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Research Update:

Azul S.A. 'B+' Global Scale And 'brAA' National Scale Ratings Affirmed; Outlook Still Stable

Primary Credit Analyst:
Bruno Ferreira, Sao Paulo + 55 11 3039 9779; bruno.ferreira@spglobal.com

Secondary Contact:
Flavia M Bedran, Sao Paulo + 55 11 3039 9758; flavia.bedran@spglobal.com

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Overview

- Brazil-based airline Azul S.A. will deleverage more slowly than previously expected in the next two years because of the volatile industry and macroeconomic conditions, as illustrated by the devaluation of the Brazilian real and the spike in crude oil prices.
- Despite these factors, we expect Azul to gradually improve cash flow generation because of its ability to adjust prices, sound operating performance, and rational industry dynamics in terms of supply/demand imbalances.
- We're affirming our global scale and issue-level rating on Azul at 'B+' and the national scale rating at 'brAA'. The 'B+' issue-level rating reflects Azul's recovery rating of '4', given our average recovery expectation of 40% (rounded).
- The stable outlook reflects our view that Azul will gradually improve its financial metrics in the coming years by increasing its cash flow as it grows capacity and continues to adjust prices. It also incorporates our expectations of a stronger operating performance thanks to the company's competitive advantages and improving operating efficiency. As a result, we expect Azul's gross leverage to be below 4.5x by the end of 2018 and close to 4.0x in 2019, while funds from operations (FFO) to gross debt should improve to 14%-15% and 16%-17%, respectively.

Rating Action

On Aug. 15, 2018, S&P Global Ratings affirmed its 'B+' global scale issuer credit and issue-level ratings on Azul S.A. At the same time, we affirmed the 'brAA' Brazilian national scale issuer credit rating.

The 'B+' issue-level rating on Azul's senior unsecured debt is the same as the issuer credit rating, reflecting our recovery rating of '4', given our expectation of average recovery prospects (30%-50%; rounded estimate 40%) for unsecured creditors.

Rationale

The affirmation reflects our expectation of Azul's gradual improving credit metrics in the next few years, albeit somewhat slower than our previous forecast, supported by its fairly balanced capital structure with hedged debt principal, growth strategy that will generate higher cash flows, good operating efficiency, and ability to adjust average ticket prices during volatile industry and macroeconomic conditions. Nevertheless, we don't believe that Azul is shielded against exchange rate (FX) volatility and rises in Brent prices, because almost half of the company's cost structure is pegged to the U.S. dollar, as well as all its operating and financial leases, while it generates less than 15% of cash flows in hard currency. We now expect the company to post gross debt to EBITDA below 4.5x in 2018 and below 4.0x in 2019, versus our previous expectation of 4.0x in 2018 and around 3.5x in 2019.

After Azul's IPO and bond issuance, it refinanced debt to reduce the interest burden. Nevertheless, turbulent industry and economic conditions during the second quarter of 2018 affected the company's deleverage trend, despite the hedging strategy that protects Azul's 2024 notes and part of its fuel needs. The currency exposure corroborates our view of Azul's negative capital structure, which limits the ratings. For instance, we note that adjusted debt, including operating lease adjustment, reached almost R$11.3 billion in June 2018 (from roughly R$10 billion this March).

In our view, Azul's good operating performance ultimately reflects its competitive advantages in its unique route network that benefits from little overlap with those of its main competitors. The company is the only carrier for about 70% of its routes, giving it meaningful pricing power so that it's usually able to pass through cost increases and currency devaluation to average fares. Coupled with that, Azul has implemented its growth strategy by adding larger aircrafts to its fleet (A-320NEOs) and replacing some of its smaller E-Jets on longer-haul flights. This will not only increase Azul's cash generation because of these aircrafts' higher available seat kilometers (ASK), but will also help the company improve its operating efficiency by capturing the benefits of lower cost per seat and fuel burn efficiency.

