12 November 2020

Corporates

Deutsche Lufthansa AG
Germany, Transportation

SCOPE BBB- NEGATIVE

Corporate profile

Lufthansa is a global aviation group organised into the following business segments: Network Airlines, Eurowings, Logistics and Aviation Services. The latter segment is divided into logistics; maintenance, repair and overhaul (MRO); catering; and other, service and financial companies. The group's revenue ranks it among the leading European airlines and the largest carriers worldwide.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
Scope-adjusted debt (SaD)/EBITDA	1.4x	1.9x[1]	-5.3x[1]	5.4x[1]
Scope-adjusted funds from operations/SaD	64%	41%[2]	-7%[2]	16%[2]
Free operating cash flow/SaD	10%	7%[3]	-32%[3]	3%[3]

Rating rationale

Scope Ratings has updated its financial forecasts for Deutsche Lufthansa AG. Our revised forecasts do not change the financial risk profile. Our updated financial forecasts for 2020 and 2021 now include the most recent information (Q3 2020 reporting) provided by Lufthansa and our analytical view on business developments.

This publication does not constitute a credit rating action. For the official credit rating action release see our publication from 14 July 2020. On 14 July 2020, Scope Ratings affirmed the issuer rating for Deutsche Lufthansa AG 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 is S-3.

Lufthansa's issuer rating is based on a business risk profile of BBB- and a financial risk profile of BB-, leading to a standalone credit quality of BB. Supplementary rating drivers in terms of parent support result in a two-notch uplift to Lufthansa's standalone credit quality. The two-notch uplift reflects the strategic importance of Lufthansa to its new key shareholder, the German government, including the political goals served in supporting Lufthansa such as the protection of employment.

Following the release of Q3 2020 results and our adjustments to financial forecasts for 2020 and 2021, we now anticipate negative free operating cash flow (FOCF) of around EUR 3.8bn in 2020 (versus EUR 5.5bn-6.0bn before), primarily due to significantly lower capital expenditures in 2020. Lufthansa has managed to deliver new aircraft, and aircraft delivery postponements will be a key relief for liquidity in 2020. Our updated 2021 forecast is based on Lufthansa's updated guidance. Lufthansa expects cash flow to be break-even if capacity utilisation in 2021 reaches about 50% of the pre-pandemic level. We expect the renewed lockdowns and travel bans across various countries to affect air traffic in early 2021, but, overall, we estimate Lufthansa's capacity utilisation in 2021 to average 50% of the pre-pandemic level. This should help to avoid a further cash drain from ongoing operations in 2021.

[1] Corrected on 8 February 2021 (formerly 15x in 2019, -5x in 2020F, 5x in 2021F)
[2] Corrected on 8 February 2021 (formerly 1.9x in 2019, -5.3x in 2020F, 5.4x in 2021F)
[3] Corrected on 8 February 2021 (formerly 41% in 2019, -7% in 2020F, 16% in 2021F)

Ratings & Outlook

Corporate ratings	BBB-/Negative
Short-term rating	S-3
Senior unsecured	BBB-
Junior subordinated	BB

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Related methodology

Corporate Rating Methodology, February 2020

Last credit rating action

Scope affirms Lufthansa at BBB- and assigns Negative Outlook; review for possible downgrade resolved, July 2020

Related research

European airlines outlook: travel slump, extra debt test sector's poor cash-generating capacity, September 2020

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Bloomberg: RESP SCOP

Normalised air traffic in 2021 could support FOCF

Our updated credit metrics for 2021 are only slightly weaker than the previous estimate and still point towards a Scope-adjusted debt (SaD)/EBITDA of around 5.0x and funds from operations/SaD of around 16% in 2021. At this stage, and assuming a gradual normalisation of air traffic in 2021, including an average capacity utilisation of about 50% of the pre-pandemic level, we expect minimally positive FOCF for Lufthansa in 2021.

