Research Update:

Three South American Airlines Downgraded And Remain On CreditWatch Negative As COVID-19 Pandemic Escalates

March 27, 2020

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Rating Action Overview

- The rapid spread of the coronavirus has significantly reduced the demand for global air travel for an unpredictable period. Most South American governments shut their borders and some have even suspended domestic traveling.
- The South American airline sector is facing unprecedented drop in traffic and all airlines have announced large capacity cuts for the upcoming months,
- We are therefore lowering our ratings on Latam Airlines Group S.A., Azul S.A., and Gol Linhas Aereas Inteligentes S.A. and maintaining them on the CreditWatch negative.
- The CreditWatch negative listing reflects the potentially pernicious effect that a prolonged travel disruption could have on the companies' liquidity position and credit metrics. The listing also incorporates the uncertainty about when demand for passenger air travel will recover and to what extent.

Rating Action Rationale

Our rating actions reflect the unprecedented drop in air traffic amid the rapid spread of COVID-19. Most countries in South America (including Argentina, Chile, Colombia, Ecuador, and Perú) have closed their borders entirely, while Brazil closed most of its land borders, but has maintained airports and ports opened. Additionally, some countries like Argentina, Colombia, and Perú have even gone further, putting in place severe lockdowns that include suspension of domestic air traffic as well. Corporate and leisure travelers have suspended booked flights, while the booking curve has dramatically fallen and will likely be negligible at least for the next two months. We assume overall demand in the region will fall about 10% in the first quarter of the year, about 80% in the second quarter, given that we assume travel restrictions will remain in place for large part of the year and that we will see gradual recovery starting in July, mostly among corporate passengers.

Capacity cuts and countercyclical measures might not be enough to contain leverage. All airlines are taking countercyclical initiatives to try to offset the revenue and margin decline. The companies announced capacity cuts, grounding of aircraft, reduced salaries or incentives for unpaid leave, postponements of retrofits, and all are in discussions to extend aircraft deliveries and lessors' payments. An additional alleviating factor are the much lower fuel prices, but most of the fuel needs for 2020 were already hedged, so the upside is limited for this year. In the current scenario, we expect the drop in EBITDA and cash flows to be even deeper than in revenues, given that 40%-50% of these companies' costs are fixed. This will erode credit metrics at least in 2020.

Leverage will spike, heightened by the impact of the local currencies' depreciation on dollar-denominated debts including airplane liabilities, particularly the Brazilian real, which is the companies' largest exposure.

Liquidity at risk. While leverage continues to be a key component of credit ratings, we are more concerned in the very short term about how airlines will manage their liquidity positions, because we believe they will undergo substantial cash burns in the next couple of months, with very limited cash inflows. As we incorporate in our analysis cost reductions through the extensive wage and capex cuts, we still don't entirely consider the negotiations with lessors to postpone payments or new credit facilities under negotiations, given the uncertain timing and amounts. The Minister for Brazilian infrastructure has already announced specific measures to support the sector, including the postponement of airport fees and the extension of the ticket reimbursement period for up to 12 months. In addition, the Brazilian Development Bank (BNDES) is pondering a liquidity support program for the sector.

Latam Airlines Group

We are lowering our issuer credit rating to 'B' from 'BB-' and our senior unsecured debt ratings to 'B-' from 'B+' on Latam. Additionally, we are lowering the rating on EETC-2015 1 Class A notes to 'BBB-' from 'BBB+', the rating on Class B notes to 'BB-' from 'BB+', and the rating on Class C notes to 'B+' from 'BB'. The downgrades reflect our expectation of a drastic fall in revenue and cash flows for the year. The company has already announced a 70% reduction of its capacity, but more governments have recently placed restrictions on domestic travel, while demand for air travel has fallen even more drastically. Therefore, at this time, we do not rule out the possibility that the company could announce complete suspension of its operations for a few weeks.

