BCP Research: Azul (AZULBZ: B2/ CCC+/ B) - Updated FY20 Estimates - Favorable Liquidity, Prefer GOLLBZ 24 Converts

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Summary: We provide our updated thoughts on Brazilian airline, Azul, following better than anticipated 1Q20 results, including healthy EBITDA margins (23%), US$1.3 bn in reported available liquidity and LTM net leverage of 4.3x, balanced by cash burn in 1Q20, led by US$72 mm in realized losses on derivatives. Management's 2Q20 guidance aims at reducing capacity 75-85% y/y, opex reduction of 55% y/y and cash burn of R$3-4 mm/day.

This guidance along with our estimates suggest Azul has sufficient liquidity to make it to year end 2020 in the current demand environment, assuming continued lessor forbearance. We estimate a manageable 5.8x pro-forma LTM net leverage v. an estimated 23% liquidity to LTM revenue for year end 2020. This could be bolstered by the ~US$685 mm (R$4 bn) in BNDES support, agreed upon this week to be split equally between Gol, Azul and LATAM (~US$230 mm/airline). We expect recovery in 2021 could look similar to 2018, a year of weak profitability amidst the truckers strike, unusually strong crude and weak BRL.

Nevertheless, we continue to recognize Gol as THE pick to maintain HY Latin American airline exposure in the current crisis. Gol entered the crisis better positioned than Azul, and updated estimates suggest a stronger exit as well, with positive EBITDA margins through FY20, 4.7x pro-forma LTM net leverage and 36% liquidity to LTM revenue (pre-BNDES financing, assuming no demand recovery from 2Q20 levels). Thus, we reiterate our "Positive" High Octane rating on the GOLLBZ 3.75% 24 convert (45c, 26% Mid YTM) which continues to trade wide to GOLLBZ 25s (50c) while offering a free option on Gol equity.

	Amt (US$ MM)	Ratings (M/SP/F)	Mid Price
AZULBZ 5.875% 10/26/24	400	B2/ CCC+/ B	42.5

<u>Azul BCP Stress Test v. Updated May 2020 Estimates:</u>

We are updating our 2020 estimates for Azul (originally published as our COVID-19 Stress Test), which are substantially improved from our prior estimates and reflect recent results and management's 2Q20 and FY20 guidance. Azul entered 2Q with higher liquidity and a deeper cut to operating expenses (55% y/y in 2Q20 vs. our previous estimate of 42% y/y).

Our updated estimates assume a revenue curve similar to that of Gol (-70% y/y) and stable expense reductions for the remaining quarters of FY20. Guided measures include a 50% y/y reduction in payroll and a 75-85% reduction in capacity, which dictates our estimated reduction in variable costs. These, alongside our estimated 30% reduction in sales and marketing and other expenses, result in a 55% reduction in operating expenses y/y, in line with company guided estimates for 2Q20. Based on the aforementioned revenue curve and expense cuts, EBITDA margins are expected to be negative in 2Q20. Importantly, we assume 100% deferral of aircraft lease payments for the remainder of FY20, in line with guidance, compared to 80% deferral at Gol. In addition, we assume zero capex and deferral of all maintenance. These are balanced by continued servicing of interest payments to arrive at management's guided cash burn (assume pre-working capital) of R$3-4 mm/day for 2Q20.

Azul reported a total of US$1.3 bn in available liquidity at end-1Q20, comprised of US$243 mm in cash, US$174 mm in accounts receivable, US$180 mm in LT receivables related to its investment in TAP, US$423 mm in deposits and maintenance reserves and US$273 mm in unencumbered assets. We measure liquidity based on two of these elements: cash and A/R, totaling US$243 mm for Azul (vs. US$727 mm for Gol). Based on 1Q20 results and management guidance, we think the airline would have sufficient liquidity to fund operations through FY20 assuming NO improvement in demand from 2Q20 levels.

