

Research Update:

Azul S.A. Downgraded To 'CCC+' From 'B-' On Weaker Results And Tighter Liquidity; Outlook Negative

September 2, 2024

Rating Action Overview

- Brazilian airline Azul S.A.'s results for the first half of 2024 were softer than we expected, widening its free operating cash flow (FOCF) deficit for the year and weakening liquidity. In this context, the company is looking for ways to strengthen its capital structure and increase its liquidity.
- On Sep. 2, 2024, S&P Global Ratings lowered its global scale issuer credit rating on Azul to 'CCC+' from 'B-' and its national scale rating to 'brBB-' from 'brBBB-'. At the same time, we lowered our rating on Azul's senior unsecured notes to 'CCC-' from 'CCC' and affirmed the '6' recovery rating, indicating our expectation of minimal recovery (0%) on the remaining unsecured notes due 2024 and 2026 in the event of a payment default.
- The negative outlook reflects that we could lower the ratings in the next six to 12 months if Azul's cash flow generation and ability to access long-term financing weaken.

Rating Action Rationale

Azul's second-quarter results were weaker than we expected, leading us to forecast larger negative FOCF after lease payments. The depreciation of the Brazilian real (R\$) and a reduction in capacity and yields hampered Azul's second-quarter results.

We now forecast 3%-4% revenue growth for 2024. We still forecast a healthy EBITDA margin of about 28.0%, versus 25.2% in 2023. We expect Azul's EBITDA to grow to about R\$5.2 billion this year from R\$4.7 billion in 2023, but capital expenditures (capex) and lease payments to weigh on earnings. We forecast material FOCF deficits after lease payments of about R\$1.6 billion this year and 2025.

Azul's liquidity has tightened, and refinancing options are narrow. Azul used slightly over R\$450 million in cash in the first half of the year. As of June 30, 2024, it held cash of about R\$1.5 billion. Although financial debt maturities in the next 12 months aren't substantial, operating leases and

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capex needs are meaningful (totaling approximately R\$5 billion per year in 2024 and 2025).

The company has confirmed it is under negotiations with lessors to convert part (\$558 million) of its lease liabilities into equity and is also working on some alternatives to get new secured financing to strengthen liquidity.

Outlook

The negative outlook reflects that we could lower the ratings in the next six to 12 months if negotiations with lessors aren't successful or if they take longer than we expect, and/or if cash flow generation and Azul's ability to access long-term financing weaken.

Upside scenario

A positive rating action could result from significant liquidity relief stemming from new cash proceeds from stakeholders. An upgrade would also depend on completion of negotiations with stakeholders, diminishing risks of a debt restructuring.

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

- Our 'CCC-' rating on Azul's remaining senior unsecured notes is two notches below our issuer credit rating on the company. 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 now have. The 2028, 2029, and 2030 notes are secured on a 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\$5.2 billion.

Simplified waterfall

- Net enterprise value after administrative costs (5%): R\$4.9 billion
- First priority debt at default including six months accrued interest: R\$6.3 billion
- Total secured debt, including priority: R\$10.9 billion
- As a result, there's no residual value available to unsecured claims.
- Senior unsecured notes/lease rejected claims at default: R\$5.4 billion
- Recovery expectations for unsecured notes due 2024 and 2026: 0%

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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; CreditWatch/Outlook Action

	To	From
Azul S.A.		
Issuer Credit Rating	CCC+/Negative/--	B-/Stable/--
Brazil National Scale	brBB-/Negative/--	brBBB-/Stable/--

Downgraded

	To	From
Azul Investments LLP		
Senior Unsecured	CCC-	CCC
Recovery Rating	6(0%)	

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