

Research Update:

Azul S.A. Downgraded To 'CC' From 'CCC+' On Debt Exchange Announcement; Outlook Negative

October 30, 2024

Rating Action Overview

- On Oct. 28, 2024, Brazil-based airline company Azul S.A. announced it had reached an agreement with bondholders for additional financing, but the transaction includes debt exchanges on most of the company's market debt.
- We view this transaction, once completed, as tantamount to default. While the exchange will be at par, with no initial maturity extension or change in coupons, we believe the transaction is distressed and creditors will receive less than originally promised, given the changes in priority over collateral and expected equity conversion of part of the debt.
- On Oct. 30, 2024, S&P Global Ratings lowered its global scale issuer credit rating on Azul to 'CC' from 'CCC+'. At the same time, we kept our issue-level rating at 'CCC-' and the '6' recovery rating on the company's 2026 senior unsecured notes unchanged, as they're not part of the exchange. We also lowered our national scale issuer credit rating to 'brCC' from 'brBB-'.
- The negative outlook reflects that we will lower our global scale issuer credit rating on Azul to 'SD' (selective default) if the transaction closes under the currently analyzed terms.

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Rating Action Rationale

The downgrade follows Azul has reached an agreement with its bondholders for additional funding for up to \$500 million that contemplates an exchange on most its outstanding market debt. Azul has already entered a transaction support agreement with supporting bondholders for more than 66.7% of its 2028, 2029, and 2030 secured notes and for 95.6% of the existing convertible debentures. As part of the recently announced transaction, Azul plans to conduct exchange offers and consent solicitations for these notes, which contemplate changes in priority and equity conversion characteristics.

The announced transaction is part of a larger capital optimization plan the company has been undertaking in the past few months. For instance, Azul announced an agreement with lessors and original equipment manufacturers on Oct. 7, 2024, to eliminate a convertible instrument in exchange for Azul's new preferred shares. The agreed new financing was a precedent condition for

the lessors' agreement to be completed.

If the company completes the transaction as described, we will lower our issuer credit rating on Azul to 'SD'. Following the completion of the transaction, we would review Azul's new capital structure, cash flow, and liquidity position, and reassess our ratings. We believe all these transactions, once completed, should improve the company's liquidity and capital structure and could reduce cash-flow deficits in coming years and enable the company to gradually raise additional liquidity.

We view the exchange as a de facto restructuring and tantamount to default. We view this transaction as distressed rather than opportunistic since, without it, there's a realistic possibility of a conventional default or bankruptcy filing due to the company's shrinking liquidity and challenging financial market conditions. Azul's cash flow has remained strained in the past several quarters, resulting in a reduction of cash balances amid high lease expenses, repayment of various liabilities, and limited availability of refinancing.

Additionally, we believe credit holders will receive less than originally promised. The new super-priority funding will be ahead of the existing 2028, 2029, and 2030 notes in priority of payment from the shared collateral. Additionally, 2029 and 2030 holders that do not participate in the exchange offers and consent solicitations would hold the existing notes, which will become unsecured. Finally, the new 2029 and 2030 notes also contemplate a conversion into equity in stages and dependent on specific milestones.

Outlook

The negative outlook indicates that we will lower our issuer credit rating on Azul to 'SD' upon the transaction's completion. We could then rate the company based on our assessment of its business plan and credit metrics under the new capital structure.

Company Description

Azul, founded in 2008, is a Brazilian airline with an operating fleet of 182 aircraft as of June 2024. 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 to over 160 destinations. The company's wholly owned loyalty program, Azul Fidelidade, had over 16 million members as of December 2023. Azul generated revenue of R\$18.7 billion and posted S&P Global Ratings-adjusted EBITDA of R\$5.1 billion in the last 12 months ended June 2024.

Issue Ratings - Recovery Analysis

Key analytical factors

- We affirmed our 'CCC-' rating on Azul's remaining 2026 senior unsecured notes. The '6' recovery rating indicates no recovery expectation in a distressed scenario for unsecured creditors, which reflects the significant subordination that the holdouts on the unsecured notes have. The 2028, 2029, and 2030 notes are secured on a priority basis, and the new funding will be secured on a super-priority basis.
- We value 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. 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 aircraft, 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 55% to Azul's asset base, including a haircut of about 50% to its cash, 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 55%.
- 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\$6.8 billion
- Total secured debt, including priority: R\$12.1 billion
- As a result, there's no residual value available to unsecured claims
- Senior unsecured notes/lease rejected claims at default: R\$6.1 billion
- Recovery expectations for unsecured notes due 2026: 0%

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- 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
- 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

Downgraded

	To	From
Azul S.A.		
Issuer Credit Rating	CC/Negative/--	CCC+/Negative/--
Brazil National Scale	brCC/Negative/--	brBB-/Negative/--

Ratings Affirmed; Recovery Ratings Unchanged

Azul Investments LLP

Senior Unsecured	CCC-
Recovery Rating	6(0%)

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