Azul (US$MM)	Stress Test Analysis March '20 (WK Support)					*UPDATED* May 2020 Estimates (WK Support)				
	1Q20E	2Q20E	3Q20E	4Q20E	2020E	1Q20A	2Q20E	3Q20E	4Q20E	2020E
Revenue	**421**	**50**	**223**	**404**	**1,097**	**627**	**145**	**162**	**181**	**1,115**
EBITDA	**(37)**	**(146)**	**1**	**165**	**(17)**	**146**	**(13)**	**6**	**24**	**163**
EBITDA margin	*(9%)*	*(290%)*	*0%*	*41%*	*(2%)*	*23%*	*(9%)*	*4%*	*13%*	*15%*
Capex	(56)	(50)	(50)	(50)	(204)	(50)	-	-	-	(50)
Interest Paid	(61)	-	-	-	(61)	(63)	(59)	(43)	(53)	(218)
Taxes Paid	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Cash Lease	(127)	-	-	-	(127)	(33)	-	-	-	(33)
Working Capital	(109)	138	(91)	(88)	(149)	(62)	65	(26)	(25)	(48)
Simplified FCF	**(354)**	**(57)**	**(140)**	**28**	**(523)**	**(62)**	**(7)**	**(64)**	**(54)**	**(187)**
Cash	**71**	**14**	**(126)**	**(99)**	**(99)**	**243**	**223**	**159**	**105**	**105**
Accounts Receivable	133	0	8	154	154	175	123	141	157	157
BCP Defined Liquidity	**203**	**14**	**(118)**	**55**	**55**	**418**	**346**	**299**	**262**	**262**
Debt	**2,871**	**3,377**	**3,883**	**4,389**	**4,389**	**3,968**	**3,964**	**3,985**	**4,007**	**4,007**
Net Debt	**2,801**	**3,364**	**4,010**	**4,488**	**4,488**	**3,724**	**3,741**	**3,827**	**3,902**	**3,902**
LTM Revenue	3,081	2,330	1,618	1,098	1,098	2,848	2,861	1,725	1,115	1,115
LTM EBITDA	856	533	219	(17)	(17)	868	668	438	163	163
Leverage	3.4x	6.3x	17.7x	-	-	4.6x	5.9x	9.1x	24.6x	24.6x
Net Leverage	3.3x	6.3x	18.3x	-	-	4.3x	5.6x	8.7x	23.9x	23.9x
Pro-Forma LTM Leverage	**4.2x**	**5.0x**	**5.7x**	**6.5x**	**6.5x**	**5.9x**	**5.8x**	**5.9x**	**5.9x**	**5.9x**
Pro-Forma LTM Net Leverage	**4.1x**	**5.0x**	**5.9x**	**6.6x**	**6.6x**	**5.5x**	**5.5x**	**5.6x**	**5.8x**	**5.8x**
Cash to LTM Revenue	**2%**	**1%**	**(8%)**	**(9%)**	**(9%)**	**9%**	**8%**	**9%**	**9%**	**9%**
Liquidity to LTM Revenue	**7%**	**1%**	**(7%)**	**5%**	**5%**	**15%**	**12%**	**17%**	**23%**	**23%**
Avg. FX:	*4.42*	*5.04*	*5.04*	*5.04*		4.47	5.40	5.52	5.52	
End FX:	*5.04*	*5.04*	*5.04*	*5.04*		5.21	5.52	5.52	5.52	

Azul v. Gol - Updated May 2020 Estimates:

Nevertheless, our revised estimates continue to highlight Gol as THE pick to maintain HY Latin American airline exposure in the current crisis. Gol entered the crisis with higher margins and liquidity, lower leverage and lower international exposure than Azul. Updated estimates, which assume 70% lower revenues for the remainder of FY20, suggest Gol would maintain positive EBITDA margins (6%) in 2Q20 on 80% lower capacity, opex cost cuts v. Azul's negative EBITDA at 75-85% lower capacity, 55% opex cost cuts.

Both airlines appear to have sufficient liquidity. However, our model suggests Gol will end the year with a substantially higher BCP calculated liquidity balance (cash and A/R), while still funding a portion of its capex, interest and cash lease payments.

Azul benefits from its ability to deploy a diverse fleet of aircraft to meet capacity needs in the short-term. Yet, ultimately, Azul's fleet structure is more rigid and poised for growth in a market expected to contract. Meanwhile, Gol appears better positioned long-term for the consensus expectation that the travel market will be smaller for longer, with 1/3 of its fleet on shorter term leases and the ability to negotiate delivery terms with Boeing. While it is unlikely 2021 will look like 2019 or pre crisis expectations for 2020, we do believe travel will eventually recover, likely in line with more broadly available testing. We expect 2021 profitability will more likely reflect that of 2018, when the truckers strike coincided with unusually strong crude and weak BRL, resulting in weak profitability. If guidance is realized, we estimate Gol would have 36% liquidity to LTM revenue and pro-forma LTM net leverage of 4.7x at year-end v. Azul's 23% liquidity to LTM revenue and 5.8x pro-forma LTM net leverage.

