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Ratings

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Azul S.A.

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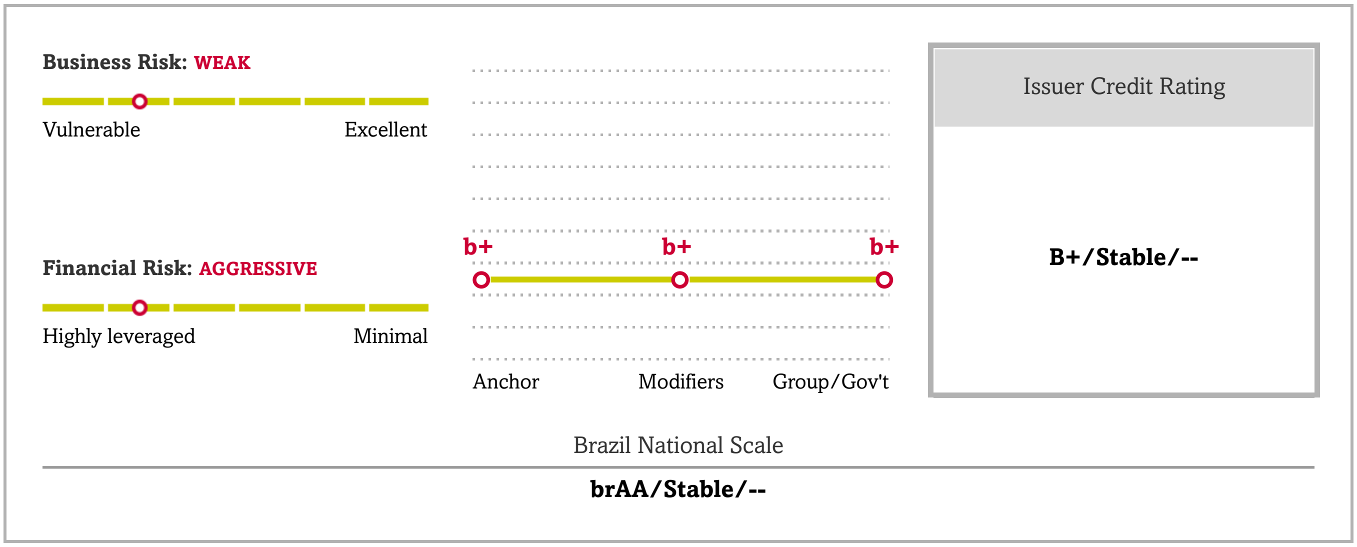
Azul S.A.



Credit Highlights

Overview

Key strengths	Key risks
Third-largest airline in Brazil, but with leading positions in the main routes it operates--it's the sole operator for about 70% of its routes.	Operates in the cyclical, capital-intensive, and price-competitive airline industry.
Focus on more regional destinations, allowing greater network capillarity	Global economic slowdown and trade disputes could affect demand and exacerbate currency volatility, hampering profitability and leverage.
Solid liquidity position.	Volatile fuel prices and domestic currency swings could affect Azul's cost structure.
	Geographic concentration, with high exposure to the Brazilian economy.

Better industry fundamentals in Brazil support profitability. Industry fundamentals have been improving since Avianca Brasil stopped operating and due to the continued disciplined supply management among the remaining three main industry players, Azul S.A. (B+/Stable/--), Gol Linhas Aereas Inteligentes S.A. (B/Stable/--) and Latam Airlines Group S.A. (BB-/Stable/--). This should allow the sector to sustain better load factors and adjusted yields, supporting higher profitability. Azul also benefitted from Avianca's slots redistribution, so that Azul was able to enter the Congonhas-Santos Dumont route--Brazil's busiest.As a result, we expect Azul to sustain load factors close to 83% and EBITDA margins close to 30% over the next couple of years.

