Research Update:

Brazilian Airline Azul S.A. Upgraded To 'B-' From 'SD' On Improved Capital Structure; Outlook Stable

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Rating Action Overview

- We reassessed the credit profile of Brazil-based airline Azul S.A. (Azul) following its debt exchange, lease liabilities renegotiation, and issuance of senior secured notes.
- As a result, the company has alleviated refinancing risk and lease payments as well as improved its maturity profile and liquidity, providing better financial flexibility during business recovery.
- On July 17, 2023, we raised our global scale issuer credit rating on Azul to 'B-' from 'SD' and our national scale rating to 'brBBB-' from 'SD'. At the same time, we raised our rating on Azul's senior unsecured notes to 'CCC' from 'D' and revised the recovery rating to '6' from '4', indicating our expectation of minimal recovery (0%) on the remaining unsecured notes due 2024 and 2026 in the event of a payment default.
- The stable outlook reflects our expectation that Azul will post stronger results in the next 12 months and emerge from its restructuring with comfortable liquidity and an improved capital structure. It also reflects the fact that the company's leverage will stay high, with debt to EBITDA of 5.0x-5.5x and funds from operations (FFO) to debt of about 10% in 2023 and 2024.

Rating Action Rationale

The upgrade reflects Azul's maturity extension and improved capital structure. On July 14, the company completed a debt exchange on its senior unsecured notes due 2024 and 2026 for secured notes due 2029 and 2030. The exchange had an aggregated acceptance of about 86%.

The transaction considerably reduced refinancing risks as only $100 million of the notes due 2024 remains outstanding. Additionally, Azul improved its maturity profile, with no material debt amortization until 2028.

Azul has also been in renegotiations with lessors and original equipment manufacturers (OEMs) that will result in a reduction of about 4 billion Brazilian reals (R$) in lease obligations and a reduction in future lease payments.

Liquidity prospects strengthened materially. On July 13, Azul raised $800 million leveraging on the same collateral of the exchange notes. The notes will be secured on a first priority basis on the company's frequent flyer program (TudoAzul), the travel business (Azul Viagens), and most of its brand and intellectual property. Azul will use part of the proceeds to prepay about $56 million of the exchanged notes due 2029 and about $105 million of the convertible debenture. We believe the remaining $640 million in additional cash will ensure a very comfortable liquidity position for the company over the next two years even as we expect it to keep burning some cash (despite improved performance).

Azul's cost of debt increased, and the company will remain highly leveraged. The coupons on the exchanged notes are now 11.5% and 10.875% (versus 5.875% and 7.25% previously), and the new notes were priced with a 11.93% coupon. Furthermore, gross debt levels will increase since the company has raised additional debt and since we still forecast negative free operating cash flow after lease payments for the next two years.

Lease payments will remain burdensome and capital expenditures will remain elevated over the next two or three years as the company's fleet transformation plan progresses. The company plans to replace its older E-190 and E-195 aircraft with next-generation E-195-E2 aircraft and fly 100% of its capacity on next-generation aircraft by 2026.

We expect Azul to keep leverage at 5.0x-5.5x over the next two years and report free operating cash flow deficits (after lease payments) of about R$60 million in 2023 and R$500 million-R$600 million in 2024.

We expect Azul's operating performance to continue improving. Azul's international capacity should grow about 60% in 2023 (as international travel remained very weak in 2022) while the company maintains a modest 4% expansion rate for its domestic business (where it's already operating about 25% above pre-pandemic levels).

We expect some pressure on yields starting in the second half of the year as Brazilian airlines continue adding capacity and macroeconomic conditions remain difficult (with sluggish GDP growth and high interest rates). However, we believe airlines will focus on protecting profitability and operating cash flow; thus, we expect a rational market and average yields in 2023 to remain strong. In addition, we forecast that Azul will benefit from an 18% drop in jet fuel prices since crude oil prices are likely to fall, and we aren't expecting a material depreciation of the Brazilian real.

