

ANALYSIS

Deutsche Lufthansa Aktiengesellschaft

Cologne, Germany

Table of Contents:

CORPORATE PROFILE	1
MANAGEMENT STRATEGY	2
RATING RATIONALE	3
KEY RATING CONSIDERATIONS	3
LIQUIDITY	8
STRUCTURAL CONSIDERATIONS	9
APPENDIX 1 – KEY CREDIT METRICS FOR LUFTHANSA – FY 2009	10
APPENDIX 2 – GLOBAL PASSENGER AIRLINE METHODOLOGY GRID AS APPLIED TO LUFTHANSA	11
MOODY'S RELATED RESEARCH	11

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Corporate Profile

Deutsche Lufthansa AG (“Lufthansa” or “the group”, rated Ba1/not prime, stable outlook), headquartered in Cologne, Germany, is the leading European airline in terms of revenues. In FY09 it reported revenues and EBIT of EUR22.3 billion and EUR96 million, respectively. Lufthansa is a member of the DAX index as one of the 30 largest publicly listed companies in Germany. As of FYE 2009, it was 100% free float. The group’s revenue base consists primarily of four divisions (excluding IT services), as follows:

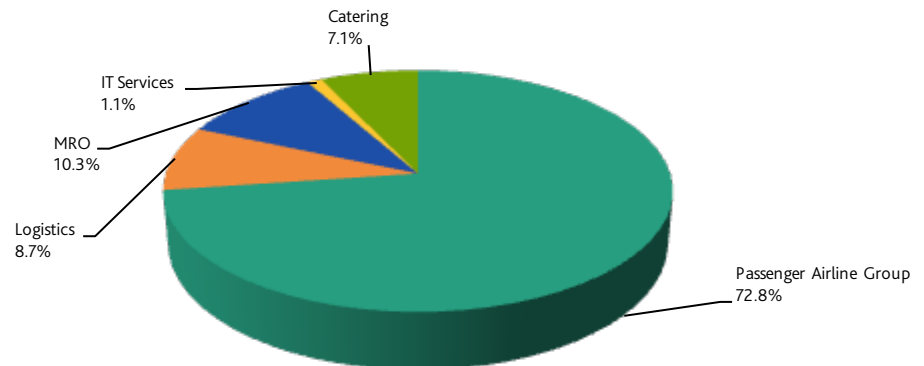
- » The **Passenger Airline Group**, or the passenger division (72.8% of the group’s external 2009 revenues) is the third-largest in the world and is the largest in Europe in terms of passenger numbers, with EUR16.2 billion in external revenues. Following a series of acquisitions in recent years, the division now comprises a number of branded airlines apart from Lufthansa, including Swiss International Airlines (fully consolidated since July 2007), Austrian Airlines (acquired in September 2009) and bmi (fully owned as of November 2009, prior to which Lufthansa had a majority stake as of July 2009). In July 2009, Lufthansa also acquired a 45% stake in Brussels Airlines (now equity consolidated).
- » **Lufthansa Cargo** (8.7% of group revenues) is the third-largest cargo airline in the world behind Korean Air Cargo and Cathay Pacific Cargo, measured by freight transported in tonne-kilometres. In 2009 the division became more dependent on emerging markets in light of the downturn in mature markets.
- » **Lufthansa Technik** (“the MRO division”) (10.3% of group revenues) is the world’s leading supplier of engineering services for civil aircrafts. The division has approximately 690 customers and a global market share of around 16%.
- » **LSG Sky Chefs** (the catering division) (7.1% of FY09 revenues) is a leading airline caterer, alongside Gate Gourmet (rated B2 stable). LSG Skychefs estimates its global market share to be about 30%. The division generated EUR1.5 billion in sales in FY 2009.

This Analysis provides an in-depth discussion of credit rating(s) for Deutsche Lufthansa Aktiengesellschaft and should be read in conjunction with Moody’s most recent Credit Opinion and rating information available on [Moody's website](#).

