

CREDIT OPINION

20 March 2020

Update

 Rate this Research

RATINGS

Azul S.A.

Domicile	Barueri, Sao Paulo, Brazil
Long Term Rating	B1, Possible Downgrade
Type	LT Corporate Family Ratings
Outlook	Rating(s) Under Review

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Azul S.A.

Update following the downgrade to B1 and placement of Azul's ratings under review for downgrade

Summary

On March 17, 2020, we downgraded Azul's ratings and placed them under review for downgrade. The action followed the rapid and widening spread of the coronavirus outbreak and its impact on the airline industry. Possible reduction in GDP growth in Latin American economies because of the COVID-19 and risk aversion is resulting in local currencies devaluation especially the Brazilian Real that comprises most of Azul's revenues will pressure margins and deteriorate leverage metrics, in part mitigated by the important reduction in fuel prices observed during the last couple of weeks.

[Azul S.A.](#)'s (Azul) B1 corporate family rating (CFR) reflects the company's unique business position in [Brazil](#) (Ba2 stable) as the only carrier in 70% of its routes, resulting in lower competition and strong pricing power. Azul's young and modern fleet, higher margins and less volatile results compared with those of its peers in the Brazilian airline market are additional credit positives. The rating also takes into consideration the company's superior network connectivity and strategic partnerships with global companies, with around 65% of its client base consisting of corporate customers.

The rating also incorporates the benefits of its experienced management team, which responded quickly to the slowdown in the Brazilian economy, and the ownership of its TudoAzul loyalty program that contributes a stable source of cash and could be used as an alternative source of liquidity if needed. Nonetheless, the B1 rating is constrained by the company's exposure to the Brazilian real and fuel price volatility. The rating also takes into consideration Azul's low geographic diversification, with most of its revenue generated in Brazil.

Credit challenges

- » Rapid and widening spread of the coronavirus
- » Slowdown in GDP growth in Latin American economies
- » Exposure to the Brazilian real and fuel price volatility
- » Low geographic diversification, with most of its revenue originating in Brazil
- » Still-high leverage, low interest coverage and near-term maturity pressures
- » Slower-than-expected economic recovery, which could threaten growth plans

Credit strengths

- » Unique position as the only carrier in 72% of its routes
- » Superior network connectivity and strategic partnerships with global companies
- » Experienced management team and conservative policies

Rating outlook

Azul's ratings are under review for downgrade. Moody's review will consider, but will not be limited to (i) the current market situation with a review of current passenger traffic conditions and pre-booking trends for the next few weeks, (ii) the liquidity measures taken by the company and their impact on the company's balance sheet, (iii) other measures being taken by the company to alleviate balance sheet and credit metrics stress.

Factors that could lead to an upgrade

The ratings are unlikely to be upgraded in the short term. Positive rating pressure would not arise until the coronavirus outbreak is brought under control, travel restrictions are lifted, and passenger volumes return to more normal levels. At this point Moody's would evaluate the balance sheet and liquidity strength of the company and positive rating pressure would require evidence that the company is capable of substantially recovering its financial metrics and restoring liquidity.

Factors that could lead to a downgrade

Moody's could further downgrade Azul if:

- » There are expectations of deeper and longer declines in passenger volumes including a material extension into Q3 2020 as a result of the coronavirus outbreak, particularly if not matched by additional sources of liquidity
- » Wider liquidity concerns increase, for instance due to cost inflexibility
- » There are clear expectations that the company will not be able to maintain financial metrics compatible with a B1 rating following the coronavirus outbreak if:
 - Gross adjusted leverage is expected to be sustainably above 6.0x
 - Retained cash flow / debt is expected to be sustainably below 9.0%

Key indicators

Exhibit 1

Azul S.A.

US Millions	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	LTM (Dec-19)	Moody's 12-18 Month Forward View
Revenue	2,472.5	1,908.9	1,922.7	2,439.9	2,494.9	2,906.0	2,000.0
EBIT Margin %	12.6%	5.6%	13.4%	19.1%	20.7%	18.2%	14.9%
Debt / EBITDA	7.0x	10.9x	5.3x	4.1x	5.3x	4.2x	7.8x
RCF / Debt	4.5%	-1.0%	1.9%	11.8%	16.9%	12.7%	3.1%
(FFO + Interest Expense) / Interest	1.5x	0.9x	1.2x	2.4x	2.8x	2.5x	1.4x

All figures and ratios are calculated using Moody's estimates and standard adjustments.

