

Research Update:

Brazilian Airline Azul Upgraded To 'CCC+' From 'CCC-' On Lower Liquidity Pressure, Outlook Stable

December 14, 2020

Rating Action Overview

- Brazilian airline Azul S.A. has alleviated pressures on its liquidity for the next 12-18 months following the recent convertible debenture issuance, and renegotiation of leasing and some debt contracts.
- Higher available cash position and the recovery in demand for domestic travel have better positioned the company to face ongoing uncertainties over the industry's rebound in the short term.
- As a result, on Dec. 14, 2020, S&P Global Ratings raised its issuer credit and issue-level ratings on Azul to 'CCC+' from 'CCC-', and the national scale corporate rating to 'brBB' from 'brCCC-'. The recovery rating remains at '4' (40%).
- The stable outlook reflects our view of diminished risks of a distressed debt restructuring in the next 12 months thanks to a larger cash position, while working capital requirements and expansion capex remain contained.

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Rating Action Rationale

Lower short-term liquidity pressures resulted in the upgrade. The recent R\$1.75 billion convertible debenture issuance (with ability to raise additional \$100 million [about R\$540 million] in the next 12 months under the same terms and conditions), along with the rescheduling of leasing payments and other debt refinancing sharply reduced the risk of a distressed debt restructuring in the next 12 months. Azul has additional R\$3 billion in potential liquidity from deposits/reserves and receivables, and R\$1.3 billion of unencumbered assets, which provide some additional financial flexibility, although not as liquid.

We don't view the recent debenture renegotiation as tantamount to default. Although we viewed the renegotiation as distressed, we don't have sufficient evidence that investors will receive less value than the original promise of the debt.

A pressured capital structure and COVID-19 risks underpin the 'CCC+' rating. Domestic flights in Brazil have robustly rebounded recently, as seen in Azul's domestic available seat kilometers (ASK) that should reach in December about 80% of the pre-pandemic level, thanks to leisure travel replacing corporate and international travel. However, there's still significant uncertainty over the consistency of this trend after the high summer season in the country. The accelerating spread of the virus in Brazil since November may stall the recovery, while timing for a widely available vaccines is unclear.

Meanwhile, Azul's balance sheet remains vulnerable, with still sizable leasing liabilities with increasing leasing cash flow disbursement (mainly as of 2022), and debt continuing to rise. We forecast a gross debt (excluding leasing) of about R\$7 billion in 2020 and R\$8 billion in 2021, compared with R\$3.5 billion in 2019.

Therefore, we view that Azul remains vulnerable to market conditions, among other factors, as fuel prices and exchange rates that under unfavorable conditions could turn Azul's financial obligations unsustainable in the medium term.

Capex and working capital management are also key to preserve liquidity. We forecast a capex disbursement of R\$1.6 billion -R\$2.0 billion in 2021 and 2022, versus about R\$600 million in 2020, mainly reflecting expenses for resuming flights of grounded fleet, which will pressure free operating cash flow (FOCF) in the short term. We expect the company's current cash position to meet these needs along with improving revenue. Azul could also struggle to fund working capital requirements over next couple of years, mainly regarding management of suppliers and air traffic liabilities, which rose to R\$5.15 billion in September 2020 from R\$3.5 billion in December 2019. We recognize that a FOCF shortfall could reflect a stronger-than-expected market recovery, leading to rising capex and working capital needs, but it would require adequate funding to avoid rating pressure.

Environmental, social, and governance (ESG) factors relevant to the rating action: Health and safety

Outlook

The stable outlook reflects our view of diminished risks of a distress debt restructuring in the next 12 months thanks to a larger cash position along with a gradual recovery of demand for air travel, while working capital and expansion capex remain contained.

Downside scenario

We could take a negative rating action in the next 6-12 months if demand recovery in Brazil stalls amid the increasing spread of COVID-19, denting consumer confidence. In this scenario, Azul's revenues stream and working capital requirement would be pressured, deteriorating cash flow and liquidity position and increasing the risks of a debt distressed restructuring.

Upside scenario

We could take a positive rating action amid a stronger-than-expected rebound in travel demand and lower risks of an additional wave of COVID-19. In this scenario, we expect Azul's debt to EBITDA to gradually approach 6.0x, while refinancing keeps improving maturity tenor and liquidity.

Company Description

Azul is a Brazilian airline founded in 2008 with a total fleet of 139 operating aircraft as of September 2020. The company is the country's largest airline in terms of domestic departures and cities it serves, with about 916 daily flights before the pandemic reaching above 100 cities. It's currently the second largest in terms of ASK in Brazil, after Gol Linhas Aereas Inteligentes S.A. In addition, the company wholly owns its loyalty program, TudoAzul, which had close to 12.4 million members as of Sept. 30, 2020. Azul generated revenue and EBITDA of about R\$7.2 billion and R\$380 million in the 12 months ended Sept. 30, 2020, stressed due to the pandemic. In 2019, these metrics were R\$11.4 billion and R\$3.6 billion, respectively.

