

Research Update:

# Latam Airlines Group S.A. Upgraded To 'B' On Strong Operating And Financial Performance, Outlook Positive

September 20, 2023

## Rating Action Overview

- Latam Airlines Group S.A. posted strong first-half 2023 results.
- We expect the company's full-year capacity to reach about 92% of pre-pandemic level and its revenue and EBITDA to exceed that level by year-end amid strong yields and controlled costs.
- We believe supply constraints and lesser competition will maintain healthy industry fundamentals through 2024.
- On Sept. 20, 2023, S&P Global Ratings raised its issuer credit rating on Latam to 'B' from 'B-' and raised its ratings on senior secured notes and term loan B to 'BB-' from 'B+'.
- The positive outlook reflects the increased potential for an upgrade in the next 6-12 months, as we believe Latam could generate and maintain funds from operations (FFO) to debt firmly above 20%.

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## Rating Action Rationale

**Latam has exceeded our previous forecast expectations.** Our upgrade of Latam follows the sharp improvement in its credit measures through the first half of 2023 and the upward revision of our base-case scenario for the next two years. Demand for air travel remains healthy, which coupled with rational supply, kept yields high and underpinned Latam's earnings and cash flow in the first half of 2023.

The company is on track to exceed pre-pandemic revenue and EBITDA. We forecast S&P-adjusted EBITDA close to \$2.4 billion in 2023 and \$2.5 billion in 2024, up from \$962 million in 2022 and \$2.2 billion in 2019. Furthermore, we expect the company will generate free operating cash flow (FOCF) of more than \$750 million in 2023 and close to \$400 million in 2024.

As a result, we estimate the company's FFO to debt between 24% and 26% and S&P-adjusted gross debt to EBITDA of 3x in 2023 and dipping below that level in 2024. These measures are

stronger than our previous forecasts and consistent with better credit quality.

**Conditions remain favorable in Latam's main markets.** Demand for air travel has remained strong despite subdued economic growth, and high inflation and interest rates. Additionally, capacity deployment has been somewhat slower, which kept Latam's yields about 14% higher than in the first half of 2022. For 2024, we expect modest economic growth but inflation and interest rates to fall, which should continue supporting travel demand in a still underpenetrated region. Furthermore, supply will likely remain constrained amid delays in aircraft deliveries, retirement of less efficient aircraft, exit of competitors in some markets (particularly in Perú and Colombia), and tight financial conditions for some of Latam's competitors that are focusing on improving profitability and cash flow. Thus, we expect a rational air travel market, minor drops in yields in the next two years from the record levels this year, but yield and revenue passenger kilometer (RPK) growth to remain healthy supporting top-line revenue.

**Latam will continue to benefit from improved cost and capital structure.** During its Chapter 11 proceedings, Latam was able to both slash debt and improve its cost structure. We estimate Latam's adjusted debt (including operating leases) will be about \$7.3 billion by the end of 2023, down from \$10.4 billion in December 2019. There could be minor debt reductions in next two years if the company uses free cash flow to pay down debt. Between 2020 and 2021, Latam implemented initiatives that resulted in \$1.3 billion in annual cost savings, including a 27% reduction in workforce, comprehensive renegotiation of supplier contracts, digitalization, and automatization. As a result, we expect cost per available seat kilometer (CASK; excluding fuel) to remain between 4.6 and 4.8 cents in 2023 and 2024, compared with 4.53 cents in 2019 despite higher inflation and slightly lower capacity than in 2019. Finally, Latam renegotiated its leases, reducing fleet cash cost by about 40%. We believe all of these give comfort to our base case, will support the company's profitability, cash flow, and leverage reduction in the next two years.

**Debt cost remains high but liquidity is very comfortable.** Given ample revolving credit facilities (RCFs) for \$1.1 billion that Latam signed upon its emergence from bankruptcy, robust operating cash flow, and no significant maturities, we expect the company to maintain a very comfortable liquidity in the next two years for the rating level. As a result, we revised our liquidity assessment on Latam to adequate from less than adequate. However, the company's cost of debt remains high. The challenge ahead for the company is to refinance the emergence capital structure with better conditions and lower costs during the next few years, reflecting the improved credit quality, and for instance, currently improved bond yields.

## Outlook

The positive outlook on Latam reflects our expectations of strong performance and that credit metrics will remain in line with a stronger financial profile with FFO to debt between 24% and 26% through 2024. We expect the company will generate higher revenue and earnings thanks to gradual increases in capacity amid favorable supply-and-demand industry fundamentals that support healthy yields and profitability.