Source: Moody's Financial Metrics™

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Profile

Headquartered in Barueri near the City of Sao Paulo, Brazil, Azul S.A. (Azul) is a Brazilian airline founded by David Neeleman in 2008. The company is the largest airline in Brazil by number of cities and departures, serving 116 destinations with a fleet of 140 aircraft and operating 870 flights daily. Azul is the third-largest airline in Brazil in terms of revenue passenger kilometers (RPK). The company also flies its aircraft to select international destinations, including Fort Lauderdale, Orlando and Lisbon. Azul is the sole owner of the loyalty program TudoAzul, a strategic revenue-generating asset, which had around 12 million members as of 31 December 2019. For the 12 months ended December 2019, Azul generated BRL11.4 billion (\$2.9 billion) in net revenue and carried almost 25 million passengers.

Detailed credit considerations

Impact of the coronavirus outbreak on the airline industry

The rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. The passenger airline sector has been one of the sectors most significantly affected by the shock given its exposure to travel restrictions and sensitivity to consumer demand and sentiment. More specifically, the weaknesses in Azul's credit profile have left it vulnerable to shifts in market sentiment in these unprecedented operating conditions and Azul remains vulnerable to the outbreak continuing to spread. Today's action reflects the impact on Azul of the breadth and severity of the shock, and the broad deterioration in credit quality it has triggered. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

The rating action was prompted by the very sharp decline in passenger traffic since the outbreak of coronavirus started during January 2020, which will result in a significant negative free cash flow in 2020, a weakening liquidity profile and a significantly higher leverage. From a regionally contained outbreak the virus has rapidly spread to many different regions severely denting air travel. The International Air Travel Association's (IATA) latest scenario analysis forecasts a decline in passenger numbers of between 11% and 19% for the full year 2020.

Moody's base case assumptions are that the coronavirus pandemic will lead to a period of severe cuts in passenger traffic over at least the next three months with partial or full flight cancellations and aircraft groundings, with all regions affected globally. The base case assumes there is a gradual recovery in passenger volumes starting in the third quarter. However, there are high risks of more challenging downside scenarios and the severity and duration of the pandemic and travel restrictions is uncertain. Moody's analysis assumes around a 70% reduction in Azul's passenger traffic in the second quarter and an 30% fall for the full year, whilst also modelling significantly deeper downside cases including a full fleet grounding during Q2 and a more extended period of severely depressed volumes.

Capacity management will be key during the economic slowdown

The economic slowdown in Latin American coupled with increased risk aversion is driving the sharp devaluation in local currencies in the region. Accordingly, Azul is particularly exposed to the depreciation of the Brazilian Real, which accounts for about 80% of the company's revenues. This effect is only partially mitigated by the important reduction in fuel prices observed during the last couple of weeks. The company also hedged its US dollar notes through cross-currency swaps to mitigate the effect of the real's devaluation.

Moody's anticipates that the airline industry will require continued and further support from regulators, national governments and labor representatives to alleviate pressures on slot allocations, provide indirect or direct financial support and manage airlines' cost bases. Although there is nothing concrete yet, the Brazilian government announced that it is considering measures to support the airlines operating in Brazil including, but not limited to long term credit lines and working capital lines to be provided by state owned banks as well as allowing the companies to defer tax payments.

Exposure to foreign-currency and fuel volatility

Azul uses the Brazilian real as its functional currency for the pricing of most of its products, while a significant part of its costs and debt are denominated in US dollars, creating a mismatch among revenue, costs and liabilities, which can hurt its operating results, leverage and other credit metrics.