A resilient business model and barriers to entry sustain Azul's competitive advantage. Although we see the airline industry as high-risk, we believe that Azul's network capillarity and strategic position in the Brazilian market somewhat mitigate the risks of the competitive, cyclical, and capital-intensive airline industry. Azul's strong presence in underserved markets is possible thanks to its diverse fleet that can fit into many different routes, which enables it to be the sole operator in many of them, giving it pricing advantages and the ability to capture corporate clients. As a result, the company has higher revenue per available seat kilometer (RASK) than its competitors, and higher margins, despite incurring more expensive costs per available seat kilometer (CASK) due to lower economies of scale per flight.

Geographic concentration and cyclical industry weigh on its credit profile. Although Azul does have a significant reach across Brazil, it is concentrated in a single market, which exposes the company to economic downturns and the Brazilian regulatory framework. Also, Azul's revenues are mostly generated in Brazilian reais, while part of the company's operating costs (most notably fuel and maintenance) are linked to the dollar, exposing it to greater volatility of margins than global companies.

Outlook: Stable

The stable outlook reflects our expectation that Azul will gradually improve its metrics by increasing cash flow generation, reflecting its fleet management plan, increasing ASK by replacing its E-Jets with the new generation A320. Its metrics would also improve amid a more favorable market in Brazil after the exit of Avianca. We expect Azul to maintain its business model, sustaining market leadership in key routes it operates while it improves cash flow generation. We expect Azul's gross debt to EBITDA to be below 4.5x by the end of this year and below 4.0x next year, while funds from operations (FFO) to debt will improve to 14%-15% this year and 16%-17% next year.

Downside scenario

A negative rating action would stem from worsening market conditions in Brazil, a hike in fuel prices or greater currency volatility that could increase Azul's cost structure substantially, worsening its operating performance and leading to free operating cash flow (FOCF) shortfalls and higher leverage. In this scenario, we would see gross debt to EBITDA close to 5.0x and FFO to debt of about 12% consistently. A negative rating action is also possible if volatility in the company's cash generation results in operational cash burn, weakening Azul's liquidity.

Upside scenario

We could take a positive rating action in the next 12 months if Azul were to significantly increase its cash flow generation, while it maintains a healthier capital structure amid still favorable conditions for the sector. In this scenario, we would also need to see stronger credit metrics amid relatively stable currency levels. Thus, we could see gross debt to EBITDA trending to 3.0x, FFO to gross debt of about 30%, and FOCF to gross debt above 15% consistently.

Our Base-Case Scenario

S&P Global Ratings expects that Azul will continue to work on increasing supply through its fleet management plan, while it increases operational performance, actively managing its capacity and benefiting from favorable market conditions.

Assumptions	Key Metrics
• Brazil's GDP increasing 1.0% in 2019 and about 2.0% in 2020, supporting demand from corporate and business clients. • Brazil's CPI of about 4% starting in 2019, impacting the company's local costs, including SG&A and COGS related salaries. • Average exchange rate of R$3.90 per $1 in 2019 and R$3.95 per $1 in 2020,which impacts fuel, maintenance, and leasing payments. • End-of-period exchange rate of R$3.95 per $1 in 2019 and 2020. • Total operating fleet of 142 aircraft in 2019 and 151 in 2020. In 2020, the A320neo should represent about 35% of total fleet, up from 16% in 2018, gradually replacing the E-195. • Aircraft fuel prices increasing according to our forecasted Brent oil prices and average exchange rate. We expect average Brent oil prices of $60 per barrel (bbl) in 2019 and 2020. • ASK to increase close to 25% in 2019 and 2020, as the company replaces E195 with the A320neo and expands its routes. • Revenue passenger per kilometer (RPK) increasing 26% in 2019 and 23% in 2020, reflecting the more resilient demand for Azul's main routes and the impact of exit of Avianca Brasil. • These assumptions result in an expected load factor of about 84% in 2019 and 83% in 2020. • Average yields improving about 4% in 2019. • Capital expenditures (capex) of about R$900 million in 2019 mainly related to new aircraft, engines, and equipment. • Lease liabilities of R$11 billion – R$12 billion in 2019 and R$12 billion – R$13 billion in 2020 to fund expansion and reflecting the fleet's lower average age. • No relevant dividend payout.	• EBITDA margin: 27.5% in 2018, projected at 29%-30% in 2019, and estimated at 31.0%-31.5% in 2020 and 30.0%-31.1% in 2021; • FFO to debt: 15.2% in 2018, projected at 14%-15% in 2019, and estimated at 16%-17% in 2020 and 17%-18% in 2021; • Debt to EBITDA: 4.5x in 2018, projected at 4.0x-4.5x in 2019, and estimated at 3.5x-4.0x in 2020 and 3.5x in 2021; and • FOCF to debt: 4.9% in 2018, projected at 5%-6% in 2019, and estimated at 5%-6% in 2020 and 6%-7% in 2021.