## Downside scenario

We could revise the outlook to stable if we expect Latam's FFO-to-debt ratio to fall below 12% in 2024. This might occur if demand deteriorates amid much weaker-than-expected economic conditions, taking a toll on revenue. The ratio could also drop if the company's EBITDA falls

considerably, for instance, stemming from much higher fuel prices, leading to lower-than-expected margins and earnings.

## **Upside scenario**

We could raise the ratings in the next 6-12 months if Latam delivers results in 2023 in line with our base-case scenario and we gain further conviction that it will meet our estimates for its FFO-to-debt ratio to exceed 20% in 2024. In our view, this would most likely follow the seasonally stronger summer months in South America.

## **Company Description**

Latam is a Chilean airline holding company formed through the business combination of LAN Airlines S.A. of Chile and TAM Airlines of Brazil in 2012. The company is primarily involved in the transportation of passengers and cargo. Latam is Latin America's leading airline group, with a presence in five markets: Brazil, Chile, Colombia, Ecuador, and Peru, along with international operations across Latin America and connecting the region with Europe, North America, Africa, and Oceania.

Currently, Latam operates 143 destinations in 23 countries, with an operating fleet of 311 aircraft and a set of bilateral alliances (Delta Airlines and Qatar, among others). The cargo business has 156 destinations including 13 exclusive freighter destinations. The group operates a fleet consisting of Boeing 787, 777 and 767, and Airbus A321, A320neo, A320, and A319 aircraft.

As of February 2023, the following were Latam's main shareholders:

- Sixth Street Partners Management Co. (27.9%);
- Strategic Value Partners (16.0%);
- Delta Air Lines (10.05%);
- Qatar Airways (10.03%);
- Sculptor Capital (6.5%);
- Cueto Group (5%); and
- Other minor shareholders (24.5%).

## **Our Base-Case Scenario**

- Chile's GDP growth of 0.3% in 2023 and 2.4% in 2024, and Brazil's GDP growth of 1.7% and 1.5%, respectively.
- Chile's average inflation of 7.9% in 2023 and 3.7% in 2024, and Brazil's average inflation of 5.2% and 4.2%, respectively.
- Average exchange rate of R\$5.08 per \$1 in 2023 and R\$5.15 in 2024, and CLP810 per \$1 and CLP838, respectively.
- Fuel prices moving in tandem with our Brent oil price deck (and slightly lower refining crack) of \$85/bbl in the forecasted period.
- Available seat kilometer (ASK) increase of 21% in 2023 and 11.5% in 2024, following the

rebound of operations in Brazil and a solid recovery of international travel in 2023.

- RPK increasing by 22% in 2023 and 12% in 2024, according to expected demand growth across all of Latam's markets of operation.
- ASK and RPK growth resulting in load factor between 82% and 83% in 2023 and 2024.
- Cargo operations: Available ton kilometer (ATK) growing 14% in 2023 and 10% in 2024, and revenue ton kilometer (RTK) expanding 6% and 11%, respectively, given increasing offer of space in aircraft bellies and the conversion of narrow body aircraft into cargo haulers.
- A yield of 8.60-8.65 cents in 2023 and 8.30-8.35 cents in 2024, compared with 8.25 cents in 2022.
- Capital expenditures (capex) of \$1.1 billion in 2023 and \$1.5 billion in 2024, supporting growth, fleet, and intangibles.
- Working capital to return to 2019 levels in 2023 and 2024. The company to renegotiate and normalize payment periods to suppliers.
- Resumption of paying dividends by 2024--30% of previous year net income, in line with the Chilean law minimum.

