

Research Update:

Brazilian Airline Azul S.A. Downgraded To 'CCC+' And 'brBB-' On Ailing Capital Structure, Outlook Negative

May 18, 2020

Rating Action Overview

- We have revised our assumptions for the rebound in air traffic over the next few years and we now expect that Brazilian airlines will face a demand contraction of about 50% in 2020, keeping around 40% of Azul S.A.'s fleet grounded until the year-end. This will crimp the company's cash flows and liquidity.
- In addition, Azul has significant operating lease payments in the short-term, which requires continuous fleet management discussions to allow it to meet obligations.
- On May 18, 2020, S&P Global Ratings lowered its global scale issuer credit and issue-level ratings on Azul to 'CCC+' from 'B', and the national scale issuer credit rating to 'brBB-' from 'brA-'. The recovery rating on the rated debt remains at '4' (40%).
- The negative outlook reflects a potential further downgrade in the next 6-12 months if the industry's slower-than-expected recovery reduces Azul's access to long-term funding. This could pressure negotiations with lessors and other stakeholders, increasing the risk of debt restructuring that we would view as distressed.

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Rating Action Rationale

BNDES' funding could provide some short-term cushion, but risks persist. Azul's negotiations with BNDES, the Brazilian development bank, seem to be in advanced stages, but we don't have enough information about final terms and conditions of the proposed credit line. While on one hand the cash inflows should provide liquidity relief in the next 12 months, the BNDES loan also depends on the participation of other institutional investors and should include equity convertibility features, which depending on market interest and conversion ratios, could be deal breakers.

According to our base-case scenario, Azul's capital structure could become unsustainable in the medium term amid the lower demand for air travel, which could increase the likelihood of the company proposing a distressed debt exchange that we could view as a tantamount to a default.

Steeper-than-expected contraction in air traffic because of COVID-19 will take a further toll on liquidity and capital structure. Azul's capital structure is overwhelmingly made up of operating leases, with about R\$16 billion in lease liabilities in March 2020, including a short-term lease obligation of R\$2.4 billion. On top of that, it has R\$1 billion in short-term financial debt (excluding the OPIC debt). Despite Azul's sustainable business model, we understand that the company has a somewhat limited flexibility in its fleet structure in the next 12 months. In light of a demand contraction of about 50% in 2020 and slower-than-expected rebound in 2021, lessors will have to be even more supportive. Our base-case scenario assumes that 40% of Azul's fleet will remain grounded by the year-end.

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

- Health and safety

Outlook

The negative outlook indicates our view that Azul's capital structure could become unsustainable in the next 6-12 months amid significant amount of leasing, a tighter access to long-term funding, and subdued recovery in demand.

Downside scenario

We could downgrade Azul in the next 6-12 months stemming from a slower-than-expected market rebound amid diminished access to long-term funding, which would pressure further Azul's negotiations with lessors and other stakeholders, increasing the likelihood of debt restructuring that we would view as distressed.

Upside scenario

A positive rating action could result from significant liquidity relief amid the industry's stronger-than-expected recovery in the next 12 months. It could also stem from new cash proceeds from BNDES loan and other long-term funding. We would also expect Azul to continue obtaining waivers on its debt covenant, while lessors remain supportive in the next 12-18 months.

Our Base-Case Scenario

- Average exchange rate of R\$4.9 per \$1 in 2020 and R\$4.8 in 2021.
- Fuel benchmark prices decreasing in line with our Brent oil price deck of \$30/bbl in 2020 and \$50 in 2021 (from about \$60/bbl in 2019). However, we assume the company won't capture the full effect of lower oil prices in 2020 because it already has the bulk of this year's fuel needs hedged.
- RPK to fall 45%-50% in 2020, and recovering to about 75% of the 2019 level. The drop will mostly be due to the coronavirus outbreak, which we believe will continue denting demand in 2021.
- Load factors in the 70%-75% range, which could plummet depending on consumer behavior and duration social-distancing measures.

- Capex at maintenance levels.

Base on those assumptions, we expect the following metrics:

- EBITDA decline of 60%-65%, leading to gross debt to EBITDA of about 15x by the year-end, recovering to 9x in 2021.
- A shortfall in cash FFO around R\$850 million in 2020 after payment of contracted leases obligation.

Liquidity

We view the company's liquidity position as weak because we now expect a substantial cash deficit over the next 12 months. Despite the potential credit line from BNDES, the short-term debt of R\$1 billion and operational lease commitments will continue to pressure Azul's cash position. Even amid recovering demand, higher working capital needs could prevent a significant improvement in the short term. In addition, the company will continue to breach covenant in our base case, which limits financial flexibility, and requires significant improvement on lease structure or tapping the market to relieve liquidity, but the market is virtually closed now for the industry.

Principal Liquidity Sources:

- Unrestricted cash position of about R\$1.2 billion as of March 2020.

Principal Liquidity Uses:

- Short-term debt maturities of R\$1 billion in the next 12 months, excluding OPIC debt for which Azul obtained waivers in April;
- A deficit of R\$850 million in cash FFO in the next 12 months; and
- Maintenance capex of about R\$500 million in the next 12 months.

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: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action

| | To | From |
|-----------------------------|-------------------|-------------------|
| Azul S.A. | | |
| Issuer Credit Rating | CCC+/Negative/-- | B/Watch Neg/-- |
| Brazil National Scale | brBB-/Negative/-- | brA-/Watch Neg/-- |
| Azul Investments LLP | | |
| Senior Unsecured | CCC+ | B /Watch Neg |
| Recovery Rating | 4(40%) | |

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