Our base-case scenario assumes a year-over-year drop of 30%-35% in revenue in 2020 and 60%-70% in EBITDA, compared with the $2.2 billion level in 2019. As a result, we estimate debt to EBITDA could peak this year beyond 10x depending on the foreign-exchange rate at year-end, from 4.0x in 2019. In this scenario, we are assuming a gradual recovery during the second half of the year and that revenue and EBITDA would normalize in 2021, with debt to EBITDA falling below 6.0x.

Given then minimal or barely any operations in the very short term, we expect the company to burn cash in the next couple of months, rapidly depleting its liquidity cushion. We now assess Latam's liquidity as less than adequate. The company had a cash position of $1.57 billion as of December 2019 and we expect operational cash flows to be close to zero for the full year. Yet Latam has access to a $600 million revolving credit facility, and it could eventually raise some additional liquidity from unencumbered assets and should have access to a support program from BNDES. However, its short-term maturities in 2020 are considerable: about $1.1 billion and we estimate minimum capex needs of $400 million - $500 million. Therefore, depending on the length of the coronavirus impact and effects from working capital and cost-cut initiatives on cash generation, we could further revise our liquidity assessment to weak in the short term, which would trigger further downgrades.

Gol Linhas Aéreas Inteligentes

We are lowering our global scale issuer credit and issue-level ratings on Gol to 'B-' and the national scale issuer credit rating to 'brBBB-'. The rating on the term loan due August 2020 is 'BB', because it reflects the backstop guarantee of Delta Airlines (BB/Watch Neg/--). The downgrade reflects the harsh scenario for Gol's cash flows over the next few weeks, with an announced capacity shutdown of 90% of its domestic flights and 100% of its international flights until the end of April at least, similar to peers in the region. The company's metrics will take a hit, and could erode further liquidity depending on the extension of the shutdown.

Prospects for recovery will be unclear over the next few months, with a likely capacity reduction of 40% in the region in 2020, according to IATA. Under this assumption, we could see Gol's EBITDA decline of 40%-50% in 2020 compared with last year, reaching a gross debt to EBITDA way above 6.0x by year-end depending on foreign exchange rate movements, compared with our adjusted metric of 3.5x in 2019. Metrics volatility could be exacerbated by foreign exchange volatility, despite the reduction in oil prices. Nonetheless we understand that Gol has predominantly domestic operations, with low exposure to international flights. Therefore, the impact on its operations should be softer than the abovementioned scenario and with faster recovery.

Gol has announced several measures to cope with the crisis over the next few months, including payroll reduction, negotiations over lessors and other suppliers' tenor extension, capex cuts, among others. We believe such measures could reduce operating costs to below R$400 million per month from more than R$900 million, operating at a 10% capacity. Also, the ability to extend air ticket refunds in 12 months and extension of other sector #fares in six months will help somewhat working capital management.

We revised our liquidity assessment on Gol to less than adequate from adequate because of the potential of negligible cash generation in the next 12 months amid sizable short-term debt of R$2.5 billion as of December 2019, mitigated by its cash position of R$2.9 billion, including about R$1.0 billion in foreign currency. The company could breach covenants on its debentures, but we expect it to obtain necessary waivers due to extraordinary conditions, and because these loans are from local banks with which Gol has long-term relationship. Nonetheless, we will monitor the effectiveness of cash preservation measures as well as the company's ability to access other sources of funding to navigate such a turbulent scenario, including any potential funding support from BNDES.

Azul S.A.

We are lowering our global scale issuer credit and issue-level ratings on Azul to 'B' and the national scale issuer credit rating to 'brA-'. Similar to the troubling trends in the sector, the downgrade reflects the much weaker-than-expected scenario for the next couple of weeks, with capacity reduction of 90% at Azul's domestic operations until the end of April at least. This will batter Azul's metrics and liquidity position, although it holds significant cash position compared with short-term financial debt.

