Deutsche Lufthansa AG
Germany, Airlines

Corporate profile

Deutsche Lufthansa AG (Lufthansa Group) is a global aviation group organised into the following business segments: Network Airlines, Eurowings, 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	2019	2020	2021E	2022E
EBITDA/interest cover	14.8x	-8.4x	1.2x	8.3x
Scope-adjusted debt (SaD)/EBITDA	1.9x	-4.7x	31.1x	4.0x
Scope-adjusted funds from operations/SaD	41%	-22%	4%	21%
Free operating cash flow/SaD	7%	-26%	-5%	6%
Liquidity	60%	>100%	>200%	>200%

Rating rationale

Scope Ratings GmbH (Scope) has today affirmed the issuer rating of Deutsche Lufthansa AG at BBB-/Negative. Scope has also affirmed the BBB- senior unsecured debt rating and the BB contractually subordinated debt (hybrid) rating. The S-3 short-term rating has also been affirmed.

The rating affirmation is based on Lufthansa Group's improving financial situation despite the slow recovery of air traffic. The Outlook remains Negative, however, reflecting the continuing uncertainty regarding the pandemic's impact and a potential recovery, even with state aid and the measures taken to reduce cash burn and secure liquidity (including a potential equity increase).

The business risk profile (assessed at BBB-) reflects the fact that Lufthansa remains among the largest airline group globally, with a worldwide presence via multiple hubs. This is despite Lufthansa having downsized its fleet in response to the lower demand, a step also taken by most of its peers during the pandemic. In addition, the group aims to not only defend its market position but also strengthen it, both inside and outside its hubs. While the pace of recovery remains uncertain, the group is ready to meet any surge in demand by providing a segmented offering and exploiting growth opportunities. Further, diversification into other activities, especially the cargo business, has helped to offset the impact of reduced passenger traffic, still a major revenue driver. The group is taking the opportunity to restructure during the crisis, with the aim to thrive in a new norm that may see the downfall of weaker airlines.

With vaccinations accelerating, bookings have risen, especially among leisure customers on European short haul and transatlantic flights. The group is expecting a recovery this year to around 40% of 2019 capacity, though pre-crisis levels are not anticipated before 2024 or 2025. Profitability is still weak with the load factor remaining below 70%. While EBITDA remains negative, the group is expected to break even either this year or early in the next, helped by the gradual traffic recovery and efforts to reduce costs by accelerating fleet restructuring and modernisation, simplifying operations and reducing overheads and personnel costs.

Ratings & Outlook

Corporate rating	BBB-/Negative
Short-term rating	S-3
Senior unsecured rating	BBB-
Hybrid	BB

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Related Methodology

Corporate Rating Methodology: July 2021

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The financial risk profile (assessed at BB-) is based on the still weak credit metrics due to the limited cash generation. At this stage, we expect a Scope-adjusted debt (SaD)/EBITDA ratio of above 10x and a funds from operations/SaD ratio of around 4% for 2021, with gradual improvements thereafter due to cash inflow from ongoing operations and no dividend payments. We still expect revenues in 2021 to be around 55% lower than in 2019. Assuming the recovery continues into 2023 and given the actions taken to reduce capex and fixed cash costs, our base case foresees credit metrics to improve, with a SaD/EBITDA of below 3.5x by 2023. The analysis assumes a capital increase of at least EUR 2.5bn, as the group was authorised to draw up to EUR 5.5bn subject to conditions being met. Net proceeds from the capital increase would be directed towards repaying stabilisation funds (provided by Germany's Economic Stabilisation Fund) as well as strengthening the balance sheet. We did not account for proceeds from non-core divestments (AirPlus and LSG) or the option to draw the full EUR 4.5bn silent participation 1 of the state aid package. Scope believes the group can achieve its net debt/EBITDA target of 3.5x via the ongoing restructuring, cost-cutting, possible divestitures, undrawn state aid funds and, more importantly, the traffic recovery that will ensure strong free operating cash flow.

