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Research Update:

Latam Airlines Group S.A. Upgraded To 'B+' From 'B' On Consistently Stronger Credit Metrics; Outlook Positive

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Rating Action Overview

- Healthy market conditions will continue improving Latam's results and credit metrics during 2024.
- We now expect funds from operations (FFO) to debt close to 30% in 2024, slightly above our previous forecast, and in line with our upside triggers.
- As a result, S&P Global Ratings raised its issuer credit rating on Latam by one notch to 'B+' from 'B'.
- At the same time, we raised our issue-level rating on the company's secured debt to 'BB' from 'BB-', stemming from higher issuer credit rating. We kept the '1' recovery rating unchanged.
- The positive outlook reflects our expectation that the company will be able to maintain relatively stable profitability with EBITDA margins about 20% and FFO to debt near 30% over the next couple of years.

Rating Action Rationale

2024 credit metrics should continue strengthening. Our upgrade of Latam Airlines Group S.A. (Latam) follows the sharp improvement in its credit measures during 2023 and our expectation that they will remain in good shape in the next two years. The company's 2023 revenue and EBITDA have exceeded pre-pandemic levels, and we forecast further expansion for 2024.

Air travel demand remains healthy, which coupled with rational supply, kept yields high and underpins Latam's earnings. Additionally, following its bankruptcy filing in 2020, Latam was able to reduce its fleet cost and streamline its overall cost structure. And through several cost-saving initiatives, including digitalization and automatization of processes, the company has offset cost inflation pressures.

We forecast EBITDA close to $2.7 billion in 2024 and 2025, compared with $2.4 billion in 2023.

Furthermore, we expect the company should be able to generate free operating cash flow (FOCF) between $500 million and $700 million in the next two years. As a result, we estimate the company's FFO to debt between 28% and 30% and S&P Global Ratings' gross adjusted debt to EBITDA of 2.5x-2.6x in 2024 and 2025. These measures are slightly stronger than our previous forecasts and point to Latam's improved financial risk profile and credit quality.

We expect industry fundamentals to remain favorable through 2024. Despite the region's modest economic growth, we believe that the improved environment in terms of inflation and interest rates should continue supporting air travel demand in a still underpenetrated region. Even when we assume minor drops in yields in the next two years from the record levels in 2023, we expect revenue passenger kilometer (RPK) growth and yields to remain healthy.

Furthermore, the industry's supply will likely remain constrained amid delays in aircraft manufacturers' deliveries, retirement of less efficient aircraft, and overall lower competitive pressures in the region. In the past year, we have witnessed the exit of competitors in some markets like that of Ultra Air and Viva Air in Colombia and Perú or Equair in Ecuador. In addition, some of Latam's competitors are still facing tighter financial conditions, prompting them to focus on enhancing cash flow or improving their capital structures (i.e. Gol, the main competitor in Brazil, filed for bankruptcy proceedings in January 2024). Thus, we continue expecting a rational market. In this context, we forecast Latam to expand capacity by about 13%. To support this endeavor, Latam has received 30 new aircraft in 2023 (to renew and expand the fleet) and launched 21 additional routes.

Nevertheless, the industry's revenue and cost visibility is low beyond a few months. The pressure on travelers' disposable incomes or increases in fuel prices could significantly alter our assumptions for 2024.

Latam's capital structure should remain lighter. During Chapter 11 proceedings, Latam was able to slash its debt. We estimate Latam's adjusted debt (including operating leases) will be about $7.0 billion for the next two years, down from $10.4 billion in December 2019, and there could be further minor debt reductions in next two years if the company uses FOCF for that purpose. However, the company's cost of debt remains high, and Latam would face the scenario of refinancing the post-emergence capital structure through better conditions and lower costs during the next two years.

Outlook

The positive outlook on Latam reflects our expectations that it will continue posting robust performance over the next 12 months, confirming our base-case assumptions and its overall stronger business and financial position. We expect the company will generate higher revenue and sound profitability thanks to gradual increases in capacity amid favorable supply-and-demand industry fundamentals that support healthy yields.

