Lufthansa rating downgraded to BBB- and under review for a possible downgrade

Lufthansa rating downgraded from BBB to BBB- and under review for a possible downgrade due to projected deterioration in financial risk profile following impact of coronavirus.

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

Rating action

Scope Ratings has today downgraded the issuer credit rating of Deutsche Lufthansa AG from BBB to BBB- and placed the rating under review for a possible downgrade. At the same time, Scope downgraded the short-term rating of Deutsche Lufthansa AG from S-2 to S-3. The rating for senior unsecured debt was downgraded from BBB to BBB-. Junior subordinated debt was downgraded from BB+ to BB. The downgrades follow Scope's rating review that now captures the likely negative effects of the coronavirus pandemic on Lufthansa's financial risk profile.

Rating rationale

The rating downgrade by one notch from BBB to BBB- of Lufthansa’s issuer rating is primarily driven by the expected deterioration of its financial risk profile in 2020 and beyond due to the grounding of aircraft and virtual suspension of its passenger aviation business amid the coronavirus pandemic. Lufthansa's senior unsecured debt ratings and junior subordinated debt (hybrid bond) have been downgraded by one notch.

Scope believes that Lufthansa’s business risk profile will remain at BBB-, supported by globally diversified operations including a diversified worldwide route network, geographical reach, a broad fleet of aircraft and a solid position in the premium market for long-haul traffic. However, the airline’s business risk profile is limited by the risk of cyclical changes to discretionary travel due to unexpected events (such as the current worldwide coronavirus outbreak), the fiercely competitive environment, and high operating leverage.

Lufthansa has massively scaled back its capacity following the worldwide spread of coronavirus. At this stage, Scope expects revenues to decline by about 40% in 2020, assuming that passenger flight operations gradually resume in June 2020 with a provisional flight schedule and significantly lower flight frequencies than last year. In view of Lufthansa’s cost structure, split into 60% variable costs and 40% fixed costs, operating leverage will drastically reduce operating profit (EBITDA) in 2020 and likewise decrease projected cash flow generation.

Lufthansa has responded to the deteriorating trading conditions quickly and initiated a cost reduction programme, including a cut in marketing spending, the offer of unpaid leave and the delay of non-safety maintenance work. The cost measures will be supplemented by short-time work for staff, thus reducing personnel costs substantially. Business in the cargo unit is holding up well in the current environment, given various transportation needs and a shift away from land to air transport in view of the border controls enforced recently.

The MRO (maintenance, repair and overhaul) unit is likely to feel the effects of grounded aircraft worldwide from the second quarter 2020 onwards. Overall, Scope expects this year’s EBITDA to decline by 75%, if not more. Consequently, Lufthansa’s cash generation in 2020 will be limited.
Credit ratios provide less insight than normal in the current environment and Scope's financial risk profile assessment is clearly focussed on the group's liquidity situation. Lufthansa entered 2020 with EUR 1.4bn in cash and EUR 2.0bn in cash equivalents (marketable securities). In addition, the group had available the usual bilateral lines agreed with various commercial banks in an amount of EUR 774m. Total liquidity as of March 2020 was EUR 4.3bn plus undrawn committed bilateral lines, free of financial covenants, due to financing activities completed in the first two months of the year. Reported short-term debt for 2020 of EUR 1.6bn should be safely covered but projected negative free operating cash flows are likely to be a more severe drain on liquidity.

Key to the preservation of cash within the group, on top of the cost reduction measures already initiated, will be two important levers: i) keeping cash from unused flight documents within the group; and ii) reducing projected capital expenditures in 2020 and possibly beyond. Lufthansa has obligations from unused flight documents of EUR 4.0bn as of 31 December 2019. The airline is managing these liabilities and trying to retain the cash in the group by offering vouchers and generous re-booking options. The cash outflow from unused flight documents is difficult to gauge at this stage and Scope has assumed that some customers will request a refund on their unused tickets. Lufthansa's original plan of EUR 3.0bn in capex to in-fleet new aircraft is very likely to be cut drastically. The decrease in capex largely depends on ongoing negotiations with aircraft makers regarding the order delay and the reduction of pre-delivery payments for ordered aircraft. The magnitude of negative free operating cash flow in 2020 very much depends on Lufthansa's success in keeping cash outflows from unused flight documents and capex in check.

To fund cash needs from operations in 2020, Lufthansa can revert to the 86% of its fleet which it owns, of which almost 90% is unencumbered. The total book value of unencumbered aircraft is about EUR 10bn and aircraft can be used as collateral to raise funds. Lufthansa has a carve-out for aircraft financing in its negative pledge of senior unsecured debt outstanding. The group has no intention to enter into ‘fire-sale’-and-lease-back transactions and is currently in negotiations with a wide variety of its relationship banks over securing collateralised aircraft financing, possibly backed by state guarantees. Many of the aircraft financing deals can be effectuated quickly. At this stage, Scope does not see the need to make use of the entire collateral to arrange funding. Scope currently forecasts funding needs of about EUR 2.0-2.5bn in 2020 but cautions that this forecast is very sensitive to the agency's assumptions regarding reduced capex spending and the retention of cash from unused flight documents within the group. This forecast is likewise based on the assumption that Lufthansa would want to retain a certain cash balance throughout the year.

**Review for a possible downgrade**

The issuer credit rating is under review for a possible downgrade. Scope will closely follow developments in the global aviation sector and, in particular, its assumptions with regard to a gradual resumption of flight operations at Lufthansa in the third quarter of 2020. In addition, Scope will also closely monitor updates and developments regarding unused flight documents, capital expenditure cuts, and possible aircraft financing arrangements. Scope will resolve the review status once there is more clarity and visibility on the development of the corona crisis and its impact on Lufthansa. The rating agency expects to resolve the review status within the next six months.

At this stage, Scope does not foresee any positive rating-change drivers given the expected negative developments.

**Long-term and short-term debt ratings**

The short-term rating is S-3. This is because Scope has placed the BBB- issuer credit rating under review for a possible downgrade. Senior unsecured debt is rated BBB- as Scope does not notch senior unsecured debt for investment-grade rated issuers. The outstanding hybrid bond, junior subordinated debt, remains two notches below the issuer credit rating and has been downgraded by one notch to BB.
Stress testing & Cash flow analysis
No stress testing was performed. Scope performed its standard cash flow forecasting for the company.

Methodology
The methodology/ies used for this rating(s) and/or rating outlook(s) is Rating Methodology, Corporate Ratings available on www.scoperatings.com


Solicitation, key sources and quality of information
The rated entity 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.

Lead analyst: Werner Stäblein, Executive Director
Person responsible for approval of the rating: Olaf Tölke, Managing Director

The ratings/outlooks were first released by Scope on 4 Nov 2016. The ratings/outlooks were last updated on 4 June 2019

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

Conditions of use / exclusion of liability
© 2020 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Analysis GmbH, Scope Investor Services GmbH and Scope Risk Solutions GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope’s ratings, rating reports, rating opinions and related research and credit opinions 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. Scope’s ratings, rating reports, rating opinions, or related research and credit opinions are provided ‘as is’ without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope’s ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope’s credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin. Scope Ratings
Analyst Contact: Werner Stäblein: w.staeblein@scoperatings.com
Team Leader: Olaf Tölke: o.toelke@scoperatings.com