Strategic options to deleverage

Our forecasts do not include potential proceeds from the sale of Lufthansa's European catering operations. On 10 December 2019, Lufthansa announced it had agreed to sell to Gategroup its European catering operations, lounge business, and retail convenience food with a long-term catering agreement for Lufthansa. Negotiations have been delayed due to the Covid-19 crisis. Lufthansa’s management has communicated its confidence that the transaction can be closed in late 2020 or early 2020. While financial details of the transaction are not disclosed, we expect a successful sale of the European catering unit to provide substantial cash inflows that could be used for de-leveraging. Our forecasts likewise do not include the strategic funding decision that Lufthansa may still take, which includes the sale of the non-European catering business. In the analyst call for 2019 results (March 2020), Lufthansa management also indirectly confirmed that an IPO or partial sale of Lufthansa Technik is being considered to reduce the elevated indebtedness resulting from the Covid-19 pandemic. It was, however, clearly communicated that Lufthansa Technik would remain majority-owned.

Outlook

Low visibility on rebound of air traffic leads to Negative 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.

Further funding needs in 2021 indicative of negative rating action

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 a SaD/EBITDA of above 4.0x on a sustained basis. We deem a withdrawal or weakening of parent support to be a remote scenario.

Positive rating action tied to capital structure measures

A positive rating action appears a remote scenario at this stage. Lufthansa is unlikely to deleverage significantly beyond our 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 SaD/EBITDA reached below 3.5x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Globally diversified operations with various well-known brands • Scale of operations, including diversified worldwide route network and geographical reach, with strong positions at hubs in Frankfurt, Munich, Zurich, and Vienna • Diversified operations (MRO/catering) with strong market positions mitigating cyclicality risks in passenger and cargo traffic • Multi-hub strategy gives customers a broad range of travel options; leading position in home market of Germany; competitive advantage in premium market for long-haul traffic • Co-founder of Star Alliance, supporting increased flight frequencies • Broad fleet of aircraft	• Exposed to cyclical changes in discretionary travel (business and leisure) and event risks, such as natural disasters, contagious diseases and strikes, which negatively affect passenger volumes • Fiercely competitive environment, including yield pressure from low-cost airlines and other network airlines • Risk of material fluctuations in operating profits for passenger airline segment due to risk of volatile passenger and cargo traffic and high operating leverage • Multi-hub strategy has low flexibility to adjust capacity tactically or strategically without repercussions on the overall system

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant deleveraging beyond our base case • Capital structure measures to reduce elevated debt levels • Leverage (SaD/EBITDA) of sustainably below 3.5x	• Further travel restrictions and bans leading to deterioration of air traffic • Deterioration of SaD/EBITDA to sustainably above 4.0x

Financial overview

In EURm			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
SaD/EBITDA	1.4x	1.9x*	-5.3x*	5.4x*
Scope-adjusted funds from operations/SaD	64%	41%*	-7%*	16%*
Free operating cash flow/SaD	10%	7%*	-32%*	3%*
Scope-adjusted EBITDA in EUR m	**2017**	**2019**	**2020F**	**20221F**
EBITDA	4,978	4,465	-2,223	2,132
Operating lease payments in respective year	521	0	0	0
Scope-adjusted EBITDA	**5,499**	4,465	**-2,223**	**2,132**
Scope-adjusted funds from operations in EUR m	**2017**	**2019**	**2020F**	**2021F**
EBITDA	4,978	4,465	-2,223	2,132
less: (net) cash interest as per cash flow statement	-18	-108	-318	-352
less: cash tax paid as per cash flow statement	-670	-1,009	1,998	211
less: pension interest	-97	-119	-105	-105
add: depreciation component, operating leases	390	0	0	0
add: dividends received from equity investments	143	243	-205	5
Scope-adjusted funds from operations	**4,726**	**3,472**	**-853**	**1,891**
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	6,685	10,030	13,846	13,822
Cash and cash equivalents	-3,235	-3,385	-3,790	-4,047
add: cash not accessible	61	61	61	61
add: pension adjustment	1,753	2,167	2,167	2,167
add: operating lease obligation	2,492	0	0	0
add: other bank borrowing	39	17	17	17
add: fair value hedges	-105	-178	-178	-178
less: hybrid bond	-250	-250	-250	-250
Scope-adjusted debt	**7,439**	**8,462**	**11,873**	**11,592**

*Corrected on 8 February 2021. See footnotes on page 1 for details.

