus and Boeing wide-body aircraft, with deliveries expected after 2025.

Lufthansa announced in May 2023 its agreement with the Italian Ministry of Economy and Finance to acquire a minority 41% stake in ITA Airways through a €325 million capital increase, which will flow directly to ITA Airways. The announced transaction is consistent with Lufthansa's strategy to focus on its core passenger airline business. With the planned transaction, Lufthansa would expand its presence in the third largest airline market in Europe, while enhancing its short-haul network feeding the hub in Rome and broadening its access to premium leisure and business travel destinations out of the point-to-point Milan Linate airport. The transaction is subject to regulatory approvals.

Our Base-Case Scenario

Assumptions

- Lufthansa's RPK at 85%-86% of 2019 levels in 2023, compared with 70% in 2022 and just 30% in 2021, and approaches pre-pandemic levels in 2024. Demand for leisure travel, in particular, fuels the recovery in passenger volumes, while business traffic stays below the pre-pandemic base. Deployed capacity (available seat kilometers) will be at 85% of pre-pandemic base constrained by staff shortages at Lufthansa's German hubs and potential delays in aircraft deliveries. We expect these issues to ease, but not completely disappear, in 2024.
- Revenue of about €35 billion in 2023 (and close to €37 billion including LSG catering business sold in October 2023), increasing to at least €38 billion in 2024 driven by resilient leisure travel demand and passenger load factors of around 83% (somewhat above the historical average of 82%).
- 2023 yields significantly exceeding the pre-pandemic levels. We forecast roughly 6%-7% growth in air fares in 2023 on prior year, which follows a marked 17% increase in 2022. We assume flat yields in 2024 supported by the industrywide capacity constraints.
- Increase in the fuel bill to €8.0 billion, after €7.6 billion in 2022, as capacity increases, and jet fuel prices remain high. We link our forecast to S&P Global Ratings' oil price assumptions of $85 per barrel (/bbl) in the reminder of 2023 and $85/bbl in 2024. We also consider the group's recent fuel hedging positions with 74% of planned Brent crude oil consumption hedged in 2024 with an after-hedge rate at $951 per metric ton (as compared with the current price of $908 per

metric ton according to IATA). We expect Lufthansa will carry on its hedging policy, guided 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 increasing to €4.8 billion-€4.9 billion in 2023 after €3.7 billion in 2022. We expect materially declining EBITDA from the cargo segment (albeit remaining above the 2019 pre-pandemic €161 million) and overall cost inflation to be absorbed by air passenger traffic growth and strong yields. In 2024, we forecast flat-to-slightly higher adjusted EBITDA, assuming normalized air travel demand coinciding with lingering capacity constraints. We assume that the inflationary pressure on cost base will be largely offset by gains from efficiency measures and lower year-on-year one-off costs (as defined by Lufthansa) such as for recruitment/training and flight irregularities.
- Acceleration in gross capex of €3.7 billion in 2023 (net capex €2.7 billion) and €4.0 billion-€4.5 billion in 2024 (net capex €3.0 billion-€3.5 billion), after €2.4 billion in 2022, following two years of low capex at €1.3 billion in 2021 and €1.2 billion in 2020.
- Resumption of ordinary dividends, with a payout ratio of 20%-40% of the previous year's net income, and the first dividend distribution expected in 2024.
- A pension-deficit adjustment to debt of about €900 million (based on reported pension provisions of €2 billion as of Sept. 30, 2023), with a 2022 deferred tax asset for pension provisions carried forward in 2023 and 2024.
- Cash outflows of €325 million for the announced acquisition of a 41% stake in ITA Airways and cash inflow from the announced sale of Lufthansa AirPlus Servicekarten GmbH to SEB Kort Bank AB of Stockholm for about €450 million. Both transactions are subject to regulatory approvals and are expected to close in 2024.

