Research Update:

Deutsche Lufthansa AG Upgraded To 'BB' On Air Traffic Recovery And Reduced Financial Leverage; Outlook Positive

November 30, 2022

Rating Action Overview

- We expect Deutsche Lufthansa AG (Lufthansa)'s adjusted EBITDA to significantly exceed our previous forecast in 2022 and its free operating cash flow (FOCF; after leases) to turn materially positive thanks to the strong performance in nonpassenger segments and significant rebound in demand for air travel in second-half 2022, which supported by the lower pension deficit, leads to S&P Global Ratings-adjusted funds from operations (FFO) to debt of close to 30% and an upward revision of our stand-alone credit profile (SACP) to 'bb' from 'b+'.
- We think that the air traffic recovery will continue (albeit at a slower pace) in 2023, supporting the relative resilience of credit metrics, but uncertainty persists regarding demand and pricing (yields) amid a recessionary and inflationary backdrop over the next few quarters, which weighs on further rating upside at this time.
- We now assess the likelihood of extraordinary financial support from the German government as low and withdrew Lufthansa's status as a government-related entity because we view the state aid provided as pandemic-related and one-off in nature, with limited rationale for further support as Lufthansa's corporate credit quality improves.
- We therefore raised our long-term issuer credit and issue ratings on Lufthansa and its senior unsecured debt to 'BB' from 'BB-' and our issue rating on its junior subordinated debt to 'B' from 'CCC+'. The short-term issuer credit rating was affirmed at 'B'.
- The positive outlook reflects at least a one-in-three chance that we may raise our ratings on Lufthansa in the next 12 months.

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Rating Action Rationale

We now expect that Lufthansa will generate €3.4 billion-€3.6 billion of EBITDA in 2022, which is about €1 billion higher than our previous forecast. This is a significant improvement from just breakeven EBITDA achieved in 2021, although still 20% below pre-pandemic levels. The recovery is driven by record-high operating performance in the logistics (cargo freight), and maintenance repair and overhaul (MRO) segments, further supported by the turnaround in Lufthansa's core airline passenger business since the summer. Third-quarter 2022 was the first since the start of the pandemic when Lufthansa's airlines made a positive contribution (about 70% of 2019 levels) to the group's total EBIT. This turnaround was spurred by strong pent-up demand for air passenger travel to leisure destinations and for visiting friends and family, as well as record-high yields, exceeding pre-pandemic levels. Ticket prices were especially remarkable for long-haul destinations, particularly North America, which also benefited from U.S. dollar appreciation against the euro. That said, in the first nine months of 2022 the airline segment did not positively contribute to EBIT, constrained by the weak first half. This was more than compensated by continuous record-high performance in the logistics segment with January-to-September EBIT of about €1.3 billion after €946 million in 2021--and versus negative €33 million in full year 2019 and positive €263 million in full year 2018--fueled by unprecedently elevated air freight yields. However, we do not view this as sustainable and expect air freight rates to moderate, as congestion in marine infrastructure eases, ocean freight rates fall, and airline belly capacity expands.

Recovering EBITDA and a strong working capital inflow will translate into materially positive FOCF (after leases) this year. Improved operating performance in general and about a €2.6 billion working capital inflow, from strong customer bookings/prepayments underpinned by the record-high fares and more efficient working capital management, led reported FOCF before leases to surge to €3.6 billon in the first nine months of 2022. On the back of the strong momentum year-to-date and after the typical seasonal working capital unwind in the fourth quarter, we now expect 2022 FOCF (after leases) of about €1.5 billion, which compares to our previous assessment of slightly negative to neutral FOCF. This captures our capital expenditure (capex) forecast of about €2.5 billion, which is above deflated pandemic levels of €1.2 billion-€1.3 billion, but largely in line with the group's annual depreciation.

We now expect Lufthansa's adjusted debt to decline significantly, but only partly due to FOCF improvement. We forecast about €9 billion in adjusted debt at year-end 2022, down from €12.4 billion at year-end 2021 and €10.8 billion before the pandemic. The decline is spurred by:

- Positive FOCF being used for debt reduction. We expect Lufthansa's financial debt will decline about €1.4 billion from the €14.3 billion reported at year-end 2021 but remain significantly above the €7.2 billion at year-end 2019. Our forecast factors scheduled and early debt repayments, including the remaining €500 million drawn under the bank loans guaranteed by the Belgian and Austrian states.
- A material reduction in our pension adjustment, which we now forecast at about €1.6 billion versus €3.6 billion in 2021 and €4.3 billion in 2019, due to anticipated higher interest rates over our forecast period. Our adjustment represents the difference between the most recent estimated cumulated net plan assets and net plan liabilities under defined benefit schemes after tax.

