S&P Global Ratings

Research

Research Update:

Deutsche Lufthansa AG Outlook Revised To Stable On Recovery In Air Traffic

November 8, 2021

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Rating Action Overview

- After the weak first half of 2021, demand in intra-European air passenger traffic, especially for holidays and leisure destinations, picked up in the summer. Considering the increasing rate of vaccinations and easing travel restrictions across Europe, as well as the anticipated reopening of some important long-haul destinations such as North America, we expect the global air passenger traffic demand to continue its recovery, albeit from the very low 2020 levels.
- In 2021, we expect Deutsche Lufthansa AG (Lufthansa) to see demand as measured in revenue-passenger-kilometers (RPK) at only about 30% of the pre-pandemic level. Despite the delayed traffic recovery in 2021, Lufthansa stabilized its liquidity through proactive cash flow management and external funding. In 2022, demand in air passenger traffic should recover to up to 70% of the pre-pandemic level, and teamed with the cost-reduction measures, should improve adjusted EBITDA to €2.0 billion-€2.5 billion from the break-even forecast for this year and translate into credit metrics commensurate with the current rating.
- We therefore revised the outlook on Lufthansa to stable from negative. At the same time, we affirmed the 'BB-/B' long- and short-term issuer credit ratings on Lufthansa, the 'BB-' rating on the group's senior unsecured debt, and the 'CC' rating on the junior subordinated debt.
- The stable outlook is based on an expected continued recovery in air traffic, allowing Lufthansa to restore its credit ratios in line with the current ratings, and a markedly lower likelihood of a downgrade.

Rating Action Rationale

Air traffic demand recovery for European airlines should accelerate in 2022. In Europe, air passenger traffic in 2021 (as measured by RPK) will reach only 30% of 2019 levels (at best). This is the lower end of the 30%-50% range we published Feb. 18, 2021 (see "Europe's 2021 Air Passenger Traffic Likely To Stall At 30%-50% Of 2019 Level," published on RatingsDirect). In 2022, the intra-Europe traffic will recover to 60%-75% of pre-pandemic levels, Europe-North America traffic will rebound to 50%-65% of 2019-base, while Europe-Asia and North America-Asia travel will continue lagging behind other regions, with 20%-25% of pre-crisis levels, according to our base case. Our current estimates are based on assumptions of no further prolonged lockdowns or renewed border closures beyond those currently in place.

After the sluggish first half of 2021, Lufthansa's recovery is taking shape. In response to the delayed recovery in the intra-European traffic and very low intercontinental demand during that period, Lufthansa limited its capacity (available seat kilometres [ASK]) to 21% and 29% of 2019 level in the first and second quarters, respectively, while the 49% load factor was significantly below the pre-pandemic level. With the start of significant demand recovery for the short-haul leisure and holiday destinations in July, Lufthansa built up the third-quarter capacity to 50% of the pre-pandemic level and plans to deploy about 60% of 2019 ASK in the fourth quarter. For the full year, this translates to 40% of 2019 levels and below our previous forecast of 50%-55% (see "Lufthansa Downgraded To 'BB-' From 'BB' On Lower Air Traffic; Outlook Negative," published Nov. 19, 2020, on RatingsDirect). After incurring €915 million reported EBITDA loss (before results of equity investments) in the first six months, Lufthansa's EBITDA is likely to turn positive in the second year-half, fuelled by the demand recovery, extraordinary strong performance of the cargo business, and cost-savings measures (70% of the €3.5 billion cost-savings target by 2024 was achieved to date). Nevertheless, we expect EBITDA for the full year to only break-even compared with our previous forecast of substantial EBITDA.

We anticipate the air traffic demand will continue climbing in 2022 and contribute to the airline's financial recovery. We envisage Lufthansa's operating performance improving in 2022, driven by the continued recovery of the European short-haul traffic and resumption in long-haul flights to North America, which was one of its most profitable destinations before the pandemic. Lufthansa plans to deploy 65% of its 2019 capacity in first-quarter 2022 and ramp it up to 80% in the second half of the year, encouraged by the recent pre-bookings trend of 80% of the pre-pandemic level. This compares with our air passenger traffic forecast for Lufthansa of up to 70% of the pre-pandemic level. We factor in risks of slower demand recovery in business and corporate travelling as compared with travelling for leisure and visiting family and friends, and we do not exclude structural segment losses in the medium term. We also anticipate a delayed and sluggish recovery in Europe-Asia passenger traffic. The uncertainty about the interplay between yields development, increased oil prices, and potential inflationary pressure on consumer sentiment is only partly captured in our forecasts and may exert additional pressure. We now anticipate Lufthansa's EBITDA, as adjusted by S&P Global Ratings, will rebound in 2022 to €2.0 billion-€2.5 billion. This translates to S&P Global Ratings-adjusted funds from operations (FFO) to debt of at least 6%, which is commensurate with our rating guideline. That said, we do not expect Lufthansa to generate positive free operating cash flow (FOCF; after leases) given the planned capital expenditure (capex) increases up to the annual €2.2 billion.

