FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Azul's Outlook to Negative; Affirms IDR at 'B-'

Thu 11 Jul, 2024 - 17:40 ET

Fitch Ratings - Rio de Janeiro - 11 Jul 2024: Fitch Ratings has affirmed Azul S.A.'s (Azul) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'B-' and its Long-Term National Scale rating at 'BB(bra)'. Fitch has also affirmed Azul Investments LLP's unsecured bonds at 'CCC+'/'RR5', as well as Azul Secured Finance LLP's senior secured notes at 'B-'/'RR4'. The Rating Outlook of Azul's IDRs has been revised to Negative from Stable. Fitch has assigned a Negative Outlook to Azul's Long-Term National Scale Rating.

The Negative Outlook reflects Azul's cash flow burn pressures from its high lease and interest expense burden, BRL depreciation and fuel price volatilities and its significant dependence on accessing credit market to fund its free cash flow generation and to maintain healthy liquidity levels.

Azul's ratings are supported by its strong regional market position in the Brazilian domestic airlines industry and solid operating margins, as well as its limited geographic diversification and foreign exchange (FX) exposure. In terms of leverage, Azul's credit metrics are relatively adequate but the high operating leverage (pos-pandemic restructuring) and its ongoing capex program require additional funding. Azul has limited financial flexibility given its already high secured debt basis.

KEY RATING DRIVERS

Challenge to Access Credit Lines: Azul's ability to continue to access new credit lines, seeking to support its liquidity position and fund cash burn/negative free cash flow generation are key factors to its ratings. The company faces important business seasonality with a large portion of its cash flow being generated during second half of the year, most notable during the fourth quarter. The current scenario of BRL depreciation and fuel price volatilities put further pressure on its cash flow in the short-term. During 1H24, Fitch estimates that Azul has raised around BRL1.5 billion, including bond re-tap and local issuance, which helped to sustain liquidity position.

Ongoing Refinancing Risks: The need to fund the recurring negative free cash flow generation and equity notes are Azul's main refinancing issues until 2027. Azul´s major outstanding bonds mature on 2028, 2029 and 2030. In the short to medium term, Azul's faces maturity of its unsecured 2024 and 2026 bonds (USD68 million and USD32 million, respectively), and instalments of its lease notes and equity instruments. During second half of 2024 Azul faces around BRL841 million of debt maturities, including outstanding bond due 2024 (USD68 million). For 2025-2027, the company starts to face larger maturities of its lease equity instrument.

Pressures on EBITDA Growing: Fitch expects Azul's adjusted EBITDA to continue to improve during 2024 and 2025 due to the solid domestic traffic level as well as cost efficiencies, including fleet modernization, and capacity expansion. As mentioned, the exogenous factors (FX rate and fuel) are expected to put some pressure on cash flow this year. Fitch forecasts Azul's adjusted EBITDA to reach around BRL6.2 billion in 2024 and BRL7.2 billion in 2025, an increase from BRL5.0 billion in 2023 and BRL3.6 billion during 2019 (pre-pandemic).

EBITDA margin are expected around 30%-32%. Azul's traffic levels have been above 2019's levels since mid-2021, given the company's strong growth strategy. Fitch estimates Azul's 2024 total traffic volume are around 28% higher than 2019, and capacity level at 33%.

FCF to Remain Negative: In Fitch's forecasts, Azul's free cash flow generation remains negative during 2024 and 2025, at around BRL1.3 billion and BRL1.5 billion, respectively. The high leasing and interest expenses post-restructuring after the COVID-19 pandemic and its ongoing growth strategy and fleet modernization further dent its operating cash flow generation. For 2024 and 2025, Fitch estimates capex of around BRL2.1 billion and BRL2.5 billion, respectively. The fleet modernization is a key pillar on Azul's strategy to improve profitability. The company expects to double its E2 fleet by 2025, and those aircraft brings around 26% reduction per cost per seat.

Improving Credit Metrics: The ongoing improvements of EBITDA generation are expected to help restore its credit profile in terms of leverage. Fitch's base case scenario forecasts the company's total and net adjusted leverage/EBITDAR ratios at around 4.5x and 4.2x, respectively, during 2024, an improvement from the 2023 levels of 5.3x and 4.8x. Fitch calculates Azul's total debt at BRL27.7 billion, which also includes convertible debentures, leases notes and leases equity instrument. Lessors exchanged COVID lease deferrals for notes due 2030 and equity instrument convertible into Azul's shares (40/60 split).

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. (LATAM). Azul is the sole provider of services on 82% 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 2023.

