

RATING ACTION COMMENTARY

Fitch Downgrades Azul's Ratings to 'CC'

Thu 31 Oct, 2024 - 17:11 ET

Fitch Ratings - Rio de Janeiro - 31 Oct 2024: Fitch Ratings has downgraded Azul S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'CC' from 'CCC', and National Scale Rating to 'CC(bra)' from 'CCC(bra)'. Fitch has also downgraded Azul Secured Finance LLP's senior secured notes to 'CC'/ Recovery Rating 'RR4' from 'CCC'/ 'RR4' and Azul Investments LLP's unsecured notes to 'C'/ 'RR6' from 'CC'/ 'RR6'.

The downgrades follow Azul's broader refinancing agreements, which include its main creditors and suppliers, and is likely to result in an exchange offer and consent solicitations for its existing 2028, 2029 and 2030 notes. Per its criteria, Fitch views this as a distressed debt exchange (DDE). The deal is assessed to avoid a default. Despite no immediate debt haircut or maturity extension, bondholders who do not accept the deal may face worse terms due to the larger secured debt profile and likely lower return from the equitization of part of the 2029 and 2030 notes.

KEY RATING DRIVERS

New Agreement with Bondholders: Azul has negotiated an agreement with its existing bondholders for up to USD500 million in superpriority new funding, with USD150 million to be provided until Nov.01 2024, USD250 million expected before year end, with the potential to unlock a further USD100 million thereafter. The raise of the new money is key to support Azul's cash burn and support further conditions from the agreement with lessors and OEMs.

Lessors & OEM Agreement: Azul has reached commercial agreements with lessors and OEMs covering about 98% of its equity issuance obligations. This deal eliminates their pro-rata share of the BRL3.1 billion in exchange for up to 100 million new preferred shares of Azul in a one-time issuance. These agreements include a financing condition tied to ongoing negotiations with bondholders and the ability to raise new debt. According to Azul, this agreement will improve cash flow by approximately USD150 million by reducing certain lessors and OEMs obligations over the next 18 months

Cash Flow Burn: Azul faces negative headwinds including BRL devaluation, an approximately 10% revenue loss due to Rio Grande do Sul flooding, and delays in receiving new aircraft, all of which will pressure its operating cash flow generation during 2024. These challenges, combined with high interest and rental payments and capex, result in negative free cash flow generation. Fitch estimates EBITDA for the second half of the year to be around BRL3.3 billion to BRL3.6 billion, while lease rental, interest and capex should total BRL4.1 billion.

DERIVATION SUMMARY

Azul's 'CC' rating reflects the company's announced broader refinancing agreement, which will likely include an exchange offer, which Fitch considers a DDE. This announcement occurs in the context of high refinancing risks and cash flow burns. The company has a solid market position in the Brazilian airlines domestic market, and is the sole airline for 80% of its routes.

Azul has a weaker business and financial position compared to LATAM Airlines Group S.A (BB-/Positive Outlook), which has a more diversified business model, significant regional market position, strong capital structure and robust liquidity position. Azul's rating is also weaker than Avianca Group International Limited (B/Stable), mostly reflecting relatively higher leverage ratios and refinancing risks.

RECOVERY ANALYSIS

KEY RECOVERY RATING ASSUMPTIONS

The recovery analysis assumes that AZUL would be considered a going concern in bankruptcy and that the company would be reorganized rather than liquidated. Fitch has assumed a 10% administrative claim.

Going-Concern Approach: AZUL's going concern EBITDA is BRL2.5 billion which incorporates the low-end expectations of Azul's EBITDA post-pandemic, adjusted by lease expenses, plus a discount of 20%. The going-concern EBITDA estimate reflects Fitch's view of a sustainable, post-reorganization EBITDA level, upon which Fitch bases the valuation of the company. The enterprise value (EV)/EBITDA multiple applied is 5.5x, reflecting AZUL's strong market position in the Brazil.

Fitch applies a waterfall analysis to the post-default EV based on the relative claims of the debt in the capital structure. The debt waterfall assumptions consider the company's total debt as of June 30, 2024. These assumptions result in a recovery rate for the first-lien secured bonds within the 'RR1' range, but due to the soft cap of Brazil, this is kept at 'RR4', and second-lien secured notes fall within 'RR4' range. Azul's senior secured are

rated at 'CC'/RR4'. For the unsecured notes, the recovery is within the RR6 range, therefore results in two notches downgrade from the IDR, being rated at 'C'/RR6'

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating

Action/Upgrade

-- Completion of the proposed exchange offer will lead to a downgrade of the Long-Term IDRs to 'RD' and then subsequently to an upgrade to a rating level that reflects the post-DDE credit profile.

Factors that Could, Individually or Collectively, Lead to Negative Rating

Action/Downgrade

-- Announcement that the Threshold Consent has been reached will lead to a downgrade of the Long Term IDRs to 'C';

-- An uncured payment default on any material financial obligation would lead to a downgrade of the IDRs to 'RD'.

LIQUIDITY AND DEBT STRUCTURE

High Refinancing Risks: Azul's short-term maturities totaled BRL6.0 billion (BRL1.5 billion of financial debt and BRL4.5 billion of leasing obligations) as of June 30, 2024. Azul's readily available cash, per Fitch's criteria, declined to BRL1.5 billion from BRL1.9 billion at end of December 2023. As per agency's estimates, Azul would not be able to generate enough cash flow nor has sufficient liquidity to fulfil those obligations, without new money.

Total long-term debt was BRL31.5 billion, and primarily consists of BRL14.3 billion of leasing obligations, BRL382 million of cross-border senior unsecured notes due 2024, BRL176 million due 2026, and BRL9.9 billion of secured issuances due 2028, 2029 and 2030, BRL2.1 billion of other loans and financing, BRL3.6 billion of lessors equity/note and BRL1 billion of convertible debentures.

ISSUER PROFILE

Azul is one of Brazil's largest local airlines, with significant presence in the regional market and being the sole player on 82% of its routes. During 2023, 93% of its revenues were derived from passengers and 7% from cargo and others.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

[Click here](#) to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

RATING ACTIONS

ENTITY / DEBT ⚡	RATING ⚡	RECOVERY ⚡	PRIOR ⚡
AZUL Investments LLP			
senior unsecured	LT C Downgrade	RR6	CC
Azul S.A.	LT IDR CC Downgrade		CCC
	LC LT IDR CC Downgrade		CCC
	Natl LT CC(bra) Downgrade		CCC(bra)

Azul Secured
Finance LLP

senior secured	LT	CC	Downgrade	RR4	CCC
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Senior Secured 2nd Lien	LT	CC	Downgrade	RR4	CCC
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[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Country-Specific Treatment of Recovery Ratings Criteria \(pub. 03 Mar 2023\)](#)

[Parent and Subsidiary Linkage Rating Criteria \(pub. 16 Jun 2023\)](#)

[Corporate Rating Criteria \(pub. 03 Nov 2023\) \(including rating assumption sensitivity\)](#)

[Sector Navigators – Addendum to the Corporate Rating Criteria \(pub. 21 Jun 2024\)](#)

[Corporate Recovery Ratings and Instrument Ratings Criteria \(pub. 02 Aug 2024\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

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ENDORSEMENT STATUS

AZUL Investments LLP	EU Endorsed, UK Endorsed
Azul S.A.	EU Endorsed, UK Endorsed
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