Repayment of silent participation I and good cash flow management caps adjusted debt in 2021 at the previous year level, which supports the recovery in credit metrics. The weak start of the year and the €900 million deferred tax payments in the second year-half should constrain operating cash flow in 2021, albeit we expect it close to break-even, which is a material improvement as compared to €2.4 billion negative in 2020, as the revenue contribution increases and proactive working capital management enhances the benefits of traffic recovery. At the same time, we expect S&P Global Ratings-adjusted debt at end-2021 (carrying forward the pension obligation from Dec. 31, 2020) to not exceed €15.9 billion, the level recorded at end-2020. This is supported by the capital increase completed in October with the total proceeds of €2.2 billion, €1.5 billion of which were used to repay the outstanding drawing under silent participation I in the same amount, which we treated as akin to debt under our hybrid criteria. Lufthansa is also limiting the cash burn with another year of subdued capex of €1.5 billion, versus €1.2 billion in 2020 and €3.7 billion in 2019.

We believe Lufthansa will enter 2022 with ample liquidity. We forecast that Lufthansa following several rounds of external funding measures (including recent capital increase) in 2021 will increase its cash on hand by year-end to about €6.6 billion, as compared to €5.5 billion recorded at end-2020. This, along with about €1.5 billion undrawn amount under the company's committed credit lines maturing beyond next 12 months (including the Swiss and Belgian state aid, but excluding the silent participations as they are planned to be cancelled by year-end), is slightly above the company's new target liquidity range of €6 billion-€8 billion (considerably above the €2.3 billion minimum liquidity target before the pandemic) and should provide Lufthansa with ample headroom for unforeseen setbacks or operational headwinds, as the traffic recovery is unfolding.

The planned cancellation of silent participation I and II by Lufthansa does not alter our view on the airline's government-related status. After the repayment of the €1.5 billion drawing under €4.5 billion silent participation I, Lufthansa plans to repay the €1 billion silent participation II and cancel both hybrid instruments, which were provided as part of the German state aid package by the Economic Stabilization Fund, by year-end. In our November 2020 review we anticipated this early redemption of the hybrids, among others due to their multiple material coupon step-ups. The German government stake in Lufthansa share capital fell to 14% following the October capital increase from initially 20%. We understand that the German government can sell its stake six months after the capital increase completion and must exit the shareholder structure of Lufthansa no later than 24 months after the capital increase, provided that the silent participations are repaid and contractual conditions are met. The anticipated termination of the state aid package does not, however, alter our view of the moderate likelihood of extraordinary support Lufthansa could receive from the German government under a stress scenario. This translates into one notch uplift from our 'b+' assessment of Lufthansa's stand-alone credit profile (SACP). We base our view on the important role Lufthansa plays for the German government, rather than its link, which we continue assessing as limited.

Outlook

The stable outlook reflects our expectation that the air passenger traffic recovery will continue. Consequently, for Lufthansa we expect its EBITDA to turn positive in the second-half 2021, increasing (but still well below pre-pandemic levels) in 2022. This should produce credit ratios supportive of the rating with adjusted FFO to debt of at least 6% in 2022, with further improvements thereafter. Furthermore, we consider a sustained solid liquidity position, a critical and stabilizing rating factor.

Downside scenario

We could lower ratings if we expect credit ratios to deteriorate materially, with adjusted FFO to debt returning to less than 6% on a sustainable basis. This could occur if there is a major resurgence of the pandemic, prompting renewed prolonged lockdowns and deterioration in consumer confidence. In this scenario, we might conclude that the fundamental risk characteristics of the industry have worsened, particularly for airlines that rely significantly on business and long-haul international travel and reflect that in our assessment of business risk.

We could lower the rating if we revise down our assessment of the likelihood of government support and Lufthansa's SACP does not improve to 'bb-' in the meantime. This could occur if the pandemic-related adverse effect on the industry eases, passenger air traffic returns towards normal levels, and therefore the rationale for government support diminishes, while the airline stabilizes its financial position.

Upside scenario

We could raise the ratings if Lufthansa improves its adjusted FFO to debt to 6%-12% and start generating a sustained positive FOCF (after leases).

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, 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 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.