Base-case projections

Better industry fundamental and Azul's fleet management plan to support growth and higher margins.We expect Azul to post ASK growth of 25% in 2019 and 2020 while it maintains load factor of 83%-84%, reflecting more rational supply management in the sector after the exit of Avianca Brasil, the addition of larger aircraft to the fleet (A320neo) and replacing some of its smaller E-Jets on longer-haul flights. The A320 should strength its network, while reducing cost per seats in longer routes.

High liquidity cushion and conservative hedging should diminish volatility. We expect Azul to maintain a robust cash position in order to lessen the impact of the volatile exchange rates have on costs and on foreign currency debt. Our base-case scenario also assumes that the company will maintain a hedging strategy of 40% of fuel price for the next 12 months.

Company Description

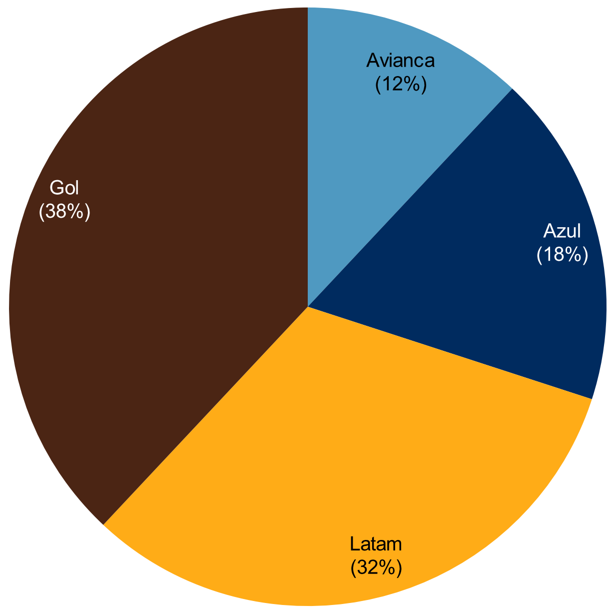
Azul is a Brazil-based, low-cost airline founded in 2008 with a total fleet of 134 aircraft. The company is the country's largest airline in terms of domestic departures and cities it serves, with about 822 daily flights. It is the third largest in terms of ASK. As of the end of 2018, Azul provides air transportation services to 23 million passengers per year to about 110 destinations through 222 non-stop routes, mainly in Brazil. In addition, the company wholly owns its loyalty program TudoAzul, which had close to 11 million members as of Dec. 31, 2018. Azul generated revenue of about R$10 billion in the 12 months ended June 30, 2019.

Business Risk: Weak

Azul is Brazil's third-largest airline in terms of market share. The company posted significant growth following the exit of Avianca Brasil, increasing its market share to 25% in June 2019 from 18% in June 2018, versus Gol's and Latam's 40% and 34%, respectively.