## Key metrics

### Latam Airlines Group S.A.--Forecast summary

Industry sector: Air transport

(Mil. \$)	--Fiscal year ended Dec. 31--						
	2019a	2020a	2021a	2022a	2023e	2024f	2025f
Revenue	10,070	3,924	4,884	9,363	11,286	12,127	12,674
EBITDA (reported)	2,223	(1,412)	(2,260)	2,391	2,302	2,492	2,634
Plus/(less): Other	--	474	1,612	(1,429)	102	34	--
EBITDA	2,223	(938)	(648)	962	2,404	2,526	2,634
Less: Cash interest paid	(552)	(222)	(112)	(532)	(609)	(690)	(676)
Less: Cash taxes paid	(45)	(66)	(9)	(14)	(27)	(39)	(110)
Funds from operations (FFO)	1,625	(1,226)	(770)	415	1,767	1,797	1,848
EBIT	779	(4,006)	(1,792)	835	1,226	1,189	1,155
Interest expense	591	599	813	953	588	684	658
Cash flow from operations (CFO)	2,292	(680)	(287)	(417)	1,885	1,875	2,001
Capital expenditure (capex)	1,415	388	668	820	1,099	1,496	1,566
Free operating cash flow (FOCF)	877	(1,068)	(955)	(1,237)	785	378	435
Dividends	55	1	--	--	--	156	106
Discretionary cash flow (DCF)	822	(1,069)	(955)	(1,237)	785	222	329
Debt (reported)	7,244	7,739	7,442	4,565	4,301	3,790	3,561
Plus: Lease liabilities debt	3,172	3,121	2,961	2,216	2,979	3,109	3,490
Plus/(less): Other	--	397	662	0	--	--	--
Debt	10,416	11,257	11,064	6,782	7,281	6,898	7,051

## Latam Airlines Group S.A.--Forecast summary (cont.)

Industry sector: Air transport

(Mil. \$)	--Fiscal year ended Dec. 31--						
	2019a	2020a	2021a	2022a	2023e	2024f	2025f
Equity	3,129	(2,442)	(7,067)	31	550	746	1,011
Cash and short-term investments (reported)	1,572	1,746	1,148	1,720	1,952	1,352	1,034
<b>Adjusted ratios</b>							
Debt/EBITDA (x)	4.7	(12.0)	(17.1)	7.0	3.0	2.7	2.7
FFO/debt (%)	15.6	(10.9)	(7.0)	6.1	24.3	26.1	26.2
FFO cash interest coverage (x)	3.9	(4.5)	(5.9)	1.8	3.9	3.6	3.7
FOCF/debt (%)	8.4	(9.5)	(8.6)	(18.2)	10.8	5.5	6.2
Annual revenue growth (%)	1.8	(61.0)	24.5	91.7	20.5	7.5	4.5
EBITDA margin (%)	22.1	(23.9)	(13.3)	10.3	21.3	20.8	20.8
Return on capital (%)	5.7	(35.8)	(28.0)	15.4	16.7	15.4	14.7

All figures are adjusted by S&P Global Ratings, unless stated as reported. EBITDA excludes power by the hour rental costs. a--Actual. e--Estimate. f--Forecast.

## Liquidity

We assess Latam's liquidity as adequate. We expect sources of liquidity to cover uses by more than 2x in the next 12 months. However, we still believe Latam needs to rebuild its issuance reputation in capital markets and banks, while refinancing and reducing debt cost. On the other hand, Latam holds a comfortable cash position, which coupled with RCFs for \$1.1 billion, should address unexpected liquidity events. Additionally, the company holds material unencumbered assets including aircraft and engines that could be used to raise additional liquidity. Latam also holds a very comfortable debt maturity profile with no material amortization until 2027. Additionally, the company has worked to streamline its fleet, resulting in lower lease obligations that should underpin cash FFO, but we expect higher capex as Latam continues ramping up operations. Finally, the company doesn't have leverage or coverage financial covenants.

Principal Liquidity Sources:

- Cash position of roughly \$1.5 billion as of June 30, 2023;
- Expected cash FFO of about \$1.4 billion in the next 12 months;
- \$1.1 billion in RCFs with full availability due 2025 and 2026;
- Working capital inflows for about \$100 million; and
- Asset sales for about \$50 million in the next 12 months.

Principal Liquidity Uses:

- Short-term debt of \$445 million as of June 30, 2023;
- Maintenance and fleet capex of about \$1.3 billion in the next 12 months; and
- Dividend payout of 30% in 2024--about \$75 million in the next 12 months.

## Covenants

For RCFs, Latam must keep a minimum liquidity of \$750 million on a consolidated basis and a minimum of \$400 million on a stand-alone basis (Latam Chile and TAM subsidiaries) at any time the RCF is drawn. The company was in compliance with these covenants as of June 30, 2023, and we expect it to remain so. Post-emergence debt consisting of the new senior secured notes, term loan B, and new RCFs, will also include a collateral coverage covenant, which must be equal or higher than 1.6x, and based on current collateral value informed by the company, Latam should comfortably comply with this covenant.

