Credit Rating Announcement

04 June 2019

Rating on Lufthansa raised to BBB, Outlook Stable

Corporate credit rating on German aviation group Deutsche Lufthansa AG raised to BBB from BBB-. Senior unsecured debt rating raised to BBB from BBB- previously. Subordinated junior debt raised to BB+ from BB. Short-term rating affirmed. Outlook Stable.

Rating action

Scope Ratings has today raised its long-term issuer rating for German aviation group Deutsche Lufthansa AG from ‘BBB-’ to ‘BBB’. At the same time, the rating on long-term senior unsecured debt issued by Lufthansa was raised from ‘BBB- to ‘BBB’. The subordinated junior debt rating was raised from ‘BB’ to ‘BB+’. Affirmation of short-term rating at ‘S-2’. All long-term ratings have a Stable Outlook.

Rating rationale

The change in ratings is driven by Scope’s expectation that Lufthansa is likely to continue to achieve financial credit metrics commensurate with a ‘BBB’ corporate credit rating. The group has enhanced its financial risk profile over the past two years with improving credit metrics, such as SaD/EBITDA moving from 2.2x in 2016 to 1.4x in 2018. This was primarily supported by a significant reduction of pension obligations, decreased currency and fuel-cost adjusted unit costs (CASK) at passenger airlines and stable demand in its MRO and Logistics unit.

2018 was a difficult year for Lufthansa with about EUR 1.1bn of headwinds (a fuel cost increase of EUR 855m, integration costs for Air Berlin of EUR 170m and an increase in irregularity costs of EUR 214m) but the group counterbalanced most of these effects by reducing unit costs (CASK). Scope expects 2019 to be the fourth consecutive year with unit costs reductions (CASK ex fuel and currency were down 1.2% at passenger airlines), partly due to the non-recurrence of integration costs and significantly lower irregularity costs. Lufthansa and Eurowings have taken steps to stabilise flight operations to avoid the service irregularities that afflicted the airline in 2018. While some of the flight delays and cancellations in 2018 were attributable to limitations in air traffic control and weather-related conditions, Scope does not believe these effects will take a similar toll on operating profit in 2019. Network Airlines (Lufthansa German Airlines, Swiss, and Austrian Airlines) and Eurowings have planned for a substantial number of reserve aircraft for the 2019 summer flight schedule, added more slack to timetables, brought forward landing times to avoid night flight bans, and expanded standby crews to cope with unexpected issues.

Lufthansa reported EBITDA of about EUR 5.0bn in 2018. The expected reduction of irregularity costs (EUR 518m in 2018 vs EUR 304m in 2017) back to a more normal level together with the non-recurrence of integration costs related to Air Berlin (EUR 170m) should support operating profit in a magnitude of about EUR 400-500m in 2019. At the same time, Lufthansa will have to cope with increased fuel headwinds (EUR

600m) in 2019. In terms of yields in the passenger aviation business, Scope expects the first half of 2019 to remain difficult (as already evidenced by the yield declines of 8.8% at Eurowings and 6.5% at Network Airlines in Q1 2019).

The European short-haul segment is still characterised by oversupply from the winter flight schedules. Market-wide capacity growth is expected to subside in the second half of 2019, supporting a more favourable yield development in that period. Eurowings has scaled its capacity growth ambitions (available seat kilometres, ASK) back to 0% and competing airlines have likewise scaled back European ambitions for ASK growth in 2019. For the time being, some capacity is also held back system-wide through the grounding of Boeing 737 Max 8 aircraft outside the Lufthansa group. Scope foresees stable operating profits (EBITDA) in 2019 due to a more rational competitive environment and Lufthansa's focus on stability in its flight operations.

Scope's estimates for 2019 are at the lower end of Lufthansa's public guidance (Adjusted EBIT in a range of 6.5%-8.0% versus Scope's estimate of 6.9% for Adj. EBIT). However, projected cash flow generation and capex spending EUR 3.6bn including the effects from capitalising the engine overhaul) should lead to a free operating cash flow substantially above dividend payments (EUR 380m payable in 2019). Cash flow generation in 2019 is slightly held back by higher cash-effective income taxes payable, an effect that Scope believes will reverse in 2020. Consequently, credit metrics should moderately improve further in 2020. Overall, Scope estimates SaD/EBITDA of 1.4x in 2019 followed by slight improvements in 2020 towards 1.2x. The financial risk profile leaves some headroom for unforeseen negative developments.