Chart 1

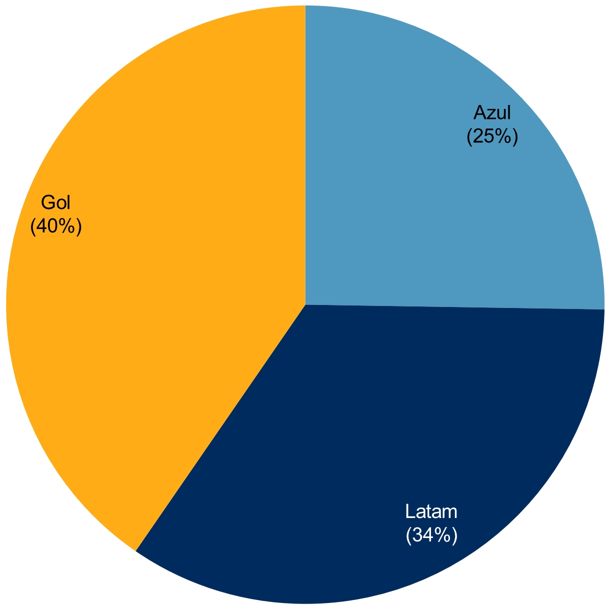
Domestic Market Share In 2018



Source: S&P Global Ratings.

Chart 2

Domestic Market Share In 2019



Source: S&P Global Ratings.

The company focuses on regional airports in economically dynamic areas of the country. This allows Azul to capture a significant amount of corporate client demand, which has proven to be resilient even during the economic downturn in Brazil. Also, Azul is the only carrier in about 70% of its routes, and it has a leading position in seven out of the ten largest domestic airports in number of departures in Brazil. This business model allows the company to charge higher average ticket prices, bolstering margins and RASK above those of competitors, despite incurring greater CASK due to lower economies of scale per flight.

Although the company has small presence in international routes, it has been expanding its alliances with international carriers--mainly TAP and United Airlines--through code share agreements, improving commercial cooperation, and synergies. Azul also counts on its own frequent flier program, TudoAzul.

Peer comparison

Table 1

Azul SA. -- Peer Comparison

	Azul S.A.	Latam Airlines Group S.A.	Gol Linhas Aereas Inteligentes S.A.
Issuer credit rating	B+/Stable/--	BB-/Stable/--	B/Stable/--
Country	Brazil	Chile	Brazil
Business risk profile	5 - Weak	4 - Fair	5 - Weak

Table 1

Azul SA. -- Peer Comparison (cont.)			
	Azul S.A.	**Latam Airlines Group S.A.**	**Gol Linhas Aereas Inteligentes S.A.**
Financial risk profile	5 - Aggressive	5 - Aggressive	5 - Aggressive
Anchor	b+	bb-	b+
Diversification/portfolio effect	Neutral (0)	Neutral (0)	Neutral (0)
Capital structure	Negative (-1)	Neutral (0)	Negative (-1)
Financial policy	Neutral (0)	Neutral (0)	Neutral (0)
Liquidity	Adequate (0)	Adequate (0)	Adequate (0)
M&G	Fair (0)	Satisfactory (0)	Fair (0)
CRA	Positive (+1)	Neutral (0)	Neutral (0)
SACP	b+	bb-	b
	--Fiscal year ended Dec. 31, 2018--		
S&P's Adjusted Figures (Mil. $)			
Revenues	2,364.4	9,895.5	2,947.7
EBITDA	677.5	2,228.0	635.2
Funds from operations (FFO)	474.9	1,639.2	365.6
Net income from continuing operations	108.6	213.2	(280.4)
Cash flow from operations	384.6	1,455.3	572.3
Capital expenditures	220.8	741.5	226.2
Free operating cash flow	163.7	713.7	346.1
Discretionary cash flow	160.6	641.1	56.7
Cash and short-term investments	435.7	1,465.6	337.0
Debt	2,999.9	8,621.4	3,230.8
Equity	817.2	3,746.8	(1,163.8)
Adjusted ratios			
EBITDA margin (%)	27.5	22.5	20.9
Return on Capital (%)	9.1	7.8	13.0
EBITDA interest coverage (x)	3.0	4.0	2.2
FFO cash interest coverage (x)	3.4	3.9	2.6
Debt/EBITDA (x)	4.6	3.9	5.2
FFO/debt (%)	15.2	19.0	10.9
Cash flow from operations/debt (%)	12.2	16.9	17.3
Free operating cash flow/debt (%)	4.9	8.3	10.3
Discretionary cash flow/debt (%)	4.8	7.4	8.2

