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Scope affirms Lufthansa at BBB- and assigns Negative Outlook; review for possible downgrade resolved

Lufthansa issuer rating affirmed at BBB-, Outlook Negative, following provision of state aid

The latest information on the rating, including rating reports and related methodologies, is available on this **LINK**.

Rating action

Scope Ratings has today affirmed the issuer credit rating of Deutsche Lufthansa at BBB- and assigned an Outlook of Negative. Senior unsecured debt was affirmed at BBB- and junior subordinated debt was affirmed at BB. The short-term rating of S-3 was also affirmed. These rating actions resolve the review for a possible downgrade from the last rating action dated 31 March 2020.

Rating rationale

The rating actions follow the provision of state aid by the German Federal Economic Stabilisation Fund ('WSF') and the approval of the state aid by Lufthansa shareholders and the European Commission. This has affected two areas: i) the financial risk profile, notably the liquidity assessment; and ii) supplementary rating drivers, leading to a two-notch uplift of Lufthansa's standalone credit quality.

Scope has updated Lufthansa's financial forecasts for 2020 and 2021. The base case for a gradual in-fleeting of grounded aircraft remains unchanged. According to Lufthansa's plans, 90% of originally planned short-haul connections and 70% of long-haul connections will be served via its new flight schedule by September 2020. This should lead to a gradual increase in revenues from the passenger business. In view of the significant decline in air travel worldwide, Scope has lowered the forecasted revenue contributions of Lufthansa Technik and the catering business. The cargo business should remain resilient given that most belly-space capacity from passenger aircraft is unavailable to the market, leading to higher freight rates.

Scope expects a negative EBITDA for 2020. Free operating cash flow in 2020 is forecast to be negative at around EUR 5.5bn-6.0bn, though the magnitude will depend on the repayment of unused flight documents. Scope forecasts capital expenditures in 2020 of less than EUR 2.0bn. The state aid provided by WSF is enabling Lufthansa to bridge the cash flow shortfall from ongoing operations.

The financial risk profile assessment places more emphasis on 2021 and continues to assume a normalisation of flight traffic in 2020. Cost-cutting measures initiated by Lufthansa combined with lower jet fuel prices should feed into operating earnings in 2021. Currently, Scope forecasts EBITDA of about of EUR 2.5bn and capex of below EUR 2.0bn for 2021. With a gradual resumption of flight operations, Lufthansa should see higher cash inflow from advance ticket purchases in 2021. At this stage, the Scope-adjusted debt/EBITDA ratio is expected at around 5x and funds from operations/Scope-adjusted debt at around 15% for 2021, with gradual improvements thereafter due to cash inflow from ongoing operations and no dividend payments. Scope still expects revenues in 2021 to be around 30% lower than in 2019, i.e. before the coronavirus pandemic broke out.

The silent capital contribution ('silent partnership') from WSF of EUR 5.7bn has been treated as debt in Scope's financial analysis. While the silent partnership has certain equity characteristics such as an unlimited maturity, subordination and deferrable coupon payments, the criterion of permanence is not satisfied, as Lufthansa is able to repay the silent partnership anytime. In addition, coupon step-ups, from 4% in 2020-2021 to 9.5% by 2027, incentivise early repayment. It is likewise Scope's understanding that Lufthansa's management will strive to repay the silent partnership as soon as this is financially feasible. The conversion options for EUR 1.0bn of the silent partnership would only become effective in the event of a takeover attempt and/or if Lufthansa deferred payment on the silent partnership from 2024-2026.

Lufthansa's business risk profile is unchanged at BBB-, supported by globally diversified operations including the diversified worldwide route network, geographical reach, broad fleet of aircraft and solid position in the premium market for long-haul traffic. The business risk profile is limited by the risks of cyclical changes to discretionary travel that may result from event risks (as is currently the case with the pandemic), the fiercely competitive environment, and high operating leverage.

Lufthansa's liquidity is adequate, thanks to state aid via the EUR 5.7bn silent partnership, the EUR 3.0bn three-year revolving facility and the EUR 300m direct equity injection. These amounts plus available liquidity (EUR 4.3bn as of March 2020) are sufficient to cover short-term debt (EUR 1.6bn as of 31 December 2019) and the negative free operating cash flow forecast for 2020. For 2021, Scope expects free operating cash flow to be positive, supporting the coverage of financial maturities in 2021F in addition to the unrestricted liquidity.

Supplementary rating drivers in terms of parent support result in a two-notch uplift to Lufthansa's standalone credit quality. While the German government's EUR 300m direct equity injection has not resulted in majority ownership, reflecting 20% of voting rights and the provision of the non-voting subordinated silent partnership (EUR 5.7bn), Lufthansa remains strategically important to its new key shareholder. This view is based on the government's ability to convert some of its silent participation into statutory equity in the event of a takeover attempt of Lufthansa, as well as the political goals served in supporting Lufthansa such as the protection of employment.

Outlook

The Outlook is Negative. Visibility on further developments of the pandemic is low. Further, it remains uncertain whether economic deterioration, including via lower leisure and business travel, turns out more severe than that currently forecasted and incorporated in the assigned rating. Risks regarding a re-emergence of travel restrictions and lockdowns as well as uncertainty about the speed of recovery in air travel add further uncertainty.

A negative rating action would be warranted if travel restrictions including travel bans were to derail the expected gradual improvement in Lufthansa's important passenger business, leading to further funding needs and lower operating profits in 2021 than envisaged currently. A negative rating action would be indicated by Scope-adjusted debt/EBITDA reaching above 4.0x on a sustained basis. Scope deems a withdrawal or weakening of parent support to be a remote scenario.

A positive rating action appears a remote scenario at this stage. Lufthansa is unlikely to deleverage significantly beyond Scope's forecasts for 2021 unless capital structure measures were taken that reduce the elevated debt levels caused by the funding of negative cash flows in 2020F. A positive change in the Outlook to Stable would be possible if Scope-adjusted debt/EBITDA fell below 3.5x on a sustained basis.

Long-term and short-term debt ratings

The short-term rating is S-3. Senior unsecured debt has been rated BBB- as Scope does not notch upwards senior unsecured debt of issuers with an investment-grade rating. The outstanding hybrid bond, junior subordinated debt, remains rated at BB, two notches below the issuer credit rating.

Stress testing & cash flow analysis
No stress testing was performed. Scope performed its standard cash flow forecasting for the company.

Methodology

The methodology used for this rating(s) and/or rating outlook(s) Rating Methodology, Corporate Ratings (26 February 2020) is available on https://www.scoperatings.com/#!methodology/list.

Information on the meaning of each rating category, including definitions of default and recoveries can be viewed in the “Rating Definitions - Credit Ratings and Ancillary Services” published on https://www.scoperatings.com/#!governance-and-policies/rating-scale. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope’s definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale. Guidance and information on how Environmental, Social or Governance factors (ESG factor) are incorporated into the rating can be found in the respective sections of the methodologies or guidance documents provided on https://www.scoperatings.com/#!methodology/list.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.

The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties, and Scope-internal sources

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope’s ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

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The issuer rating/outlook, the short-term rating and the senior unsecured debt rating were first released by Scope on 4 November 2016. The ratings/outlooks were last updated on 31 March 2020

The junior subordinated debt rating was first released by Scope on 6 June 2018. The rating was last updated on 31 March 2020.

Potential conflicts

Please see www.scoperatings.com for a list of potential conflicts of interest related to the issuance of credit ratings.

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