Assuming the potential for a 40% capacity reduction in 2020, according to IATA's estimate for the region, we could see Azul's EBITDA drop 50%-60% in 2020 from 2019, and potentially reaching gross debt to EBITDA close to 7.0x by the end, versus below 4.5x in 2019. Nonetheless, we understand that Azul is more exposed to domestic flights, therefore, the impact could be lower than the scenario above.

The company is taking several measures to preserve cash and reduce costs. We estimate that they could reduce operating costs to R$300 million - R$400 million per month, operating at a 10% capacity, from R$900 million - R$1 billion.

We still view Azul's liquidity position as somewhat stronger than those of its regional peers, with a cash position of R$1.7 billion versus short-term financial debt of R$480 million as of December 2019, and maintenance capex of R$600 million – R$700 million. In addition, Azul's financial debt in foreign currency is hedged against the real's depreciation until up to R$4.75 per $1, cushioning its balance sheet and limiting margin calls beyond this level. Nonetheless, we are revising the liquidity assessment on Azul to less than adequate from adequate because of the short-term turmoil in debt market, with uncertain access to new funding in the very short term and uncertainties over impact on its future cash flows. We could see some pressure on the company's quarterly covenant measurement on the export/import loan, which totals about $150 million. Nonetheless, we expect Azul to be able to obtain waivers if necessary, due to extraordinary conditions and because of its long-term relationship with creditors.

We will continue to monitor the company's liquidity position as well as its ability to access funding amid this grim scenario, including any potential funding support from BNDES.

CreditWatch

We are keeping all ratings on these airlines on CreditWatch negative, which reflects the uncertainty over the duration and severity of the public health crisis and its impact on the airlines' liquidity and capacity to contain leverage. We could further lower the ratings if demand falls deeper than our current assumptions for the year if the market rebound takes longer. We could also lower the ratings if we expect any significant deficit in the airlines' liquidity position stemming from margin calls or tickets reimbursements, if new financing and renegotiated contracts are not enough to sustain cash or if we expect persistent weak credit metrics beyond 2020.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: Guarantee Criteria, Oct. 21, 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

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Corporates | Industrials: Criteria For Rating Aircraft-Backed Debt And Enhanced Equipment Trust Certificates, Sept. 12, 2002

Ratings List

Downgraded

****************** Azul S.A. ******************		
	To	**From**
Azul S.A.		
Issuer Credit Rating		
Global Scale	B/Watch Neg/--	B+/Watch Neg/--
Brazil National Scale	brA-/Watch Neg/--	brAA/Watch Neg/--
Azul Investments LLP		
Senior Unsecured	B/Watch Neg	B+/Watch Neg
Recovery Rating	4(40%)	4(45%)
************ Gol Linhas Aereas Inteligentes S.A. ***********		
Gol Linhas Aereas Inteligentes S.A.		
Issuer Credit Rating		
Global Scale	B-/Watch Neg/--	B/Watch Neg/--
Brazil National Scale	brBBB-/Watch Neg/--	brA/Watch Neg/--
Gol Finance		
Senior Unsecured	B-/Watch Neg	B/Watch Neg
Recovery Rating	4(30%)	4(35%)
************** Latam Airlines Group S.A. **************		
Latam Airlines Group S.A.		
Issuer Credit Rating		
Global Scale	B/Watch Neg/--	BB-/Watch Neg/--
Latam Airlines Group S.A.		
Equipment Trust Certificates	BB-/Watch Neg	BB+/Watch Neg
Equipment Trust Certificates	B+/Watch Neg	BB/Watch Neg
Equipment Trust Certificates	BBB-/Watch Neg	BBB+/Watch Neg
Senior Unsecured	B-/Watch Neg	B+/Watch Neg

Downgraded

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	To	**From**
LATAM Finance Limited		
Senior Unsecured	B-/Watch Neg	B+/Watch Neg

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.