Financial Risk: Aggressive

We expect Azul to continue improving its operating cash flows, offsetting the higher volumes of operating lease debt due to depreciation of the currency, and fleet renewal and expansion. Higher operating cash flows will allow the company to deleverage gradually. Lower Brent prices, lower capacity additions following Avianca Brasil's bankruptcy, price adjustments, as well as Azul's efficient fleet and route strategies will also support deleveraging. We expect the company to maintain a high cash position and use only a part of it to prepay debt, which is a conservative strategy for its liquidity and offsets potential negative effects from volatility in exchange rates and the cyclical demand in the airline business. We expect debt to EBITDA to be in the 4.0x-4.5x range by the end of 2019 and 3.5x-4.0x in 2020, while FFO to debt remains between 14% and 16% for the next two years.

Financial summary

Table 2

Azul S.A. -- Financial Indicators					
Industry Sector: Air Transport					
	-- Fiscal year ended December 31 --				
	2018	**2017**	**2016**	**2015**	**2014**
Rating History	B+/Stable/brAA	B+/Stable/brAA	NR	NR	NR
(Mil. R$)					
Revenues	9,153.4	7,789.5	6,669.9	6,257.9	5,803.1
EBITDA	2,516.8	2,287.4	1,748.5	1,054.5	1,288.2
Funds from operations (FFO)	1,769.6	1,513.9	788.9	123.9	606.6
Net income from continuing operations	420.3	529.0	(126)	(1,074.9)	(65)
Cash flow from operations	1,419.9	1,071.6	817.6	283.1	721.7
Capital expenditures	854.8	645.6	442.1	1,246.4	447.8
Free operating cash flow	565.1	426.0	375.5	(963.3)	273.9
Discretionary cash flow	552.9	378.6	29.1	(963.3)	273.9
Cash and short-term investments	1,686.6	1,798.5	880.4	666.4	888.8
Debt	11,613.7	9,877.5	9,897.9	12,321.1	8,103.9
Equity	3,163.7	2,833.6	1,002.0	(392.2)	416.5
Adjusted Ratios	0.0	0.0	0.0	0.0	0.0
EBITDA margin (%)	27.5	29.4	26.2	16.8	22.2
Return on capital (%)	9.1	10.8	6.4	2.2	9.0
EBITDA interest coverage (x)	3.0	2.6	1.6	1.1	1.9
FFO cash interest coverage (x)	3.4	3.0	1.8	1.1	1.9
Debt/EBITDA (x)	4.6	4.3	5.7	11.7	6.3
FFO/Debt (%)	15.2	15.3	8.0	1.0	7.5
Cash flow from operations/debt (%)	12.2	10.8	8.3	2.3	8.9
Free operating cash flow/debt (%)	4.9	4.3	3.8	(7.8)	3.4
Discretionary cash flow/debt (%)	4.8	3.8	0.3	(7.8)	3.4

Liquidity: Adequate

We view Azul's liquidity is adequate. Given robust cash position, forecasted cash generation, and manageable debt amortization schedule, we expect liquidity sources to surpass uses by more than 1.2x in the next 12 months and that sources will continue to exceed uses even if EBITDA declines by 30%. Azul is subject to debt-payment acceleration covenants under some of its debt contracts, which require adjusted net debt to EBITDA to be lower than 5.5x to 6.5x (depending on the contract) and interest coverage greater than 1.2x, both of which we expect the company to meet with significant headroom.

