Deutsche Lufthansa AG
Germany, Transportation

SCOPE BBB- POSITIVE

Corporate profile

Lufthansa is a global aviation group organized into three segments. Network Airlines, Point-to-Point, 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	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	11x	16x	14x	14x
SaD/EBITDA	2.2x	1.4x	1.3x	1.0x
Scope-adjusted FFO/SaD	41%	63%	71%	93%
FOCF/SaD	16%	34%	25%	39%

Rating rationale

Scope Ratings updated its financial forecasts for Deutsche Lufthansa AG. Our revised forecasts do not change the financial risk profile assessment. Our forecast for 2018F now includes slightly higher integration costs for Air Berlin and the effect of the expected higher oil bill for the Lufthansa Group.

This publication does not constitute a credit rating action. For the official credit rating action release click **here**. On Nov. 4, 2016, Scope assigned Deutsche Lufthansa AG an issuer rating of BBB-. 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 Positive.

Following the release of full year results for 2017 and 1Q18 results, we have slightly adjusted our financial forecast for Lufthansa and do now reflect all our debt-related adjustments in our ratio calculations (versus the estimates for those adjustments prior to the release of the annual accounts). We have now included slightly higher cost in 2018F for the integration of aircraft acquired from insolvent Air Berlin. We have also adjusted the estimated cost base for the expected rise in LH's fuel bill in 2018. Overall, our EBITDA estimate for 2018F is now EUR 4.5bn versus EUR 4.7bn in our earlier estimate. Our forecast for 2018F is broadly in line with LH's public guidance that indicates that the Adjusted EBIT (as defined by LH) should be "slightly below previous year" (we estimate the Adj. EBIT of EUR 2.77bn versus EUR 2.973bn reported by LH in 2017).

Credit ratios in 2018F and 2019F continue to indicate an improving financial risk profile and our forecasts for 2018F point to a Scope-adjusted debt/EBITDA of 1.3x while funds from operations should represent about 70% of SaD in 2018F. Further improvements in LH's credit metrics in 2019F are possible given our belief that estimate free operating cash flows in each of 2018 and 2019 should substantially exceed projected dividend payments.

LH's liquidity continues to be solid. Financial obligations in the medium term are covered by cash, bilateral committed credit lines and the expected excess of FOCF over dividend payments.

Ratings & Outlook

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

Analysts

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Related methodology

Corporate Rating Methodology, January 2018

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Further financial flexibility also results from the high share of unencumbered aircraft in the fleet. LH's dividend payment for 2017, in line with the company's long-standing dividend policy, suggests that LH will continue the path of a cautious financial policy that balances interests of shareholders and debtholders.

News flow on a potential takeover of certain assets from bankrupt carrier Alitalia is limited and the situation remains unchanged. LH has repeatedly mentioned to rule out an entire takeover of Alitalia and LH's management would be only interested in certain assets of Alitalia once the operations of the Italian carrier are restructured. Alitalia's fleet size is slightly greater than the fleet size of bankrupt Air Berlin. We continue to believe that Alitalia will eventually liquidated piecemeal. Lufthansa has not publicly provided more details about the offer submitted to the administrator (Alitalia is under administration since May 2017). To provide more guidance and transparency on the potential impact of a transaction involving certain assets of Alitalia, we have analysed any such hypothetical deal assuming that Lufthansa was to pay EUR 500m to acquire major parts (including aircraft) from Alitalia. This number (EUR 500m) was neither published nor confirmed by Lufthansa and must not mistakenly be assumed to represent information about the offer that Lufthansa submitted to the administrator. In the hypothetical event that any Alitalia transaction was to lead to a EUR 500m cash effect, our rating and outlook would remain unchanged.

Outlook

The Outlook is Positive and incorporates our expectation that Lufthansa should achieve debt protection measures, such as SaD/EBITDA of significantly below 2.0x, in the medium term.

We would consider a positive rating action if SaD/EBITDA or Scope-adjusted FFO/SaD were to improve sustainably to levels of below 1.5x and above 60%, respectively.

We would consider a negative rating action, including a change of Outlook back to Stable, if SaD/EBITDA were to deteriorate to about 2.5x. 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. Weakening operating profits at Lufthansa could also result from intensifying competition from low-cost carriers (LCCs) or other network carriers, in particular at the major hubs of Frankfurt or Munich.