Our Base-Case Scenario

- Brazil's GDP contraction of 4.7% in 2020, and growth of 3.2% in 2021 and 2.6% in 2022.
- Air traffic declines 45% in 2020 and 20%-25% in 20201 from the 2019 level. For 2022, we expect total capacity closer to the 2019 level.
- Average FX of R\$5.15-R\$5.30 per \$1 over the next few years.
- West Texas Intermediate crude oil prices of about \$35 per barrel in 2020 and \$45 per barrel in 2021.
- Average yield declining about 15% in 2020 and growing 10% in 2021, reflecting market conditions and shift towards leisure travel.
- Total leasing liabilities at R\$12 billion – R\$13 billion as of 2020, reflecting renegotiated terms.
- Capital spending of R\$550 million – R\$600 million in 2020 and R\$1.6 billion – R\$2.0 billion annually in 2021 and 2022 to resume operation of grounded fleet.
- No significant change to the operating fleet over the next couple of years, maintaining the number at about 140.
- No dividends or share repurchases.

Based on those assumptions, we now expect EBITDA of about R\$600 million in 2020 and recovering to R\$2.3 billion in 2021 and R\$3.0 billion – R\$3.5 billion in 2022, leading to gross debt to EBITDA of 8.5x in 2021 and 6.0x in 2022.

Liquidity

We revised our liquidity assessment on Azul to less than adequate from weak, mainly reflecting higher cushion stemming from the R\$1.75 billion debenture issuance, negotiations with lessors, and debt refinancing. Nevertheless, risks remain regarding demand recovery, which could further pressure cash flows amid the sizable leasing payment, along with still sizable debt, increasing interest burden. In addition, we expect the company to breach its debt payment acceleration covenant of debt to EBITDA of 5.5x in 2021, requiring a waiver negotiation.

Principal Liquidity Sources:

- Unrestricted short-term cash position of R\$1.6 billion in Sept. 30, 2020; and
- The R\$1.75 billion convertible debenture issuance in November 2020.

Principal Liquidity Uses:

- Short-term debt of R\$1 billion;
- A shortfall in FFO of R\$600 million for the next 12 months from Sept. 30, 2020;
- Working capital outflow of about R\$350 million; and
- Capex of R\$1.3 billion in the next 12 months from Sept. 30, 2020.

Covenants

The company's operating lease agreements and bonds don't have financial covenants. But the bonds have the usual cross-default provisions with other relevant debts and events of default. Azul has a financial covenant on its debentures, which require debt to EBITDA below 6.5x and fixed-charge interest coverage above 1.2x. The covenants are of debt acceleration type.

Also, Azul has a debt payment acceleration financial covenant for U.S. International Development Finance Corporation's loan of about \$150 million (about R\$810 million), which is measured quarterly. It requires a maximum debt to EBITDA of 5.5x and fixed-charge interest coverage above 1.2x.

We currently forecast Azul would breach its covenants in 2021, but we expect it be able to obtain waiver as it did in 2020.

Issue Ratings - Recovery Analysis

Key analytical factors

We're maintaining our '4' recovery rating (40% rounded estimate) and raising the issue-level rating to 'CCC+' from 'CCC-', following the upgrade of the issuer credit rating. We have valued the company on a discrete asset basis (discrete asset valuation [DAV]), 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 various assets at default based on net book value for current assets and appraisals for aircrafts, after adjusted for expected realizations rates in a distressed scenario. We include the recently issued R\$1.7 billion convertible debenture in our default scenario. We have considered it as an unsecured claim in our analysis because it's primarily backed by off-balance assets, mainly intellectual properties of Azul and TudoAzul, which are not included in the DAV.

Simulated default assumptions

- Simulated year of default: 2022
- We apply an overall haircut of 65%-70% to Azul's asset base, including about 80% dilution rate to its cash position, because the company would likely use part of its cash position to fund working capital needs and repay more expensive loans in a distress scenario.
- We apply a 5% cut for administrative expenses.
- Therefore, we arrive at a gross enterprise value of about R\$4 billion.

Simplified waterfall

- Gross enterprise value, DAV approach: R\$4 billion
- Net recovery value after administrative costs (5%): R\$3.8 billion
- Secured and priority debt at default: R\$1.5 billion
- Total value available to unsecured claims: R\$2.3 billion
- Senior unsecured debt default: R\$5.8 billion
- Recovery expectations: 30%-50% (rounded estimate 40%)

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

	To	From
Azul Investments LLP		
Senior Unsecured	CCC+	CCC-

Upgraded; CreditWatch/Outlook Action

	To	From
Azul S.A.		
Issuer Credit Rating	CCC+/Stable/--	CCC-/Negative/--

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Brazil National Scale brBB/Stable/-- brCCC-/Negative/--

Ratings Affirmed

Azul Investments LLP

Senior Unsecured

Local Currency CCC+

Recovery Rating 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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 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. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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