As Brazil is the company's key market, Azul's operating results are highly correlated to the Brazilian economy. During 2023, 93% of its revenues derived from passengers and 7% from cargo and others, and 79% of its revenues were originated within local market.

Potential Merger with GOL: The current rating does not incorporate any consolidation movement. Azul has been vocal on its strategy to consolidated the market and it is considering a potential transaction with GOL Linhas Aereas Inteligentes S.A. (GOL; IDR, D), that is going through Chapter 11 Process in US. It is still unclear the final terms of the deal and the proforma capital structure of the combined entity.

DERIVATION SUMMARY

Azul has a weaker position relative to global peers given its limited geographic diversification, higher operating leverage and weaker financial flexibility. In terms of its regional peers, it has a weaker position compared to LATAM (BB-/Positive) and Avianca Group International Limited (B/Stable) in terms of business diversification, liquidity and financial flexibility, but has a stronger cash position compared to GOL Linhas Aereas Inteligentes S.A. (D). Different from the others, Azul has not completed a debt haircut as part of the debt restructuring post COVID, like LATAM and Avianca did.

Azul's strong position in the Brazilian regional market and high operating margins have 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 only partially mitigates this risk.

Fitch expects LATAM and Avianca to maintain gross leverage around 2.5x and 3.5x in the next two years, while Azul is still to move around 4.5x in 2024. Azul's leasing and interest burden and ongoing capex program implies in much higher risks to fund its sizeable negative free cash flow. In terms of EBITDA coverage, Azul is expected to report 1.3x in 2024, while LATAM and Avianca 2.3x and 4.2x.

In terms of liquidity position, measured as cash over LTM revenues, Azul also has weaker metric (around 10%-12%) compared to LATAM (24%, including revolving facility) and Avianca (around 15-20%). LATAM has a sizeable stand-by credit facility of USD1.1 billion.

KEY ASSUMPTIONS

--Fitch's base case during 2024 and 2025 includes an increase in ASK by 9% and RPK of around 8%;

--Load factors around 79% during 2024 and 2025;

-- Adjusted EBITDAR Margin of around 30%-32% in 2024 and 2025

--Capex of BRL2.1 billion in 2024 and BRL2.5 billion in 2025

RECOVERY ANALYSIS

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 BRL2.5 billion which incorporates the low-end expectations of Azul's EBITDA post-pandemic, adjusted by lease expenses, plus a discount of 20%. 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 total debt as of March 31 2024. 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;

--Gross and net leverage ratios consistently below 4.5x and 4.0x;

--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 and healthy yields scenario;

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 5.5x and 5.0x;

--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.

LIQUIDITY AND DEBT STRUCTURE

Refinancing Risks: Azul's liquidity position is poor in light of the recurring negative free cash flow and refinancing risks. As of March 31 2024, Azul's total debt, calculated by Fitch, was BRL27.7 billion, with BRL4.9 billion in short term (BRL3.7 billion of leasing obligations) and BRL1.4 billion of cash readily available. During 2023 and LTM March 2024, Azul's cash to LTM revenue were 12% and 7%, respectively. Fitch expects Azul to maintain this ratio around 9%-10% during 2024 and 2025.

Per Fitch's calculation, Azul's total debt also includes convertible debentures, leases, notes and leases equity instrument. The company faces maturities of BRL1.5 billion during April-Dec 2024, BRL1.2 billion in 2025, BRL1.4 billion in 2026, BRL1.1 billion in 2027, BRL6.0 billion in 2028 and remaining amount (BRL6 billion) spread 2029 on. Azul has limited financial flexibility given its already high secured debt basis. During 1H24, Fitch estimates that Azul has raised around BRL1.6 billion, including bond re-tap and local issuance, which helped to sustain liquidity position.

ISSUER PROFILE

Azul is one of Brazil's largest local airlines, with significant presence in the regional market and being the sole player on 82% of its routes. During 2023, 93% of its revenues were derived from passengers and 7% 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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
AZUL Investments LLP					
senior unsecured	LT	CCC+	Affirmed	RR5	CCC+
Azul S.A.	LT IDR	B- Rating Outlook Negative	Affirmed		B- Rating Outlook Stable
	LC LT IDR	B- Rating Outlook Negative	Affirmed		B- Rating Outlook Stable

	Natl LT	BB(bra) Rating Outlook Negative	Affirmed			BB(bra)
Azul Secured Finance LLP						
senior secured	LT	B-	Affirmed		RR4	B-
Senior Secured 2nd Lien	LT	B-	Affirmed		RR4	B-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

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

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

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 21 Jun 2024)

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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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