



**28 February 2020**

ASX Market Announcements Office  
Australian Securities Exchange  
20 Bridge Street  
Sydney NSW 2000

## **S&P Global Ratings Outlook Update**

Virgin Australia Holdings (ASX: VAH & VAHHA) provides the attached S&P Global Ratings report for release to the market, revising its ratings outlook for the Group.

**ENDS**

**This announcement was authorised for release by Virgin Australia CEO and Managing Director, Paul Scurrah.**

**For further information please contact:**

Virgin Australia Public Affairs  
1800 142 467  
[publicaffairs@virginaustralia.com](mailto:publicaffairs@virginaustralia.com)

Virgin Australia Investor Relations  
[investor.relations@virginaustralia.com](mailto:investor.relations@virginaustralia.com)

Research Update:

# Virgin Australia Outlook Revised To Negative On Industry Downturn; Ratings Affirmed

February 28, 2020

## Rating Action Overview

- A combination of issues—the new coronavirus (COVID-19) outbreak, prolonged bushfire season, and softer economic conditions—has reduced domestic passenger demand in Australia.
- In our view, Virgin Australia Holdings Ltd.'s debt-to-EBITDA ratio may exceed 6.0x for the year-ended June 30, 2020, despite concerted efforts to reduce capacity, exit loss-making routes, and accelerate cost reduction and fleet simplification initiatives.
- On Feb. 28, 2020, S&P Global Ratings revised its outlook on Virgin Australia to negative from stable. We also affirmed the 'B+' long-term issuer credit rating on the company and 'B' issue credit rating on the company's debt. The recovery ratings on the debt remain unchanged at '5'.
- The negative outlook reflects our view that challenging industry conditions over the next six months are likely to pressure Virgin Australia's earnings profile. Under our base-case operating scenario, there is an elevated risk that adjusted debt to EBITDA could exceed 6x in fiscal 2020 before recovering below 6x in fiscal 2021.

### PRIMARY CREDIT ANALYST

**Joel Yap**  
Melbourne  
(61) 3-9631-2196  
joel.yap  
@spglobal.com

### SECONDARY CONTACT

**Craig W Parker**  
Melbourne  
(61) 3-9631-2073  
craig.parker  
@spglobal.com

## Rating Action Rationale

**We revised the outlook to negative based on our expectation that restrictions on inbound tourism from Chinese nationals will cut Virgin Australia's earnings for fiscal 2020.** Given Virgin Australia's modest direct international exposure, the fallout will mainly affect domestic earnings. Inbound tourists from China typically fly several domestic segments during their visit. At this stage, the company anticipates the COVID-19 outbreak to reduce the airline's earnings by A\$50 million to A\$75 million. In addition, Australia's prolonged bushfire season and softer economic conditions are contributing to a broader industry downturn.

**We anticipate adjusted debt to EBITDA is at an elevated risk of exceeding 6x in fiscal 2020.** The carrier was left with limited ratings headroom following its repurchase of 35% interest in its Velocity frequent flyer business. Further, we anticipate the costs of implementing the group's transformation program will weigh on earnings over the next six months at least.

**In our view, the length and severity of COVID-19 will largely determine Virgin Australia's earnings recovery.** At this stage, we expect the bulk of the COVID-19 fallout to occur over the first two quarters of calendar 2020. This implies that external conditions should recover in fiscal 2021. In addition, we expect benefits of the group's transformation program to flow through earnings for fiscal 2021.

**We expect Virgin Australia's initiatives to reduce its cost base and simplify its fleet should improve the airline's longer-term sustainability.** The carrier has flagged capacity reduction of 3% in fiscal 2020 and 5% in fiscal 2021. We expect a capacity reduction of this magnitude to reduce Virgin Australia's cost base and support broader industry fundamentals. In addition, we expect the exit of loss-making routes, reduced headcount and leaner cost base, fleet simplification, and 100% retention of Velocity earnings to support the carrier's longer-term financial health.