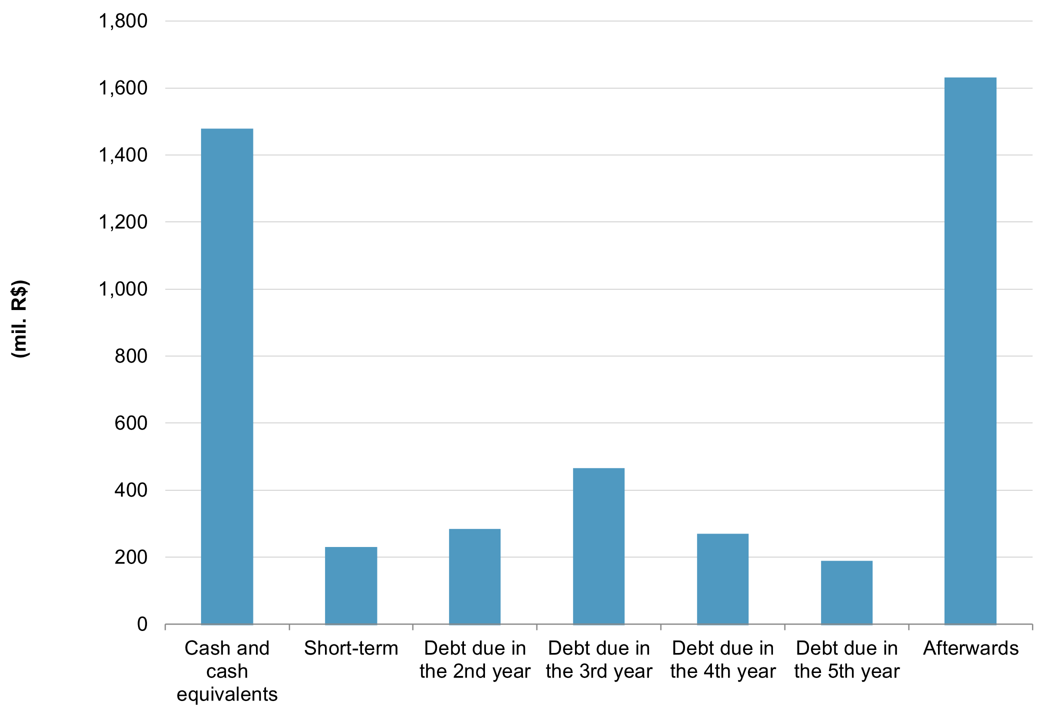
Principal Liquidity Sources	Principal Liquidity Uses
• Cash position of R$1.4 billion as of June 30, 2019; and • Expected cash FFO of about R$1.3 billion in the next 12 months.	• Short-term debt of R$227 million as of June 30, 2019; • Annual capex of about R$900 million; • Working capital outflows of R$242 million in the next 12 months; and • No dividend payout.

Debt maturities

As of June 2019, Azul had the following debt maturity profile, not including the hedge impact on its senior unsecured note:

Chart 3

Debt Maturity Profile



Source: Company's financial data.

Covenant Analysis

Compliance expectations

As of December 2018, the company's debt totaled R$822 million under the acceleration-type covenants. The covenants are mostly related to Azul's debentures (9th and 10th issuances) and to aircraft financing. The company's operating lease agreements or bonds don't have financial covenants, although the bonds have the usual cross-default provisions with other relevant debt amounts and events of default. Azul was compliant with such clauses as of December 2018, and according to our projections, it will be able to comply with those covenants over the next few years, and with about 30% cushion in the next 12 months.

Requirements

The covenants require maximum leverage of 5.5x to 6.5x Debt to EBITDA (depending on the contract) and adjusted debt service coverage ratio of 1.2x.

Other Credit Considerations

We believe that Azul's sizable amount of dollar-denominated debt on an adjusted basis and its exposure to unhedged fuel costs could add volatility to margins and financial metrics. This is because dollar-denominated operating costs outweigh revenue in the same currency, given that about 50% of the company's total costs are linked to foreign currency, while foreign currency revenue is likely to represent about 10% of total revenues in 2019. Therefore, we view Azul's capital structure as negative, as its financial metrics remain exposed to currency mismatches that could lead to covenant pressures if the Brazilian real were to weaken sharply. However, we believe Azul compares favorably with its peers in the 'B' rating category. This stems from Azul's strategy of operating in markets with little or no competition, which generate higher margins than for domestic peers. It also reflects the company's policy of hedging all of its foreign currency debt and interest expenses from exchange rate volatility amid a significant cushion in its liquidity. We also consider that Azul has contingent assets consisting of a portion of TAP's convertible bonds, which are denominated in euros and are a source of foreign currency, given their face value.

