19 JUL 2023

Fitch Downgrades AZUL to 'RD'; Upgrades to 'B-'

Fitch Ratings - Rio de Janeiro - 19 Jul 2023: Fitch Ratings has downgraded Azul S.A.'s (Azul) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'RD' from 'C', following the conclusion of its exchange offer, which Fitch considered a distressed debt exchange (DDE). Simultaneously, Fitch has upgraded Azul's IDRs to 'B-' from 'RD' to reflect its post-restructuring risk profile.

In addition, Fitch has downgraded Azul Investments LLP's unsecured bonds to 'RD' from 'C/RR4', as well as Azul's Long-Term National Scale rating to 'RD(bra)' from 'C(bra)'. Concurrently, Fitch has upgraded Azul's unsecured bonds to 'CCC+'/'RR5' from 'RD', as well as Azul's Long-Term National Scale rating to 'BB(bra)' from 'RD(bra)'. Fitch has also assigned a final 'B-'/'RR4' rating to Azul Secured Finance LLP's senior secured USD800 million notes due 2028, and 'B-' /'RR4' rating on the senior secured second lien notes due 2029 and 2030. Azul's corporate Rating Outlook is Stable.

Azul's ratings reflects the overall improvement in the company's credit profile post restructuring plan, including enhanced liquidity and ongoing improvements on operating cash flow and leverage ratios. Azul's limited financial flexibility and high industry risks remain as rating constrains.

Key Rating Drivers

Exchange Offer Qualified as DDE: Azul's exchange offer transaction was considered a DDE under Fitch's criteria, due to the involvement of a substantial portion of Azul's classes of obligors (including lessors and OEMs refinancing agreements), leading to a broader restructuring plan to avoid a payment default. The extension of the maturity date, including of the local convertible debentures, and material reduction in terms of bondholders that do not accept the deal due to the elimination of some restrictive covenants, as well as structural subordination, have also been incorporated into this assessment.

Improving Credit Profile: The conclusion of Azul's full debt restructuring plan, as well as the ongoing improvements of its operating cash flow generation, are expected to help restore its credit profile in terms of leverage and refinancing risks. Fitch's base case scenario forecasts the company's total and net adjusted leverage/EBITDAR ratios at around 4.6x and 4.0x, respectively, during 2023, an improvement from the 2022 levels of 7.4x and 7.1x.

The reduction in lease payment and the maturity extension of most of its debt reduce the pressure on cash flow and address most near-term maturities, leaving Azul with a manageable amount of scheduled maturities until 2028. Lessors are exchanging COVID lease deferrals for notes due 2030 and equity instrument convertible into Azul's shares (40/60 split).

Limited Financial Flexibility: Azul's ability to continue to access new credit lines, seeking to restore its liquidity position and to improve its financial flexibility are key factors to support continuous improvement on its credit risks profile. Azul has a track record of maintaining strong cash balances, which in the past helped reduce short-term refinancing risks and industry volatility. Azul's readily available cash, per Fitch's criteria, declined to BRL466 million as of March 31 2023 from BRL668 million as of Dec. 31, 2022 and from BRL3.1 billion at end of December 2021.

Azul's increasing share of secured debt has a short to medium term impact on its financial flexibility, given the likely weaker unencumbered asset base, and should continue to constrain rating in the medium term.

Stronger Operations: Fitch expects Azul's adjusted EBITDA to improve during 2023 due to the solid domestic traffic level, benefits from elimination of PIS/Cofins taxes, better FX rates and lower fuel prices, as well as cost efficiencies and capacity expansion. Fitch forecasts Azul's adjusted EBITDA to reach around BRL5.5 billion in 2023 and BRL6.2 billion in 2024, an increase from BRL3.2 billion in 2022 and BRL3.6 billion during 2019 (pre-pandemic). Azul's traffic levels have been above 2019's levels since mid-2021, given the company's strong growth strategy. Fitch estimates Azul's 2023 total traffic volume are around 21% higher than 2019, and capacity level at 25%.

FCF to Remain Negative: In Fitch's forecasts, Azul's free cash flow generation remains negative during 2023 and 2024, at around BRL1.6 billion and BRL0.9 billion, respectively. The lower lease expenses related to pandemic-related deferral agreements brings Azul some relief; however, the ongoing growth in operations and growing leases payments, as well as higher interest rates remains a burden. For 2023 and 2024, Fitch estimates capex of around BRL1.8 billion and BRL1.4 billion, respectively. Azul is expected to marginally increase its fleet during the next two years.

Strong Domestic Market Position: Azul's credit profile benefits from its unique regional airline market position in Brazil, with a strong presence in underserved markets and limited route overlap with competitors, GOL Linhas Aereas Inteligentes S.A. and LATAM Airlines Group S.A. Azul is the sole provider of services on 80% of its routes and is one of the three largest airline companies in Brazil, with a market share of around 29%, as measured by revenues/passenger/kilometer (RPK) in 2022. As Brazil is the company's key market, Azul's operating results are highly correlated to the Brazilian economy. During 2022, 91% of its revenues derived from passengers and 9% from cargo and others, and 82% of its revenues were originated within local market.

Derivation Summary

Azul's ratings reflects the overall improvement in the company's credit profile post restructuring plan, including improved liquidity and, ongoing improvements on operating cash flow and leverage ratios. The company's recent financial stress, limited financial flexibility and high industry risks remain as rating constrains.

