

Applied Corporate Finance

Latam Airlines and COVID-19

Class-Case Discussion

Rui Silva

Plan Of Attack

- Background
- Discussion/Proposed Solution Of Case
- What Happened?

Background Of Case

- Latam Airlines, the largest airline in Latin America filed for Chapter 11 Bankruptcy in the United States
 - Had \$10.4 billion in debt
 - Could not meet coupon payments
- Company was profitable before the pandemic
 - But COVID-19 led to a stop of most flights
 - In June 2020, Latam was operating at 5% of capacity
- To survive, the company needs:
 - To restructure the debt
 - New capital

Lan Chile

- Latam is the result of a merger between Lan Chile and Tam
- Lan Chile
 - Founded in 1929 by the Chilean government
 - Privatized in late 1980's and early 1990's
 - One of the initial owners (Cueto) still has a significant stake
 - Another of the initial private owners (Piñera) is the current president of Chile
 - ADRs traded in the NYSE since 1997
 - Joined Oneworld in 2000

Tam Brazil

- Tam Brazil
 - Founded in 1976 by Rolim Amaro
 - In 1996, bought Lapsa from the Paraguayan government and formed Tam Mercosur
 - Started trading in São Paulo in 2005 and in the NYSE in 2006
 - Joined Star Alliance in 2010
- In 2010, Lan and Tam announced a merger.

Latam Airlines

- Prior to the merger
 - Lan had a market cap of \$9 billion
 - Tam had a market cap of \$4 billion
 - Estimated synergies of \$600 million over 4 years
 - Estimated transaction/integration costs \$200 million
- Merger concluded in 2012
 - Latam Airlines became second largest airline in the world by market cap (\$12billion), behind China Airways

Latam Airlines (cont'd)

- Following the merger things did not go exactly according to plan
- Merger integration was more difficult than anticipated
 - “When two large groups merge, they take a lot of time to understand themselves internally.”
- Bad luck
 - Oil prices went up
 - Devaluation of the real relative to the dollar
- Between 2012 and 2013, Latam lost 1/3 of its market capitalization

Latam Airlines (cont'd)

- Deep restructuring process in 2016
- Qatar Airways purchased 10% stake in 2016
- Delta Airlines purchased 20% stake in 2019 for \$2 billion
- By 2019, largest owners were:
 - 21% Cueto family group
 - 20% Delta Airlines
 - 16% Chilean Pension Funds
 - 10% Qatar

Latam Airlines (cont'd)

- The company employed about 42k people
- Fleet comprised of 340 airplanes
- Average of 162 flights per day
 - 145 destinations in 26 countries
- In 2019 transported 74.2 million passengers
- Cargo business
 - Accounted for about 10% of revenues [Ex. 6]
 - Use of cargo holds on passenger planes + freighter planes
 - 152 destinations in 29 countries

Latam Airlines Finances in 2019

- Revenues of \$10 billion
- Net profits of \$196 million
- Debt of \$10.4 billion
- Debt-to-asset ratio of 85%
 - More than other airline companies (e.g., 76% and 62% for Delta and Southwest, respectively)

Reorganization vs. Liquidation

- What is the difference for a company between filing for bankruptcy reorganization vs. filing for liquidation?
 - Liquidation (Chapter 7): the company disappears
 - Reorganization (Chapter 11): the company is restructured to continue to operate
 - The restructuring that takes place in chapter 11 is not only on the structure of liabilities.
 - It is also in terms of change in strategy/business model
 - Renegotiation of contracts and incentive structures
 - Goal: not be in chapter 11 again (chapter 22?)
 - Bottom line: Reorganization makes sense if company has liquidity problems but is viable in the long term.

Why did Latam chose Ch. 11?

- Latam was a viable company with a solid business pre-pandemic
- Some airline companies filed for Chapter 11 after September 11 and recovered very well
- Latam Airlines was “too big to fail” – it is essential for the Latin American continent, especially for Chile and Brazil
- The economic value of the company exceeded the liquidation value of the assets, so it was not financial convenient to liquidate the firm.