Under our base case, recovery in EBITDA and lower adjusted debt will lead to credit metrics improvement, with the financial risk profile revised up two categories to significant from highly leveraged. We expect adjusted FFO to debt will improve to close to 30% in 2022, which compares with a negative value in 2021 and our previous forecast of 12%-15%. Furthermore, we think that the lower adjusted debt will provide ample headroom under the now significant financial risk profile for any potential challenges due to mounting macroeconomic and inflationary headwinds and likely moderation in air cargo freight rates, which combined could weigh on Lufthansa's performance. However, there is uncertainty about the interplay between demand and pricing (yields) amid a recessionary and inflationary backdrop over the next few quarters, which may exert additional pressure and currently weighs on rating upside.

We ceased to factor government support into the rating, as the rationale for it has diminished. Lufthansa's credit quality is improving and potential pandemic-related disruption to its operations is remote. Therefore, we now view government support as unlikely. We also understand that the state aid provided under the Temporary Framework Scheme (closed in June 2022) was solely pandemic-related and targeted at preventing a potential liquidity crunch and do not expect it in the foreseeable future. Moreover, in our opinion, the provision of government support to an airline is subject to strict EU competition regulations under normal trading conditions.

Outlook

The positive outlook reflects at least a one-in-three chance that we may raise our ratings on Lufthansa in the next 12 months.

Upside scenario

We could raise our ratings if Lufthansa improves its adjusted FFO to debt to clearly above 30% on a sustainable basis. This could occur if air passenger demand is not significantly hindered by expected sluggish economic growth and inflationary pressures and Lufthansa's proactive yield management curbs inflationary pressure on its cost base, while it continues to prioritize deleveraging.

Downside scenario

We could revise the outlook to stable if adjusted FFO to debt remains consistently at 20%-30%, for example, because eroding customer purchasing power leads to materially lower air travel.

Company Description

Lufthansa carried about 145 million passengers in 2019, making it the fourth-largest airline in the world. It operates out of 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 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 kilometers (RPK), of which half came from long-haul intercontinental flights to and from the Americas (mainly the U.S.).

Our Base-Case Scenario

Assumptions

- European air passenger traffic recovers to 75%-80% of 2019 levels (measured in RPKs) in 2022 from just 30% in 2021, fueled by pent-up demand for air travel in the crucial summer season. That said, we think cost-of-living inflation and rising interest rates will weigh on consumer confidence and business spending and constrain 2023 traffic at about or slightly above 2022 levels (or 75%-85% of 2019 levels). We expect near pre-pandemic traffic will be reached only in 2024.
- Lufthansa's RPK (a measure of passenger demand) recovers to up to 75% of 2019 levels in 2022, compared with just 30% in 2021, and about 80% in 2023. Deployed capacity (available seat kilometers) will be just slightly above passenger numbers. In 2022, we expect it to be constrained by operational disruptions amid significant staff shortages--causing delays, long security queues, and flight cancellations across Europe. Although we expect these issues to ease in 2023, delays in deliveries of aircraft and spare parts should limit capacity in the coming year.
- Revenue recovers to €31 billion-€33 billion in 2022 after €16.8 billion in 2021, supported by the surge in demand for leisure travel during the summer, particularly record-high yields, as well as strong performance in all nonpassenger-related segments. In 2023, we expect Lufthansa's revenue to recover close to pre-pandemic levels of €36.4 billion, due to the continued, albeit slower, recovery in demand for passenger flights and largely flat yields, supported by the industry's disciplined capacity deployment and expiring lower-priced fuel hedges.
- A significantly higher fuel bill of about €7.5 billion in 2022 compared with €2.4 billion paid in 2021, as capacity increases and oil prices surge. We expect fuel costs in 2023 somewhat exceeding our 2022 forecast, due to the moderate capacity built up. We link our forecast to S&P Global Ratings' oil price assumptions of $100 per barrel (/bbl) in 2022 and $90/bbl in 2023. Our forecast also considers the recent fuel hedging positions with 65% of planned Brent crude oil consumption hedged in 2022 and 50% in 2023, along with hedges for crack spreads introduced in 2022.
- Lufthansa's S&P Global Ratings-adjusted EBITDA increases to €3.4 billion-€3.6 billion in 2022 after just breaking even in 2021. A large part of 2022 EBITDA is from the logistics segment boosted by record-high air freight rates. In 2023, we forecast adjusted EBITDA close to our 2022 forecast levels. That said, our 2023 forecast is subject to uncertainty and depends on to what extent recovering passenger revenue (factor of traffic and yield strength) will offset the expected high fuel bill and other cost inflation, and how much higher-margin cargo revenue will decrease as air freight rates moderate.
- After two years of low capex, with €1.3 billion in 2021 and €1.2 billion in 2020, an increase to about €2.5 billion per year in the forecast period as new more-fuel-efficient aircraft are delivered.
- A significantly decreased pension deficit of about €1.6 billion from 2022 due to higher discount rates, which we expect to persist.

