Deutsche Lufthansa AG
Germany, Transportation

Corporate profile

Lufthansa is a global aviation group organized into the following business segments: Network Airlines, Eurowings, Logistics and Aviation Services (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	**2017**	**2018**	**2019F**	**2020F**
SaD/EBITDA	1.4x	1.4x	1.7x	1.5x
Scope-adjusted FFO/SaD	63%	64%	44%	56%
FOCF/SaD	34%	10%	8%	15%

Rating rationale

Scope Ratings updated its financial forecasts for Deutsche Lufthansa AG. Our revised forecasts do not change the financial risk profile assessment. Our forecasts for 2019F and 2020F now include the update guidance from June 2019 provided by Lufthansa for 2019F including our analytical view.

This publication does not constitute a credit rating action. For the official credit rating action release see our publication from June 4, 2019. On June 4, 2019, Scope raised the issuer rating for Deutsche Lufthansa AG to BBB from BBB- previously. Senior unsecured debt issued by the company is rated BBB. Subordinated junior debt is rated BB+. The short-term rating is S-2. The outlook is Stable.

Following Lufthansa's revision of the full year guidance for 2019 and subsequent release of half-year results, we have slightly adjusted our financial forecasts for Lufthansa. Our adjustments to financial forecasts were minimal as we had incorporated operating profit estimates at the lower end of Lufthansa's preceding guidance.

Lufthansa's revised guidance for 2019 for adj. EBIT margin is now for a range of 5.5%-6.5% (versus 6.5%-8.0% before). Price deterioration in Europe due to market-wide overcapacities and growing low-cost carrier competition will likely continue to leave their marks on the profitability of Eurowings. In view of this environment, it remains difficult for the Group to pass on the increased fuel bill (EUR 550m in 2019) via higher ticket prices. The guidance revision was less surprising with regards to the overcapacity in the European short-haul market as this was well flagged before. The magnitude of impact on Eurowings (now guided to achieve a negative adj. EBIT margin in the range of -4% to -6% versus 0% previously) was the most pronounced. The new earnings guidance for Eurowings suggests that the operating loss at Eurowing in 2019F is higher than the operating loss posted in 2018, i.e. there is no improvement for the operating profit which was burdened by the integration costs of Air Berlin and the high irregularity costs for flight operations recorded in 2018.

Lufthansa's full-year results will likewise be burdened by a provision for tax risks for the years 2001-2005 following the revaluation of those risks (EUR 340m charge).

Ratings & Outlook

Corporate Ratings	BBB/Stable
Short Term Rating	S-2
Senior Unsec. Rating	BBB
Junior subordinated	BB+

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Related methodology

Corporate Rating Methodology

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At Network Airlines the long-haul business proven to be resilient offsetting the price pressures in two of Lufthansa's home markets, Germany and Austria. The mild revision of the guidance for Network Airlines (now expected to achieve adj. EBIT in a range of 7% to 9.5%) was effectively reflected in our prior forecasts. The European market will very likely remain challenging for the remainder of the year. The original expectation that overcapacity which existed in the winter schedules 2018/2019 of all airlines in the region would subside has proven to be slightly too optimistic.

While there will be a significant reduction of irregularity costs in 2019F (EUR 518m in 2018 and EUR 304m in 2018) and no significant costs for the integration of Air Berlin (was EUR 170m in 2018), most of those effects will be negatively balanced by the yield pressure at Eurowings and the short-haul business at Network Airlines.

As expected, the very high levels of profit margins reported in the Logistics (cargo) unit have been a bellwether for difficult times ahead. The Logistics business reported adj. EBIT margin of close to 10% in 2018 and 2017. High load factors, improving yields and the effects from the cost reduction measures taken in the Logistics unit have lifted the margin to the levels not observed for a decade. In view of the strong demand for airfreight in 2018 and high demand for special freight business (eg, express) new capacity was attracted to the airfreight market eventually leading to price effects. We likewise believe that some volume effects (pre-buy of merchandise ahead of the implementation of tariffs in different regions) has led to a one-time volume effect in 2018. The Logistics unit can de-fleet cargo aircraft (as it was done in 2016 when market capacity exceeded demand substantially) and should be able to adjust to the new market environment.