Why did Latam chose to file for bankruptcy in the US?

- Chilean reorganization process was new and inexperienced (p.6)
 - Latam is a company with a complex structure with many international subsidiaries, domestic and foreign shareholders, creditors, and suppliers.
 - Efficient for the reorganization process to be centralized in one place.
 - US had judges specialized in bankruptcy. Chile did not.
 - Chapter 11 was a known and reliable procedure (recognized by Chilean courts)

Why did Latam chose to file for bankruptcy in the US?

- Chapter 11 gave more time to come up with a reorganization plant
 - 120 days vs. 30 days
 - For a company of the size and complexity of Latam, this can prove very valuable.
 - Flexibility is also especially valuable in times of high uncertainty
- In the US, DIP financing has super-seniority during and after the reorganization process
 - In Chile, DIP seniority is only applied during reorganization
 - This makes it easier to attract new funds and avoid debt overhang problems

Why did Latam chose to file for bankruptcy in the US?

- Chapter 11 made it easier for the debtor to unilaterally cancel lease contracts pending execution
 - This is critical for Latam Airlines, because, like many airlines, a sizeable fraction of liabilities is in the form of lease contracts [Ex. 8]

Can this decision affect the development of the Chilean capital market?

- A bit of a side question, but are there consequences of using US and UK bankruptcy proceedings for the development of local capital markets?
- On the one hand, this specialization may be efficient
 - Chilean courts deal with local small/simple cases, US courts deal with large complex cases
- On the other hand, can lead to vicious cycle
 - If Chilean courts are never exposed to this type of cases, they will never get the capacity to deal with such cases
 - An efficient bankruptcy process is a crucial determinant of a well functioning capital market

What were Latam Airlines greatest vulnerability at the onset of the pandemic?

- Company operated across many geographic markets giving it diversification benefits against local “idiosyncratic” shocks
 - This is similar to other large airlines and safer than smaller specialized companies
- Operating income (gross margin) was good
- However, leverage was relatively high (p.4)
 - Higher leverage is associated with higher vulnerability to negative shocks in the demand. Why?
 - Fixed repayment promises are hard to fulfill when revenues drop
 - The higher the level of debt, the higher the debt service promises

What were Latam Airlines greatest vulnerability at the onset of the pandemic?

	2019 - MUS \$					
	Delta	American	Southwest	United	Avianca	Latam
Operating revenues	47,007	45,768	22,428	43,259	4,622	10,070
Operatin expenses	40,389	42,703	19,471	38,958	5,176	7,951
Operating (loss) income	6,618	3,065	2,957	4,301	-554	2,119
Gross margin	14.08%	6.70%	13.18%	9.94%	-11.99%	21.04%
Interest expense	301	1,095	82	646	300	564
Net (loss) profit fort he year	4,767	1,686	2,300	3,009	-894	196
Net margin	10.14%	3.68%	10.26%	6.96%	-19.34%	1.95%

	2019					
	Delta	American	Southwest	United	Avianca	Latam
Liabilities/Assets	0.76	1	0.62	0.78	1	0.85
Liabilities/Equity	3.2	-509	1.6	3.6	1,425	5.7
Operating income/interests	21.99	2.80	36.06	6.66	-1.85	3.76

Source: Exhibit 7

Was/is Latam a viable company in the long run?

- While the company filed for Chapter 11, it may still end up being liquidated.
- Will it?
 - Depends on your view of the firm
 - And also on what the aviation industry will look like in the future

Is there a future for aviation?

- How long do you believe it will take the global airline industry to return to 2019 total revenue levels?
 - 6 to 12 months - 7%
 - 12 to 18 months - 19%
 - 18 months to 3 years - 44%
 - 3 years - 16%
 - More than 3 years - 14%
 - Don't know – 1%
- Source: “How top aviation leaders see the future of the airline industry” Forbes July 14, 2020

Is there a future for aviation?