Upside scenario

We could raise the ratings in the next 6 to 12 months if Latam continues delivering results in line with our base-case scenario and we gain further conviction that it will post a relatively stable profitability with EBITDA margins around 20%. An upside would depend on having greater visibility on Latam's ability to maintain capacity increases and confidence that passenger traffic will remain healthy despite soft macroeconomic conditions, now that the company has reached pre-pandemic capacity. An upgrade would also require that Latam maintains FFO to debt consistently at about 30%.

Downside scenario

We could revise the outlook to stable if we expect higher volatility in EBITDA margin or that it will fall considerably short from our base-case assumptions. We could also revise the outlook to stable if the FFO-to-debt ratio trends closer to 20% in 2024. This might occur if demand deteriorates amid much weaker-than-expected economic conditions or if fuel prices are much higher, leading to lower-than-expected margins and earnings.

Company Description

Latam is a Chilean airline holding company 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 148 destinations in 26 countries, with an operating fleet of 333 aircraft and a set of bilateral alliances (Delta Airlines and Qatar Airways, among others). The cargo business has 166 destinations including 18 exclusive freighter destinations. The company operates a fleet consisting of Boeing 787, 777 and 767, and Airbus A321, A320neo, A320, and A319 aircraft. As of December 2023, the following were Latam's main shareholders:

- Sixth Street Partners Management Co. (27.91%);
- Strategic Value Partners (16.02%);
- Delta Air Lines (10.05%);
- Qatar Airways (10.03%);
- Cueto Group (5.03%); and
- Other minor shareholders (30.97%).

Our Base-Case Scenario

Assumptions

- Chile's GDP growth of 1.9% in 2024 and 2.7% in 2025, and Brazil's GDP growth of 1.5% in 2024 and 1.9% in 2025.
- Chile's average inflation of 3.5% in 2024 and 3.1% in 2025, and Brazil's average inflation of 3.6% in 2024 and 3.7% in 2025.
- Average exchange rate of R$5.1 per $1 in 2024 and R$5.2 in 2025 (Brazil), and CLP915 per $1 in 2024 and CLP935 in 2025 (Chile).
- Local currency depreciation usually lowers revenue as the pricing of the tickets in Brazil and Chile is in domestic currencies. It also reduces the company's ability to pass through costs to average airfares, considering the amount of costs denominated in hard currency.
- Fuel prices moving in tandem with our Brent oil price deck (and slightly lower refining crack) of

$85/bbl in the forecasted period.

- The available seat kilometer (ASK) increase of 12%-13% in 2024 and 6% in 2025, reflecting a full recovery of international business and further growth in domestic markets.
- RPK increasing by 13%-14% in 2024 and 5%-6% in 2025, according to the expected demand growth in all markets of operation.
- ASK and RPK growth driving load factor between 84% and 86% in 2024 and 2025.
- Cargo operations: Available ton kilometer (ATK) growing about 11% in 2024 and 5% in 2025; and revenue ton kilometer (RTK) expanding by 13% and 7%, respectively, from the increasing offer of space in aircraft belly and the conversion of narrow body aircraft into cargo.

A yield of 8.65-8.7 cents in 2024 and 8.50-8.55 cents in 2025, compared with 8.96 cents in 2023.

- Capex of $1.4 billion in 2024 and $1.5 billion in 2025, supporting growth, the fleet, and intangibles.
- Resumption of dividends payments in 2024. We forecast 30% of previous year net income in line with the Chilean legal minimum.
- We contemplate some liability management and debt repayment in 2024 that could reduce interest payments in the next two years.