Around 40% of Azul's 2019 operating expenses and 89% of its total short-term debt were denominated in foreign currencies. Dollar-denominated fuel constituted about 32% of Azul's operating costs, with only around 16% of its revenue in hard currencies. Azul has

around \$1.5 billion in foreign-currency assets, including dollar-denominated cash, cash deposits and maintenance reserves; a TAP bond denominated in euros; and a dollar-denominated aircraft fleet. In fact, Azul's dollar-denominated assets exceed its dollar-denominated liabilities, and Azul aims to cover its exposure to nonoperational dollar flow by 50%-100% for the 12 months through 2020.

Azul's fuel-hedging strategy comprises derivatives with financial institutions and fixed-price contracts with its main supplier, [Petrobras](#) (Ba2 stable). The objective is to fix the price of up to 60% of its fuel consumption for the first quarter, 45% for the second quarter, 35% for the third quarter and 20% for the fourth quarter. As of 30 June 2019, Azul had locked in fuel contracts for around 40% of its next 12 months' consumption through derivative financial instruments and fixed-price contracts with its main supplier. The company also hedged its US dollar notes through cross-currency swaps to mitigate the effect of the real's devaluation.

Experienced management team and conservative policies

Azul has a seasoned management team with many years of experience in the airline industry, which has responded quickly to the economic slowdown in Brazil and has established conservative financial policies and corporate governance standards. The company's management took advantage of its expertise acquired with JetBlue's E-Jets and, with the acquisition of TRIP, gained the know-how of the world's largest ATR aircraft operator.

Neeleman, a dual Brazilian and US citizen, is Azul's founder and the chairman of its board of directors. Before Azul, Neeleman founded JetBlue, where he held the position of the chief executive officer from 1998 to 2007 and the chairman of the board of directors from 2002 to 2008. Neeleman's career in the airline industry began in 1984, when he co-founded Morris Air. Neeleman was also the co-founder of WestJet Airlines and served as a member of its board of directors from 1996 to 1999. Neeleman is also part of a consortium that acquired an equity interest in TAP through TAP's privatization process in 2015 and is currently a member of the board of directors of TAP.

John Rodgerson is Azul's chief executive officer. Before Rodgerson held the position, he was Azul's chief financial officer and investor relations officer, and was responsible for the planning and financial analysis, treasury and accounting departments. Rodgerson worked on Azul's initial business plan with Neeleman and was part of the founding team. Before joining Azul, Rodgerson served as the director of planning and financial analysis at JetBlue from 2003 to 2008.

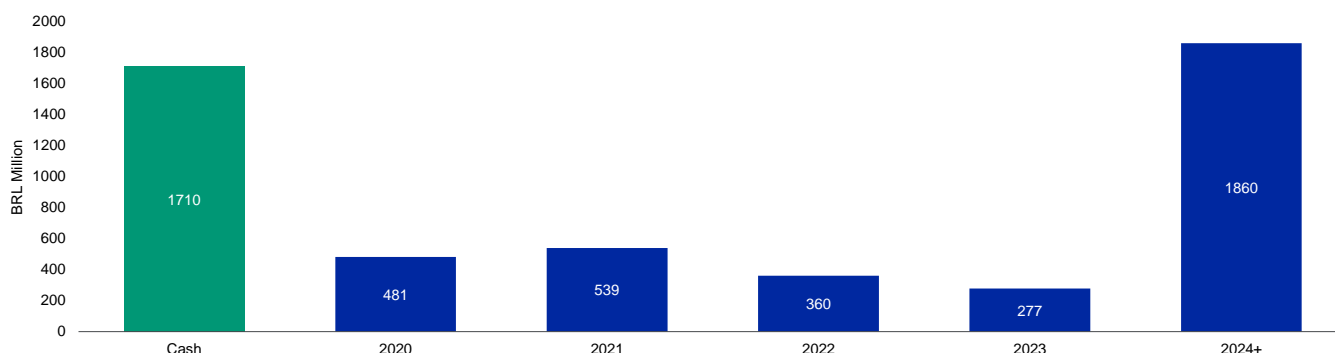
Liquidity analysis

Currently, Azul's liquidity is adequate. As of 2019, Azul's cash position of BRL1.7 billion was enough to cover 3.5x the company's short-term debt. Azul's financial policies target a minimum cash availability of 15% of its last-12-month net revenue and the company does not have committed credit facilities. Azul's long-term investments in TAP's bonds, accounts receivables and its investment in its wholly owned subsidiary TudoAzul that add up to around BRL5 billion, could be used as alternative sources of liquidity if needed. In downside scenarios Azul's access to financial markets and alternative sources of liquidity may be required.