Environmental, Social, And Governance

The airline industry is subject to long-term risks from environmental and social factors. But we don't view them as a considerable rating driver for Azul. The prevalence of unions in the airline industry leads to moderately high social risks; 100% of Azul's employees are unionized. In addition, the industry has high public visibility regarding safety, noise, and other factors. In order to adapt to the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), as of 2019, the Brazilian National Civil Aviation Agency (ANAC) requires all carriers to report their CO_2 emission levels. It is part of implementing environmental obligations under Chicago Convention, of which Brazil is a signatory.

Azul has been reducing its CO_2 emission per ASK through the renewal of its fleet for more technological and fuel efficient models. Also, its average fleet age is 5.9 years, significantly lower than those of most large airlines in the U.S. (average of 10 to 16 years). And Azul aims to reduce fuel consumption in the future. We assess Azul's management and governance as fair, because we believe management has a solid knowledge of the airline industry, amid absence of high turnover with many of directors working in the company since its inception.

Issue Ratings - Recovery Analysis

Key analytical factors

The 'B+' rating on Azul's senior unsecured note due 2024 is at the same level as the issuer credit rating, reflecting a recovery rating of '4' with an average recovery expectation of 45% (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 debts, which are 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 distress 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 45% of its unsecured loans.

Simulated default assumptions

- Simulated year of default: 2023
- 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$2.3 billion.

Simplified waterfall

- Net enterprise value (after 5% administrative expenses): R$2.2 billion
- Secured debt: R$686 million (FINAME and other secured debt)
- 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: 45%)

Reconciliation

Table 3

Reconciliation Of Azul S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. R$)

	--Rolling 12 months ended June 30, 2019--						
Azul S.A. reported amounts							
	Debt	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
	3,051.2	2,073.6	1,132.5	705.7	2,828.5	1,466.6	1,111.1
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	(0.7)	--	--
Cash taxes paid: Other	--	--	--	--	--	--	--
Cash interest paid	--	--	--	--	(629.4)	--	--
Reported lease liabilities	9,585	--	--	--	--	--	--
Operating leases	--	736.2	247.8	247.8	(247.8)	488.4	--
Nonoperating income (expense)	--	--	41.3	--	--	--	--
Debt: Derivatives	-219	--	--	--	--	--	--
Debt: Tax liabilities	101	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	19.9	19.9	--	--	--	--
EBITDA: Other	--	(1.2)	(1.2)	--	--	--	--
Total adjustments	9,466	754.9	307.7	247.8	(877.9)	488.4	0.0
S&P Global Ratings' adjusted amounts							
	Debt	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
	12,517.4	2,828.5	1,440.2	953.5	1,950.6	1,955.0	1,111.1

Ratings Score Snapshot

Issuer Credit Rating

B+/Stable/--

Business risk: Weak

- **Country risk:** Moderately high
- **Industry risk:** High
- **Competitive position:** Fair

Financial risk: Aggressive

- **Cash flow/Leverage:** Aggressive

Anchor: b+

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Negative (-1 notch)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Fair (no impact)
- **Comparable rating analysis:** Positive (+1 notch)

Stand-alone credit profile : b+

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 - 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	**Aggressive**	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	**b+**	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of September 6, 2019)*

Azul S.A.		
Issuer Credit Rating		B+/Stable/--
Brazil National Scale		brAA/Stable/--
Issuer Credit Ratings History		
11-Oct-2017		B+/Stable/--
11-Jul-2018	*Brazil National Scale*	brAA/Stable/--
11-Oct-2017		brA-/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.