- How well prepared do you believe the airline industry was for the COVID pandemic?
 - Poorly prepared - 46%
 - Could not prepare for such a Black Swan event - 41%
 - Somewhat prepared - 12%
 - Very well prepared - 1%
 - Don't know – 1%

Is there a future for aviation?

- Will the airline industry survive the COVID crisis?
 - Yes, but fundamentally changed - 69%
 - Yes, of course - 20%
 - Will not recover as we know it - 7%
 - Permanently damaged - 4%
- Moving from the survey, historically, airlines have gone bankrupt several times.
- But despite the bankruptcies the industry tended to recover

What changes should Latam make to adjust to “new normal” of airlines?

- After September 11, 2001, there was a large drop in air travel demand
 - Airlines cancelled flights and kept planes on land for a while
 - But the industry recovered
- Is Covid-19 similar to 9/11?
 - 9/11 was a crisis of confidence and safety
 - To some extent, Covid-19 is too
 - However, the measures needed to restore confidence may be significantly different

Remedies for COVID-19 safety concerns

- Airlines may need to invest in air purifiers, filters, and other hygiene measures
- May have to leave space between seats – this means that airlines have to leave empty a significant part of the cabin
- New COVID variants and new pandemics may also be in the horizon

What should Latam do?

- Re-evaluate optimal size and scope of networks and fleet
 - Consider M&A and consolidation
 - Pay closer attention to cash levels
 - More conservative capital structure
 - Less operational leverage (more flexible contracts)
-
- Indeed, Latam Airlines already announced an organizational plan that includes, among other things, a reduction in size, fleet, and personnel.

Would you invest in Latam?

- If you were the chief investment officer of an international mutual fund, would you invest in Latam Airlines through debtor in possession (DIP) financing?
- Distressed investing is a high risk-high return proposition
- The backdrop is:
 - Historically low interest rates
 - High volatility in equity markets (macro uncertainty about vaccine, rebounds, new variants, economic recovery, among others)

Volatile equity markets

S&P 500 (^GSPC) ☆

SNP - SNP Real Time Price. Currency in USD

4,141.99 -46.44 (-1.11%)

As of 1:11PM EDT. Market open.



To invest or not to invest, that is the question...

- On the positive side:
 - DIP gives priority to new investors – DIP loans have preference over all the other creditors, including secured loans
 - Covid recovery could allow the company to come back strong
- On the negative side:
 - Risks are still large
 - Airline industry has been one of the most affected industries during the pandemic
 - Some changes may be permanent (zoom vs. travel)
 - In bankruptcy, even DIP may bear losses.

Tranche A or Tranche C?

Exhibit 16 Chapter 11 Debtor-in-Possession Financing Tranches

TRANCHES DIP	Interest	Conditions
Tranche A	Interest 12% - 14%	Payment preference over tranche C
Tranche B	Reserved for government aid	To be define
Tranche C	Interest 14.5%	Interest paid at the end of the process, and option to convert shares into equity

Who would prefer tranches A and C?

- Pros of tranche A:
 - Priority over tranche C.
 - In fact, senior to all existing and new debt except for tranche B, which is reserved to the government
 - In case of no government assistance, tranche A would have absolute priority over all debt

- Pros of tranche C:
 - Higher yield
 - Secured (although not sure by what)
 - Convertible to equity (although not enough information on the case regarding conversion rate, so hard to know how much the warrants are worth)
 - Who would value this option the most?

What about tranche B?

- This tranche needs to be carefully designed
- Why?
 - It affects the value of other tranches – if it is not well designed, it may scare away other investors
 - Must provide enough incentives for a government bailout
- Should the Chilean Government intervene?

Government financial aid by region

Regional variations

The \$123 billion in government financial aid is equal to 14% of 2019's total airline revenues (\$838 billion). The regional variations of the aid dispersion indicate that there are gaps that will need to be filled.