Scope has not included any effects from the potential changes in the scope of operations at Lufthansa in 2019 or 2020. One key change could be the (partial) sale of the catering business (LSG Group). Lufthansa has started a strategic review on the future of the unit within the group and Scope would expect substantial divestiture proceeds if any such sale was to be achieved. However, Scope does not expect any disposal, if completed at all, to be closed before 2020. The same is true for Lufthansa's publicly confirmed interest in Condor. Scope would view as positive a move to acquire Condor because this would pre-empt competitors' attempts to seize slots and connections in Lufthansa's home market. An acquisition price for Condor is difficult to estimate given the operating margins at Condor, an aged fleet, and possible intervention by the cartel authorities. Lufthansa's interest in Alitalia and the potential acquisition of some parts of the Italian carrier have not changed. The criteria defined by Lufthansa (restructured Alitalia, no government involvement) still remain unsatisfied. Consequently, the Alitalia transaction continues to look as remote as it was in the past quarters.

Lufthansa's liquidity remains better than adequate. The unrestricted cash position as of 31 Dec 2018 was EUR 3.2bn. In addition, EUR 849m of bilateral, undrawn and committed lines were available on the same date. Maturities of EUR 1.1bn in 2019 include the senior unsecured bond of EUR 500m due in Sept 2019. Lufthansa has already completed various refinancing transactions in 2019 including a promissory note issuance ("Schuldscheindarlehen" EUR 800m) and various secured aircraft financings. Short-term financial maturities are therefore covered. Short-term maturities in 2020 are manageable (EUR 0.5bn).

Outlook and rating-change drivers

The Outlook is Stable and incorporates Scope's expectation that Lufthansa should achieve debt protection measures such as Scope-adjusted debt (SaD)/EBITDA of below 1.5x and funds from operations/SaD of above 60% in the medium term.

Scope would consider a positive rating action if SaD/EBITDA or funds from operations/SaD were to improve sustainably to levels below 1.0x and above 100%, respectively.

Scope would consider a negative rating action if SaD/EBITDA were to deteriorate to levels of above 1.5x sustainably. This could be triggered by a sudden and unexpected negative change in discretionary travel (business and leisure) due to shifts in the macroeconomic environment, lower business confidence or event risks such as natural disasters, terrorist activities, political unrest or contagious diseases.

The rating is positively driven by the following:

- Significant deleveraging beyond Scope's base case; viewed as unlikely given the highly competitive environment and capex needs for fleet renewal programme;
- Successful reduction of unit costs and structural cost disadvantages through agreement of long-term labour agreements;
- Globally diversified operations with various well-known brands;
- Scale of operations including diversified worldwide route network and geographical reach with strong positions at its hubs in Frankfurt, Munich, Vienna, and Zurich;
- Diversified operations (MRO/Catering) with strong market positions mitigating risks of cyclicality in passenger and cargo traffic;
- Multi-hub strategy gives customers broad range of travel options; leading market position in home market of Germany; competitive advantage in premium long-haul traffic;
- Alliances with various international airlines, notably Star Alliance, supporting increased flight frequencies;
- Broad fleet of aircraft; fleet renewal programme with next-generation aircraft to support improving cost structures.

The following limit the rating:

- Sudden and unexpected negative changes to discretionary travel (business and leisure) due to a changed macroeconomic environment or lower business confidence;
- Event risks of natural disasters, terrorist activities, political unrest, contagious diseases or strikes by cabin crew or pilots;
- Intensifying competition from low-cost carriers and Gulf carriers, in particular at the major hubs in Frankfurt and Munich;
- Potential negative effects from the risk of over-capacity build-up in air travel industry;
- Exposure to cyclical changes in discretionary travel (business and leisure) and event risks such as natural disasters, contagious diseases or strikes negatively affecting passenger volumes;
- Intensely competitive environment including yield pressure from low-cost airlines and other network airlines;
- Risk of material fluctuations in operating profits in passenger airline division resulting from risk of volatility in passenger and cargo traffic and high operating leverage;
- Operating performance occasionally affected by strikes and labour disputes;
- Multi-hub strategy has drawback of strategic or tactical elimination of capacity without repercussions on the overall system.

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 and/or rating outlook Corporate Rating Methodology is available on www.scoperatings.com.
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 definition of default as well as definitions of rating notations can be found in Scope’s public credit rating methodologies on www.scoperatings.com.
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.
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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 04.11.2016. The ratings/outlooks were last updated on 21.12.2017

Potential conflicts

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