**Australia's duopoly-like domestic market supports airlines' profitability and reduces capital expenditure demands.** Qantas Airways and Virgin Australia--the two dominant domestic carriers--have signaled their intention to reduce capacity in the face of weaker demand conditions. Virgin Australia's fleet remains the youngest in the Australian domestic market, which we believe provides it some scope to reduce new aircraft deliveries.

## **Outlook**

The negative outlook reflects our view that challenging industry conditions over the next six months are likely to pressure Virgin Australia's fiscal 2020 earnings profile. We forecast that adjusted debt to EBITDA may exceed 6x in fiscal 2020 before recovering below 6x in fiscal 2021.

The outlook also reflects our view that there is a degree of uncertainty regarding Virgin Australia's ownership structure and the willingness of its owners to provide timely and coordinated funding support in the event of severe financial stress.

## **Downside scenario**

We could lower the rating if industry conditions worsen beyond our expectations, such that we expect the group's adjusted debt-to-EBITDA ratio remains elevated above 6.0x in fiscal 2021, free operating cash flow becomes materially negative, or if liquidity pressures intensify.

We could also lower the rating if we expect Virgin Australia's owners to be collectively less likely to support the carrier during periods of severe financial stress.

## **Upside scenario**

We could revise the outlook to stable if we believe Virgin Australia will successfully execute on its operating strategy such that improved profitability and cash generation enable forecast adjusted debt to EBITDA to maintain below 6.0x in fiscal 2021, supported by adequate liquidity.

## **Company Description**

Virgin Australia Holdings Ltd. operates a domestic and international airlines business in Australia. It operates through Virgin Australia Domestic, Virgin Australia International, and its low cost airline Tigerair Australia. In addition, Virgin has operations across cargo transportation,

fly-in/fly-out charter, and a frequent flyer program, Velocity.

The company was formerly known as Virgin Blue Holdings Limited and change its name to Virgin Australia Holdings Limited in 2011. Virgin Australia is currently 90%-owned by Etihad Airways, Singapore Airlines, Nanshan Group, HNA Group, and Virgin Group. Virgin Australia is not a member of any of the airline alliances. However, the airline does maintain strategic commercial alliances with Etihad Airways P.J.S.C, Singapore Airlines Ltd., Delta Airways, and more recently, HNA Aviation Group Co. Ltd.

## **Our Base-Case Scenario**

- Australian real GDP growth of about 2.2% and 2.3% through calendar 2020 and 2021, respectively;
- Weakening domestic market conditions combined with lower inbound tourism;
- Single digit decline in available seat kilometers (capacity) in the domestic and international routes;
- Flat revenue-seat-factor growth (capacity utilization) on domestic routes due to slowing economy;
- Broadly flat domestic yield and downward pressure on international yield;
- Brent crude oil price assumption of US\$60 per barrel for calendar 2020 and US\$55 per barrel for calendar 2021;
- Higher implementation costs in fiscal 2020 associated with group restructuring initiatives, with benefits to flow through in fiscal 2021;
- Our assumption of A\$750 million of restricted cash; and
- Capital expenditure to remain moderate in fiscal 2020 with the deferral of Boeing 737-Max planes.

Based on these assumptions, we arrive at the following adjusted credit measures for the years ending June 30, 2020 and 2021:

- Adjusted debt to EBITDA potentially exceeding 6.0x in fiscal 2020 before recovering below 6.0x in fiscal 2021; and
- Free cash flow to debt of less than 5% in fiscal 2020 and 2021.

## **Liquidity**

Virgin Australia's liquidity position is adequate. We expect the group's sources of liquidity to exceed its uses by more than 1.2x over the next 12 months, and expect sources to exceed uses even if EBITDA were to decline by 30%--the minimum we expect under our criteria covering airlines. The company has a manageable debt-maturity profile over the next two years.