CHART 1

Comparatively well diversified structure of revenues

Revenues by Division (FY 2009)



Source: company

Management Strategy

In line with the industry, Lufthansa suffered from a sharp downturn in demand in 2009, predominantly in its key passenger and cargo divisions. Nevertheless, its ability to generate a modest operating profit positions it well among competitors. The industry recession has also heightened the competitive pressure from low-cost carriers. Lufthansa's metrics have further been impacted by its acquisitive growth in recent years, which has been fairly high by industry standards, as it has been one of the main consolidators in the European industry. Prior to 2009, acquisitions included Swiss International Airlines ('Swiss'), which has been fully consolidated since July 2007. From being loss-making at the time of acquisition, Swiss was the most profitable airline within the group in 2009. In January 2008, Lufthansa acquired a 19% stake in JetBlue Airways (Caa1, positive outlook) for USD300 million; since then, the two airlines have increased their partnership activities, such as through the implementation of code-sharing connections via JFK and Boston airports. In addition:

- » In September 2009, Lufthansa acquired 100% of **Austrian Airlines**. Lufthansa paid approximately EUR200 million in cash, with the transaction being conditional on the granting of a EUR500 million restructuring aid package from the Austrian government. As a result of this acquisition, Vienna became an additional hub within the Lufthansa network and strengthened the group's position in the Eastern European market. Management also targets c.EUR100 million in annual synergies from this acquisition.
- » During 2009, Lufthansa took full ownership of **bmi** in two stages. In July it acquired the 50% stake (plus one share) owned by Sir Michael Bishop for GBP48 million (in addition to GBP175 million to cancel a previously-agreed put option). In October it acquired SAS's 20% stake for GBP38 million. bmi has an 11% share of slots at London Heathrow and has been fully consolidated since July 2009.
- » In June 2009, Lufthansa acquired 45% of **Brussels Airlines** for a cash consideration of EUR65 million. Lufthansa retains a call option on the remaining 55% share capital, which can be exercised from 2011 onwards. This investment strengthens Lufthansa's position on routes between Europe and Africa, where the group historically had less of a presence than competitors such as Air France and Iberia

With these acquisitions, Lufthansa's passenger division is able to operate a multi-hub network that includes Frankfurt, Munich and Zurich, and more recently Brussels and Vienna. It is now the third-largest passenger airline in the world, behind Delta Air Lines (B2, stable outlook) and the proposed United-Continental merger. However, the newly-acquired airlines have also been a factor in the weakening in Lufthansa's credit metrics, partly as a result of the assumed debt, but also due to their relative weak earnings to date. Hence Lufthansa has implemented a restructuring at both airlines. At Austrian Airlines this has included adapting the Vienna airport as a hub; staff cuts; and synergies with the Lufthansa group in terms of sales, ground handling, procurement and IT systems.

In response to the industry downturn, in 2009 Lufthansa also initiated its "Climb 2011" restructuring programme, which aims to achieve an increase in earnings of EUR1.0 billion by 2011 (full-year benefit realised in FY2012). Most of the measures will focus on a sustained reduction in the cost base through staff reductions, increased productivity and revised supplier contracts; however, some measures will also target increased earning capacity and a review of capital expenditure and flight capacities.

Rating Rationale

The current Corporate Family Rating of Ba1 (stable outlook) is two notches above the rating indicated by Moody's Global Passenger Airlines Rating Methodology based on 2009 metrics. The difference is largely attributable to metrics which we believe remain weak for the current rating category, although in common with other airlines, we expect that there will be a gradual improvement in these metrics in the course of 2010. At the same time, Lufthansa's rating reflects its solid business profile with a very diversified route network and business segments which have helped to mitigate somewhat its exposure to the current downturn, as well as its solid liquidity position.

Key Rating Considerations

Difficult market conditions but strong competitive positioning

With revenues of EUR22.3 billion in FY 2009, Lufthansa is one of the largest airlines globally. The passenger division consisted of 722 aircraft at FY09, with a high level of ownership. The division has one of the most diversified networks among its peers in terms of geography.