Lufthansa's liquidity is robust, bolstered by huge efforts to secure and preserve a comfortable cash buffer and reduce the cash drain. Liquidity is further strengthened by the undrawn state aid, unused credit lines of EUR 360m as of 2021Q1, a more than 70% unencumbered fleet, and a potential direct equity injection (subject to state-aid conditions). As of 31 March 2021, Deutsche Lufthansa AG had centrally available liquidity of EUR 3.7bn. A further EUR 4.5bn is available from the Economic Stabilisation Fund (Silent Participation I). Altogether, the group's available liquidity comes to EUR 10.6bn, which is more than sufficient to cover around EUR 2.1bn in outstanding short-term debt as of 2021Q1 and the negative free operating cash flow forecast for 2021. For 2022, Scope expects free operating cash flow to be positive, which will support coverage of financial maturities in that year and boost unrestricted liquidity.

Supplementary rating drivers in terms of parent support result in a two-notch uplift above Lufthansa's standalone credit quality. The German government's EUR 300m direct equity injection did not result in majority ownership, but 20% of voting rights. Despite this seemingly low representation, Scope believes Lufthansa remains strategically important to the German state, therefore we are upholding the two-notch rating uplift for parent support.

Outlook and rating-change drivers

This Negative Outlook reflects the persistent uncertainty around the speed at which international air traffic and, subsequently, Lufthansa's operating performance will recover over the next few years.

Scope may downgrade the rating further if it expects Lufthansa's financial metrics to remain weak beyond 2022 with no medium-term recovery of SaD/EBITDA to below 3.5x. This could be the result of a slower-than-expected recovery of free operating cash flow amid a sluggish revival of international air travel or new governmental travel restrictions imposed.

A positive rating action (i.e. Outlook back to Stable) could be warranted if free operating cash flow and the potential capital increase allowed SaD/EBITDA to reach below 3.5x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Broad fleet of aircraft • 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 • Co-founder of Star Alliance, supporting increased flight frequencies	• Multi-hub strategy has low flexibility to adjust capacity tactically or strategically without repercussions on the overall system • 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

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA of below 3.5x sustainably	• Further travel restrictions and bans leading to deterioration of air traffic • SaD/EBITDA of persistently above 3.5x beyond 2022

Financial overview

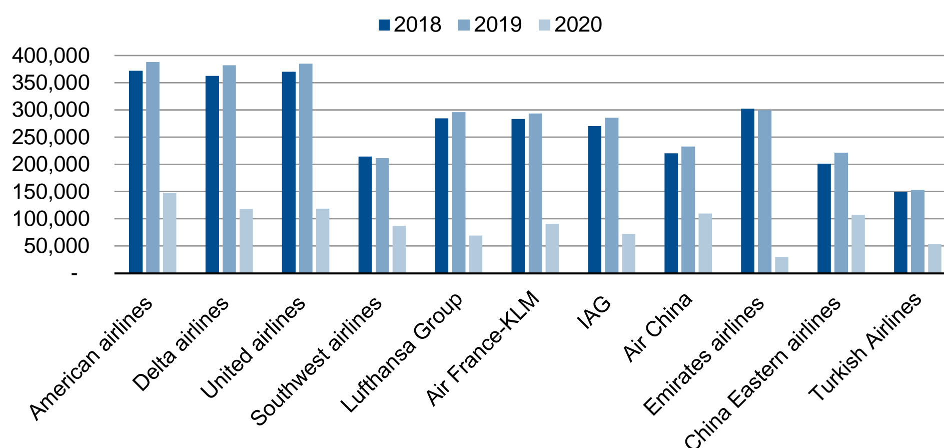
			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	14.8x	-8.4x	1.2x	8.3x
Scope-adjusted debt (SaD)/EBITDA	1.9x	-4.7x	31.1x	4.0x
Scope-adjusted funds from operations/SaD	41%	-22%	4%	21%
Free operating cash flow/SaD	7%	-26%	-5%	6%
Scope-adjusted EBITDA in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	4,465	-2,700	471	3,454
Operating lease payments in respective year	0	0	0	0
Scope-adjusted EBITDA	4,465	-2,700	471	3,454
Scope-adjusted funds from operations in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	4,465	-2,700	471	3,454
less: (net) cash interest as per cash flow statement	-108	-157	-296	-331
less: cash tax paid as per cash flow statement	-1,009	81	437	-154
less: pension interest	-119	-97	-100	-100
add: dividend received from @equity	243	57	30	35
Scope-adjusted funds from operations	3,472	-2,816	542	2,904
Scope-adjusted debt in EUR m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	10,047	15,382	18,456	19,141
less: hybrid bonds	-250	-250	-250	-250
less: cash and cash equivalents	-3,385	-5,460	-6,598	-8,041
add: cash not accessible	61	61	100	100
add: pension adjustment	2,167	3,034	3,034	3,034
add: operating lease obligations	0	0	0	0
Other	-178	-112	-112	-112
Scope-adjusted debt	8,462	12,655	14,630	13,871

