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Equity Research

LATAM Airlines Group – Equity Report

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ABSTRACT

This report contains the description of a valuation performed on LATAM Airlines, the largest airline in South America. This study was conducted by analyzing the factors that may affect the company's value. In this individual part a deep-dive into the possibility of defaulting was performed. This risk is perceived as substantial. An estimated share price of 2.26\$ (the target value for the 31st of December 2020) was computed, which leads us to recommend investors to sell their position in LATAM Airlines.

*THIS REPORT WAS PREPARED EXCLUSIVELY FOR ACADEMIC PURPOSES BY [INSERT STUDENT'S NAME], A MASTER IN FINANCE STUDENT OF THE NOVA SCHOOL OF BUSINESS AND ECONOMICS. THE REPORT WAS SUPERVISED BY A NOVA SBE FACULTY MEMBER, ACTING IN A MERE ACADEMIC CAPACITY, WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL.
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Individual Part – Lukas Maasch

The Impact of COVID-19 on the LATAM airlines group with respect to the increasing risk of default and respective effect on the share price

Regarding the valuation of LATAM, we faced unique difficulties considering the current worldwide situation. To capture all that in detail in the report in 32 pages was not possible. Therefore, I would like to use these additional 5 pages to deep dive and explain our reasoning behind the bankruptcy risk and the respective probability weighted reduction in the share price, which in the report was just mentioned very quickly in order not to breach the page limit.

The impact of the Covid19 pandemic on the aviation industry is an incomparable event. On average 90% of the fleets of most European airlines are grounded and LATAM as well only operates 5% of its normally scheduled flights. Consequently, this puts pressure on the company as revenues are cut, but fixed costs, such as Wages & Benefits, are still incurring. Furthermore, the industry characterizes itself to typically have high leverage ratios and thus high interest expenses. Prior to the Covid19-pandemic, in 31st December 2019 LATAM was estimated to have a D/E ratio of 1.59 slightly higher than the average of the peer group estimated to be around 1.27. Although being considered as a cyclical industry these high leverage ratios are justified by the high amount of fixed assets in the form of airplanes, which are used as a collateral or a security. However, under the current circumstances it needs to be assumed that the market value of pre-owned airplanes in the secondary market probably decreased significantly. The pandemic is affecting airlines all around the world and hence the demand for pre-owned airplanes is at a minimum. Additionally, the future outlook is unknown and many airlines plan to downsize their operations and fleet.

The high interest expenses combined with the current cash burning leads to a significant threat of default if the company is unable to raise new funds. This increased risk of default is also observable in the reaction of investors, namely the cost of debt and the share price. The yield on LATAM's corporate bond has gone up from 4.8% (February 2020) to 7.0% (April 2020). A further event that is important to mention happened on the 17th of March 2020. On that date LATAM's stock decreased from 3.38 USD the day prior to 1.76 USD, which reflects a decrease in value of 49%. This decrease was initiated by a statement of the Chilean economy minister Lucas Palacio that opposed a bailout by the Chilean government: “We are prioritizing people and I

think it's rushed. I think it's wishful thinking, for one company to be asking something of that nature.”¹ Those two events depict the sensitivity of investors to the increased probability of default and their perception that LATAM is depending on government aid.

In order to assess this risk of default we performed a monthly forecast of Cash-Flows for 2020 to assess what magnitude the current Cash-Outflows have and if LATAM will run out of cash to serve its obligations in the near future. Firstly, the current (with date of 31st March 2020) available cash & equivalents were estimated at about 1.13bn USD for the end of March 2020:

| | 31.12.2019 | 31.03.2020 |
|-----------------------------|------------|------------------|
| Cash | 1.072.579 | |
| +Current Financial Assets | 499.504 | |
| +Receivables | | 1.244.348 |
| -Liabilities within 90 days | | 2.287.910 |
| = | | 528.521 |
| +Credit Line Facility | | 600.000 |
| Cash available 31.03.2019 | | 1.128.521 |