CHART 2

Group revenues by geography (FY 2009)

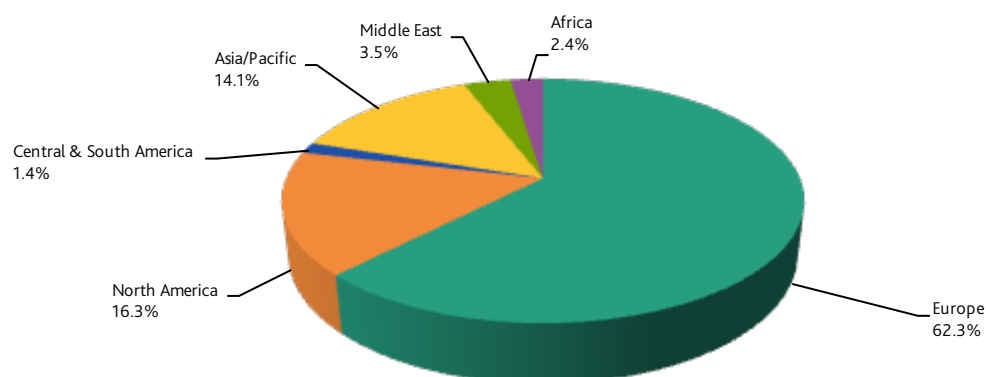
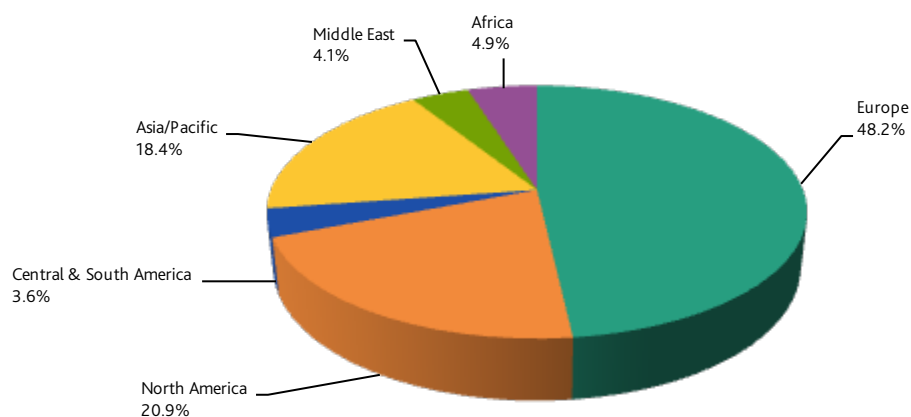


CHART 3

Passenger revenues by region (FY2009)



Moody's believes that the general diversification of the company's activities by segment has helped to mitigate its exposure to the recession. Hence while demand and profits in the passenger and logistics divisions were severely impacted by the market downturn, the MRO division remained fairly resilient reflecting the largely non-cyclical nature of its business.