As a result, in our base case, Azul's S&P Global Ratings-adjusted EBITDA should jump to about R$5.2 billion this year from R$2.7 billion in 2022. In line with this, we forecast adjusted debt to EBITDA by year-end 2023 of about -5.5x (compared with 8.8x in 2022) and FFO to debt of 10% (compared with 6.4% in 2022).

Outlook

The stable outlook reflects our expectations that Azul's operations will keep recovering in the next 12 months (as international business surpasses pre-pandemic levels) and that the company will emerge from its restructuring with comfortable liquidity, improved cash flow, and an improved capital structure. Debt to EBITDA should remain at 5.0x-5.5x and FFO to debt should remain at about 10% in 2023 and 2024.

Downside scenario

We could lower the ratings over the next 12 months if Azul's operating performance deteriorates materially, with the company returning to much lower EBITDA generation and significant cash burn. This could occur if a significant economic slowdown hits demand, which would take a toll on revenue passenger kilometers (RPKs) or yields, while oil prices rise or remain very high. If such a situation is severe enough, it could eventually result in inadequate liquidity or a capital structure that we view as unsustainable in the long term.

Upside scenario

We could raise our ratings over the next 12 months if improved earnings and margins provide confidence that Azul will achieve FFO to debt above 12%, debt to EBITDA below 5.0x, and positive free cash flow after lease payments. This might occur if demand remains stronger than expected (despite likely softness in the economy) and oil prices decline beyond our base-case expectations.

Company Description

Azul, founded in 2008, is a Brazilian airline with a fleet of 194 aircraft as of December 2022. It's the country's largest airline in terms of domestic departures and the number of cities it serves, with almost 1,000 daily flights reaching over 150 destinations. The company's wholly owned loyalty program, TudoAzul, had close to 15 million members as of December 2022. Azul generated revenue of R$15.9 billion and EBITDA of R$2.7 billion in 2022.

Our Base-Case Scenario

Assumptions

- Modest GDP growth in Brazil of 1.7% in 2023 and 1.5% in 2024.
- Inflation in Brazil of 5.2% in 2023 and 4.2% in 2024, affecting Azul's local costs, including selling, general, and administrative costs and some costs of goods sold (for instance, salaries).
- Average exchange rate of R$5.08-R$5.15 per US$1 over the next two years, which affects fuel prices, maintenance costs, leasing payments, and the debt burden.
- Sharp 60% recovery in international air traffic in 2023, with overall available seat kilometers (ASKs) expanding 12%-13% in 2023 and about 10% in 2024, resulting in capacity about 25% higher in 2023 than before the pandemic. (We expect RPKs to move in tandem.)
- West Texas Intermediate crude oil price of about US$80 per barrel in both 2023 and 2024, down from US$96 in 2022.
- Average yield improving by 3.5% in 2023 but falling 2% in 2024.
- A new capital structurethat takes into account the exchange of 2024 and 2026 notes for 2029 and 2030 notes, as well as the issuance of new priority debt for $800 million in 2023.
- Lease liabilities renegotiation, including a reduction of about R$4 billion in 2023 and the issuance in exchange of lessor and OEM's senior unsecured notes for R$2.3 billion and an equity convertible instrument for $R3.6 billion. (We incorporate the convertible in our debt

calculation and convert into equity in line with the scheduled vesting periods.)

- Capex of R$1.6 billion in 2023 and R$1.3 billion in 2024.
- No dividends in the next two years.