Exhibit 1: Cash available 31.03.2019

Based on the cash available and the estimated cash flows for the next 9 months, the month of bankruptcy without additional financing was estimated to be in July 2020.

| | Mrz 20 | Apr 20 | Mai 20 | Jun 20 | Jul 20 | Aug 20 | Sep 20 | Okt 20 | Nov 20 | Dez 20 |
|---|------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Passenger Revenue | 469.010 | 19.763 | 19.763 | 54.201 | 119.051 | 188.745 | 258.440 | 309.739 | 344.586 | 379.433 |
| -Brazil | 166.758 | 8.654 | 8.654 | 25.962 | 54.088 | 75.724 | 97.359 | 118.994 | 129.812 | 140.629 |
| -SSC | 93.391 | 4.847 | 4.847 | 14.542 | 30.296 | 42.414 | 54.532 | 66.650 | 72.709 | 78.768 |
| -International | 220.961 | 6.772 | 6.772 | 15.096 | 37.739 | 75.478 | 113.217 | 132.086 | 150.955 | 169.825 |
| -other | -12.100 | -510 | -510 | -1.398 | -3.071 | -4.870 | -6.668 | -7.991 | -8.890 | -9.789 |
| Cargo Revenue | 81.463 | 61.494 | 61.494 | 61.494 | 73.792 | 90.338 | 90.338 | 90.338 | 90.338 | 90.338 |
| Other Revenue | 13.123 | 1.937 | 1.937 | 2.758 | 4.597 | 6.653 | 8.315 | 9.538 | 10.369 | 11.199 |
| Total Revenue | 563.597 | 83.194 | 83.194 | 118.453 | 197.441 | 285.737 | 357.093 | 409.615 | 445.293 | 480.971 |
| Total Costs | -536.983 | -235.641 | -235.641 | -247.797 | -274.791 | -307.821 | -334.514 | -354.161 | -367.508 | -380.854 |
| Employees | -112.173 | -74.782 | -74.782 | -74.782 | -74.782 | -74.782 | -74.782 | -74.782 | -74.782 | -74.782 |
| Fuel | -160.112 | -23.635 | -23.635 | -33.651 | -56.091 | -81.175 | -101.447 | -116.368 | -126.503 | -136.639 |
| Other | -264.699 | -137.224 | -137.224 | -139.364 | -143.918 | -151.864 | -158.285 | -163.012 | -166.223 | -169.433 |
| EBITDA | 26.613 | -152.447 | -152.447 | -129.344 | -77.350 | -22.084 | 22.579 | 55.454 | 77.785 | 100.117 |
| D&A | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 | -122.498 |
| NOPLAT | | -274.945 | -274.945 | -251.842 | -199.848 | -144.582 | -99.919 | -67.044 | -44.713 | -22.381 |
| Operating CF | | -152.447 | -152.447 | -129.344 | -77.350 | -22.084 | 22.579 | 55.454 | 77.785 | 100.117 |
| CAPEX | | -36.268 | -36.268 | -36.268 | -36.268 | -36.268 | -36.268 | -36.268 | -36.268 | -36.268 |
| FCF | | -188.714 | -188.714 | -165.611 | -113.617 | -58.351 | -13.688 | 19.186 | 41.518 | 63.849 |
| Debt Payment to outstanding Liabilities | | 136.284 | 136.284 | 136.284 | 136.284 | 136.284 | 136.284 | 136.284 | 136.284 | 136.284 |
| Cumulative Cash | 1.128.521 | 803.522 | 478.524 | 176.628 | -73.274 | -267.909 | -417.882 | -534.980 | -629.746 | -702.181 |

Exhibit 2: Cash-Outflows and Date of Bankruptcy

This is in line with the statements of Santiago Alvarez, LATAM's president for Colombia, who stated on the 15th April 2020 the company will have cash for around three to four months.² These estimations are also more