Key metrics

- Adjusted FFO to debt improving and staying at 53%-55% in 2023 and 50%-55% in 2024, compared with about 42% in 2022 and a negative figure in 2021.
- Adjusted FOCF (after gross capex) in 2023 likely declining from €1.7 billion generated in 2022, but remaining clearly positive, and decreasing further in 2024 as cash outflows for new aircraft gain pace. 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, underpinned by its ample cash position and availability under its sustainability-linked revolving credit facility (RCF) closed in April 2022, with a minimum liquid funds target of €8 billion-€10 billion, as defined by the group. The company's liquid funds amounted to €11.1 billion as of Sept. 30, 2023, and included €9.0 billion of cash and liquid securities on the balance sheet and €2.1 billion available on the undrawn credit lines. The group reported short-term borrowings (excluding leases) of about €3.3 billion as of that date, including €1.6 billion in bullet bonds.

Furthermore, 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 1.8x-2.0x in the 24 months started Oct. 1, 2023.

Our estimate of Lufthansa's principal liquidity sources as of Sept. 30, 2023, for the upcoming 12 months comprised:

- Unrestricted cash, cash equivalents, and liquid securities of €9 billion.
- Available funds under the committed RCF maturing beyond 12 months of about €2.1 billion.
- Our forecast FFO of €3.7 billion-€3.8 billion.
- Cash inflow of €510 million from the completed disposal of LSG catering business and committed sale of Lufthansa AirPlus Servicekarten.

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

- Short-term financial debt, excluding leases of about €3.3 billion.
- Our forecast intra-year working capital outflows of €1.5 billion.
- Net capex of €3.0 billion-€3.3 billion in line with the group's guidance.
- Cash outflow of €325 million for the committed acquisition of a 41% stake in ITA Airways.

Environmental, Social, And Governance

Social factors are a moderately 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 our rating by four notches. After pandemic-related travel restrictions were lifted, the group has been seeing a significant recovery in European short-haul leisure travel, while business and some long-haul international flights are taking longer to return. In 2022, demand for Lufthansa's flights (as measured in RPKs) recovered to about 70% of the 2019 level from just 30% in 2021. In 2023, we expect the recovery to continue, but still forecast RPKs at up to 15% below pre-pandemic levels in 2023.

Environmental factors are a moderately negative consideration, as is the case for 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 result in significant cash outflows but also in reduced fleet's running cost and environmental impact over time.

Hybrid Debt

Our issue rating on Lufthansa's junior subordinated debt (hybrid bond) is 'BB'. This takes into account a two-notch deduction from our 'BBB-' issuer credit rating on Lufthansa. The two-notch differential reflects our notching methodology for rating hybrid capital instruments, under which we deduct:

- One notch for subordination because our issuer credit rating on Lufthansa is now investment grade (that is, higher than 'BB+'); and
- An additional notch for payment flexibility, to reflect the deferral risk.

We now treat the hybrid bond as having no equity content. This is because the residual time until the effective maturity is less than 20 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. Hybrids with no equity content are treated wholly as debt and all coupon payments are treated as interest for our ratio calculation purposes, which is the case for Lufthansa.

Issue Ratings - Subordination Risk Analysis

Capital structure

On Dec. 31, 2022, Lufthansa's capital structure consisted of €15.151 billion of total borrowings, of which €8.033 billion was unsecured debt (bonds and liabilities to banks), €184 million was secured bank debt (liabilities to banks), and €6.934 billion was 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-3
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	Neutral (no impact)
Stand-alone credit profile	bbb-

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Health and safety

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: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate 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, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Industry Top Trends Update Europe: Transportation, July 18, 2023
- Full Analysis: Deutsche Lufthansa AG, July 14, 2023
- European Air Travel Defies Economic Pressures On Robust Demand, June 7, 2023
- Europe's Airlines To Bear Highest Carbon Costs, April 3, 2023

Ratings List

Upgraded

	To	From
Deutsche Lufthansa AG		
Issuer Credit Rating	BBB-/Stable/A-3	BB+/Positive/B
Senior Unsecured	BBB-	BB+
Recovery rating	NR	3(65%)
Junior Subordinated	BB	B+

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