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 • Operating performance occasionally affected by strikes and labour disputes • 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 1.5x (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 levels of about 2.5x

Financial overview

In EURm			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
SaD/EBITDA (x)	2.2x	1.4x	1.3x	1.0x
Scope-adjusted FFO/SaD	41%	63%	71%	93%
FOCF/SaD	16%	34%	25%	39%
Scope-adjusted EBITDA in EUR m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	3,959	5,205	4,468	4,885
Operating lease payment in respective year	430	472	472	472
UFO agreement (2016) / VC agreement (2017)	-652	-582	0	0
Scope-adjusted EBITDA	**3,737**	**5,095**	**4,940**	**5,357**
Scope funds from operations in EUR m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	3,959	5,205	4,468	4,885
less: (net) cash interest as per cash flow statement	-50	-92	-90	-95
less: cash tax paid as per cash flow statement	-54	-385	-442	-498
less: pension interest	-151	-159	-150	-150
add: depreciation component op leases	298	337	334	334
add: dividends received from @equity	80	87	160	145
less: UFO agreement (2016)/VC agreement (2017)	-652	-582	0	0
Scope funds from operations	**3,430**	**4,411**	**4,280**	**4,620**
Scope-adjusted debt in EUR m	**2016**	**2017**	**2018F**	**2019F**
Reported gross financial debt	6,575	6,814	6,114	6,114
Cash and cash equivalents	-3,937	-3,948	-3,902	-5,038
add: cash not accessible	65	69	69	69
add: pension adjustment	3,361	1,571	1,571	1,571
add: operating lease obligation	2,613	2,768	2,768	2,768
add: other bank borrowing	63	18	18	18
add: fair value hedges	-98	-83	-83	-83
less: hybrid bond	-250	-250	-250	-250
Scope-adjusted debt	**8,392**	**6,959**	**6,305**	**5,168**

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 (click **here** for further details).

Financial risk profile

Lufthansa's key credit metrics are expected to improve in 2018F, supported by stable operating profits (excluding the integration costs for Air Berlin operations), solid free cash flow generation, moderate dividend payments and reduced pension obligations.

Our base case includes:

- Unit cost improvements following the agreement with the pilot union of 1% (about EUR 100-150m in cost savings). The initial agreement reached with Vereinigung Cockpit (VC) includes the additional benefit that strikes will be ruled out until 2022, reducing the risk of extra strike-related expenses. Lufthansa has guided for an incremental fuel bill of EUR 600m in 2018 vs. 2017 and expects not to be able to recover these incremental expenses via ticket prices. We expect a CASK reduction of 1% in 2018 and further CASK reductions in 2019F, notably at Eurowings.
- A negative contribution to the Adj. EBIT from the point-to-point business (Eurowings Group) in 2018. This follows the operating profit reported by Eurowings in 2017 (Adj. EBIT of EUR 153m). The phase-in and integration of aircraft taken over from Air Berlin including expenses such as crew sourcing, repainting, aircraft maintenance plus integration of Brussels Airlines' operations are expected to lead to one-time costs. Despite the unit cost reduction achieved in 2017 (CASK at Eurowings were reduced by 6.5% in 2017), a continuation of cost reduction, and growth in passenger numbers, we do not believe that these effects combined will outweigh the one-time integration costs. The profit contribution from Air Berlin is expected to have its full effect from 2019F onwards.
- Continuation of strong operating profit contributions from the Logistics business. High load factors and improving yields combined with the effects from cost reduction measures taken have lifted the margin (Adj. EBIT) in the Logistics business to one of the highest levels in the past 10 years (currently 9.7%). The profit momentum was maintained in 1Q18. Market demand for airfreight continues to grow faster than the supply of new capacity (new ton kilometers) and Lufthansa's logistics unit benefits from high volumes in international trade and special freight business. Following the turn-around of the logistics unit in 2017 (logistics business had a negative Adj. EBIT in 2016), we see the favorable environment for air cargo as a key support to earnings in 2018. Lufthansa has reactivated one MD-11 aircraft in Nov. 2017 following the de-fleeting of cargo aircraft in 2016 when overcapacity in the airfreight industry existed.
- Benefits from an agreement with Fraport. Lufthansa has agreed a freeze of airport charges for Frankfurt airport for the years 2018 and 2019. Further negotiations with Fraport are ongoing and savings for infrastructure should be a double-digit amount (in EURm) in 2018. In addition, Lufthansa should continue to benefit from lower air traffic control fees agreed with Deutsche Flugsicherung in 2017.