The new guidance for a low single digit revenue increase combined with the guidance for adj. EBIT suggests that Lufthansa's adj. EBIT should be in a range of EUR 2.0-2.4bn in 2019F. We are at the lower end of this range with our estimates.

Our new forecasts for 2019F suggest a mild deterioration of credit metrics, primarily due to higher cash taxes payable (eventually dragging down the free operating cash flow in 2019). We are now looking for a Scope-adjust debt (SaD)/EBITDA ratio of 1.7x in 2019F followed by mild improvement in 2020F. This is within the understanding of our outlook for the current rating of "BBB". We have not included effects from possible changes of consolidation at Lufthansa Group through either disposals or acquisitions in our estimates (see below).

Outlook

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.

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; fleet renewal programme to support improvements in cost structures through next-generation aircraft • Moderate leverage as measured by SaD/EBITDA and good financial flexibility	• 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 the 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 • Substantial reduction of unit costs (cost per available seat kilometer) and structural cost disadvantages • Financial credit metrics sustainably below 1.0x (SaD/EBITDA)	• Sudden and unexpected negative changes to discretionary travel (business and leisure) due to shifts in macroeconomic environment, or lower business confidence • Event risks including natural disasters, terrorist activities, political unrest, contagious diseases, and strikes by cabin crew or pilots; potential negative effects from the risk of overcapacity build-up in the air travel industry • Intensifying competition from LCCs or other network carriers, in particular at the major hubs of Frankfurt or Munich • Deterioration of SaD/EBITDA to sustainably above 1.5x

Financial overview

In EURm			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
SaD/EBITDA (x)	1.4x	1.4x	1.7x	1.5x
Scope-adjusted FFO/SaD	63%	64%	44%	56%
FOCF/SaD	34%	10%	8%	15%
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	5,205	4,978	4,577	4,872
Operating lease payment in respective year	472	521	0	0
UFO agreement (2016) / VC agreement (2017)	-582	0	0	0
Scope-adjusted EBITDA	**5,095**	**5,499**	**4,577**	**4,872**
Scope funds from operations in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	5,205	4,978	4,577	4,872
less: (net) cash interest as per cash flow statement	-92	-18	-250	-215
less: cash tax paid as per cash flow statement	-385	-670	-900	-478
less: pension interest	-159	-97	-93	-92
add: depreciation component op leases	337	390	0	0
add: dividends received from @equity	87	143	130	142
less: UFO agreement (2016)/VC agreement (2017)	-582	0	0	0
Scope funds from operations	**4,411**	**4,726**	**3,464**	**4,229**
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	6,814	6,685	6,935	6,935
Cash and cash equivalents	-3,948	-3,235	-3,254	-3,539
add: cash not accessible	69	61	61	61
add: pension adjustment	1,571	1,753	2,085	2,085
add: operating lease obligation	2,768	2,492	2,300	2,300
add: other bank borrowing	18	39	39	39
add: fair value hedges	-83	-105	-105	-105
less: hybrid bond	-250	-250	-250	-250
Scope-adjusted debt	**6,959**	**7,439**	**7,811**	**7,525**

Business risk profile

For our business profile assessment, we refer to our earlier publication on Lufthansa covering our analysis of the key parameters that are relevant for the rating (see our notes published on Nov. 4, 2016 and June 7, 2018).

Financial risk profile

The unchanged financial risk profile assessment now reflects the projected credit ratios for a SaD/EBITDA of 1.7x in 2019F (vs. 1.4x before) followed by 1.5x in 2020F (vs. 1.2x before. Free operating cash flow (FOCF) in 2019 will be held back at Lufthansa by (non-recurring) higher cash payments for income taxes and we see FOCF in 2019 below the level of the dividend payment (EUR 400m). Coverage of regular dividend payments through FOCF should be achieved again in 2020F.

Liquidity

The short-term rating is S-2. Scope views Lufthansa's liquidity and financial flexibility as more than adequate in accordance with our methodology for determining the liquidity of corporates. Future financial liabilities are covered by internal sources (cash and expected cash generation) and external sources (committed bilateral credit lines). Lufthansa has strong banking relationships, as demonstrated by numerous bilateral lines with different institutions and a good standing in public debt markets.

Lufthansa's liquidity remains 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 September 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).