TABLE 1

Operating results by segment

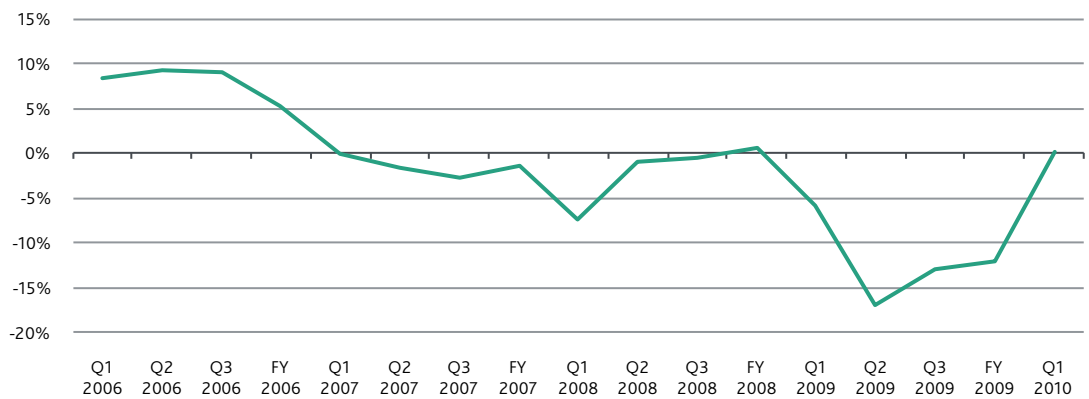
OPERATING RESULT*	PASSENGER AIRLINE GROUP	LOGISTICS	MRO	CATERING	IT, OTHER, & CONSOLIDATION	GROUP
EUR mn						
FY07	826	136	293	100	23	1,378
FY08	789	164	299	70	-42	1,280
FY09	-8	-171	316	72	-79	130

*Data are not fully comparable due to changes in consolidation

Source: company

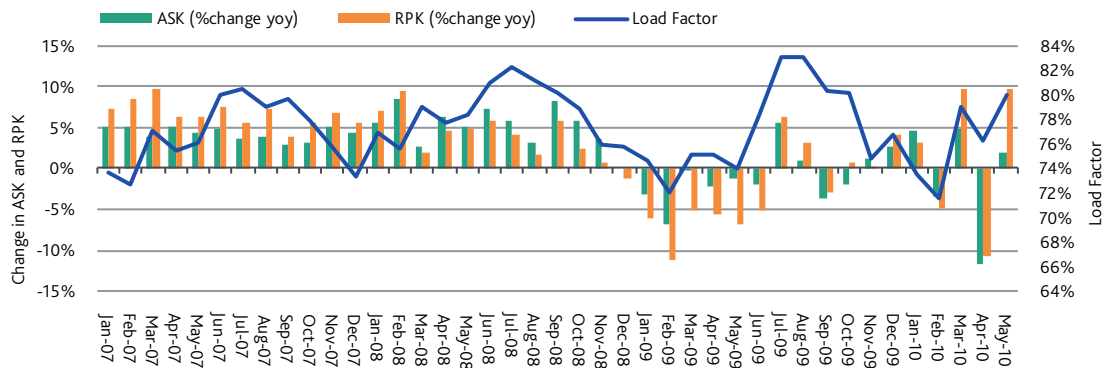
The weakness in demand affected primarily the passenger and cargo segments. In terms of passengers, the group carried 76.5 million passengers in 2009, a year-on-year increase of 8.5%; adjusted for the consolidation of new companies, the number of passengers fell by 1.7% on a comparable basis. However, in common with peers, the main weakness was in terms of yields. The company reports that revenues fell 8.3%, and by 14.7% on a comparable basis, due mainly to lower prices. Similarly, yields (revenues per revenue passenger kilometre) fell 12% in 2009, albeit were fairly stable in Q1 2010. However, we believe that a longer-term recovery in yields will be correlated to a continued economic recovery but also to commodity prices, especially rising fuel costs, which could delay the expected recovery in industry profitability.

CHART 4
Passenger yields only starting to stabilize
 Lufthansa passenger yields (yoy % change)



* Yields include the FX impact.
 Source: Company

CHART 5
Traffic statistics also starting to stabilise at low levels
 Lufthansa Passenger Airlines



Source: Company

Demand in the catering segment was also very volatile, mainly due to capacity reductions by airlines and more economy travel, as well as the loss of SAS as a major customer. The impact on profits in

2009 was mitigated by cost cuts. However, the impact of the downturn was most pronounced in the cargo division, which saw revenues fall by nearly a third, and a c.10% drop in revenues per cargo-tonnes kilometres, reflecting the decline in global trade. The first quarter of 2010 saw a strong climb in revenues and a return to profitability, although the group remains cautious for the full-year outlook.