Given its sizable liquidity advantage and more flexible fleet structure, we continue to advocate investors focus on Gol for Latin American airline exposure through the crisis.

UPDATED May 2020 Estimates (WK Support)	AZUL					GOL				
	1Q20A	2Q20E	3Q20E	4Q20E	2020E	1Q20A	2Q20E	3Q20E	4Q20E	2020E
Revenue	**627**	**145**	**162**	**181**	**1,115**	**704**	**166**	**163**	**163**	**1,197**
EBITDA	**146**	**(13)**	**6**	**24**	**163**	**151**	**10**	**10**	**10**	**182**
EBITDA margin	*23%*	*(9%)*	*4%*	*13%*	*15%*	*21%*	*6%*	*6%*	*6%*	*15%*
Capex	(50)	-	-	-	(50)	(52)	(35)	(34)	(34)	(154)
Interest Paid	(63)	(59)	(43)	(53)	(218)	(52)	(10)	(50)	(10)	(123)
Taxes Paid	(0)	(0)	(0)	(0)	(0)	(6)	(21)	(8)	(10)	(44)
Cash Lease	(33)	-	-	-	(33)	(94)	(16)	(15)	(15)	(141)
Working Capital	(62)	65	(26)	(25)	(48)	(123)	12	-	-	(111)
Simplified FCF	**(62)**	**(7)**	**(64)**	**(54)**	**(187)**	**(177)**	**(58)**	**(97)**	**(59)**	**(391)**
Cash	**243**	**223**	**159**	**105**	**105**	**575**	**485**	**388**	**329**	**329**
Accounts Receivable	175	123	141	157	157	152	122	122	122	122
BCP Defined Liquidity	**418**	**346**	**299**	**262**	**262**	**727**	**607**	**510**	**451**	**451**
Debt	**3,968**	**3,964**	**3,985**	**4,007**	**4,007**	**3,259**	**3,317**	**3,378**	**3,439**	**3,439**
Net Debt	**3,724**	**3,741**	**3,827**	**3,902**	**3,902**	**2,684**	**2,832**	**2,990**	**3,110**	**3,110**
LTM Revenue	2,848	2,861	1,725	1,115	1,115	3,364	3,446	1,958	1,197	1,197
LTM EBITDA	868	668	438	163	163	1,058	891	587	182	182
LTM Leverage	4.6x	5.9x	9.1x	24.6x	24.6x	3.1x	3.7x	5.8x	18.9x	18.9x
LTM Net Leverage	4.3x	5.6x	8.7x	23.9x	23.9x	2.5x	3.2x	5.1x	17.1x	17.1x
Pro-Forma LTM Leverage	**5.9x**	**5.8x**	**5.9x**	**5.9x**	**5.9x**	**4.9x**	**5.0x**	**5.1x**	**5.2x**	**5.2x**
Pro-Forma LTM Net Leverage	**5.5x**	**5.5x**	**5.6x**	**5.8x**	**5.8x**	**4.0x**	**4.3x**	**4.5x**	**4.7x**	**4.7x**
Cash to LTM Revenue	**9%**	**8%**	**9%**	**9%**	**9%**	**17%**	**14%**	**20%**	**26%**	**26%**
Liquidity to LTM Revenue	**15%**	**12%**	**17%**	**23%**	**23%**	**22%**	**17%**	**26%**	**36%**	**36%**
Avg. FX (5-5-20):	*4.47*	*5.40*	*5.52*	*5.52*		*4.47*	*5.40*	*5.52*	*5.52*	
End FX (5-5-20):	*5.21*	*5.52*	*5.52*	*5.52*		*5.21*	*5.52*	*5.52*	*5.52*	

Review of Azul 1Q20 Financial Results:

- As of end-1Q20, the company has a total of 138 aircraft, of which 49 are next-generation, which account for 55% of total 1Q20 capacity
    - Azul has been operating 15-20 aircraft since April 2020
- RPK's grew by 10.8% y/y on capacity growth of 12.0%
- Load factor contracted 87 bps y/y and 237 bps q/q to to 81.0%
- Average fare increased by 5.5% y/y in BRL, and yields decreased 1.6% y/y to 35.17 cents in BRL
- Revenue decreased 7% y/y and 21% q/q in USD terms to US$627 mm
    - We highlight revenues increased 10% y/y in BRL terms on stronger demand in January and February and a 12% growth in capacity
- EBITDA decreased 24% y/y and 51% q/q to US$146 mm
- Azul's EBITDA margin contracted 514 bps y/y and 1,447 bps q/q to 23%
- Free cash flow was negative US$62 mm on weaker EBITDA and WK outflow, which outpaced substantial capex reductions
    - Capex contracted 56% q/q to US$50 mm
    - Interest payments decreased 4% q/q to US$63 mm
    - Working capital was negative US$62 mm
    - Cash lease payments decreased 64% q/q to US$33 mm
- Cash and equivalents decreased 43% q/q to US$243 mm, while liquidity decreased 41% q/q to US$418 mm
- Cash to LTM revenue and Liquidity to LTM revenue were 9% (-485 bps y/y, -612 bps q/q) and 15% (-1,260 bps y/y, -999 bps q/q), respectively
- Net Debt increased 8% q/q to US$3,724 mm with pro forma net leverage expanding to 4.3x

Azul (US$MM)	1Q20	4Q19	3Q19	2Q19	1Q19	y/y	q/q
Revenue	**627**	**790**	**763**	**668**	**675**	**(7%)**	**(21%)**
EBITDA	**146**	**299**	**236**	**187**	**192**	**(24%)**	**(51%)**
EBITDA margin	23%	38%	31%	28%	28%	(514 bps)	(1,447 bps)
Capex	(50)	(113)	(85)	(57)	(122)	(59%)	(56%)
Interest paid	(63)	(66)	(54)	(74)	(52)	22%	(4%)
Taxes paid	(0)	(0)	(0)	(0)	(0)	-	-
Working capital	(62)	66	54	78	(86)	-	(194%)
FCF (before cash lease payments)	**(29)**	**186**	**150**	**135**	**(67)**	**(57%)**	**(116%)**
Cash lease payments	(33)	(93)	(100)	(72)	(83)	(60%)	(64%)
FCF	**(62)**	**93**	**50**	**63**	**(150)**	**(59%)**	**(167%)**
Gross Debt	**3,968**	**3,882**	**3,364**	**3,282**	**3,178**	**25%**	**2%**
Operating and finance lease liabilities	3,046	3,008	2,547	2,490	2,403	27%	1%
Other aircraft loans and financing	251	263	201	172	147	71%	(5%)
Loans and financing	672	611	615	620	628	7%	10%
Net Debt	**3,724**	**3,457**	**2,988**	**2,899**	**2,845**	**31%**	**8%**
Cash and equivalents	**243**	**425**	**376**	**383**	**333**	**(27%)**	**(43%)**
Cash and cash equivalents	102	409	366	315	232	(56%)	(75%)
Short-term investments	142	15	10	68	101	40%	820%
Liquidity	**418**	**714**	**719**	**748**	**678**	**(38%)**	**(41%)**
Accounts Receivable	175	290	343	365	345	(49%)	(40%)
Cash/LTM Revenue	**9%**	**15%**	**14%**	**15%**	**13%**	**(485 bps)**	**(612 bps)**
Liquidity/LTM Revenue	**15%**	**25%**	**26%**	**29%**	**27%**	**(1,260 bps)**	**(999 bps)**
Gross Leverage	**6.8x**	**3.2x**	**3.6x**	**4.4x**	**4.1x**	**2.7x**	**3.5x**
Net Leverage	**6.4x**	**2.9x**	**3.2x**	**3.9x**	**3.7x**	**2.7x**	**3.5x**
Pro Forma Gross Leverage (Gross Debt (incl op leases) / Trailing LTM EBITDA)	**4.6x**	**4.2x**	**4.1x**	**4.3x**	**4.4x**	**0.2x**	**0.3x**
Pro Forma Net Leverage (Net Debt (incl op leases) / Trailing LTM EBITDA)	**4.3x**	**3.8x**	**3.7x**	**3.8x**	**3.9x**	**0.4x**	**0.5x**

Megan E. McDonald
Investment Research Analyst
BCP Securities, LLC

289 Greenwich Avenue, Ste 4
Greenwich, CT 06830
+1-203-629-2185 ext. 312
mmcdonald@bcpsecurities.com
www.bcpsecurities.com

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