Business risk profile BBB-

Global leader in different aviation services

Lufthansa is among the largest network carriers worldwide as measured by revenue passenger kilometres. Its Aviation Services segment contains several group companies that are global leaders in their respective sectors. To secure and build on its successful positioning, Aviation Services is permanently adapting its business models to changing markets and competitive environments.

Figure 1: Largest airlines worldwide by revenue passengers seat (RPK) in EUR m



Source: Bloomberg, Scope

Lufthansa business segments

Network Airlines

Lufthansa's passenger business is split into the business segments Network Airlines and Eurowings (point-to-point operations, detailed in next section). Network Airlines is focused on the hub and long-haul carrier business, which includes all domestic and European routes from and to Frankfurt, Munich, Zurich, Vienna and Brussels.

The airlines operating under this segment are Lufthansa German Airlines, SWISS, Austrian Airlines and Brussels Airlines. Their market positions are supported by their strong presence in their respective home markets of Germany, Switzerland, Austria and Belgium, providing customers with a broad range of travel options covering more than 100 countries. The broad fleet of aircraft and good position in long-haul premium traffic further bolster Lufthansa's competitive position. Lufthansa's high-density network of routes is complemented by its long-standing partnerships, alliances, collaborations and code-sharing connections with international airlines.

Intense pricing competition is a key threat for Network Airlines; yield pressure even exists for premium traffic. Low-cost carriers (LCCs) in the short and medium-haul segments are providing fierce competition, but have so far failed to dent Lufthansa's position in key domestic markets. LCCs do not always target the same passengers as Lufthansa as they serve secondary airports and mostly leisure travellers. Recently, however, LCCs have started operations at major airports, such as Ryanair with a larger flight schedule to various destinations to and from Frankfurt, and easyJet in Berlin. This could force Lufthansa to cater to the typically price-sensitive LCC customer. At the same time, certain long-haul routes are seeing a competitive squeeze from full-service carriers including the three largest American airlines, Air France-KLM, IAG and the Middle Eastern carriers.

Eurowings (point-to-point segment)

The point to-point segment is part of the strategy to create a low-cost brand for point-to-point connections under the umbrella of the Eurowings brand. To this end, Eurowings focuses on a different cost structure, including the harmonisation of its fleet with A320 aircraft and A330-200 aircraft for long-haul traffic.

Along with aircraft costs, Eurowings aims to keep crew-related, maintenance and other operational costs low. Eurowings is a traditional LCC: about 75% of customers travel for leisure and 25% for business, both to and from primary and secondary airports.

Eurowings benefits from structurally higher revenues per available seat kilometre. This is because it has more business travellers than other LCCs and has slot constraints at certain airports. However, Eurowings could still improve in lowering operating costs (CASK) compared to the other LCCs.Before the Covid crisis, Eurowings further expanded its fleet and undertook passive consolidation.,

Lufthansa Group and most of the peers had to downsize during the pandemic to reduce cash burn and match the lower demand. The Group also ceased Germanwings' operations and phased out old aircraft. The restructuring and modernisation plan has given Lufthansa the flexibility to meet increasing demand or take advantage of growth opportunities. However, the pace of a recovery in aviation depends heavily on the easing of restrictions, which is being helped by the vaccination roll-out. The group assumes a recovery in 2021 of 40% of the 2019 capacity and 90% or more in 2024.