The unencumbered fleet of aircraft is a further potential source of financial flexibility given the liquid market for commercial aircraft created by aircraft lessors, banks, and private funds. As of Dec. 31, 2018, 77% of Lufthansa's fleet was unencumbered (was 75% in 2017, 72% in 2016 and 74% in 2015). Unencumbered aircraft could serve as collateral for secured financing if the need arises.

Sale of catering business, Condor, Alitalia

We have not included any effects from the potential changes in the scope of consolidation at Lufthansa in 2019 or 2020.

Catering (LSG Group): One key change could be the (partial) sale of the catering business. Lufthansa initiated 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. Potential acquirers of the Catering business are unlikely from the strategic (airline) catering industry (such as Gategroup, SATS or Do&Co) as there are potentially too many antitrust hurdles. The Catering business may likewise be sold separately as some of the value of the business depends on the large customer Lufthansa.

Condor: Lufthansa has 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. Lufthansa is a key feeder airline for Condor and Condor was a part of the Lufthansa Group until late 1990s – the final 25% stake in Condor was sold to Thomas Cook in 2009. Condor is a leisure airline with about 40 aircraft in operation serving vacation destinations worldwide with some complementary routes to Lufthansa. Condor could be merged into Eurowings and during the annual general shareholder meeting, Lufthansa's CEO confirmed that a non-binding offer for Condor's short-haul and long-haul business was placed. A key drawback of Condor is its aged fleet with B757 and B767 long-haul aircraft with average fleet age of about 20 years. Replacement investments for renewal of Condor's fleet would be substantial but in view of Lufthansa's existing fleet renewal program for its own fleet, we see a chance that those aircraft de-fleeted by Lufthansa could be used to replace the aged fleet of Condor. An acquisition price for Condor is difficult to estimate given the operating margins at Condor, an aged fleet, and possible intervention by cartel authorities.

Alitalia:

Lufthansa's interest in Alitalia and the potential acquisition of some parts of the Italian carrier have not changed. Alitalia's fleet size is slightly larger than the former fleet size of bankrupt Air Berlin. The criteria defined by Lufthansa (restructured Alitalia, no government involvement) still remain unsatisfied. Lufthansa has repeatedly mentioned to rule out an entire takeover of Alitalia and Lufthansa would only be interested in certain assets of Alitalia once the operations of the Italian carrier are restructured. Consequently, the Alitalia transaction continues to look as remote as it was in the past quarters.

Financial policy, dividend payments and shareholder remuneration

Lufthansa has publicly declared certain transparent financial parameters for its principal financial policy and strategy, including for shareholder remuneration. In June 2019, Lufthansa changed its long-standing dividend policy and now plans to pay out a regular dividend of 20%-40% of the Group's net profit (adjusted for one-time gains and losses). The prior policy stipulated a payout of 10%-25% of Lufthansa's Group EBIT, subject to the availability of distributable reserves at the holding accounts. With reference to the old dividend policy, Lufthansa has proven to distribute dividends to shareholders cautiously. The payout ratio for 2018 was 13%. This compares to a payout ratio of 13% for 2017 (excluding the effect from the pilot union agreement) and the dividend declared for 2016 was 14% of previous year's EBIT (at that time adjusted for the effect of the agreement with UFO union).

In our base case we have assumed that Lufthansa continues with its policy of dividend continuity. Future dividend payments are therefore covered by expected cash generated from ongoing operations less capex (FOCF), eventually leading to a small deleveraging. Lufthansa's moderate dividend payout (and moderate payout policy) is a key support for the rating.

In principle, Lufthansa's dividend and shareholder remuneration policies provide the option of special dividends or share buybacks. However, we do not believe that Lufthansa will use any of these instruments. In our opinion, cash generated from ongoing business will continue to be used to fund fleet modernisation.

Lufthansa has proved that it can balance debtholder interests with shareholder interests when needed, by reducing dividend payments in economically weaker periods (dividends in 2010 for 2009 were cut substantially).

We also highlight the cautious attitude that Lufthansa is expected to maintain with regard to its financial flexibility. Lufthansa’s policy is to keep a minimum liquidity reserve of EUR 2.3bn to accommodate unforeseen changes in demand and air traffic.

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