Key metrics

Azul S.A.--Forecast summary

Industry sector: Air transport							
	--Year ended Dec. 31--						
(Mil. R$)	**2019a**	**2020a**	**2021a**	**2022a**	**2023e**	**2024f**	**2025f**
Revenue	11,442	5,744	9,976	15,948	18,778	20,427	21,755
EBITDA (reported)	2,475	(351)	1,599	3,524	5,236	5,985	6,634
Plus/Less: Other	1,131	505	(507)	(846)	34	34	34
EBITDA	3,607	154	1,092	2,678	5,270	6,019	6,668
Less: Cash interest paid	(1,028)	(480)	(625)	(1,170)	(2,106)	(2,845)	(2,834)
Less: Cash taxes paid	--	(0)	--	--	(286)	(218)	(354)
Funds from operations	2,579	(326)	467	1,508	2,878	2,956	3,480
EBIT	2,088	(1,594)	(320)	879	3,505	3,846	4,357
Cash flow from operations	2,595	976	(311)	2,437	2,963	2,950	3,402
Capital expenditures	1,560	453	777	1,451	1,562	1,314	1,386
Free operating cash flow	1,034	524	(1,087)	986	1,401	1,636	2,016
Debt (reported)	3,518	7,361	10,019	8,636	14,938	17,446	17,012
Plus: Lease liabilities debt	12,107	12,521	14,891	14,583	9,960	11,114	12,757
Plus/Less: Other	(109)	47	106	378	3,696	3,222	2,274
Debt	15,516	19,929	25,015	23,598	28,594	31,782	32,043
Cash and short-term investments (reported)	1,710	3,157	3,075	668	4,310	6,072	5,162
Adjusted ratios							
Debt/EBITDA (x)	4.3	129.1	22.9	8.8	5.4	5.3	4.8
FFO/debt (%)	16.6	(1.6)	1.9	6.4	10.1	9.3	10.9
FFO cash interest coverage (x)	3.5	0.3	1.7	2.3	2.4	2.0	2.2
EBITDA interest coverage (x)	3.1	0.1	0.3	0.6	2.3	2.2	2.4
CFO/debt (%)	16.7	4.9	(1.2)	10.3	10.4	9.3	10.6
FOCF/debt (%)	6.7	2.6	(4.3)	4.2	4.9	5.1	6.3
EBITDA margin (%)	31.5	2.7	10.9	16.8	28.1	29.5	30.7

All figures are adjusted by S&P Global Ratings unless stated as reported. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. CFO--Cash flow from operations. FOCF--Free operating cash flow. R$--Brazilian real.

Liquidity

Azul's liquidity position is adequate, mainly reflecting its strengthened cash position following the successful private placement for $800 million. Because of improved results and lower lease payments, we expect cash FFO to pick up.

We expect sources of liquidity to cover uses by more than 1.5x in the next 12 months. Furthermore, once Azul has finished optimizing its capital structure and achieved an improved amortization profile and much better operational performance, we think Azul will regain access to local financing via banks or capital markets.

We expect the company to maintain a cushion of over 15% on its financial covenants going forward.

Principal liquidity sources:

- Unrestricted short-term cash position of R$466 million as of March 2023
- Cash FFO after lease payments of R$1.2 billion in the next 12 months
- Working capital inflows of about R$75 million for the next 12 months
- Proceeds from secured notes of R$3.8 billion

Principal liquidity uses:

- Short-term debt of R$1.3 billion in the next 12 months
- Prepayment of convertible bonds and exchanged notes due 2029 for about $R800 million
- Capex of about R$1.5 billion over the next 12 months

Covenants

Azul has debt acceleration covenants on its debentures, its loan with the U.S. International Development Finance Corp. (DFC), and other financings.

The covenants on the debentures were changed to:

- An adjusted debt service coverage ratio greater than or equal to 1.2x; and
- Debt to EBITDA less than or equal to 6.5x in 2023, 5.0x in 2024 and 2025, and 4.5x in 2026 and 2027.

The loan with DFC requires:

- Debt to EBITDA below 5.5x, and
- Fixed-charge interest coverage greater than 1.2x.

In March 2023, Azul obtained a waiver from the DFC, for the quarter ended March 31, 2023, on the covenant requiring an adjusted debt service coverage ratio of at least 1.2x. We expect the company to comply with its covenants in 2023. If it breaches any covenant in the future, we would expect the company to continue to be able to obtain waivers to avoid debt acceleration.

Environmental, Social, And Governance

ESG credit indicators: To E-3, S-4, G-2; From: E-3, S-5, G-2

The fact that only 23% of Azul's pre-pandemic business was international travel has allowed for a faster capacity and revenue recovery than for other airlines in the world. Because of that and the recent debt restructuring, we expect the company to maintain a sustainable capital structure. As a result, we revised the social credit indicator to S-4 from S-5.