## Environmental, Social, And Governance

Social factors are a negative consideration in our credit analysis of Latam, because of the pandemic-related financial hit to the industry. Its EBITDA and cash flows deteriorated, prompting the company to file for bankruptcy to protect liquidity and overhaul operations. Additionally, a significant portion of Latam's capacity and revenue comes from international travel which is taking longer to recover. We expect Latam to surpass domestic pre-pandemic traffic levels by the end of 2023, but international traffic only by 2024.

Environmental factors are a moderately negative consideration in our credit rating analysis of Latam. All airlines face long-term risk from potentially tighter GHG emissions regulation. Latam's average fleet age is in line with global average of 10-12 years. During bankruptcy, Latam rejected several lease contracts and signed new ones to accelerate its fleet renewal plan, which will reduce fuel consumption, GHG emissions, and the average fleet age.

## Issue Ratings - Recovery Analysis

### Key analytical factors

The 'BB-' rating on the \$1.1 billion term loan B and on the \$1.15 billion first-lien senior secured notes is two notches above the issuer credit rating. This is based on a '1' recovery rating, indicating our view that lenders could expect very high recovery of principal in the event of payment default. The two debt instruments are secured by intangible assets including intellectual property, frequent flyer program, the cargo business and certain slots, gates and routes (among other assets). In our opinion, under a new stress scenario for Latam, it would again seek an organized restructuring process under U.S. laws, since these constitute a specialized framework for companies with international investors and have a precedent of such a restructuring. We valued the company on a going concern basis using a discrete asset valuation method, as per our assessment for airlines. Our valuations reflect our estimate of the value of the various assets at default based on net book value for current assets and appraisals for aircraft and route authorities, adjusted for expected realization rates in a distressed scenario.

### Simulated default assumptions

- Simulated default scenario in 2026, derived from consistently low air passenger volumes, low rates from a steep decline in demand, limited ability to raise ticket prices in a highly competitive environment, and difficult economic conditions. This could hurt Latam's EBITDA

and limit its capacity for debt repayment, as was the case in 2020.

- We also assumed that at the moment of default, the company would have used 60% of its revolving credit facilities (RCFs) totaling \$660 million.
- Available and restricted cash would plummet by 75%, because Latam would have liquidated most of its cash before defaulting on its debt.
- We apply a 25% dilution rate to receivables, because we consider these levels to be already at minimum and they would be realized only if the company grants discounts.
- Given that inventory includes spare parts, we apply a 49% haircut given our belief that under pressure, the company could still sell them at a discount.
- A 50% realization rate for building assets.
- Spare engines, advanced maintenance, and flight equipment have a haircut of 56%. This dilution considers our view that under a stressed scenario, the company's capex wouldn't be aggressive or it would issue additional debt funding; therefore, Latam would use available inventory to address operational needs.
- For slots, we use a 50% realization rate considering that these slots are located in main Brazilian and Peruvian airports. Airports in both countries have a limited number of takeoff and landing slots because of infrastructure limitations.
- For routes, we assume that about 50% of the total are international routes, to which we apply a 50% realization rate in line with slots, resulting in an effective realization rate of 25%.
- We expect a mixed realization rate on the company's owned aircraft between 55% and 75%, depending on age and asset type, mainly consisting of 59 aircraft that average 14 years old.
- We don't include the company's pledge of the cargo business, brand intellectual property, and interest in the frequent flyer program because we think those values are embedded in the attractiveness of company's routes, slots, and aircraft

## **Simplified waterfall**

- Net enterprise value (after 5% administrative costs): \$5.7 billion
- Total senior secured debt: \$3.2 billion (Including Term Loan B, Senior secured notes, 60% of RCF, Spare Engine facility, PDP (pre delivery payment) and other secured debt as of June)
- Recovery expectations: 90%-100% (rounded estimate 95%)

## **Ratings Score Snapshot**

Business risk: Weak

- Country risk: Intermediate risk
- Industry risk: High risk
- Competitive position: Fair

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Fair
- Comparable rating analysis: Neutral

Stand-alone credit profile: b

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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 | 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, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## Ratings List

### Upgraded; CreditWatch/Outlook Action

	To	From
<b>Latam Airlines Group S.A.</b>		
Issuer Credit Rating	B/Positive/--	B-/Stable/--

### Upgraded

	To	From
<b>Latam Airlines Group S.A.</b>		
Senior Secured	BB-	B+



Recovery Rating

1 (95%)

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