TABLE 2

Trends in traffic for Lufthansa cargo

YOY % CHANGES	EXTERNAL REVENUES	REVENUES PER CARGO- TONNES KM	
	FY 2009	FY 2009	Q1 2010
Europe	-34.0	-8.8	+7.1
Americas	-34.0	-11.8	+28.7
Asia/Pacific	-29.3	-11.5	+22.5
Middle East	-28.6	+3.7	+2.7
Total	-31.3	-10.4	+22.2

Source: company

The cost structure has been significantly impacted by volatility in fuel prices...

In common with peers, Lufthansa's cost structure in 2008 was significantly impacted by fuel costs, which jumped 39% in 2008, but fell back 32% in 2009. As a percentage of total operating costs, these went from 17% in 2007 to 21% in 2008, and then to c.15% in 2009. The company nevertheless maintains one of the more conservative fuel hedging policies in the industry. As of December 2009, the passenger division had hedged 67% of its fuel requirement for 2010 and 26% for 2011, and has further mitigated the impact through fuel surcharges, although Moody's believes that these retain more limited flexibility during an industry downturn.

As a mainline carrier, Lufthansa has been impacted by the growth of low-cost carriers with lower cost structures. In turn, Lufthansa operates its own no-frills airlines, Germanwings, which was profitable in 2009, albeit only a very small share of group revenues. While main-line airlines have suffered to a greater degree from the recession, it remains to be seen to what extent this is cyclical and will reverse during the expected recovery going forward. Lufthansa's EBITDA margin was at 10% in 2009 (as adjusted by Moody's), and below its average of 13% in the past five years. We note that the margin at Lufthansa is impacted more than that of many peers by its sizeable non-passenger businesses. In Q1 2010, results, and margins, were further impacted by losses at the newly-consolidated airlines (Austrian and bmi).

...but the company's Climb 2011 initiative targets some long-term structural benefits

In 2009, Lufthansa passenger Airlines initiated the "Climb 2011" programme with the objective of improving earnings by EUR1.0 billion as of FY2012. By re-examining its cost structure and business model, the company is targeting to secure its long-term competitive position. Moody's views this initiative as a pro-active response to structural changes in the industry, and in particular with regards to short-haul traffic, which we believe will continue to be increasingly challenged by alternative modes of transport.

TABLE 3

Climb 2011 objectives

CATEGORY	DESCRIPTION OF COST SAVING GOAL	POTENTIAL COST SAVING (EURMN)
Administration	20% reduction in staff capacity	55
Suppliers	Contributions from suppliers	230
Staff productivity	Cutting unit staff costs by 10%	190
Income	Increased seating capacity and examining new pricing models	170
Fleet structure	Reviewing dimensions of short-haul traffic	130
Capacities	Adjusting flight capacities (more flexibility)	55
Capital expenditure	Adjusted aircraft deliveries from 2010	TBD

Source: company

Metrics have been impacted by lower demand and acquisitions

In line with the industry trend, Lufthansa's key credit metrics deteriorated significantly since 2007, which was a comparatively strong year. In 2009, group revenues fell 10.3%, or 15% on a comparable basis. The revenue base was somewhat more skewed towards passenger revenues due to the consolidation of acquired entities. Operating expenses also fell 3.6%, or 8.6% on a comparable basis. As noted earlier, this reflected in large part a significant decline in fuel charges; while staff costs, the largest single cost item, were fairly stable before accounting for new consolidations.