- Stable profit contributions (Adj. EBIT) from the MRO (maintenance, repair, and overhaul) business (Lufthansa Technik). The MRO business continues to be the most profitable and most stable division within the Lufthansa Group, a reflection of high passenger numbers and utilization of aircraft worldwide. Lufthansa Technik has further expanded the number of aircraft under contract. The services 4,556 aircraft (2017), having expanded its customer base from 4,132 aircraft in 2016, 3,700 in 2015, and 3,300 in 2014. About two thirds of services is for aircraft from outside the Lufthansa Group. We expect the MRO industry to continue to grow by about 4%-5% p.a. in line with a higher number of commercial aircraft deliveries in the future and supported by the expected increase in air traffic.

Our forecasts for 2018F point to a SaD/EBITDA of 1.3x and Scope-adjusted FFO/SaD of 71%, followed by gradual improvements of these key credit metrics in 2019F.

Key adjustments to calculate Scope-adjusted debt for year-end 2017 are as follows:

- Adjustment for unfunded pension obligations of EUR 1.6bn. The unfunded pension obligation (post tax) was lowered by more than 50% in 2017. This follows the one-time reduction of pension obligations after the agreement on retirement and transitional payments reached in Q417 with the pilot union Vereinigung Cockpit (reduced the pension obligation by EUR 1.3bn). This followed the reduction of reported pensions obligations by EUR 0.7bn after the collective bargaining agreement reached with the cabin crew in 2016. A one-time contribution to pension plan assets of EUR 1.6bn in 2017 to fully fund transitional payment obligations ("Übergangsversorgung") for flight attendants has further reduced the pension deficit in 2017.
- The net present value of operating lease obligations of EUR 2.8bn. This adjustment has remained fairly stable in 2017 primarily because Lufthansa made buy-outs of aircraft from operating lease contracts that were originally entered by Air Berlin.

Our belief that credit metrics will improve slightly is supported by a continuation of FOCF generation above projected dividends. We anticipate capital expenditures in 2018 to be slightly higher than in 2017. Lufthansa has guided for a capex level of about EUR 3.4bn in 2018. Our base case also includes the assumption of moderate dividend payouts in 2019F and beyond (dividend declared for 2017 was 13.8% of EBIT excluding the one-time gain that resulted from the agreement with the pilot union). We expect both dividends and capex to be safely covered by cash flows from operations in 2018 and beyond.

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 our view, Lufthansa has a moderate dividend payout policy, targeting 10-25% of Lufthansa Group's EBIT, subject to the availability of distributable reserves in the holding accounts.

The payout ratio for 2017 was 13.8% (excluding the effect from the pilot union agreement) and the dividend declared for 2016 was about 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 dividend payments will remain at levels of less than 15% of EBIT. Consequently, we continue to believe that future dividend payments are covered by expected cash generated from ongoing operations (FOCF), eventually leading to further deleveraging going forward. Lufthansa's moderate dividend payout is a key support for the rating. Targeted payout ratios suggest that free cash flows from ongoing operations are very likely sufficient to accommodate shareholder interests via dividends.

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).

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 and/or the buy-out of aircraft that are currently under operating lease (notably aircraft taken over from Air Berlin).

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.

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. In Dec. 2016 (first tranche of EUR 541m) and Jan. 2017 (second tranche of EUR 659m), Lufthansa completed a Schuldschein placement supporting an improved spread of its financial maturities including an extension of its maturities.

Liquidity is supported by:

- Cash and cash equivalents of 3.9bn EUR bn on 31 December 2017. Of the reported liquidity, an amount of EUR 69m is not immediately accessible due to contractual restrictions (notably cash located at joint ventures), currency conversion limitations and/or other restrictions on repatriation.
- Lufthansa has EUR 855m in bilateral lines with 36 different banks. At the end of 2017, none were utilised. Each of the credit lines has a term of two years, which is extended at the end of the first year if it is not cancelled. Bilateral credit lines are free of financial maintenance covenants.
- We project FOCF of about EUR 1.0bn in 2017 and about EUR 1.6bn in 2018.

Liquidity is used as follows:

- Financial maturities of EUR 0.7bn as of 31 December 2017 due in 2018, mainly from aircraft financings and finance leases. We believe that Lufthansa will repay these maturities with existing liquidity.
- The next sizable maturity is a bond (EUR 500m) due in 2019.
- Dividend payments of EUR 0.4bn in 2018. The cash effect of the dividend could turn out be slightly lower. Lufthansa has offered its shareholders the option of a scrip dividend. The percentage of shareholders that receive new shares in Lufthansa in lieu of the dividend payments is not known at this stage.
- 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 31 December 2017, about 75% of Lufthansa's fleet was unencumbered (was 72% in 2016 and 74% in 2015). Unencumbered aircraft could serve as collateral for secured financing if the need arises.

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