

Global Credit Research - 05 Apr 2013

Brazil

## Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	B3
NSR Corporate Family Rating -Dom Curr	Ba3.br
<b>Gol Finance</b>	
Outlook	Stable
Bkd Senior Unsecured	B3
<b>VRG Linhas Aereas S.A.</b>	
Outlook	Stable
Senior Unsecured -Dom Curr	B3
NSR Senior Unsecured -Dom Curr	Ba3.br

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## Key Indicators

[1]Gol Linhas Aereas Inteligentes S.A.	12/31/12	12/31/2011	12/31/2010	12/31/2009	12/31/2008
EBITDA Margin	7.5%	11.2%	24.1%	22.0%	12.8%
EBIT/Interest	-0.5x	0.1x	1.9x	1.3x	0.5x
RCF/Net Debt	-0.7%	3.4%	17.2%	11.3%	0.4%
Debt/EBITDA	17.2x	10.9x	4.9x	6.3x	10.4x

[1] All ratios are calculated using Moody's standard accounting adjustments

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

## Opinion

### Rating Drivers

- Weak credit metrics, driven by significant exposure to foreign currency and fuel price volatility
- Aggressive industry competition threatening GOL's strong market share and ability to increase fares
- Liquidity remains adequate supported by large cash position outstanding
- Management team focused on the turnaround plan to improve profitability and increase cash generation

- Macro-economic fundamentals and socio-economic trends remain supportive for the industry in the medium term

## **Corporate Profile**

Based in Sao Paulo, Gol Linhas Aéreas Inteligentes S.A. (GOL) was founded in 2001 and currently is the largest low-cost and low-fare carrier in Latin America, offering approximately 900 daily passenger flights to connect Brazil's major cities and various destinations in South America and the Caribbean. GOL also provides cargo and charter flight services. The company's loyalty program, Smiles, allows members to accumulate miles on GOL and selected international partners to redeem tickets in more than 560 locations around the world. In 2012, GOL reported consolidated net revenues of BRL8.2 billion (USD4.1 billion) and EBITDAR of BRL258 million (USD132 million).

## **RATING RATIONALE**

GOL's B3 rating reflects the challenging environment for the Brazilian aviation industry and the company's weak operating and financial metrics over the last two years. Operating margins and cash flow generation were significantly affected by material exchange rate volatility, high fuel prices and significant increases in airport fees. At the same time, the pass thru of higher costs to passenger fares has been limited by a weaker than expected demand growth in 2012 and the still aggressive competitive environment for domestic airlines, which has been threatening GOL's market share. As a result, GOL's credit metrics in 2012 are weak for the B3 rating category providing limited financial flexibility for the company to absorb continued high fuel prices or any further currency devaluation of local currency.

Despite these pressures, the B3 rating acknowledges the company's low-cost and efficient business model supported by its strong brand name, the modern young fleet of Boeing 737 aircraft and strategic alliances with global airlines. The stable outlook reflects the attractive industry fundamentals in the medium term, along with our expectation that GOL's management effort to streamline operations and adjust capacity will significantly improve profitability and leverage ratios over the next 12-18 months. It also considers the company's adequate liquidity position and manageable debt profile over the next two years.

## **DETAILED RATING CONSIDERATIONS**

### **SIGNIFICANT EXPOSURE TO EXCHANGE RATE VOLATILITY**

Around 70% of GOL's reported gross debt, 54% of its operating expenses including fuel prices, aircraft rent, airport fees and maintenance, and almost all of its capital expenditures are denominated in U.S. dollars. GOL does have an active hedging program for its foreign currency exposure and jet fuel needs, but it is only intended to protect 10% to 40% of the exposure in short term. The protection provided by the hedging instruments did not insulate the company from a major negative impact on the balance sheet and operating expenses in 2012, when the average depreciation of the Brazilian real against the U.S. dollar reached 17%. The company has also been suffering from an associated cost increase in fuel jet prices ( which virtually doubled since 2009) and the increased landing and navigation assistance fees resulting from new calculation methodologies introduced by Infraero (+ 30% in 2012).

For this year, we do not foresee significant exchange rate volatility. We also expect some decline in oil prices based on limited increases on global growth, significant increases in oil supply, and some reduction in political risk premium. Nevertheless, the increasing risk-aversion among global investors as a result of the sovereign crisis in Europe could eventually trigger another major weakness in the Brazilian real versus the U.S. dollar, highlighting what is arguably the weakest link in GOL's business model. We estimate that for each BRL0.20 devaluation in the Real, GOL's EBIT declines by BRL200 million while leverage as measured by Gross Debt to EBITDA increases by approximately 3.0 times.

While implementing a more conservative hedging program with derivatives remains very expensive in Brazil, the company's strategy to address the currency risk exposure has been to increase the availability of international routes, which provides for a natural hedge with dollar denominated revenues. International flights represented 7% of net revenues in 2012, but we expect it to reach 10% - 12% of net revenues over the next two years. Last December, GOL launched daily flights to Santo Domingo, Miami and Orlando, which will partially mitigate the company's exposure to exchange rate volatility in the future.