Social factors remain a negative consideration since Azul's finances are still suffering from the pandemic-induced economic shock. Although revenue and EBITDA in 2023 should be well above pre-pandemic levels, cash flows and leverage remain much weaker. The company increased adjusted debt over 50% between December 2019 and December 2022 to preserve liquidity and fund operations during the pandemic, finally pushing the company into debt and lease liabilities restructuring and default.

Environmental factors are a moderately negative consideration in our credit rating analysis of Azul. All airlines face long-term risk from tighter greenhouse gas emissions regulation. Azul has a younger fleet with an average age of 7.1 years--lower than the global average--and through fleet transformation, it has reduced fuel consumption per ASK and currently operates 70% of its seats with low-carbon aircraft. But this might not be enough to offset long-term risks.

Issue Ratings--Recovery Analysis

Key analytical factors

- The 'CCC' rating on Azul's remaining senior unsecured notes is two notches lower than the issuer credit rating. We have revised our recovery rating to '6' (from '4' before the debt exchange), which indicates no recovery expectation in a distress scenario for unsecured creditors. We are assessing recovery under the pro forma capital structure, considering both the exchanged notes and the new notes due 2028. The much lower recovery responds to the significant subordination the holdouts on the unsecured notes now have. The 2029 and 2030 notes (the exchanged notes) are now secured, and the 2028 notes are secured on a priority basis. Additionally, total debt increased to R$15.4 billion from R$10.6 billion in our previous recovery assessment..
- We have valued Azul on a discrete asset basis (discrete asset valuation), although we believe that it would reorganize successfully and continue to operate following a hypothetical default scenario. Our analysis under the going concern scenario reflects the size of the company's operations in Brazil. Our valuations reflect our estimate of the value of the assets at default based on net book value for current assets and appraisals for aircrafts, after adjusting for expected realization rates in a distressed scenario.

Simulated default assumptions

- Simulated year of default: 2025

- We apply an overall haircut of about 63% to Azul's asset base, including a haircut of about 75% to its cash (including proceeds from the new notes) because the company would likely use part of its cash position to fund working capital needs and repay more expensive loans in a distressed scenario.
- An effective realization of about 65% of receivables.
- For intangibles, including slots, we use an effective realization rate of about 50%.
- Therefore, we arrive at a gross enterprise value of about R$5.3 billion.

Simplified waterfall

- Net enterprise value after administrative costs (5%): R$5.0 billion
- First priority debt at default including six months accrued interest: R$5.8 billion
- Total secured debt, including priority: R$11.0 billion
- As a result, there's no residual value available to unsecured claims.
- Senior unsecured notes/lease rejected claims at default: R$4.8 billion
- Recovery expectations for unsecured notes due 2024 and 2026: 0%

Ratings Score Snapshot

Issuer Credit Rating	B-/Stable/--
Business risk:	Weak
Country risk:	Moderately high
Industry risk:	High
Competitive position:	Weak
Financial risk:	Highly leveraged
Cash flow/leverage:	Highly leveraged
Anchor:	b-
Modifiers:	
Diversification/portfolio effect:	Neutral (no impact)
Capital structure:	Negative (no impact)
Liquidity:	Adequate (no impact)
Financial policy:	Neutral (no impact)
Management and governance:	Fair (no impact)
Comparable rating analysis:	Neutral (no impact)

Related Criteria

- General Criteria: National And Regional Scale Credit Ratings Methodology , June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10,

2021

- General Criteria: Group Rating Methodology , July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments , April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers , Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments , Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers , Dec. 16, 2014
- General Criteria: Methodology: Industry Risk , Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions , Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology , Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities , Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings , Oct. 1, 2012
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Azul S.A.		
Issuer Credit Rating	B-/Stable/--	SD/--/--
Brazil National Scale	brBBB-/Stable/--	SD/--/--
Upgraded		
Azul Investments LLP		
	To	**From**
Senior Unsecured	CCC	D
Recovery Rating	6(0%)	4(40%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.