FitchRatings

FITCH AFFIRMS HEATHROW FUNDING'S BONDS & HEATHROW FINANCE'S HIGH-YIELD BONDS

Fitch Ratings-London/Paris-26 June 2013: Fitch Ratings has affirmed Heathrow Funding Limited's (Heathrow Funding or the issuer) bonds issued under its debt issuance programme and Heathrow Finance Plc's (Heathrow Finance or the HoldCo) high-yield bonds, as follows:

Class A bonds: affirmed at 'A-', Outlook Stable
Class B bonds: affirmed at 'BBB', Outlook Stable
Heathrow Finance high-yield bonds: affirmed at 'BB+', Outlook Stable

The affirmations reflect Heathrow's (LHR) stable performance and Fitch's assessment of its ability to service and refinance its issuer and Holdco debt. They also reflect the different structural support available to both the issuer's and Holdco's creditors.

On 30 April 2013, the Civil Aviation Authority (CAA) announced its initial proposition for the price cap applicable at Heathrow from April 2014 to March 2018 (next regulatory period, or Q6). The price cap is based on a weighted average cost of capital (WACC) of 5.35%, materially lower than the 6.2% in force until 2014 and which Fitch had accounted for Q6 in its previous base and rating cases. This lower price cap proposal, if confirmed by year end, would introduce some downside risk, ie risk that Heathrow cannot achieve the implied assumptions, notably as far as operating cost efficiencies and cost of debt are concerned.

This downside risk is partly offset by the "starting point" improved performance. The good commercial and financial performance achieved by Heathrow in 2012 and early 2013 has built up some headroom in the rating, as reflected in the affirmation, as the credit metrics for all tranches of debt remain within Fitch's credit guidance for the next five years. The somewhat unfavourable price cap determination is also mitigated by a materially lower average cost of debt applying to the current debt stock, due to an active and successful debt management, with shorter dated GBP3bn bonds raised in 2012 at favourable conditions.

KEY RATING DRIVERS
Resilient Hub Airport
LHR is a large hub/gateway airport serving a very strong origin and destination market. LHR's performance through the recent economic crisis was one of the strongest in the industry, with a maximum peak-trough fall in traffic of just 3.4%. This is due to a combination of factors that Fitch considers stable over time: the attractiveness of London as a world business centre; the role of Heathrow as a hub offering very strong yield for its resident airlines; the location and connectivity of LHR with the well-off western and central districts of the city; the capacity constraint at LHR (with only two runways for +70m pax and a legal cap on annual aircraft movements), suggesting there is unsatisfied demand (which first absorbs shocks in demand).

Transparent But Constraining Price-Cap Regulation
Heathrow is subject to economic regulation, with a price cap calculated under a single till methodology and that neutralises inflation (RPI+X). The cap is set for five years by the CAA, which has a duty to ensure airports' operations and investments remain financeable. The price cap is established to offset LHR's (considerable) market power and is highly sensitive to several building blocks (cost of capital, traffic forecast, operational efficiency). The regulatory process that leads to the cap determination is very transparent but creates a material uncertainty every five years. Price cap settlements can prove detrimental to the airport, as CAA's assumptions can appear aggressive ex-post. For example, the traffic forecast for Q5 was designed before the 2007-2008 crisis and proved overly optimistic. However, this was partly offset by higher-than planned inflation. The Civil Aviation Act, adopted in December 2012, updates the CAA's duties and renews the framework for the economic regulation. It stipulates that a license will be introduced in Q6. From

Fitch's perspective, as currently drafted, this license would have no material impact.

Well-Controlled Renewal Plan

Heathrow implements a detailed capital improvement plan, agreed to by the regulator. The plan for the current regulatory period (2008-2013, or Q5) exceeded GBP5bn and is now largely complete, with a good track record in delivering on time and on budget. The regulated asset base concept allows for the self-financing of most investments through the tariff. After delivery of a brand new T2 in 2014, LHR will mostly feature state-of-the art terminals. The Q6 capex plan is more modest and represents less of a challenge than Q5. The building of a third runway is currently ruled out by the government, but may resurface later.

Multi-Layer Debt Structure

The class A debt benefits from its seniority and protective debt structure (ring-fencing of all cash flows from Heathrow and set of covenants limiting leverage). It is exposed to some hedging and refinancing risk, which is mitigated by strong market access due to an established multi-currency debt platform and the use of diverse maturities. The class B and Heathrow Finance debt have weaker debt structures due to the subordination of these tranches.

Stable Performance Expected

Fitch has reflected a mix of CAA's and Heathrow's assumptions in its rating case, generally adopting the most prudent of the two. It has also assumed that the regulator's Q6 determination would remain as per the initial proposal, that RPI reverts to a 2.5% trend in the medium term and that Heathrow could face adverse financing conditions (6.9% all in cost for senior debt) in two of the next five years. Fitch forecasts that in this scenario, the company should be able to maintain post-maintenance and tax interest cover ratios (PMICR) for each class of debt at levels above Fitch's current rating thresholds - 1.5x-1.6x for a 'A-' rating of class A debt, 1.2x-1.3x for a 'BBB' rating of class B debt and 1.1x-1.15x for a 'BB+' rating of BAA (SH) debt. Furthermore, the average dividend/interest cover ratio at the BAA (SH) level is also in excess of the 3.0x that Fitch considers appropriate for a 'BB+' rating at HoldCo level.

RATING SENSITIVITIES

Exposure to Aviation Market

The Stable Outlook reflects the expectation that Heathrow will continue to post a stable performance, despite weak economic prospects. A marked and durable degradation of the British economy could derail Heathrow's good record of resilience. Evidence of recessionary prospects over a prolonged horizon (two years) or failure to achieve operational efficiency gains could prompt a revision of the Outlook to Negative. Net debt/EBITDA above 8.5x and PMICR below 1.6x for class A would also suggest a downgrade.

Although Fitch deems this is less likely, a material improvement in the economic environment could support higher load factors and use of larger aircrafts by airlines, in turn improving the passenger throughput at Heathrow with a favourable impact on credit ratios. Net debt/EBITDA consistently below 7x and average PMICR above 1.8x for class A would suggest a rating upgrade.

Regulatory Risk

The initial proposal for price determination is unfavourable for Heathrow but Fitch believes the airport can face it without a downgrade. However, should the final determination be even lower, a downgrade could be justified.

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Applicable criteria, 'Rating Criteria for Airports', dated 27 November 2012, and 'Rating Criteria for Infrastructure and Project Finance', dated 11 July 2012, are available at www.fitchratings.com .

Applicable Criteria and Related Research:
Rating Criteria for Airports
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695600
Rating Criteria for Infrastructure and Project Finance
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=682867