Business risk profile

Business risk profile at BBB-

For our business profile assessment, we refer to our earlier publication on Lufthansa, which covers our analysis of the most relevant parameters for the rating (see our notes published on 4 November 2016 and 7 June 2018). Our business risk profile assessment for Lufthansa is at BBB-.

Financial risk profile

9M 2020 reflects impact of Covid-19 on air travel

Lufthansa's results for 9M 2020 reflects the impact of the Covid-19 pandemic on global aviation traffic. Group revenues declined 60% YoY while traffic revenues were down by 65%. In 9M 2020, Lufthansa Group airlines carried 32.2m passengers, representing only 29% of the level in last year's period. The logistics business developed positively in 9M 2020 with a revenue increase of 4% YoY. While freight capacity was down by 36%, triggered by a loss of freight capacity in passenger aircraft ('bellies'), cargo yields have increased in all regions due to the global loss of cargo capacity in passenger aircraft. Lufthansa reduced its capacity significantly as soon as the pandemic broke out in spring 2020. Tentative signs of market recovery in July and August 2020, with a gradual increase in flight capacities from levels in the preceding months, have worsened again after the summer travel season with the renewal of travel restrictions.

Winter flight schedule adjusted to reflect renewed restrictions

In the upcoming winter months, demand for air travel is expected to remain low due to the global increase of infection rates and the associated travel restrictions. The group has accordingly adjusted its winter flight schedule and now plans to offer a maximum of 25% of last year's capacity (available-seat-kilometres) in Q4 2020. This reduction is to ensure flight operations continue to positively contribute to earnings. Currently, we anticipate group revenue to decline by 63% in 2020 and then increase by 45% in 2021. For 2021, this assumes flight capacity can reach 50% of the pre-Covid-19 capacity on average. With new testing procedures such as coronavirus 'quick tests' introduced at selected airports in Q4 2020, Lufthansa may gradually benefit from a reopening of long-haul traffic, notably transatlantic connections, in the near term.

Capacity to be adjusted to shrinkage of aviation market

With the break-out of the pandemic, Lufthansa initiated wide-ranging restructuring measures across all operating functions with the aim of reducing fixed costs in the longer term. With no realistic chance for global aviation traffic to move back to pre-Covid-19 levels until 2024, Lufthansa's financial outlook and cash generation will depend strongly on a shrinkage of its overall capacity, including staffing levels. As at 9M 2020, Lufthansa reduced staff costs by around EUR 900m, and around 13,000 employees have left the group. Lufthansa is negotiating with collective bargaining partners (workers council, unions) on further cost reductions to adapt the group's size to the markedly smaller aviation market expected in the medium term. In 9M 2020, Lufthansa reduced fixed costs by more than one-third, including through short-time work schemes for a large part of the personnel. Short-time work arrangements in Germany have already been extended until the end of 2021, which will provide some relief on operating costs in 2021. Lufthansa expects to reach an agreement with its collective bargaining partners in Q4 2020. Any such agreement would result in a non-cash one-time restructuring expense booked in Q4 2020. The amount would depend primarily on the progress of negotiations, and the resulting cash effect in 2021 is difficult to judge at this stage.

Cash generation

EUR 2.3bn cash burn in 9M 2020

Lufthansa reported negative FOCF of EUR 2.3bn in 9M 2020, of which EUR 2.0bn was booked in Q3 2020. The cash burn in 2020 is better than we had expected earlier in the year. A drastic cut in capital expenditures and use of pre-delivery payments made in the past for new aircraft reduced capital expenditure to EUR 800m in 9M 2020, and we expect the level to reach around EUR 1.0bn at end-2020. As at 9M 2020, Lufthansa has repaid substantial amounts of unused flight documents to customers for coronavirus-related flight cancellations (EUR 2.0bn in Q3 2020 alone). The remaining outstanding amount of unused flight documents currently stands at EUR 300m and is subject to air traffic developments, including on ticket bookings. With rising air traffic expected in 2021, we likewise expect cash inflow from unused flight documents to increase.