### **INDUSTRY FUNDAMENTALS REMAIN POSITIVE**

The growth of middle class in Brazil and the ongoing migration from ground to air transportation in long distance

travel, led flight demand to exceed GDP growth by around 2 to 3 times during last decade. However, during 2012, the lower than expected economic growth caused a deceleration of passenger demand growth, particularly in the high yield business segment.

According to Bain & Co, the Brazilian aviation market should continue to grow on average 10% per year, reaching 211 million transported passengers by 2020. Going forward, we expect a more moderate growth rate in line with an annual GDP growth in the 2.5% to 3.5% range, but with positive momentum building around the major events that will be hosted in the country, such as the FIFA soccer games in 2013 and 2014 and the Olympic Games in 2016.

GOL remains one of the largest low cost carriers in the industry with a relevant 35% share of the Brazilian airline market. As a result, the company is also well positioned to benefit from the projected demand growth. The airline industry in general and GOL in particular, should continue to benefit from the growing middle-class that is now estimated to have surpassed the 100 million mark (approximately 53% of the Brazilian population). Additionally, there is a potential to improve air travel penetration rate. We estimate that only 27.5 million passengers per year (about 15% of the Brazilian population), currently use air travel on a frequent basis.

#### **YIELDS PRESSURED BY INDUSTRY HIGH CAPACITY AND AGGRESSIVE COMPETITION**

Encouraged by prospects for double digit demand growth, existing carriers and new entrants added significant new capacity in the Brazilian aviation market from 2007 through 2011. During this period, the industry's domestic supply as measured by Available Seat Kilometers (ASK) increased around 16% per year to 116 million. The aggressive competitive environment pressured GOL's passenger yields, which have been consistently declining since 2008 to an average of 19.51 BRL cents in 2011. Additionally, the company is experiencing a contraction in its market share, which declined from the mid forties to the mid thirties over the last five years. As discussed above, the pressure on yields came at a time of stubbornly high fuel prices and other dollar denominated expenses. Unlike some other countries, fuel and baggage surcharges are not allowed by Brazilian law, which makes GOL and other local carriers more reliant on yields as opportunities to improve profitability.

In 2012, the lower than expected economic growth in Brazil led to an imbalance of supply and demand. GOL responded to these challenges by reducing its fleet size and canceling or rescheduling some routes, in an attempt to improve load factors and recover profitability. The company cut capacity in ASK terms by 5.4% in 2012. As a result, GOL's average passenger yield remained relatively flat in 2012, or just 0.8% higher than the previous year, while its load factor slightly improved to 70% from 69% in 2011.

This strategy has not been enough to offset higher fuel costs, so GOL expects to cut another 7% capacity in 2013 and improve passenger revenues per ASK by more than 10%. The risk of this strategy is that cutting capacity result in lower passenger traffic, which could lead to further market share losses in a highly competitive environment. Nevertheless, we see a relatively more disciplined approach toward capacity management from the other domestic carriers going forward. The company largest competitor, for example, indicated that will follow GOL's footsteps in 2013 with a 5% to 7% reduction in domestic ASK. This strategy could lay the foundation for a further recovery in yields and load factors during the next couple years.

#### **KEY FINANCIAL METRICS HAVE SHOWN MEANINGFUL DETERIORATION**

As a result of the significant cost pressures and limited pricing power, which hit GOL both at the same time, adjusted EBITDA margins further declined last year to 7.5% (down from 11.6% in 2011 and 24.1% in 2010). The pressure on GOL's operating margins when combined with the negative impact of the weak Brazilian real on its total debt outstanding, resulted in a major increase in leverage as measured by the adjusted Gross Debt to EBITDA of 17.2x in 2012 (up from 10.9x in 2011 and 4.9x in 2010). Moody's EBITDA calculation excludes approximately BRL140 million non-recurring expenses associated with winding up of Webjet during the 4Q12. It is also adjusted with the capitalization of operating aircraft leases.

GOL's weak credit metrics reflect the challenging environment experienced by the company over the last couple years as a consequence of overcapacity in the domestic airline industry, increasing fuel prices, and the still limited availability of a natural hedge. If there is no significant price fuel or exchange rate volatility, we believe that GOL could improve operating performance. The low cost structure has been a long time hallmark of GOL's culture and the management stays focused on a turnaround plan to improve cash generation. The recently announced cost-cutting initiatives should result in meaningful margin improvement over the near term.

#### **Liquidity Profile**

GOL's has adequate liquidity. On December 31, 2012, GOL reported total cash outstanding of BRL1.4 billion or

17% of LTM revenues, which compares unfavorably with its strong cash position one year earlier (i.e. BRL2.2 billion or 30% of LTM revenues in 2011). Nevertheless, the company's cash outstanding comfortably covers its effective near term debt maturities until 2015 (BRL629 million in 2013 and BRL397 million). Additionally the company reported dollar denominated deposits in the amount of BRL498 million to cover maintenance and lease related obligations, and BRL225 restricted cash deposits as collateral for its derivative positions.