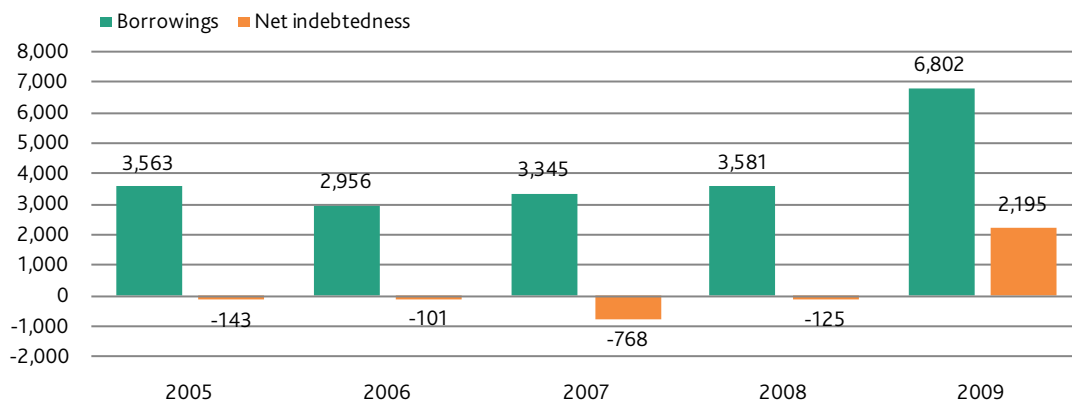
The passenger and logistics businesses were largely responsible for the decline in profitability, and similarly we believe that these divisions will also underpin any recovery in group earnings. While logistics already returned to profits in Q1 2010, the passenger business remained significantly loss-making, due in part to consolidations, as well as other one-off events such as a pilot strike and the impact of the Icelandic volcano. Moody's has previously noted that this latter event, as well as potentially rising oil prices, may delay an improvement in profitability and metrics to levels in line with the current rating.

Lufthansa's overall capital expenditures were reported at EUR2.3 billion in 2009, versus EUR2.15 billion in 2008, largely on account of 'primary' investments in new aircraft, while other investments (PP&E and equity investments) were reduced. The combination of reduced cash flows, as well as debt used to acquire new companies and assumed from acquisitions, resulted in reported net debt rising from negative (net cash) of EUR125 million in 2008 to EUR2.2 billion in 2009.

CHART 6

Net indebtedness has risen with investments particularly in 2009

Development of borrowings and net indebtedness (EURmn)



Source: company

The impact on metrics was that gross debt/EBITDA (as adjusted by Moody's) rose to 6.4x in 2009 (and last 12 months to Q1 2010) from 3.6x in 2008, and for Retained Cash Flow/Net Debt fell to 18.4% from 29.3% in the same period. The leverage metric in particular is deemed weak for the current rating, for which we expect it to trend towards 5x. Nevertheless, we note that leverage remains low relative to many rated peers. Moody's principal adjustment to Lufthansa's metrics are its operating leases and pension obligations. The latter increased to EUR3.25 billion from EUR2.36 billion in 2008, largely on account of the lower interest rates and company acquisitions.

Liquidity

Lufthansa's liquidity remains satisfactory and the company has taken measures to secure liquidity in the course of 2009. The company reported total liquidity (cash and securities) of EUR4.7 billion at FYE2009, versus EUR3.8 billion in 2008. This left a ratio of cash to reported debt of 68%, which is quite high by industry standards. Moody's notes also that the company raised its target of minimum strategic liquidity to EUR2.3 billion from the EUR2.0 billion previously. In addition, Lufthansa retained EUR1.7 billion of committed bilateral short-term credit facilities with various banks. Against this, the company reported EUR693 million of short-term debt at FYE2009 (EUR848 million in March 2010). The company generated moderately negative free cash flows in the past two years (after dividends). We note that the company will not pay a dividend for 2009, while we expect that industry conditions should enable some improvement in operating performance and cash flows in the current fiscal year. Finally we note that the company launched an EUR4 billion Debt Issuance Program in March 2009, under which two bonds amounting to EUR1.6 billion were issued during the year.

At FYE09 67% of the fleet was unencumbered (83% at the core Lufthansa fleet), which provides additional flexibility to secure financing. Lufthansa also received c.EUR97 million in April 2010 as part of the partial IPO of Amadeus, reducing its equity stake to 7.6% from its original 11.6%.

