

Research Update:

Brazilian Airline Azul Downgraded To 'CCC-' From 'CCC+' On Higher Risk Of Distressed Debt Restructure; Outlook Negative

July 24, 2020

Rating Action Overview

- Although Brazilian airline Azul S.A.'s traffic improved in June and July, the demand pattern mainly for higher value added corporate travels is difficult to predict.
- Azul has over R\$700 million of bank debt maturities due from September to December 2020. Although the company is in advanced stages for obtaining new funding with BNDES that would alleviate short-term liquidity pressures and is also in talks to reduce lessors' payments, the timing of renegotiations are uncertain, as well as the willingness to pay down debt contracts in full and on time. We believe the likelihood of a distressed debt exchange with banks, which we could likely consider as a tantamount to a default, has increased.
- As a result, on July 24, 2020, S&P Global Ratings lowered its global scale issuer and issue-level credit ratings on Azul to 'CCC-' from 'CCC+' and its national scale issuer credit rating to 'brCCC-' from 'brBB-'.
- The negative outlook reflects rising concerns about the company's potential need to restructure its debt by extending maturities, which, according to its final terms and conditions, we could consider as equivalent to a default. It also reflects risks of a slower-than-expected market rebound and challenges about the timing to access other sources of funding or refinancing that could further worsen the company's ability to meet its interest or principal obligations on time.

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Rating Action Rationale

Debt restructure risks rising despite BNDES funding negotiations. Although we expect the BNDES funding negotiation to be completed in the upcoming weeks, alleviating pressure on the company's liquidity position, we see a high likelihood of a distressed extension on Azul's other bilateral bank loans, which amount to R\$1.8 billion and of which over R\$700 million matures from September through December 2020. Depending on the terms and conditions of these renegotiations, we could consider them as tantamount to a default. At the same time, even though

part of the proceeds of the BNDES funding should be disbursed soon, the timing is still uncertain, which increases incentive for Azul to protect cash balances and pursue a refinancing or debt restructuring. This would be aligned with haircuts in payments with employees, lessors, and shareholders, which are all under discussion.

Haircut with lessors and improved traffic demand are offsetting factors. We expect the company to address most of its short-term leasing commitments by negotiating payments with lessors and obtaining discounts or partial deferred payments for 2020 and 2021. At the same time, we see some improvement in demand from what we previously expected, with increasing capacity each month since April--when the pandemic hit the company hardest--which should result in a demand recovery of about 50% of pre-pandemic capacity by the end of the year.

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

- Health and safety.

Outlook

The negative outlook reflects the increased short-term liquidity pressures that the company will face in the next six months in the context of a still subdued recovery in demand and low access to long-term funding given the current industry conditions. In our view, this increases the likelihood that the company would have to enter into any type of restructuring of its debt in order to extend maturities as it adjusts its operational capacity.

Downside scenario

We could downgrade Azul if we believe a default is a virtual certainty or if the company announces or undertakes a distressed restructuring in the next six months that we could consider equivalent to a default because of slower-than-expected access to long-term funding.

Upside scenario

A positive rating action could result from significant liquidity relief amid stronger-than-expected recovery for the airline industry in the next 6-12 months. It could also stem from new cash proceeds from the BNDES program and other long-term funding.

We would also expect Azul to be able to continue obtaining waivers on its debt covenants, while its stakeholders, as lessors, remain supportive in the next 12-18 months.

Company Description

Azul is a Brazilian low-cost airline founded in 2008 with a total fleet of 140 operating aircraft as of March 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. It is the third largest in terms of available seat kilometers (ASK). As of the end of 2019, Azul provided air transportation services to 26 million passengers per year to about 116 destinations through 229 non-stop routes, mainly in Brazil. In addition, the company wholly owns its loyalty program TudoAzul, which had close to 12 million members as of Dec. 31, 2019. Azul generated revenues of about R\$11.7 billion in the 12 months ended March 31, 2020.

Our Base-Case Scenario

- Brazil's GDP to contract 7.0% in 2020 and expand 3.5% in 2021.
- 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 per barrel (bbl) in 2020 and \$50/bbl 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.
- Revenue passenger kilometers (RPK) falling 40%-45% in 2020, and recovering to about 75% of 2019's level in 2021. The drop in 2020 is mostly due to the coronavirus outbreak, which we believe will spill over to 2021 demand.
- We continue to see load factors in the 70%-75% range, which could be significantly worse depending on consumer behavior and social distancing measures.
- Capital expenditures (capex) at maintenance levels for 2020 and increasing in 2021 following some recovery in activity.

Based on those assumptions, we now expect an EBITDA decline of 55%-60% for Azul, leading to gross debt to EBITDA of about 13.0x by the year's end, recovering to about 8.0x in 2021.

Liquidity

We consider Azul's liquidity position as weak, mainly reflecting diminishing cash flow generation and relevant short-term debt maturities and leasing commitments. Ongoing negotiations with lessors and proceeds from the BNDES funding should alleviate short-term pressures on the company's liquidity position, but we still see some risks in the very short-term--mainly qualitative factors in the terms of continued covenant breach, low capability to absorb high impact events without refinancing, and likely willingness to protect cash balance under the stressed period airlines are facing. Apart from that, demand rebound until the end of the year is still uncertain and could put additional pressure on the company's working capital requirements, along with unused flight tickets. The timing for refinancing its bank loans also remains unclear. In our view, the company's financial flexibility is tight, because it would depend on significant new capital market or bank debt to improve capital structure permanently, and access to capital markets is currently limited.

Sources over uses of cash (without considering the new BNDES funding) still has about 15% of deficit, which would be manageable under normal market conditions. But the likelihood of the company preserving cash to meet industry adversities is high amid so much uncertainty. This, along with weak qualitative factors such as continued covenant breach, continue to pressure Azul's capital structure.

Principal liquidity sources:

- Unrestricted short-term cash position of about R\$1.6 billion in June 2020.
- Cash funds from operations (FFO) of R\$1.2 billion for the next 12 months from June 30, 2020.
- Negative leasing payments of R\$570 million in the next 12 months.

Principal liquidity uses:

- Short-term debt of R\$2.0 billion.
- Working capital outflows of R\$113 million for the next 12 months as of June 2020.
- Maintenance capex of R\$500 million.

Issue Ratings - Recovery Analysis

Key analytical factors

The 'CCC-' rating on Azul's senior unsecured notes due 2024 is at the same level as the issuer credit rating, reflecting a recovery rating of '4' with an average recovery expectation of 40% (rounded) for unsecured creditors. Although most of Azul's fleet is under operating and financial leases, the issue-level rating reflects the company's non-aircraft related debt, which is mostly unsecured. We analyze Azul's recovery under a going concern scenario, because of the size of the company's operations in Brazil, which benefit from little or no competition, and given that we don't expect other players to replace Azul should it cease to operate. These factors lead us to believe that the company would likely be restructured in a distressed scenario.

Our valuations reflect our estimate of the value of the various assets at emergence adjusted for expected realizations rates in a distressed scenario. Under this scenario, we believe Azul's available assets would be enough to meet its secured loans and about 40% of its unsecured loans.

Simulated default assumptions

- Simulated year of default: 2020
- We apply an overall haircut of about 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\$3.1 billion.

Simplified waterfall

- Net enterprise value (after 5% administrative expenses): R\$2.9 billion
- Secured debt: R\$1.3 million (FINAME and aircraft purchases)
- Total value available to unsecured claims: R\$1.5 billion
- Total senior unsecured debt: R\$3.1 billion
- Expected recovery of senior unsecured debt: 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: 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

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

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