A significant cash buffer remains a critical ratings driver for GOL, given the air travel industry's inherent vulnerability to sudden external shocks. During 2013, we expect the company to improve its overall liquidity profile with cash on hands and investments of at least 20% of LTM revenues. GOL may strengthen its liquidity and financial flexibility through a combination of debt and partial asset divestitures, such as the proposed IPO of the Smiles unit. During the 1Q13, the company already concluded the issuance of a 10-year USD200 million unsecured notes to replace short term debt maturities lengthening the company's debt maturity profile. Alternatively, the company could raise cash through aircraft sale-leasebacks or anticipation of receivables.

Certain credit agreements contain financial covenants that restrict the company's ability to raise additional debt by imposing a maximum leverage ceiling of 3.5x reported Net Debt to EBITDA and minimum interest coverage of 1.3x. As a result of the poor operating performance, the company violated these covenants in both 2011 and 2012; so far, the management has been able to obtain the necessary waivers from the debenture holders.

### **Corporate Governance**

GOL is a public company, indirectly controlled by the Constantino family, with preferred shares listed on the NYSE and Level 2 of BM&FBovespa. The company is in compliance with the requirements of Sarbanes-Oxley Law (SOX) and uses internal controls according to the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Board of Directors is composed by nine members, of which four are considered independent per Bovespa's definitions. The company does not have a permanent Fiscal Council, but there are several internal committees to support management's decision. GOL has above average disclosure of financial statements, including quarterly publication of cash flow statements and operating performance. Nevertheless, we believe there is room for further improvement, such as more information regarding their hedging positions and associated profit and losses.

In June 2012, GOL's board of directors elected Mr. Paulo Kakinoff as the new company's CEO. Mr. Kakinoff came from Volkswagen Group where he served for 19 years. He replaced the position occupied by Mr. Constantino de Oliveira Junior, who was elected Chairman of the Board of Directors. We see this change as credit positive because it brought an experienced manager to team while improving corporate governance.

In December 2011, Delta Airlines and GOL signed an agreement involving the acquisition by the U.S. company of a strategic minority interest of 3% in GOL's total capital through an investment of USD100 million. The objective of this agreement was to create synergies between GOL's Smiles and Delta's Skymiles, the loyalty programs of these two companies. As a result, Delta obtained one seat in GOL's board of directors.

### **Rating Outlook**

The stable outlook reflects the company's adequate liquidity position to meet short term debt maturities and the expectation that the domestic aviation industry will appropriately manage capacity to sustain growth in passenger yields. The stable outlook also assumes a gradual and consistent improvement in GOL's credit metrics with the implementation of the management's strategy to improve profitability, absent a material reduction in fuel costs or significant devaluation of local currency.

### **What Could Change the Rating - Up**

Upward pressure on GOL's ratings and outlook is possible if the company meaningfully reduces its adjusted leverage to below 6.0 times on a gross basis, generates at least 5% of retained cash flow to gross debt, and maintains EBIT interest coverage above 1.0x for a prolonged period without compromising its liquidity profile.

### **What Could Change the Rating - Down**

Downward pressure on GOL's ratings or the ratings' outlook could occur if the company is unable to significantly improve operating margins and leverage over the next few quarters, for example, as a result of another significant devaluation of the local currency or fuel price increases beyond the limits of its existing hedge protection agreements. Moody's perception of any deterioration in the company's liquidity position or financial flexibility to meet capital requirements could also lead to a negative rating action for GOL.

## RATING METHODOLOGY GRID

The grid implied rating from Moody's 12-18 month forward view of the Global Passenger Airlines Industry methodology is B3, which is in line with GOL's corporate family rating. Moody's projection does not incorporate the IPO of the Smiles unit.

### Rating Factors

Gol Linhas Aereas Inteligentes S.A.

Passenger Airlines Industry [1][2]	Current 2012 FYE		[3]Moody's 12-18 month Forward View	
<b>Factor 1: Cost Structure (16%)</b>				
a) Fleet Age (average in years)	7 - 8	Baa	7 - 9	Baa
b) EBITDA Margin	7.5%	Ca	10% - 15%	Caa
<b>Factor 2: Market Conditions (28%)</b>				
a) Business Profile		Ba		Ba
b) Geographic Diversity		B		B
<b>Factor 3: Coverage and Leverage (36%)</b>				
a) EBIT/Interest	-0.5x	Ca	0.5x - 1.0x	Caa
b) RCF/Net Debt	-0.7%	Ca	2% - 4%	Ca
c) Debt/EBITDA	17.2x	Ca	10.0x - 12.0x	Ca
<b>Factor 4: Financial Policy (20%)</b>				
a) Financial Policy		B		B
<b>Rating:</b>				
a) Indicated Rating from Grid		B3		B3
b) Actual Rating Assigned				B3

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, 2 and 3." In addition, Moody's adjusts for one-time items. [2] As of 12/31/2012; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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