Structural considerations

The company's level of debt secured on assets increased significantly in 2009, to EUR1.1bn from EUR269 million in FY2008 (excluding capitalised finance leases). The bulk of this increase relates to the consolidation of Austrian Airlines in that year, whose debt structure was virtually all secured. While Moody's incorporates this debt into our LGD assessment, Moody's understands that there are no cross-guarantees or cross-default between debt at the two airlines. We note further Lufthansa's intention to raise additional secured financing in 2010, including some already carried out in the first quarter, albeit with the intention not to significantly increase the net level after debt amortisation. Our Ba1 rating of the senior unsecured notes, at the same level as the Corporate Family Rating, assumes that the overall debt structure will not change significantly in the course of 2010. In this regard, Moody's believes that there remains limited flexibility to increase the level of secured financing beyond current levels in order to avoid potential notching of the senior unsecured rating.

Appendix 1 – Key Credit Metrics for Lufthansa – FY 2009

Deutsche Lufthansa Aktiengesellschaft		12/31/09 (Annual) As Rep						12/31/09 (Annual) As Adj	
Credit Opinion Ratios		Standard Adjustments					Non- Standard Adjustment s	Total Adj.	
		Pensions	Op Leases	Int Exp - Disc	Align FFO	Unusual			
EBITDA Margin %	Pretax Income	-229	19			106	-5	120	-109
	+ Interest Expense	506	-21	164	-29			114	620
	+ Other Non-Recurring Expen:	0							0
	+ Depreciation	1409		328		-88		240	1,649
	+ Amortization =	66							66 =
Revenue	22283							22,283	22,283
	7.9%								10.0%
RCF / Net Debt	Funds from Operations	1,767		328	-129		107	306	2,073
	- Preferred Dividends	0							0
	- Common Dividends	-333							-333
	- Minority Dividends =	0							0 =
	Short-term debt	0							0
+ Long-term Debt - Gross	6,802	3,250	3,936			148	7,334	14,136	
- Cash & Cash Equivalents	-1136					-3529	-3529	-4665	
	25.3%								18.4%
Debt / EBITDA	Short-term debt	0							0
	+ Long-term Debt - Gros:=	6,802	3,250	3,936			148	7,334	14,136 =
	Pretax Income	-229	19			106	-5	120	-109
	+ Interest Expense	506	-21	164	-29			114	620
	+ Other Non-Recurring Expen:	0							0
+ Depreciation	1,409		328		-88		240	1,649	
+ Amortization	66							66	
	3.9x								6.4x

Appendix 2 – Global Passenger Airline Methodology Grid as Applied to Lufthansa

Rating Factors							
Deutsche Lufthansa Aktiengesellschaft (as of 31 December 2009)							
GLOBAL PASSENGER AIRLINE INDUSTRY	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Cost Structure							
a) Fleet Age					x		
b) RPK/FTE							x
b) Fuel Hedging				x			
c) EBITDA margin							10.0%
Factor 2: Geographical Diversity							
a) Number of markets of operations				x			
Factor 3: Financial Flexibility/Liquidity							
a) Cash Liquidity					x		
b) Degree of Encumbered Assets						x	
Factor 4: Financial Metrics							
a) EBIT / Interest							0.8x
b) RCF / Net Debt					18.4%		
c) Debt / EBITDA						6.4x	
d) Debt / Capital					69.6%		
Rating:							
a) Indicated Rating from Methodology					Ba3		
b) Actual Rating Assigned					Ba1		

Moody's Related Research

Industry Outlooks

- » [Annual Outlook: Global Airline Sector Stable On Expectations of Passenger, Yield Growth; June 2010 \(125533\)](#).
- » [Global Airlines: Improvement In Yields Remains Elusive; November 2009 \(121473\)](#)
- » [Japanese Airlines Face Stiff Headwinds, August 2009 \(119599\)](#)

Rating Methodologies

- » [Global Passenger Airlines, March 2009 \(115216\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 125584

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