	2019 REVENUES (\$ BILLION)	AID PROMISED (\$ BILLION)	% OF 2019 REVENUES
Global	\$838	\$123	14%
North America	\$264	\$66	25%
Europe	\$207	\$30	15%
Asia-Pacific	\$257	\$26	10%
Latin America	\$38	\$0.3	0.8%
Africa & Middle East	\$72	\$0.8	1.1%

Source: IATA (<https://www.iata.org/en/pressroom/pr/2020-05-26-01/>)

Reasons for Governmental Support

- Latam Airlines is of strategic importance
 - Important direct employer
 - Additional employment through supplier networks
 - Customer of a great number of suppliers, including local SMEs
 - Catalyst for tourism and trade
- Latam contributes to a non-trivial fraction of Chile's GDP
 - In good times contributes with significant tax payments
- Finance minister's claim: State would help the company not shareholders

Reasons against Governmental Support

- Helping large companies was a policy with little public support
 - In October 2019, Chile went through an episode of social unrest. One of the factors contributing to the protest seems to have been a generalized feeling of abuse by large corporations
 - The current President of Chile owned a 20% stake of Latam 10 years ago → a bailout today would be help to former partners of the president.
- Governments typically require firms to maintain jobs in exchange for support. However, Latam's restructuring plan includes massive layoffs.
- Government support to international companies may end up being collected by foreign operations

Chile's fiscal capacity

Fiscal indicators 2020	Country				
	Chile	Brazil	Colombia	Ecuador	Peru
Gross debt % of GDP	32.3	98.2	57.8	63.0	36.5
Net debt % of GDP	12.8	62.8	46.2	No data.	18.7
Expenditure % of GDP	27.8	39.9	30.9	37.2	25.3
Revenue % of GDP	21.5	30.5	28.5	30.1	18.2

- Chile seems to be in a relatively strong fiscal position
- So, the main issue may be political will not fiscal capacity

What Happened?