Aviation Services

The segment is divided into logistics; maintenance, repair and overhaul (MRO); catering; and other, service and financial companies.

Logistics (Lufthansa Cargo)

Lufthansa Cargo is among the top cargo airlines worldwide as measured by revenue tonne kilometres. Airfreight is a traditionally very volatile industry. In the cargo business, any reduction in input costs (lower oil prices) is immediately reflected in pricing – unlike passenger fares, where the airline is provided some relief from lower oil prices. Visibility in the segment is limited to a few weeks and demand can change quickly.

Global airfreight traffic has declined much less during the pandemic than passenger traffic. Lufthansa Cargo was particularly affected by the loss of belly capacity on passenger aircraft: overall capacity fell by 36% in 2020. Freighter capacities, in contrast, increased slightly. Important to note that the Cargo business had a stellar year, recording record earnings of EUR 772m from the upward pressure on yields which more than compensated for the belly capacity decline. Only Lufthansa Cargo made a positive contribution to group earnings in 2020 alongside some active cost management.

MRO (maintenance, repair and overhaul)

Lufthansa Technik is one of the largest MRO providers for aircraft, engines and aircraft components worldwide in a fragmented market. About 30% of revenues depend on in-house airline customers. Key competitors in the industry are aircraft manufacturers (notably Airbus and Boeing), engine and engine-component manufacturers (Rolls-Royce, General Electric, MTU), and independent MRO contractors (e.g. ST Aerospace, SR Technics).

Lufthansa Technik's market position is strong, reflected in the large number of aircraft served under exclusive contracts. We also expect the MRO industry to continue to grow, in line with a higher number of commercial aircraft deliveries in the future and supported by the expected increase in air traffic.

While the share of earnings contributed by the MRO unit continues to decline (given the substantially growing share of operating profits from the passenger airline business), we view the more stable MRO business as positive for Lufthansa's overall business risk. The coronavirus crisis has had a considerable impact on the MRO business. Flight hours declined significantly across the industry. Moreover, the economic pressure on airlines that led to the grounding and retiring of aircraft had a strong impact on Lufthansa Technik. However, Lufthansa Technik is adapting well to the pandemic, expanding its range of crisis products such as the provision of considerably more parking and storage services for aircraft maintenance customers.

Catering (LSG Group)

Lufthansa's catering business, LSG Group, was the leader in global airline catering, especially in America and Europe, until its European arm was sold to Gategroup in 2019. The airline catering market is very fragmented, with only one truly global rival to LSG Group (Gategroup with its Gategourmet brand) and many local/regional suppliers. In addition, logistics companies and restaurant chains have entered the market in recent years, creating industry overcapacity and negative effects on pricing. The growth of LCCs has also reduced in-flight catering on short and medium-haul flights, thus decreasing overall demand in transport catering. Despite difficult market conditions, LSG Group has held its good position.

Only 20% of the unit's revenues depend on Lufthansa's in-house airlines. Revenue in the catering segment fell by 61% in 2020, mainly due to the sharp decline in global passenger numbers due to the coronavirus crisis. planned disposal of the remaining parts of the LSG business was postponed due to the crisis. The LSG Group is preparing to resume sales activities as part of its strategic and organisational realignment as soon as conditions permit.

Other, service and financial services companies

This segment includes the group's service and financial companies, above all AirPlus, Lufthansa Aviation Training and Lufthansa Systems, as well as Lufthansa group functions.

