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**Research Update:**

## Avianca Holdings S.A. 'B' Corporate Credit Rating Affirmed; Outlook Remains Stable

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## Research Update:

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## Overview

- Colombia-based airline operator Avianca faced challenging conditions in 2017 because of a pilots' strike. However, the company took several actions to mitigate this effect and its key financial credits performed in line with our expectations.
- We are affirming our 'B' rating on Avianca.
- At the same time, we are affirming our 'B-' issue-level rating on the company's \$550 million senior unsecured notes due 2020.
- The stable outlook reflects our expectation that Avianca will post key credit metrics with debt to EBITDA of about 5.0x and FFO to debt of about 14% in the next 12 months, commensurate with its debt-financed fleet expansion strategy. We also consider that the company will continue to normalize its operations after the pilots' strike in the second half of 2017.

## Rating Action

On April 24, 2018, S&P Global Ratings affirmed its 'B' corporate credit rating on Avianca Holdings S.A. At the same time, we affirmed our 'B-' issue-level rating on the company's \$550 million senior unsecured notes due 2020. The outlook on the corporate credit rating is stable.

## Rationale

The affirmation reflects our view that Avianca's credit metrics have remained commensurate with its rating category. This is in spite of the challenging operational conditions that the company faced in the second half of 2017, as a result of a 51-day illegal strike by about third of its pilots, which mainly affected its deployable capacity in its domestic market. However, the company was able to partially mitigate the negative effects through the deployment of a larger capacity fleet, a change in its mix of operating carriers, and an optimization of its routes (particularly in Colombia) and use of staff. It also deployed more wet leases (includes aircraft, complete with crew, maintenance, and insurance). Overall, the airline's performance in 2017 was commensurate with our expectations.

The company is still a relatively small player in the industry and continues to be concentrated in Latin America, particularly in Colombia, which accounts

for about 45% of its consolidated revenue. The airline's growth has also been underpinned by favorable macroeconomic conditions in its key markets, benefiting traffic, load factors, and recovery of yields. However, the company has continued to expand its operations through new international routes (particularly Europe and North America), the incorporation of a new fleet with higher capacity and fuel efficiency, and the deployment of routes and aircrafts, in line with market conditions. Avianca has a strong market position in Colombia, Peru, and Central America, mainly due to its routes, frequencies, capacity, and stable load factors.

The company's strategic alliance with United is still under negotiation and is subject to regulatory approval; however, we anticipate that it would enhance the company's business model by increasing its network, routes, and frequencies, strengthening its competitive position, and introducing further operating efficiencies. The company could also benefit from the codesharing agreements closed in 2017 with Singapore Airlines and All Nippon Airlines, which will help it to increase its route offerings and build a presence in Asia. We note that our base case does not incorporate Avianca Brazil's operations because these are not consolidated in Avianca Holdings.

We believe that Avianca's leverage will remain relatively high in the next few years because of the company's debt-financed fleet expansion strategy, aimed at improving capacity and efficiency, and because of new international routes. Those factors notwithstanding, we believe that its metrics will improve gradually as a result of favorable macroeconomic conditions in its key markets along with the normalization of its operations, after the pilots' strike, as well as continued operation efficiencies, and the further incorporation of a new fleet and new routes.

Our issue-level rating on the notes is one notch lower than our corporate credit rating on Avianca, reflecting the structural subordination of the notes to existing secured debt. Under our criteria, aircraft financings are assumed to be senior secured obligations with priority of payment relative to unsecured debt. We note that operating leases are not considered in the calculation. Currently, Avianca's debt priority ratio is about 60% of total debt, leading to a one notch downward adjustment.

Our base-case scenario assumes:

- GDP growth for Colombia and Latin America of about 2.5% and of 2.2% in 2018, respectively, and 2.6% in 2019 for both countries. Overall, this modest demand growth is an improvement compared to 2017 GDP growth of 1.8% and 1.2%, respectively.
- Consumer price index (CPI) inflation in Colombia of 3.7% in 2018 and 3.5% in 2019, compared to 4.1% in 2017, and an average foreign exchange rate of Colombian peso (COP) 2,990 in 2018 and COP3,025 in 2019. CPI inflation indicates a downward trend that could contribute to stability in consumer prices and provide flexibility for fare increases, while reduced foreign exchange volatility will contribute to more stable demand and growth in international routes.