Under our base-case scenario, we also include the following assumptions:

- Brazil's GDP increasing by 1.6% in 2018 and 2.4% in 2019, supporting increased demand for air travel among corporate and leisure clients;
- Average exchange rate of R$3.60 per $1 in 2018 and R$3.75 per $1 in 2019, affecting Azul's foreign-denominated expenses, including fuel, maintenance, and aircraft leasing;
- Brazilian consumer price index (CPI) growing 3.7% in 2018, followed by 4.1% in 2019, affecting Azul's main costs and expenses denominated in local currency, including salaries, which also increase with the company's higher capacity. This is offset by the roughly 35%-40% gain in efficiency from the introduction of larger aircrafts;
- Aircraft fuel prices increasing according to our forecasted Brent oil prices of $67 per barrel (bbl) in 2018 and $60/bbl in 2019, on average, affecting the company's unhedged fuel costs;
- We assume Azul will increase ASK by about 15%-16% in 2018 and by roughly 16%-17% in 2019, as it replaces smaller aircraft with larger ones and

expands its route network;

- Revenue passenger per kilometer (RPK) increasing by 14%-15% in 2018 and 16%-17% in 2019 because of more resilient demand for Azul's main routes and the delivery of larger aircraft, as seen in the 15% rise in RPK during the first six months of this year;
- These assumptions result in an expected load factor of about 79.5%-80.5% in 2018 and 2019;
- Yields improving by around 10% in 2018 and flat in 2019;
- Landing fees increasing with expected growth rate for annual departures, which we assume at 3% in the next few years;
- Capital expenditures (capex) of about R$640 million in 2018 and R$1.0 billion in 2019, mainly related to new aircrafts, engines, and equipment. Until 2019, Azul will finance new aircraft by operating leases that are already contracted;
- Our divestment assumption includes proceeds from the sale of aircraft for about R$400 million in 2018; and
- No relevant dividend payout--we assume Azul's dividend policy of 0.1% over the previous year's net income.

Because of these assumptions, we arrive at the following credit metrics:

- Revenue of R$9.0 billion–R$9.1 billion in 2018 and R$10.4 billion--R$10.5 billion in 2019;
- EBITDA of R$2.5 billion-R$2.6 billion in 2018 and R$3.2 billion–R$3.3 billion in 2019;
- FFO of R$1.8 billion-R$1.9 billion in 2018 and R$2.4 billion-R$2.5 billion in 2019;
- Gross debt to EBITDA below 4.5x in 2018 and between 3.6x-3.8x in 2019;
- FFO to gross debt of 16%-17% in 2018 and slightly above 20% in 2019;
- EBITDA interest coverage slightly above 3.0x in 2018 and above 3.5x in 2019; and
- Free operating cash flow (FOCF) to debt of 5%-6% in 2018 and 8%-9% in 2019.

We ran a sensitivity scenario for Azul, assuming an average and end of period exchange rate of R$3.8 per $1 in 2018 and R$4.0 per $1 in 2019. Under this scenario, Azul's gross credit metrics would be:

- Gross debt to EBITDA between 4.6x-4.7x in 2018 and slightly above 4.0x in 2019;
- FFO to gross debt around 15% in 2018 and 18% in 2019;
- EBITDA interest coverage slightly above 3.0x in 2018 and 3.5x in 2019; and
- FOCF to debt below 5% in 2018 and around 6%-7% in 2019.

We believe Azul compares favorably with its peers in the 'B' rating category such as Avianca Holdings S.A. (B/Stable/--). Although we analyze the company's metrics on a gross debt basis, we acknowledge that thanks to the debt refinancing that followed Azul's IPO and the notes placement, coupled with its ongoing fleet restructuring, we expect Azul to deleverage in the next few years. We also believe this will stem from Azul's strategy of operating in markets with little or no competition, which generate higher margins and good operating efficiency compared to those of domestic players. We also consider that Azul has contingent assets composed of a portion of Portugal-based airline TAP's convertible bonds, which are denominated in Euros and are a source of foreign currency for the company given their face value. We also consider that Azul wholly owns its millage program, Tudo Azul.

Liquidity

We view Azul's liquidity as adequate, because we expect the company's sources over uses of liquidity to be higher than 1.2x in the next 12 months and that sources will continue to exceed uses even if EBITDA declines by 30%. Azul holds sizable cash reserves and benefits from a smooth debt maturity profile. The company's fleet expansion will involve significant capex in the coming years, although it has already contracted funding for airlines to be delivered until 2019. We expect meaningful working capital requirements in the coming years to reflect the company's growth trajectory, which is offset by Azul's increasing cash flow generation and credit friendly dividend policy--consisting of 0.1% of previous years' net income. We believe the company has the ability to absorb high-impact, low probability events, and we acknowledge its access to capital markets last year when it first placed its international bonds after the IPO.