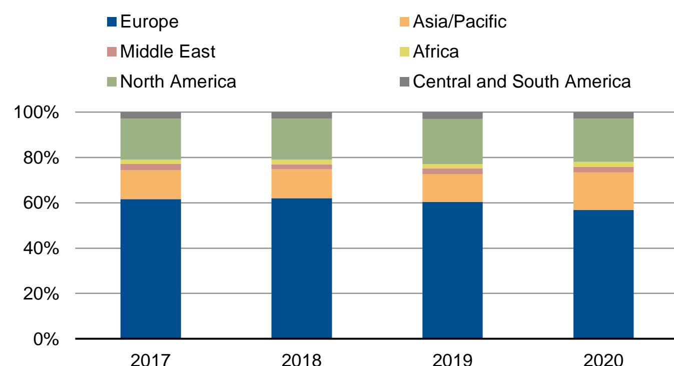
Lufthansa plans to divest non-core assets, which include AirPlus and the remaining part of LSG business, to focus on its main activities. However, disposals of subsidiaries will only take place when the fair value can be realized.

We maintain our stance that Lufthansa has a strong position within the airlines industry. This is based on the company's leading position not only among worldwide airlines but also MRO providers, bolstered by the expectation that Lufthansa will emerge from the crisis even stronger.

Diversification by geography and products supports competitive position

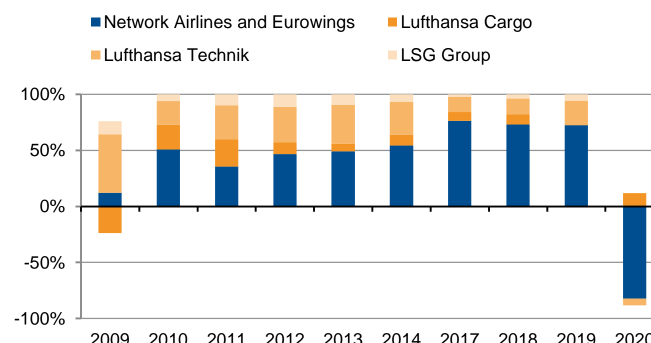
Lufthansa's diversification supports its business risk profile. The network of destinations in the passenger airline segment (including Eurowings) is broad. Group revenues are naturally more skewed towards Europe, given the major hubs in the region, but business outside Europe adds to geographic diversification.

Figure 2: Lufthansa geographical split of revenues



Source: Lufthansa,Scope

Figure 3: Lufthansa share of business segment results (EBIT) over time



Source: Lufthansa, Scope

Profitability a credit weakness

Lufthansa's profitability remains a weakness in its business risk profile. Lufthansa's EBITDA margin was below that of its peers but this gap narrowed in 2019 following structural cost improvements. In 2020, due to the coronavirus outbreak, Lufthansa, along with most other airlines, took a sharp hit in revenues and reported a net loss. The group had to quickly cut costs, specifically fixed costs, and stem the cash drain. Fixed costs have reduced by 35% since the crisis broke out.

The group's first objective in emerging out of the crisis is a breakeven EBIT, which depends on a gradual recovery of air traffic. The objective after the crisis is to increase structural profitability by continuously reducing unit costs, simplifying processes and structures, and improving productivity. The reduction in the cost base affects all group activities. It is important to note that controlling labour costs will remain a challenge, especially once Germany's short-term work schemes wind down, given their significant share in the cost structure.

Financial risk profile

Credit metrics improvement depending on traffic recovery

Lufthansa's results reflect Covid-19's impact on global aviation traffic. Group revenue declined by more than 60% in 2020 and EBITDA fell deep in the red. When the pandemic broke out, Lufthansa was restructuring across all operating functions to reduce fixed costs in the longer term. With no realistic chance for global aviation traffic to return to pre-Covid-19 levels until 2024, Lufthansa's financial outlook and cash generation will depend strongly on shrinking its overall capacity, including staffing.

Measures to stabilise the group in the wake of the pandemic caused net debt to rise significantly. Quick deleveraging will require strong free cash flows, a higher operating result, strict working capital management, and a focus on investing in projects that add the most value.

The negative cash flow since 2020 has forced the company to cut costs drastically. The group aims to continue reducing costs until 2024. As of now, capex has reduced by two-thirds and the cash drain more than halved. However, indebtedness continues to rise in 2021 due to negative cash generation and increased debt. Capital market transactions since June 2020 aimed at strengthening liquidity as well as refinancing some debt. An example of early repayment is the EUR 1bn loan with German development bank KfW in February 2021 to free up encumbered aircrafts.