Lower cash burn expected for remainder of 2020

For the remainder of 2020, Lufthansa's guidance for the average monthly cash drain is around EUR 350m. With almost all unused flight documents settled in Q3 2020, cash flow is set to improve for the remainder of the year. This monthly cash burn guidance excludes capital expenditures and volatile items such as working capital and restructuring items. Currently, we expect negative FOCF overall (including working capital and capex) of EUR 1.4bn in Q4 2020, which would lead to a total cash burn of EUR 3.7bn in 2020.

Largest part of negative FOCF in 2020 from repayment of tickets

Placing the expected negative FOCF in 2020 into perspective: EUR 3.0bn of negative FOCF is related to the settlement of unused flight documents, leaving 'only' EUR 700m of negative FOCF from ongoing operations unrelated to the repayment of unused flight documents. Lufthansa's guidance is for positive operating cash flow during 2021, which would require an increase in capacity to around 50% of the pre-crisis level. For 2021, we have modelled the average number of flights to reach the level of the pre-crisis period (2019). Positive cash generation in 2021 will depend largely on collective bargaining partners agreeing to a further reduction of fixed costs (in addition to potential cash effects in 2021 resulting from ongoing negotiations until year-end 2020). In view of the very tight control of capex and the successful renegotiations of aircraft deliveries with aircraft makers, we see capex in 2021 at similar levels as in 2020 (around EUR 1.0bn-1.2bn). Using the key assumption of passenger traffic recovering to an average of 50% of the pre-crisis level, combined with our capex and cost reduction forecast, we see Lufthansa reporting a mildly positive FOCF in 2021. This forecast is subject to various risks, notably the recovery in passenger numbers. A key conclusion, however, is that cash burn will peak in 2020.

Liquidity

Liquidity at EUR 10.1bn as of 30 September 2020

Lufthansa's liquidity is adequate. Total liquidity as of 30 September 2020 was EUR 10.1bn, of which EUR 6.3bn are unutilised under governmental support measures. So far, Lufthansa has received EUR 2.7bn from governmental stabilisation packages agreed with Germany, Austria, Belgium, and Switzerland. A silent German participation was utilised in an amount of EUR 1.0bn, and a loan secured by aircraft with KfW was agreed for the same amount. The equity capital increase of EUR 306m and utilisations of EUR 350m under the Austrian stabilisation package represent the remainder of drawings under the EUR 9.0bn governmental support schemes arranged in May 2020.

Short-term debt at EUR 3.2bn as of 30 September 2020

As of 30 September 2020, Lufthansa reported short-term financial maturities of EUR 3.2bn. This includes a hybrid bond (EUR 500m) given the first call date in February 2021, promissory notes (Schuldschein) of EUR 0.5bn, and aircraft financings. The short-term maturities also include bilateral credit lines totalling EUR 0.8bn that Lufthansa has drawn upon in Q2 2020. Bilateral lines are agreed with a large number of relationship banks (more than 30). Given that the hybrid bond does not have to be called on its first call date, Lufthansa can decide to retain the bond with no refinancing need.

Ongoing negotiations with banks that provided bilateral lines are aimed at extending debt maturities. In 2020, Lufthansa arranged EUR 250m of secured aircraft financings, with a further EUR 250m expected in the near term. Lufthansa continues to have access to unencumbered aircraft. Around 75% of Lufthansa's fleet was unencumbered prior to the governmental stabilisation packages agreed earlier this year. A total of 367 aircraft were pledged for the KfW loan, leaving a high number of unencumbered aircraft to be used as collateral. Lufthansa completed some aircraft sale-and-leaseback transactions but indicated it does not intend to make further use of this instrument because terms and conditions on secured aircraft financings are currently more favourable. On 10 Nov. 2020, Lufthansa placed a EUR 600m senior unsecured convertible bond with a 2% coupon and maturity in Nov. 2025. As pointed out, we expect Lufthansa to report a mildly positive FOCF in 2021, which would lead to no funding needs for ongoing operations. Our liquidity assessment does not consider potential proceeds from the sale of the European catering business.

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