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

Our Base-Case Scenario

Assumptions

- Diverging pace in air passenger traffic recovery across the globe in the current year with Europe expected to reach the lower end of the 30%-50% forecast range of 2019 passenger volumes.
- After another weak year constrained by the pandemic related restrictions with forecast Lufthansa's revenue passenger kilometers (RPK; a measure of passenger demand) of only about 30% of 2019 level in 2021 as compared to 23% in 2020, demand recovering to up to 70% in 2022, underpinned by our expectation of reopening of long-haul destinations such as North America and resilient European short-haul market with no further lockdowns. 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 of about 40% of 2019 base in 2021, which is in line with the group's guidance. In 2022 we expect ASK of up to 80% of the pre-pandemic level.
- Revenue recovering to €16 billion-€17 billion in 2021 after €13.6 billion in 2020, supported by the record-high growth in cargo revenue, passenger traffic yield rebound to the pre-pandemic

level in the third quarter (fueled by pent-up demand for holidays) and increased activity in the MRO segment. In 2022 we expect Lufthansa's revenue to reach up to 75% of the pre-pandemic level, largely driven by the pick-up in demand for passenger flights, while we remain cautious about future yield development, with potential headwinds from competition and increased air fares elasticity, due to potential inflationary pressure on consumers.

- The fuel bill in 2021 somewhat exceeding €1.9 billion paid in 2020, after only €692 million in the first six months, reflecting the rebound in air passenger traffic in the second half of the year as well as the increased brent crude oil price ($69.5 per barrel [/bbl] in January-October 2021 compared with $42/bbl for the same period last year). In 2022 we expect the fuel bill to almost double, reflecting the increasing fuel consumption as the capacity builds up. We link our forecast to S&P Global Ratings' oil price assumptions of $75/bbl for the remainder of 2021 and $65/bbl in 2022. Our forecast also considers fuel hedging resumed at the beginning of this year with a target hedging level of 65%.
- We expect Lufthansa's EBITDA, as adjusted by S&P Global Ratings, to break-even in 2021 after a $3.2 billion loss (including losses from ineffective fuel hedges) in 2020, supported by the record-high positive EBITDA contribution from the logistics segment as well as significant progress achieved in realization of the €3.5 billion cost-savings program. In 2022 we forecast adjusted EBITDA to reach 45%-55% of the pre-pandemic level.
- After another year of the depressed capital investments with €1.5 billion forecast in 2021 (after €1.2 billion in 2020), capex is expected to increase to up to €2.5 billion in the following years, driven by fleet renewals.
- No material working capital requirements in 2022, due to the diminished risk of ticket refunds, against the backdrop of the continuous demand recovery.

Liquidity

We assess Lufthansa's liquidity as adequate, considering the support from the group's solid cash position, availability under committed credit lines, and manageable short-term debt maturities. Our assessment is underpinned by Lufthansa's restored ability to access capital markets as demonstrated by multiple debt issuances since the end of 2020 and the recent capital increase. In our base case, liquidity sources exceed uses by more than 2.0x in the 12 months started Sept. 30, 2021, and more than 1.5x in the following 12 months. In our liquidity calculation, we exclude availability under the silent participations from the state aid package provided by the German government via the Economic Stabilization Fund, since we understand that Lufthansa intends to terminate them by year-end. The €1.5 billion drawing under silent participation I was already repaid with the proceeds from the capital increase in October.

Our estimate of Lufthansa's principal liquidity sources for the 12 months started Sept. 30, 2021, comprise:

- Nonrestricted cash, cash equivalents, and liquid securities of €7.1 billion;
- Available funds under the committed credit lines maturing beyond 12 months and those guaranteed by the Swiss and Belgian states of €1.5 billion in total;
- Remaining cash proceeds from the capital increase after the repayment of the drawing under silent participation I of €662 million; and
- Our projection of FFO of €190 million-€560 million.

Principal liquidity uses for the same period consist of:

- Short-term debt of about €1.6 billion; and
- Capex of up to €2.2 billion.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/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)

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: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- 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 Downgraded To 'BB-' From 'BB' On Lower Air Traffic; Outlook Negative, Nov. 19, 2020
- Europe's 2021 Air Passenger Traffic Likely To Stall At 30%-50% Of 2019 Level, Feb. 18, 2021

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Deutsche Lufthansa AG		
Issuer Credit Rating	BB-/Stable/B	BB-/Negative/B

Ratings Affirmed; Outlook Action

	To	From
Senior Unsecured	BB-	BB-
Recovery Rating	3(65%)	3(65%)
Junior Subordinated	CC	CC

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.