¹ Reuters: Latam carriers see 'bankruptcy pandemic' risk, Chile opposes bailout

² Reuters: LATAM Airlines will need government loans to recover after Covid19

or less in line with the estimations of FitchRatings.³ Fitch stated that LATAM will likely face Cash-Outflows of around \$600 mln in the second quarter of 2020. A further cross-check with the Lufthansa AG was performed, as Lufthansa CEO Carsten Spohr stated in the beginning of April that the Lufthansa AG faces Cash-Outflows of €1mln every hour.⁴ Converting this value to monthly figures and adjusting for the smaller size of LATAM results in estimated Cash-Outflows of \$204mln each month in the periods of a complete lockdown and travel restrictions. This namely represents April and May in LATAM's case. In July LATAM plans to increase its capacity back to 20% of their normal scheduled flights (5% in April and May).⁵ In our model we assumed in the domestic segment 15% capacity in June and 65% capacity at the end of the year 2020. Furthermore, on 19th March 2020 LATAM announced to cut wages by 50% of its 43.000 employees. This effect was incorporated in the forecast of the otherwise assumed fixed Wages & Benefit expenses. Ultimately, we estimate that without additional new financing, LATAM will run out of cash in July 2020.

This results in three different possible scenarios. In the first scenario, LATAM is able to raise new financing, which is also the most likely in our opinion. The two alternatives are filing for bankruptcy, either Chapter 7 - Liquidation, or Chapter 11 - Restructuring. It is realistic to assume that LATAM in the case of bankruptcy will file for Chapter 11 bankruptcy in the US due to the higher chance of a successful restructuring. This is supported by the fact that LATAM is listed on the New York Stock Exchange and Avianca filed for Chapter 11 bankruptcy in the US on 10th May 2020 due to not receiving aid of the Colombian government.⁶

Liquidation: This is the most unlikely scenario in our opinion. Even though LATAM did not create a lot of value for their investors (only the ROIC in 2019 was comparable to its WACC), the company is assumed to be systematically relevant and is assumed to have a slightly positive outlook under normal circumstances. Furthermore, as explained later in detail, the current estimated liquidation equity value is assumed to be far inferior than its normal equity value, as asset values are expected to be valued at a discount. It would be therefore not favourable for the equity holders to liquidate at the current time. Although the future outlook and the date when passenger numbers will be back to previous levels is difficult to estimate, we estimate that by 2023 LATAM is going to create strong cash-flows. However, in order to assess the most realistic scenario we have to look into the concrete values resulting from each scenario:

³ FitchRatings: Rating Report: LATAM Airlines Group (26th March 2020)

⁴ Boerse.ard: Wann steigt der Staat ein? Lufthansa verliert eine Million Euro pro Stunde

⁵ El Diario Financiero: Latam retomará rutas internacionales y espera tener casi 20% de operación en julio

⁶ CNN: Avianca, one of Latin America's largest airlines, files for bankruptcy.

| Assets: | Book Value | Liquidation recovery | Liquidation Value | Liquidation Value | 12.440.450 |
|--|-------------------|----------------------|-------------------|--|-------------|
| Cash, and cash equivalents | 1.072.579 | 100% | 1.072.579 | Direct bankruptcy costs (4% of EV; Lawless & Ferris) | 453.720 |
| Other financial assets | 499.504 | 100% | 499.504 | Non-financial Liabilities | 7.542.551 |
| Other non-financial current assets | 313.449 | 70% | 219.414 | Financial Liabilities | 10.416.078 |
| Trade and other accounts receivable | 1.244.348 | 70% | 871.044 | | |
| Accounts receivable from related entities | 19.645 | 0% | 0 | Equity Value | (5.971.899) |
| Inventories | 354.232 | 50% | 177.116 | | |
| Tax assets | 29.321 | 100% | 29.321 | | |
| Non-current assets and disposal groups held for sale | 485.150 | 50% | 242.575 | | |
| Total current assets | 4.018.228 | | | | |
| Property and Equipment - own aircraft | 9.363.043 | 60% | 5.617.826 | | |
| Property and Equipment - leasing | 2.869.698 | 100% | 2.869.698 | | |
| Property and Equipment - rest | 686.877 | 60% | 412.126 | | |
| Goodwill | 2.209.576 | 0% | 0 | | |
| Intangible assets other than goodwill - net | 1.448.241 | 0% | 0 | | |
| Accounts Receivable (non-current) | 4.725 | 70% | 3.308 | | |
| Non-current Tax Assets | 0 | 0% | 0 | | |
| Deferred Tax Assets | 235.583 | 100% | 235.583 | | |
| Other non-current Financial Assets | 46.907 | 100% | 46.907 | | |
| Other non-financial non-current assets | 204.928 | 70% | 143.450 | | |
| Total non-current assets | 16.577.435 | | | | |
| SUM | 21.087.806 | | 12.440.450 | | |