Key metrics

- Adjusted FFO to debt improving to close to 30% in 2022 and 2023, compared to a negative figure in 2021.
- Adjusted FOCF after leases of about €1.5 billion in 2022, and likely declining below this level in 2023. That said, the extent of the decline hinges on working capital movements, which are currently difficult to predict.

Liquidity

We assess Lufthansa's liquidity as adequate, considering the support from the airline's solid cash position, availability under its revolving credit facility (RCF), 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 at year-end 2020 and the capital increase in October 2021. In our base case, liquidity sources exceed uses more than 2.0x in the 12 months started Sept. 30, 2022, and about 2.0x in the following 12 months.

Our estimate of Lufthansa's principal liquidity sources for the 12 months started Sept. 30, 2022, comprises:

- Nonrestricted cash, cash equivalents, and liquid securities of €9.7 billion;
- Available funds under the committed RCF maturing beyond 12 months of €2 billion; and
- Our FFO projection of €2.0 billion-€2.3 billion.

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

- Short-term financial debt of about €1.2 billion (including the early repayment of the remaining €500 million drawn under the bank loans guaranteed by the Austrian and Belgian states);
- Intra-year working capital outflows of €1.5 billion; and
- Capex of about €2.5 billion.

Environmental, Social, And Governance

ESG credit indicators: To E-3, S-4, G-2; From E-3, S-5, G-2

Social factors are now a negative consideration in our credit rating analysis compared to very negative previously. This reflects the ongoing recovery in air passenger traffic following the lift of pandemic-related travel restrictions for most regions (reduced health and safety risk) and associated positive effects on Lufthansa's operating performance. In 2022, we expect demand for Lufthansa's flights (as measured in RPKs) to recover to about 70%-75% of 2019 levels from just 30% in 2021. Although we expect the recovery will continue into 2023, we still forecast RPKs 20% below pre-pandemic levels. We think that Lufthansa's focus on long-haul (with some markets, especially China, still imposing strict travel rules) and exposure to business travel constrain the pace of its recovery compared to airlines that rely more on domestic traffic (U.S. airlines) or European short-haul leisure (Ryanair and easyJet).

Environmental factors are a moderately negative consideration, like the broader airline industry, reflecting pressures to reduce greenhouse gas emissions. Therefore, Lufthansa will continue upgrading its fleet, which is about 12.7 years old, with more fuel-efficient aircraft. This will lead to a moderate increase in capex above deflated pandemic levels, which we expect to be largely in line with the fleet's annual depreciation.

Hybrid

Our issue rating on Lufthansa's junior subordinated debt (hybrid bond) is 'B'. This takes into account a three-notch deduction (including one for deferral risk) from the issuer credit rating.

We treat the hybrid bond as having 50% equity content. This is supported by the residual time until the effective maturity exceeding 15 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.

Issue Ratings - Recovery Analysis

Key analytical factors

- Our issue rating on Lufthansa's senior unsecured debt is 'BB'. The '3' recovery rating indicates 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 the prior ranking and secured creditors ranking ahead of the unsecured claims.
- Under our simulated default scenario, we assume a default in 2027 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.

Simulated default assumptions

- Year of default: 2027
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value: €15.6 billion
- Net enterprise value (after 5% administrative costs): €14.8 billion
- Total secured debt claims: €4.2 billion

- Total value available to unsecured claims: €9.9 billion
- Senior unsecured debt: €9.5 billion*
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

Note: All debt amounts include six months of prepetition interest. We believe that in a distressed scenario, 85% of the outstanding RCF will be drawn.

Ratings Score Snapshot

Issuer Credit Rating	**BB/Positive/B**
Business risk:	Satisfactory
Country risk	Low
Industry risk	High
Competitive position	Excellent
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile	bb

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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Europe's Remarkable Air Passenger Traffic Recovery Faces A Trickier 2023, Nov. 21, 2022.

Ratings List

Upgraded; Outlook Action; Ratings Affirmed

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