WEDNESDAY, 24/05/2023 - Scope Ratings GmbH

Scope affirms Deutsche Lufthansa at BBB- and changes Outlook to Positive from Stable

The raised Outlook reflects improving credit metrics driven by the continuing recovery in air traffic and by deleveraging.

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

Rating action

Scope Ratings GmbH (Scope) has today affirmed the issuer rating of Deutsche Lufthansa AG (Lufthansa) at BBB-. The rating Outlook has been changed to Positive from Stable. Scope has also affirmed the BBB- senior unsecured debt rating and the BB subordinated (hybrid) debt rating. The short-term rating has been affirmed at S-2.

Rating rationale

The rating action reflects Scope's expectation of strengthening credit metrics over the next two years, driven by the pace of recovery in air traffic and supported by recently reported results. All core business segments are on a good track. Rising passenger airlines revenues, a resilient cargo business and the contribution from maintenance, repair and overhaul (MRO) activities will ensure future growth.

The business risk profile (assessed at BBB-) continues to be supported by the group's well-diversified portfolio and the individual business segments' strengths. The group's leading market position in its home markets has allowed passenger revenues to recover in line with the rising demand in both leisure and business travel. Capacity in all of Lufthansa's passenger airlines expanded in 2022, reaching on average 72% of the pre-crisis level and helping to achieve an 80% average load factor. This momentum continued into 2023 and is expected to benefit from the sustained high air fares, the opening of key Asian markets and the further recovery of corporate travel. The full-year capacity for 2023 should reach around 85-90% of the 2019 level. With tight productivity management, the group expects capacity to normalise in 2024 at above 95% of pre-crisis levels.

The robust market positions of Lufthansa Cargo and Lufthansa Technik are key factors in Scope's strong assessment of market share and diversification for Lufthansa. Lufthansa Cargo is a market leader with a differentiated offering, also specialising in complex transport and benefitting from persistently high demand for airfreight. Technik holds a leading position in the growing MRO market and is well positioned to capture this growth, supported by a diversified customer base and partnerships with original equipment manufacturers. Lufthansa will also benefit from the especially strong demand for maintenance services as the airline industry continues to ramp up for the market recovery.

The group is making material moves towards improving profitability as showcased by the reported EBITDA of around EUR 3.8bn for the full-year 2022. Yields are increasing across all traffic regions, helped by demand for US travel to Europe being even stronger than before the pandemic. Unit costs are trending closer to 2019 levels, helped by cost reductions reaching EUR 3.2bn of the EUR 3.5bn target as of end-2022. Although rising staff costs and the high costs for air traffic control and airport use will lead to mid-single-digit cost inflation in 2023, Scope expects stable unit costs this year due to higher capacity utilisation and the full-year impact of the cost reduction programme. For 2024, unit costs will decline, driven by capacity expansion, increasing crew and aircraft productivity and efficiency gains from fleet renewals and the standardisation of operational processes and systems. The group is targeting an EBIT margin of at least 8% by 2024, and achieving this will further support Scope's profitability assessment.

Despite the resilient market share and improving profitability, the business risk profile is limited by the risks of cyclical changes to discretionary travel that may result from event risks (such as the pandemic) and the fiercely competitive environment.

The financial risk profile has improved to BBB from BB+ following the improvement in key credit metrics. Increased demand and cost savings have improved cash generation and lowered indebtedness. The Scope-adjusted debt/EBITDA leverage ratio fell below 2.5x in FY 2022. Based on strong Q1 2023 results and management guidance for improved bookings, Scope's base case for the leverage ratio is an improvement to below 2.0x already by FY 2023.

Likewise, debt protection as measured by Scope-adjusted EBITDA/interest cover will likely remain strong at around 10x, supported by Lufthansa's increased use of cheaper financing in the high interest rate environment (such as the use of JOLCO aircraft financing instead of bonds). The interest rates rise is also causing the pension deficit to reduce thanks to the higher discount rate for pension liabilities, which combined with strong cash flow, will help to strengthen the balance sheet even further.