Exhibit 3: Liquidation Scenario

The liquidation value represents \$12.5bln, which is mostly due to high discount on the Property, Plant & Equipment. As most planes would have to be liquidated within a short-term time period of around 1 year and the current situation is very unfavorable due to the minimum of demand for airplanes, we adjusted PP&E planes by a 60% discount to the current book values. With respect to this liquidation value, the Financial Debt would not be fully recovered, and equity holders would lose their complete value. Thus, the share price for this scenario is 0.

Restructuring: As examined in the Liquidation scenario, the amount of outstanding debt highly exceeds the liquidation value and equity holders would face a total loss. Therefore, we believe debt holders have a strong bargaining power in the process. As well as in the most cases of Chapter 11 bankruptcies, equity holders would probably either face a total loss in value or a strong dilution in shares. Common practice is a Debt-to-Equity Swap or the elimination of previous share and issuance of new shares with a low conversion rate for previous shareholders.⁷ However, this possible dilution is at the moment completely uncertain as it depends on the concrete offer to debt holders and possible new investors (in debt or equity), such as the government. According to the strong bargaining power of debt holders we assume that equity holders recover 10% of their value. If this scenario would be completely certain today, the share price should trade therefore at \$0.275.

Government Aid: An out-of-court solution is still the most realistic scenario with date of today. In general, LATAM is a company that is essential for the countries and governments should have an incentive to protect

⁷ Westdeutsche Zeitung: Was mit Aktien bei einer Insolvenz passiert

the employees. At the moment the only announced government aid package comes from the Brazilian Development Bank BNDES, which amounts to \$341mln.⁸ This is substantially less than what Azul, Gol and LATAM Airlines had been hoping to receive (\$1bn).⁹ According to Fitch LATAM is in discussion about aid packages with the governments of Chile and Peru. However, with information of 18th May 2020, El Diario Financiero reports that there was a meeting between high officials of LATAM and the government of Chile, but at the moment there is no negotiation and progress in the request for government aid formulated by LATAM.¹⁰ The possibility of no government aid is the main reasons for this scenario analysis. We conducted a scenario analysis including all three possible outcomes by assigning a probability of additional government loans and out-of-court solution and a probability of entering a formal bankruptcy. This is further divided into 20% chance of liquidation and a 80% chance of a successful Chapter 11 – Restructuring.

| Scenario Analysis | |
|-------------------------------|-------------|
| Probability of formal default | Share Price |
| 0% | 2,77 |
| 10% | 2,51 |
| 20% | 2,26 |
| 30% | 2,00 |
| 40% | 1,75 |
| 50% | 1,49 |
| 60% | 1,24 |
| 70% | 0,99 |
| 80% | 0,73 |
| 90% | 0,48 |
| 100% | 0,22 |

Exhibit 4: Scenario Analysis, based on different probabilities of default

Exhibit 3 describes the Share Price according to the probability of a formal default by declaring bankruptcy. From our perspective, most realistically the probabilities of default are between 20 and 30% regarding the current situation and thus we estimate an interval of our share price between 2.26 and 2.00 USD.

⁸ FitchRatings: Fitch downgrades several Latin American Airlines (19th May 2020)

⁹ Reuters: Government aid for Brazil’s airlines shrinks, while Panama’s Copa shrugs off bailout.

¹⁰ El Diario Financiero: LATAM no ve avances en su plan de financiamiento con Chile (18th May 2020)