- S&P's WTI crude oil price assumption of \$55 per barrel for 2018 and 2019. This means that, despite the recovery in oil prices, jet fuel prices will remain stable for the next two years, which benefits airline cost structures.
- Revenue growth of about 9% in 2018 and 13% in 2019, mainly driven by the normalization of operations after the pilot strike in the second half of 2017. It also reflects improved regional macroeconomic conditions, expanded capacity as a result of net fleet growth (10 aircrafts in 2018 and 7 aircrafts in 2019), and sustained load factors of around 83% (with higher load factors in routes to Europe and North America).
- Revenue growth further reflects the optimization of fleet deployment, increased passenger volumes (due to economic improvements and visa requirement changes for Colombians citizens traveling to Europe), the consolidation of international routes (particularly Europe and North America), the addition of new routes (North America and South America), and increased frequencies.
- EBITDA growth of about 5% in 2018 and 23% in 2019, reflecting our view that operations will continue to return to normal after 2017 pilot strike, as well as our assumptions of stable fuel prices, cost savings from a newer fleet with lower fuel and maintenance costs, and other operating efficiencies and cost controls.
- Capital spending of about \$670 million in 2018 and \$885 million in 2019, of which about 80% will be delegated for its fleet. The remainder will be used for corporate purposes. We expect the entrance of 53 aircrafts from 2018 to 2022, representing a net growth of 27 aircrafts from 193 in 2018 to 220 in 2020.
- Dividend payments of about \$44 million in 2018 and \$53 million in 2019.
- Net additional debt of about \$313 million in 2018 and \$282 million in 2019, mostly for corporate purposes, such as information technology projects.
- We assume that senior unsecured notes for \$550 million due 2020 are refinanced at maturity.

Based on these assumptions, we arrive at the following credit measures for 2018 and 2019:

- EBITDA margins in the 19.5%-21.5% range;
- Debt to EBITDA of about 4.5x in 2018 and about 4.8x in 2019;
- Funds from operations (FFO) to debt of about 12.5% in 2018 and about 15% in 2019; and
- FFO cash interest coverage in the 4.5x-5.5x range.

### **Liquidity**

We assess Avianca's liquidity as less than adequate, based on our view that the company's sources of liquidity will cover uses by less than 1.2x in the

next 12 months, offering scant protection against unexpected adverse conditions, particularly those related to capital spending commitments associated with fleet maintenance and renewal.

Principal Liquidity Sources:

- Cash and short-term investments of about \$509 million at Dec. 31, 2017, adjusted for restricted cash;
- Working capital inflows of about \$110 million for the following 12 months;
- Projected FFO of about \$400 million for the following 12 months; and
- Issue loans and recovered reserves of about \$215 million.

Principal Liquidity Uses (for the 12 months following Dec. 31, 2017):

- Debt maturities of about \$572 million in 2017;
- Capital spending requirements of about \$547 million for fleet maintenance and renewal; and
- Dividend payments of about \$44 million.

Our liquidity assessment incorporates our view that Avianca is likely unable to absorb low-probability adversities, even factoring in capital spending cuts, asset sales, and reduced shareholder distributions. Avianca's ability to delay or reduce capital spending is limited because of its commitments to fleet maintenance and renewal, as well as market conditions for sale-and-leaseback transactions or aircraft sales. Although Avianca has ample headroom under its financial covenants and generally high standing in credit markets, it does not have a particular core banking relationship.

## Outlook

The stable outlook reflects our expectation that Avianca will post key credit metrics that include debt to EBITDA of about 5.0x and FFO to debt of about 14% in the next 12 months, commensurate with its debt-financed fleet expansion strategy. We also consider that the company will continue to return to normal after the pilots' strike that occurred in the second half of 2017 and will post similar margins in 2018, recovering gradually thereafter thanks to operating efficiencies and benefits from the newer fleet.

### Downside scenario

We could downgrade the company if adverse industry conditions--such as lower-than-expected economic growth and foreign exchange volatility, a prolonged spike in jet fuel prices, increased competition, or the incurrence of additional debt for its fleet renewal program--weaken the company's operating margins and lead to debt to EBITDA of more than 6.0x, FFO to debt below 8% on a sustained basis, or if our liquidity assessment deteriorates as a result of these factors.

## **Upside scenario**

Although unlikely in the short to medium term, we could raise the ratings if the company's operating performance is above our expectations, which would result in debt to EBITDA well below 4.5x and FFO to debt well above 15% on a sustained basis. Such upward movement would result from improved market conditions (such as a boost in regional economic growth or COP appreciation against the dollar) or a significant reduction of debt. We could also raise the ratings if Avianca strengthens its business profile by expanding its operations and bolstering its competitive position, which could result from strategic alliances or organic growth.

## **Ratings Score Snapshot**

Corporate Credit Rating: B/Stable/--

Business risk: Weak

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

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Less than adequate
- Financial policy: Neutral
- Management and governance: Fair
- Comparable rating analysis: Neutral

Stand-alone credit profile: b

## **Related Criteria**

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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

Avianca Holdings S.A.

Corporate Credit Rating	B/Stable/--
Senior Unsecured	B-

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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