We expect Virgin Australia to have the following sources and uses of liquidity over the next 12 months:

Principal liquidity sources:

- Unrestricted cash and short-term investments of A\$900.3 million as of Dec. 31, 2019;

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- About A\$166 million in undrawn bank facilities as of Dec. 31, 2019; and
- Cash funds from operations of above A\$100 million after lease payments.

Principal liquidity uses:

- Minimal debt maturities over the 12 months ending Dec. 31, 2020;
- Capital expenditure of between A\$430 million and A\$460 million; and
- No dividend distributions to shareholders over the 12 months ending Dec. 31, 2020.

The group's next material debt maturity is its US\$350 million bond maturing in October 2021, where Virgin Australia has allocated US\$350 million of its cash balance to act as a natural hedge.

## Covenants

Virgin Australia has some financial covenants associated with certain financing arrangements.

## Compliance expectations

We expect Virgin Australia to fully comply with all of its covenant obligations.

## Requirements

One of Virgin Australia's credit facilities has a maximum asset-to-loan ratio of 70%. However, this only triggers a review event, and not an event of default.

## Issue Ratings - Recovery Analysis

### Key analytical factors

The issue rating on the senior unsecured notes is 'B' and recovery rating '5', reflecting our expectation of modest recovery prospects (10%-30%) in the event of default. This reflects primarily the group's highly encumbered asset base and capital-light business model. We note that Virgin Australia is accumulating unencumbered physical assets, which may improve recovery prospects for senior unsecured debt over time.

Our hypothetical default scenario assumes operational underperformance associated with a combination of intensified domestic competition, deterioration of general economic conditions in Australia, or an external shock such as a terrorist incident or mass pandemic event. In this scenario, Virgin Australia's earnings and cash flows would significantly fall, impairing its ability to meet its fixed obligations in fiscal 2024.

We have valued the company on a discrete asset basis as a going concern. Our valuations reflect our estimate of the value of the various assets at default based on recent market appraisals or book value as adjusted for expected realization rates in a distressed scenario. Our recovery rating assumes that overcapacity would result in some fleet rationalization.

Over the past few years Virgin Australia has further entrenched itself within Australia's two-player domestic market. We believe this strengthening supports the value contained in the airline's

frequent-flyer business, operating licenses, airport lounges, slots, and IT systems. This infrastructure would most likely be of value to foreign airlines looking to establish a direct presence in the Australian domestic market.

### **Simulated default assumptions**

- Simulated year of default 2024
- Jurisdiction: Australia
- Administration cost: 5%

### **Simplified waterfall**

- Adjusted gross enterprise value at default: A\$1.84 billion
  - Net enterprise value (after 5% administration costs): A\$1.75 billion
  - Secured first-lien debt claims: A\$1.44 billion
  - Total value available to unsecured claims: A\$311 million
  - Estimated senior unsecured notes and rejected operating lease claims: A\$1.94 billion/A\$235.4 million.
- Recovery range: 10%-30% (estimate rounded down: 10%)

### **Ratings Score Snapshot**

Issuer Credit Rating: B+/Negative/--

Business risk: Weak

- Country risk: Very low
- Industry risk: High
- Competitive position: Fair

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: b+

## Related Criteria

- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Ratings Affirmed; CreditWatch/Outlook Action

	To	From
<b>Virgin Australia Holdings Ltd.</b>		
Issuer Credit Rating	B+/Negative/--	B+/Stable/--

### Ratings Affirmed

<b>Virgin Australia Holdings Ltd.</b>		
Senior Unsecured		
AUD250 mil 8.075% med-term nts ser 2 due 03/05/2024	B	
Recovery Rating	5(10%)	
US\$350 mil 7.875% nts due 10/15/2021	B	
Recovery Rating	5(10%)	
US\$425 mil 8.125% Callable nts due 11/15/2024	B	
Recovery Rating	5(10%)	

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 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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