

BAA Funding Ltd.'s First-Half Performance Demonstrates Resilience

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BAA (SP) Ltd., which is the holding company in the financing structure for Heathrow Airport Ltd., Gatwick Airport Ltd., Stansted Airport Ltd., and Heathrow Express Opco Ltd., released at the end of July its unaudited results for the six-month period to June, 30, 2009. Its statutory accounts have been prepared under U.K. GAAP, with Gatwick treated as a continuing operation.

BAA's first-half performance demonstrated the resilience of the business to the current macro-economic downturn. The 12.8% reported revenue increase (3.8% like for like) to about £1.15 billion was primarily driven by aeronautical fee increases, as traffic at BAA's three London airports declined 7.4%, to 55.2 million passengers. Meanwhile, net retail income was relatively resilient especially at Heathrow which reaped the benefits of the new Terminal 5 and a pickup in intra-terminal transfer passengers. Overall, net retail income was down 0.6% on a reported basis but up 7.3% per passenger. Adjusted EBITDA (before exceptional items) was up 28.2%, to about £470 million or 40.7% of revenues (35.8% in the previous comparable period), as operating expenditures were down 3.1% on an underlying basis. Most of the cost reduction came from a decline in lower employment costs by 10% (underlying) followed by general expenses (down 5%). 77% of EBITDA was contributed by Heathrow which generated 56.5% of passengers.

Management confirmed that the appeal of the Competition Commission's ruling on BAA's break-up had resulted in a delay to the disposal deadline pending an appeal decision (probably by the end of this year or early 2010).

In the first eight months of the year, traffic at the three London airports was down 5.9%, with Heathrow having posted two consecutive months of growth in July and August aided by rising transfer traffic.

Cash generated from operations of about £210 million after interest (including taxation group relief of £22.2 million) partially covered capital investment of approximately £0.5 billion leaving a cash outflow of just under £300 million.

As a result, BAA (SP) Ltd.'s net reported debt rose to £9.7 billion at June 30, 2009, from £9.4 billion at year-end 2008 (the figure is the nominal value of debt and excludes intra-group loans and is before index-linked accretion of £9 million). We understand that BAA (SP) Ltd. achieved ratios of senior and junior debt to RAB (regulated asset base) of 68% and 75%, respectively, at June 30, 2009, broadly in line with the ratios posted at year-end 2008. The total indebtedness trigger level is set at the senior debt level at up to 70.0% before April 1, 2018, and 72.5% thereafter; and at 85% for junior debt.

Liquidity at June 30, 2009, was, in our view, satisfactory, with financings in place covering at least 2009 and 2010 funding needs. We understand BAA had about £2.2 billion of undrawn credit facilities and about £210 million in cash which should allow the group to repay its 2010 maturities (£1 billion) irrespective of the Gatwick disposal despite BAA's negative free cash flow forecast of about £0.4 to £0.5 billion between July 2009 and March 2010. We understand that the company could draw on its capital expenditure facility up to the portion of capital expenditure that has been funded by internal cash flow since financial closing, or close to £800 million-£900 million in March 2010.

We note, however, that although none of the refinancing, liquidity, capital expenditures, or revolver facilities at borrowing group level contain individual material adverse change (MAC) clauses, they are bound by the terms of the Common Terms Agreement and the Security Trustee and Intercreditor Deed (STID). The latter contains several references to "Material Adverse Effect", the definition of which is as follows: "Material Adverse Effect" means the effect of any event or circumstance which is materially adverse to:

- The business, assets, or financial condition of the security group taken as a whole; or
- Taking into account the resources available to it from other members of the security group, the ability of an obligor to perform its payment obligations under any transaction document; or
- The legality, validity, or enforceability (subject to the reservations) of any transaction documents in a manner which is prejudicial in any material respect to the interests of the borrower secured creditors.

The U.K. Department for Transport (DfT) in its consultation paper released on March 9, 2009, proposed changes to the security regime and/or the introduction of a special administration regime. However, according to the transaction documentation, the implementation of such changes in the security would require bondholders' and lenders' approval. This could lead to a multi-notch downgrade, reflecting the possibility that debt repayments could be accelerated by the lenders in case they don't, with no funding available to meet such obligations.

The negative outlook primarily reflects our view of the possibility in the next two years of a material change in the insolvency regime for certain British airports falling under the new regulatory framework, which has not yet been adopted or enacted. .

The credit ratings on the class A bonds issued by BAA Funding Ltd. and the tranche A and B refinancing facility lent to Heathrow Airport Ltd., Gatwick Airport Ltd., and Stansted Airport Ltd. are based on the assumption that all three airports are included in the transaction, and on certain existing security structure and enforcement mechanisms within the BAA Funding transaction that allow for the appointment of an administrative receiver through enforcement of the floating charge granted to the issuer trustee for the benefit of the noteholders.

Changes to the security regime and/or the introduction of a special administration regime may impair the ability of noteholders/lenders to take control over the assets in the event of a borrower insolvency. As a consequence, our alternative approach would typically be to rate the transaction to default of the borrowing group, but the exact rating approach or rating actions would be determined at the time of any restructuring or refinancing, taking into account all relevant factors at that time. It is not possible to say what rating action we will take in the future. We could review the ratings once the DfT has come up with a firm proposal which is expected in the course of this autumn.

Rating actions in relation to the new regulatory regime will be dependent on the final proposal and timing of implementation; we could, however, take rating actions in the coming months, depending on how quickly the DfT's proposal advances, how it materializes, and how likely we believe it is to be followed by an agreement between BAA and creditors, and then in Parliament.

The outlook also reflects our view of the uncertainties related to the ongoing sale of Gatwick airport and the liquidity situation following the March 2010 repayment. We will look closely at the ability of the Borrower group to maintain strong liquidity and cover future funding needs beyond March 2010--for instance through long-term fresh issuance--if the Gatwick sale is postponed beyond that date.

Finally, the degree and timing of the recovery in passenger traffic and in financial performance will be key for the evolution of the ratings, as the global economic recession has led the company to underperform versus the

initial business plan presented at financial closing. We will assess the degree of deviation and the measures management is able and willing to implement to bridge the gap with initial forecasts.

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