While credit metrics deteriorated in 2020 and are forecasted to remain weak in 2021, we expect an improvement starting in 2022, provided that passenger traffic recovers. Our financial risk profile assessment places more emphasis on 2022 and continues to

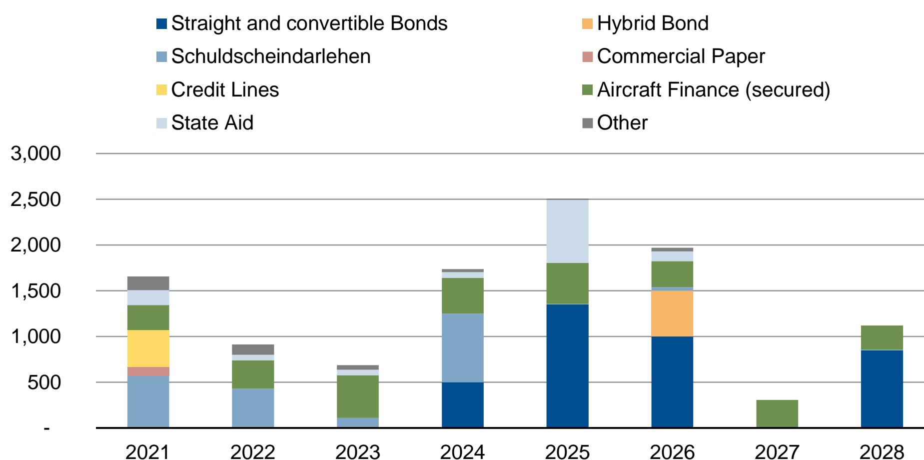
assume a gradual recovery of flight traffic, which already started in Q2 2021. The SaD/EBITDA leverage ratio is expected at below 4.5x in 2022 and below 3.5x in 2023.

Funding framework aimed at increasing flexibility against any adverse events

Our analysis also incorporates an assumed capital increase of at least EUR 2bn. The net proceeds would help to repay Economic Stabilisation Funds and strengthen the balance sheet. We did not account for potential proceeds from non-core divestments (AirPlus and LSG) or the option to draw down the full EUR 4.5bn of the state aid package. Scope believe Lufthansa can achieve its net debt/EBITDA target of 3.5x purely via the continuing restructuring, cost-cutting, possible divestitures, undrawn state aid packages and, more importantly, the traffic recovery that will ensure strong free cash flow.

Lufthansa's liquidity is robust, bolstered by huge efforts to secure and preserve a comfortable cash buffer and reduce cash drain. Liquidity is further strengthened by undrawn state aid, the unused credit lines of EUR 360m as of 2021Q1, the more than 70% unencumbered fleet, and a potential direct equity injection, subject to state aid conditions on equity drawings. As of 31 March 2021, Deutsche Lufthansa AG had centrally available liquidity of EUR 3.7bn. A further EUR 4.5bn was available from the Economic Stabilisation Fund (Silent Participation I). Altogether, the group's available liquidity comes to EUR 10.6bn, more than sufficient to cover outstanding short-term debt of EUR 2.1bn as of 2021Q1 and the negative free operating cash flow forecast for 2021. For 2022, we expect free operating cash flow to be positive, supporting the coverage of financial maturities in 2022 in addition to the unrestricted liquidity.

Figure 4: Lufthansa debt maturity profile as of 2021Q1 in EUR m



Source: Lufthansa, Scope

Parent support providing a guarantee for possible negative scenario

Supplementary rating drivers in terms of parent support result in a two-notch uplift above Lufthansa's standalone BB credit quality. The German government's EUR 300m direct equity injection did not result in majority ownership, but 20% of voting rights. Despite this seemingly low representation, Scope believes Lufthansa remains strategically important to the German state, therefore we are upholding the two-notch rating uplift for parent support.

Long-term and short-term debt ratings

Senior unsecured debt has been rated BBB-, which is in line with the issuer rating.

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

The short-term rating has been affirmed at S-3.

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