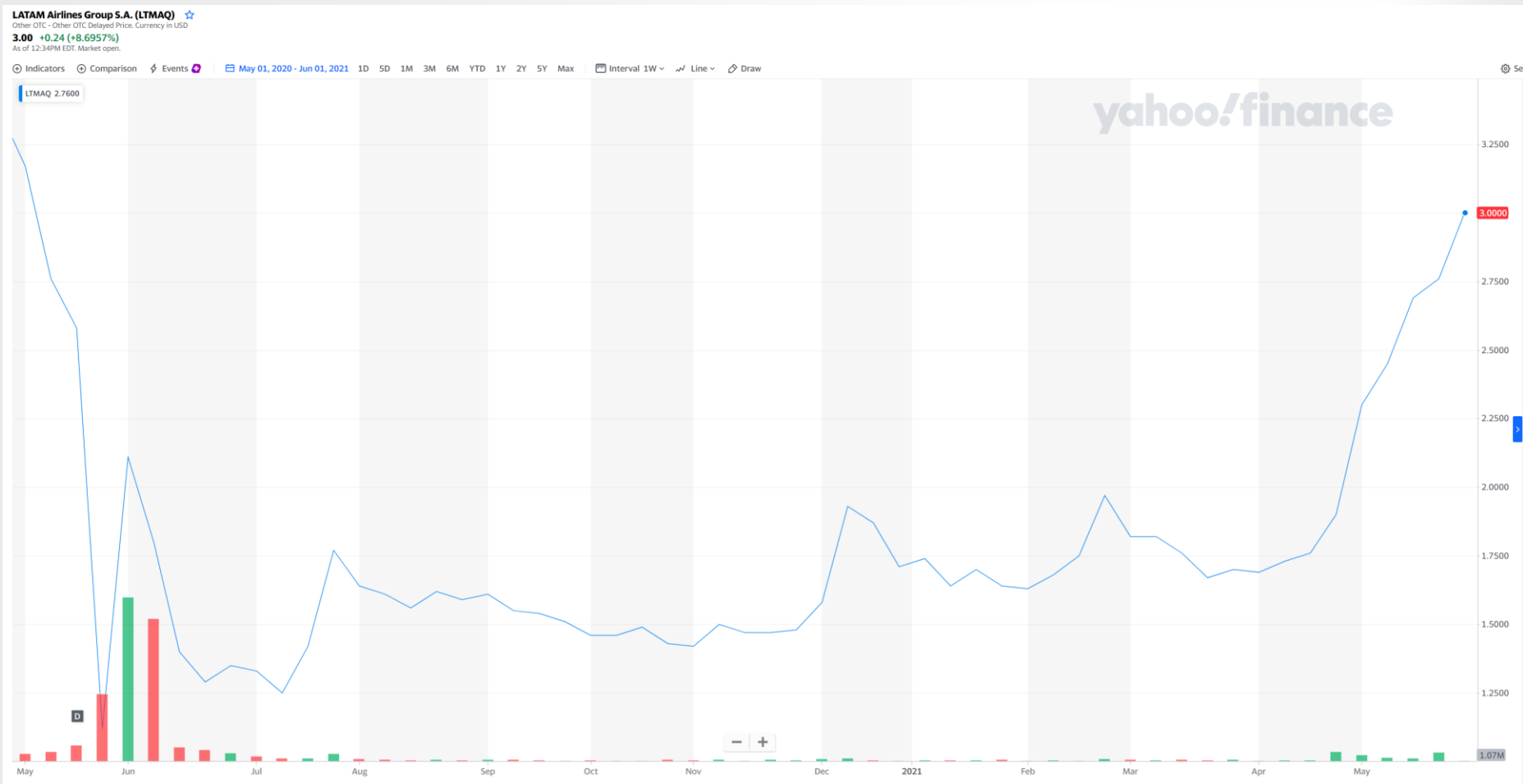
What happened

- By September 2020 there was enough appetite for Latam's DIP financing that a government intervention was not needed.
- Brazilian subsidiary was included in the Chapter 11 filing in the US.
- Latam sent the DIP proposal to the NYC court
- In response, a group of creditors claimed that the DIP proposal was favourable to the current majority shareholders who invested in tranche C of the DIP (Cueto and Amaro families, Qatar), but detrimental to creditors and other minority shareholders.
- As a result, the company prepared and delivered a new DIP proposal (without the equity conversion option for tranche C).

What happened

- The new proposal was eventually approved.
- Tranche A valued up to USD1.3 billion led by Oaktree Capital Management which committed USD1.1 billion and Knighthead Capital with USD175 million;
- Tranche C considers an amount of up to US\$ 1,150 million, which is composed by US\$ 750 million committed by Qatar Airways and the Cueto and Eblen Groups, and US\$ 250 million which will be contributed by Knighthead Capital, along with the US\$ 150 million that will be committed by the fund administered by Toesca S.A Administradora General de Fondos.
- Pfizer announced positive vaccine trial on November 9, 2020, with airline stocks reacting positively.

What happened



What happened

- Santiago-based Latam Airlines is the region's largest air carrier. After Covid-19 travel restrictions crushed revenues, the company filed for bankruptcy in New York last May. Its bonds fell as low as 16 cents on the dollar, and the stock tanked as well on the assumption that shares would be worthless during the Chapter 11 process.
- Debt securities tied to Latam have rallied in recent months, with bonds issued by its finance arm trading for more than 90 cents on the dollar. Unsecured claims -- low-ranking debts owed to parties like vendors and aircraft lessors -- are changing hands for more than 70 cents on the dollar from less than 50 cents last month, according to claims market participants.

Source: "Latam Airlines Shareholders Channel Hertz in Bankruptcy Rebound", May 20, 2021, Bloomberg.com

Takeaways

- Good example of the effect of COVID-19 on the global economy
- Discussion of reorganization vs liquidation in bankruptcy
- Why file for bankruptcy outside of the firm's jurisdiction
- Investing in a distressed company
- Complex debt structures
- Government bailouts