Key metrics

Latam Airlines Group S.A.--Forecast summary

Industry sector: Air transport

	--Fiscal year ended Dec. 31--					
(Mil. $)	**2020a**	**2021a**	**2022a**	**2023a**	**2024e**	**2025f**
Revenue	3,924	4,884	9,363	11,641	12,826	13,277
EBITDA (reported)	(1,412)	(2,260)	2,391	2,284	2,689	2,698
Plus/(less): Other	474	1,612	(1,429)	131	31	--
EBITDA	(938)	(648)	962	2,415	2,720	2,698
Less: Cash interest paid	(222)	(112)	(532)	(604)	(660)	(612)
Less: Cash taxes paid	(66)	(9)	(14)	(18)	(42)	(128)
Funds from operations (FFO)	(1,226)	(770)	415	1,792	2,018	1,958
EBIT	(4,006)	(1,792)	835	1,335	1,431	1,326
Interest expense	599	813	953	708	640	604
Cash flow from operations (CFO)	(680)	(287)	(417)	1,758	2,123	2,075
Capital expenditure (capex)	388	668	820	854	1,386	1,552
Free operating cash flow (FOCF)	(1,068)	(955)	(1,237)	904	737	524
Dividends	1	--	--	--	174	169
Discretionary cash flow (DCF)	(1,069)	(955)	(1,237)	904	562	355
Debt (reported)	7,739	7,442	4,565	3,970	3,481	3,337
Plus: Lease liabilities debt	3,121	2,961	2,216	2,968	3,451	3,653

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

Industry sector: Air transport

	--Fiscal year ended Dec. 31--					
(Mil. $)	**2020a**	**2021a**	**2022a**	**2023a**	**2024e**	**2025f**
Plus/(less): Other	397	662	0	7	--	--
Debt	11,257	11,064	6,782	6,945	6,933	6,990
Cash and short-term investments (reported)	1,746	1,148	1,720	1,890	1,657	1,419
Adjusted ratios						
Debt/EBITDA (x)	(12.0)	(17.1)	7.0	2.9	2.5	2.6
FFO/debt (%)	(10.9)	(7.0)	6.1	25.8	29.1	28.0
FFO cash interest coverage (x)	(4.5)	(5.9)	1.8	4.0	4.1	4.2
EBITDA interest coverage (x)	(1.6)	(0.8)	1.0	3.4	4.2	4.5
FOCF/debt (%)	(9.5)	(8.6)	(18.2)	13.0	10.6	7.5
EBITDA margin (%)	(23.9)	(13.3)	10.3	20.7	21.2	20.3
Return on capital (%)	(35.8)	(28.0)	15.4	18.8	18.9	16.6

All figures are adjusted by S&P Global Ratings, unless stated as reported. 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 the cost of debt. On the other hand, Latam holds a comfortable cash position, which coupled with revolving credit facilities (RCFs) for $1.1 billion, should address unexpected liquidity events. Furthermore, 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 significant amortization until 2027. The company has also worked to streamline its fleet, resulting in lower lease obligations that should underpin cash FFO, but we expect higher capex as Latam continues renewing its fleet. Finally, the company doesn't have leverage or coverage financial covenants.

Principal Liquidity Sources:

- Cash position of roughly $1.7 billion as of Dec. 31, 2023;
- Expected FFO cash generation of about $1.7 billion in the next 12 months;
- RCF with full availability of $1.1 billion due 2025 and 2026;
- Working capital inflows for about $40 million.

Principal Liquidity Uses:

- Short-term debt of $290 million as of Dec. 31, 2023;
- Maintenance and fleet capex of about $1.4 billion in the next 12 months; and
- Dividend payout of 30% in 2024, about $175 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 (for both Latam Chile and TAM subsidiaries) at any time the RCF is drawn. The company was in compliance with these covenants as of Dec. 31, 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 provided 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 flow 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 took longer to recover. Latam surpassed domestic pre-pandemic travel levels by the end of 2023, but we estimate international traffic to show full recovery during 2024.

Environmental factors are a 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 2028, 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 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 incorporates 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 unencumbered aircraft between 55% and 75%, depending on age and asset type, mainly consisting of 87 aircraft that average almost 16 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): $6.3 billion
- Total senior secured debt: $3.1 billion (including term loan B, senior secured notes, 60% of RCF, the spare engine facility, 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: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers:

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

Stand-alone credit profile: b+

Related Criteria

- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded

	To	From
Latam Airlines Group S.A.		
Issuer Credit Rating	B+/Positive/--	B/Positive/--
Latam Airlines Group S.A.		
Senior Secured	BB	BB-
Recovery Rating	1(95%)	