Azul has a weaker position relative to global peers given its limited geographic diversification and relatively higher operating leverage. In terms of its regional peers, it has a weaker position compared to Latam Airlines S.A. in terms of liquidity and financial flexibility, but has a stronger cash position compared to GOL Linhas Aereas Inteligentes S.A. (CCC+/Stable). Azul's strong position in the Brazilian regional market and high operating margins have nevertheless been key rating drivers. Foreign exchange risk exposure is a negative credit factor for Azul considering its limited geographic diversification; the company operates currency hedging which partially mitigates this risk.

Key Assumptions

Fitch's Key Assumptions Within The Rating Case for the Issuer:

--Fitch's base case during 2023 and 2024 includes an increase in RPK by 14% and 4%;

--Load factors around 80% during 2023 and 2024;

--Capex of BRL1.8 billion in 2023 and BRL1.4 billion in 2024

KEY RECOVERY RATING ASSUMPTIONS

The recovery analysis assumes that AZUL would be considered a going concern in bankruptcy and that the company would be reorganized rather than liquidated. Fitch has assumed a 10% administrative claim.

Going-Concern Approach: AZUL's going concern EBITDA is BRL2.2 billion which incorporates the low-end expectations of Azul's EBITDA post-pandemic, adjusted by lease expenses, plus a discount of 20%. This correlates to the average of BRL1.2 billion during 2016-2019 that reflects intense volatility in the airline industry in Latin America and Brazil, and the expansion of its operations during the past two years. The going-concern EBITDA estimate reflects Fitch's view of a sustainable, post-reorganization EBITDA level, upon which Fitch bases the valuation of the company. The enterprise value (EV)/EBITDA multiple applied is 5.5x, reflecting AZUL's strong market position in the Brazil.

Fitch applies a waterfall analysis to the post-default EV based on the relative claims of the debt in the capital structure. The debt waterfall assumptions consider the company's proforma total debt pos new secured issuance. These assumptions result in a recovery rate for the first-lien secured bonds within the 'RR1' range and second-lien secured notes within 'RR2' range, but due to the soft cap of Brazil at 'RR4', Azul's senior secured are rated at 'B-'/'RR4'. For the unsecured notes, the recovery is within the RR5 range, therefore results in a rating downgrade from the IDR, being rated at ´CCC+/RR5´.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Improved liquidity position, and maintenance of well-spread debt amortization profile with no major refinancing risks in the medium term;

--EBITDAR fixed-charge coverage sustained at or above 1.5x;

--FCF generation above Fitch's base case expectations;

-- Continued solid rebound of the Brazilian domestic air traffic;

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Liquidity deterioration and/ or difficulties to continue to access credit lines;

--Gross and net leverage ratios consistently above 6.5x and 6.0x;

--EBITDA fixed-charge coverage sustained at or below 1x;

--Competitive pressures leading to severe loss in market-share or yield deterioration;

--Aggressive growth strategy leading to consolidation movement financed with debt.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Limited Financial Flexibility: Azul's post restructuring process is likely to present an improvement in terms of liquidity and debt schedule amortization, but financial flexibility will remain poor. Azul's increasing share of secured debt pressures its financial flexibility, given the likely weaker unencumbered asset base. Pos-restructuring, around 67% of Azul's debt, excluding leases, will be secured. Considering the current issuance and the completion of the exchange offer, Azul will have a more manageable amount of scheduled maturities with no major pressure until 2028. Fitch estimates Azul's proforma financial debt will be around BRL15 billion, excluding leasings.

Issuer Profile

Azul is one of Brazil's largest local airlines, with significant presence in the regional market and the sole position on 80% of its routes. During 2022, 91% of its revenues were derived from passengers and 9% from cargo and others.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
AZUL Investments LLP					
• senior unsecured	LT	RD	Downgrade		C
• senior	LT	CCC+	Upgrade	RR5	RD

ENTITY/DEBT	RATING			RECOVERY	PRIOR
unsecured					
Azul S.A.	LT IDR	RD	Downgrade		C
	LT IDR	B-	Upgrade		RD
	LC LT IDR	RD	Downgrade		C
	LC LT IDR	B-	Upgrade		RD
	Natl LT	RD(bra)	Downgrade		C(bra)
	Natl LT	BB(bra)	Upgrade		RD(bra)
Azul Secured Finance LLP					
• Senior Secured 2nd Lien	LT	B-	New Rating	RR4	
• senior secured	LT	B-	New Rating	RR4	B-(EXP)

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.28 Oct 2022) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09 Apr 2021) (including rating assumption sensitivity)

Country-Specific Treatment of Recovery Ratings Criteria (pub.03 Mar 2023)

Exposure Draft: Climate Vulnerability in Corporate Ratings Criteria (pub.09 Jun 2023) (including rating assumption sensitivity)

National Scale Rating Criteria (pub.22 Dec 2020)

Parent and Subsidiary Linkage Rating Criteria (pub.16 Jun 2023)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

AZUL Investments LLP	EU Endorsed, UK Endorsed
Azul S.A.	EU Endorsed, UK Endorsed
Azul Secured Finance LLP	EU Endorsed, UK Endorsed

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