In 2022, free operating cash flow benefitted in particular from the strong increase in bookings and related advance payments as well as an improvement in working capital. However, free operating cash flow may become weaker going forward because capital expenditure will increase due to fleet renewal and operations ramp-up, to EUR 2.5bn-3bn annually. Consequently, cash flow cover as measured by Scope-adjusted free operating cash flow/debt will weaken, to a forecasted range of 5%-10% from around 32% in 2022.

The rating case assumes no material impact from the upcoming divestment of non-core assets (LSG and AirPlus), the potential disposal of the minority stake in Lufthansa Technik, and the potential purchase of a stake in ITA Airways, all which may take place in 2023.

Lufthansa's liquidity is adequate. Strong operating cash flow led to an increased liquidity position. As of 31 December 2022, Deutsche Lufthansa AG had available liquidity of EUR 8.3bn. Additionally, liquidity benefits from an EUR 2.1bn in undrawn revolving credit lines and a fleet that is more than 85% unencumbered. Altogether, available liquidity can more than cover the estimated EUR 1.88bn in outstanding short-term debt as of YE 2023.The group's long-term liquidity target is around EUR 8bn-10bn to better protect itself against potential future crises.

In terms of supplementary rating drivers, financial policy continues to be neutral for the rating. Management shows a disciplined strategy as well as a commitment to deleveraging and keeping the investment grade level. Management's aim is to resume paying dividends in 2024 once stability returns.

The rating assessment identifies labour management, CO2 emissions and indirect sustainability challenges as the main ESG challenges to the airline industry (credit-negative ESG factor).

One or more key drivers of the credit rating action are considered ESG factors.

Outlook and rating-change drivers

The Outlook is Positive and incorporates our expectation of an improving financial risk profile, exemplified by a Scope-adjusted debt/EBITDA moving towards 2.0x.

A rating upgrade could be warranted if industry and business conditions continue to improve, resulting in a significantly higher operating cash flow and an improved financial risk profile, exemplified by a Scope-adjusted debt/EBITDA sustained at below 2.0x.

Scope could revise the Outlook back to Stable, if Scope-adjusted debt/EBITDA were to remain above 2.0x on a sustained level. 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.

Long-term and short-term debt ratings

Senior unsecured debt has been affirmed at BBB-, in line with the issuer rating.

Outstanding subordinated debt (hybrid) remains two notches below the issuer credit rating, at BB.

The affirmed short-term rating of S-2 is backed by the strong short-term liquidity cover and conservative liquidity management. The rating is further supported by well-established bank relationships and good standing in the capital markets, evidenced by the revolving credit line established in 2022.

Stress testing & cash flow analysis

No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology

The methodology used for these Credit Ratings and Outlook, (General Corporate Rating Methodology, 15 July 2022), is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. 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 Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Rated Entity and/or its Related Third Parties participated in the Credit Rating process.
The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity and Scope Ratings' internal sources.

Scope Ratings considers the quality of information available to Scope Ratings on the Rated Entity or instrument to be satisfactory. The information and data supporting the Credit Ratings originate from sources Scope Ratings considers to be reliable and accurate. Scope Ratings does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and Outlook and the principal grounds on which the Credit Ratings and Outlook are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures

These Credit Ratings and Outlook are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and Outlook are UK-endorsed.
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The issuer Credit Rating/Outlook, the short term Credit Rating and the senior unsecured debt Credit Rating were first released by Scope Ratings on 4 November 2016. The Credit Ratings/Outlook were last updated on 16 september 2022.
The subordinated (hybrid) Credit Rating/Outlook was first released by Scope Ratings on 6 June 2018. The Credit Rating/Outlook was last updated on 16 september 2022.

Potential conflicts

See www.scoperatings.com under Governance & Policies/Regulatory for a list of potential conflicts of interest disclosures related to the issuance of Credit Ratings.

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