Principal liquidity sources:

- Cash and cash equivalents of R$1.5 billion as of June 30, 2018; and
- FFO of about R$1.1 billion in the next 12 months;

Principal liquidity uses:

- Short-term debt of R$542 million as of June 30, 2018;
- Capex of about R$820 million in the next 12 months, related to new aircrafts, engines, spare parts, and equipment;
- Working capital requirements of roughly R$570 million, including intra-year seasonal working capital; and
- No relevant dividend payments.

Azul is subject to payment acceleration financial covenants under its debt contracts, which require adjusted net debt to EBITDAR of less than 5.5x and interest coverage greater than 1.2x. We expect the company to meet the interest coverage ratio with a meaningful cushion, above 30% headroom, although we expect a limited cushion of about 20% for debt to EBITDAR.

Outlook

The stable outlook reflects our view that Azul will gradually improve its financial metrics in the coming years by generating increasing cash flow as it grows. The outlook also incorporates our expectations of a stronger operating performance thanks to the company's competitive advantages and improving operating efficiency, mainly due to its fleet strategy and market leadership in key routes it operates. As a result, we expect Azul's gross leverage to be below 4.5x by the end of 2018 and below 4.0x in 2019, while FFO to debt will improve to 14%-15% and 16%-17%, respectively, in the same period.

Downside scenario

We could downgrade Azul because of weaker-than-expected operating performance, potentially due to further worsening of Brazil's economy and political uncertainty in the country that could affect demand and exacerbate FX volatility, raising the company's leverage and costs. These factors would result in debt to EBITDA closer to 5.0x and FFO to debt of about 12% on a consistent basis. 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 raise the ratings if Azul deleverages and increases cash flow generation by repaying more expensive debt and improving its overall debt cost and maturity profile, which could result in gross debt to EBITDA trending to 3.0x, FFO to gross debt of about 30%, and FOCF to gross debt above 15% consistently. An upgrade is also possible if the company lowers its exposure to foreign currency volatility.

Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/--
brAA/Stable/--

Business risk: Weak
- Country risk: Moderately high
- Industry risk: High risk
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers:

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

Issue Ratings--Recovery Analysis

Key analytical factors

The 'B+' 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 debts, which are mostly unsecured. In addition, the company holds unencumbered aircraft that it could sell to reduce debt in a stress scenario.

We analyze Azul's recovery under a going concern basis, given its relevance to the markets it serves, with little or no competition, which leads us to believe that the company would likely be restructured in a distress scenario. We valuate Azul using a discrete asset value approach, focusing on the most valuable and liquid assets available. We apply an overall haircut of about 60% to Azul's asset base, including about a 75% haircut to its cash position, because the company would likely use part of its cash to fund working capital needs and repay more expensive loans as its operations and access to markets starts to weaken.

Under this scenario, we believe Azul's available assets would be enough to meet its secured loans and about 40% of its unsecured loans, including the notes due 2024.

Simulated default assumptions

- Simulated year of default: 2022.
- We include only about 23% of Azul's cash and cash reserves, because we believe the company would use those resources to continue operating and meeting working capital needs.
- Accounts receivables to decline by 32%, reflecting issues of collecting from clients and a decline in demand closer to default.
- A 20% haircut to spare parts and engines.
- A 40% haircut to the value of some domestic slots.
- An 80% haircut to aircraft equipment and engines.

- We apply a 5% cut for administrative expenses.
- Therefore, we arrive at a gross enterprise value of about R$1.6 billion.

Simplified waterfall

- Net enterprise value (after 5% administrative expenses): R$1.5 billion
- Secured debt: R$370 million
- Total value available to unsecured claims: R$1.2 billion
- Total senior unsecured debt: R$2.3 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 - 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

Ratings List

Ratings Affirmed

Azul S.A.	
Issuer Credit Rating	
Global Scale	B+/Stable/--
Brazil National Scale	brAA/Stable/--

	To	From
Azul Investments LLP		
Senior Unsecured		
Local Currency	B+	B+
Recovery Rating	4(40%)	4(45%)

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.