Exhibit 2

Funded Debt Schedule

As of December 2019 (in BRL millions)



Source: Moody's Financial Metrics™

Structural considerations

The B2 rating assigned to Azul's unsecured notes is one notch lower than the company's B1 CFR to reflect the effective subordination of those unsecured creditors to the company's other existing secured debt. Azul's consolidated debt is mainly composed of finance leases, collateralized by aircraft, debentures collateralized by credit card receivables, representing about 57% of its total debt, and the other 43% comprised of the unsecured notes. As such, the proposed unsecured notes will rank below all the company's existing and future secured claims.

ESG Considerations

Since its IPO at the end of April 2017, Azul is listed on B3 (formerly BM&FBovespa) under level 2 of the corporate governance standards that demands a minimum 25% free float, 100% tag-along rights to minority shareholders, voting rights to preferred shareholders in certain circumstances and a minimum number of independent directors, among others. Azul's board of directors comprises 11 members, of which nine are independent. The company also has an established Audit Committee.

Neeleman is Azul's largest controlling shareholder with 67% of voting shares; the balance is owned by TRIP's former shareholders. United Airlines is the largest preferred shareholder with an 8.3% share, followed by Bozano Group with a 5.8% share and TRIP's former shareholders, among others. Free float is around 80%.

The management team is composed of professionals, most of them with many years of experience in the airline industry and Azul.

Rating methodology and scorecard factors

The scorecard-indicated outcome based on our 12-18-month forward view under the Passenger Airline Industry rating methodology is B2, which is one notch below Azul's corporate family rating. The gap reflects the very sharp decline in passenger traffic since the coronavirus outbreak that started in January 2020, which will result in significant negative free cash flow in 2020, weaken Azul's liquidity and significantly increase its leverage.

Exhibit 3

Rating factors

Azul S.A.

Passenger Airlines Industry Scorecard [1][2]			Current FY 12/31/2019		Moody's 12-18 Month Forward View As of 3/19/2020 [3]	
Factor 1 : Scale (10%)	Measure	Score	Measure	Score	Measure	Score
a) Revenue (USD Billion)	\$2.9	Caa	\$2	Caa		
Factor 2 : Business Profile (25%)						
a) Market Position and Network Strength	Ba	Ba	Ba	Ba		
Factor 3 : Profitability and Efficiency (12.5%)						
a) EBIT Margin (EBIT / Revenue)	18.2%	Baa	14.9%	Ba		
Factor 4 : Leverage and Coverage (37.5%)						
a) Debt / EBITDA	4.2x	Ba	7.8x	Caa		
b) RCF / Debt	12.7%	Ba	3.1%	Caa		
c) (FFO + Interest Expense) / Interest Expense	2.5x	B	1.4x	Caa		
Factor 5 : Financial Policy (15%)						
a) Financial Policy	Ba	Ba	Ba	Ba		
Rating:						
a) Scorecard-Indicated Outcome		Ba3		B2		
b) Actual Rating Assigned				B1		

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.

[2] As of 12/31/2019(L).

[3] This represents Moody's forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures.

Source: Moody's Financial Metrics™

Ratings

Exhibit 4

Category	Moody's Rating
AZUL S.A.	
Outlook	Rating(s) Under Review
Corporate Family Rating	B1 ¹
AZUL INVESTMENTS LLP	
Outlook	Rating(s) Under Review
Bkd Senior Unsecured	B2 ¹

[1] Placed under review for possible downgrade on March 17 2020

Source: Moody's Investors Service

Appendix

Exhibit 5

Peer comparison

Azul S.A.

(in US millions)	Azul S.A. B1 RUR-DNG			Delta Air Lines, Inc. Baa3 RUR-DNG			Deutsche Lufthansa Aktienges Ba1 RUR-DNG			Gol Linhas Aereas Intelligent B1 RUR-DNG			LATAM Airlines Group S.A (LA) B1 RUR-DNG		
	FYE Dec-18	FYE Dec-19	LTM Dec-19	FYE Dec-18	FYE Dec-19	LTM Dec-19	FYE Dec-17	FYE Dec-18	LTM Sep-19	FYE Dec-18	FYE Dec-19	LTM Dec-19	FYE Dec-18	FYE Dec-19	LTM Dec-19
Revenue	\$2,495	\$2,906	\$2,906	\$44,438	\$47,007	\$47,007	\$40,200	\$42,329	\$41,338	\$3,143	\$3,521	\$3,521	\$9,895	\$10,070	\$10,070
Operating Profit	\$391	\$516	\$516	\$5,513	\$6,845	\$6,845	\$3,303	\$3,373	\$2,172	\$513	\$540	\$540	\$887	\$742	\$742
EBITDA	\$606	\$934	\$934	\$8,372	\$9,917	\$9,917	\$6,302	\$6,442	\$5,142	\$946	\$1,050	\$1,050	\$2,356	\$2,229	\$2,229
Total Debt	\$3,013	\$3,884	\$3,884	\$22,817	\$22,494	\$22,494	\$17,506	\$18,152	\$16,420	\$3,529	\$3,600	\$3,600	\$10,120	\$10,366	\$10,366
Cash & Cash Equiv.	\$302	\$410	\$410	\$1,565	\$2,882	\$2,882	\$4,741	\$3,698	\$3,897	\$337	\$646	\$646	\$1,423	\$1,496	\$1,496
EBIT / Int. Exp.	1.7x	1.6x	1.6x	6.0x	8.4x	8.4x	4.9x	5.2x	4.7x	1.4x	1.4x	1.4x	1.9x	1.3x	1.3x
Debt / EBITDA	5.3x	4.2x	4.2x	2.7x	2.3x	2.3x	2.6x	2.9x	3.3x	4.0x	3.5x	3.5x	4.3x	4.7x	4.7x
RCF / Net Debt	18.7%	14.2%	14.2%	31.4%	39.3%	39.3%	39.2%	32.5%	29.0%	21.7%	27.4%	27.4%	13.2%	11.1%	11.1%
FCF / Debt	-4.3%	-2.2%	-2.2%	5.5%	12.0%	12.0%	8.6%	-2.7%	-6.5%	3.1%	-2.4%	-2.4%	3.4%	4.1%	4.1%

All figures and ratios are calculated using Moody's estimates and standard adjustments. FYE = Financial year-end. LTM = Last 12 months. RUR* = Ratings under review, where UPG = for upgrade and DNG = for downgrade.

Source: Moody's Investors Service

Exhibit 6

Moody's-adjusted debt breakdown

Azul S.A.

(in US Millions)	FYE Dec-14	FYE Dec-15	FYE Dec-16	FYE Dec-17	FYE Dec-18	FYE Dec-19
As Reported Debt	1,327.6	1,299.7	1,253.3	1,052.1	3,012.5	3,884.2
Operating Leases	1,950.4	1,905.8	2,003.3	2,099.3	0.0	0.0
Moody's-Adjusted Debt	3,278.0	3,205.5	3,256.6	3,151.4	3,012.5	3,884.2

All figures and ratios are calculated using Moody's estimates and standard adjustments.

Source: Moody's Investors Service

Exhibit 7

Moody's-adjusted EBITDA breakdown

Azul S.A.

(in US Millions)	FYE Dec-14	FYE Dec-15	FYE Dec-16	FYE Dec-17	FYE Dec-18	FYE Dec-19
As Reported EBITDA	243.0	-52.9	302.7	445.3	266.3	625.8
Operating Leases	254.1	327.5	329.9	349.1	0.0	0.0
Unusual	29.8	81.5	-54.9	10.1	340.0	308.3
Non-Standard Adjustments	0.0	0.0	0.0	0.0	0.0	0.0
Moody's-Adjusted EBITDA	526.9	356.0	577.7	804.5	606.3	934.1

All figures and ratios are calculated using Moody's estimates and standard adjustments.

Source: Moody's Investors Service

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