

Heathrow Funding Ltd.

Multicurrency Note Issuance Programme

Transaction Update
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Rationale

Heathrow Funding Ltd. (HFL) is a corporate securitization, which grants bondholders first-ranking security over Heathrow Airport Ltd. (HAL) and the Heathrow Express rail link. Principal and interest for the financing group’s obligations is serviced through various revenue sources, but primarily through passenger charges.

The ratings on the notes issued by HFL reflect S&P Global Ratings’ assessment of:

- Heathrow Airport’s (“Heathrow”) excellent competitive position and supportive regulatory regime. These positive features have made Heathrow Airport’s performance less vulnerable to economic conditions and operational disturbances, in our view;
- The critical role of Heathrow as a global airport hub in one of the most important aviation markets globally, which drives its high cash flow generation potential and quality of airline counterparties;
- Low impact from Brexit based on our understanding that negotiation of a relatively small number of bilateral agreements between the U.K. and countries outside the EU would be sufficient to maintain operations for the vast majority of Heathrow’s long-haul traffic, which forms the fundamental base of its business;
- The credit quality of the ring-fenced business which includes Heathrow (SP) Ltd., Heathrow (AH) Ltd., and HAL with Heathrow Airport as its main asset, as well as Heathrow Express Operating Co., together with our assessment of the structural protection features available to the noteholders; and
- Heathrow Airport’s capacity to service and refinance its debt under adverse conditions, which are commensurate with ‘A-’ and ‘BBB’ rating scenarios for the class A and class B notes, respectively. This, in conjunction with the structural and liquidity enhancements,

supports our view that the issuer would be able to meet its obligations at the currently assigned rating levels.

Business Risk Summary

Heathrow (SP)’s business risk profile is supported by the following main features:

- Excellent competitive position of Heathrow Airport as the largest airport in the London area, which itself is the largest aviation passenger market in the world and the most affluent U.K. region, and the only hub airport in the U.K. with near monopoly of long-haul flights.
- A supportive regulatory environment, based on the regulatory asset base (RAB) concept, which ensures availability of cash flows to finance investments via aeronautical charges, while capping the user prices. The recovery of investment is strongly supported by the regulator’s duty to ensure Heathrow’s ability to finance the business. The five-yearly regulatory resets allow for an adjustment of the aeronautical charges in case of any underperformance against the settlement terms.
- Above average profitability among transportation infrastructure companies with an S&P Global Ratings-adjusted EBITDA margin of 60.1% in FY2015 up from 48.7% in FY2010. The increase in the margin reflects the high level of investments delivered over the period, and a return Heathrow is allowed to generate over its assets.
- Resilience to economic downturns thanks to high exposure to long-haul routes and business traffic . In 2009, passenger (pax) numbers fell by only 1.5% in response to a 5% drop in GDP—the lowest pax drop among U.K. airports (see chart 6).
- Limited passenger growth (to 75.7 million in FY2016 from 65.7 million in FY2010) due to air traffic reaching near capacity of 480 thousand air transport movements (ATMs) per year.

Financial Risk Summary

Heathrow (SP)'s financial risk profile is characterized by the following main features:

- A leverage of 8.1x debt to S&P Global Ratings-adjusted EBITDA in FY2015, with an average debt maturity profile of 11.5 years. As of Dec. 31, 2015, fixed rate debt after hedging with derivatives represented 96.3% of the group's total external debt.
- Bullet debt maturities of £600 million-£700 million on average every year during the current regulatory period. We note that the management team manages refinancing risk proactively. For instance, the two notes due in 2017 totalling £856 million (maturities Swiss franc CHF400 million 2.5% and €700 million 4.38%), were prefunded during 2016, more than six months before their respective maturities.
- Sufficient generation of cash flow from operations to cover the forecast capital expenditure (capex) plan. Capex is expected to be about £600 million-£700 million per year or about £3.2 billion over the current regulatory period. The capex is deployed mainly to improve operational efficiency of the airport and passenger experience. The regulatory framework ensures full capex recovery over the regulatory period via aeronautical charges.
- Distributions to serve subordinated debt and shareholders dividends of between £400 million-£500 million per year over the current regulatory period.
- Structural features supporting the transaction's credit quality during period of stress by limiting dividends and other subordinated payments from the structure. Structural features include a senior net debt to the regulatory asset base (RAB) ratio to be lower than 72.5% from April 2018 (prior to that below 70%). Total senior net debt comprises the class A notes, plus any senior debt issued by the group and ranking pari passu with the

class A notes (including accretion on swaps), less any cash or amounts held in authorized investments. We forecast this covenant ratio over the next three years to be comfortably below its trigger level.

Company Description

Heathrow Funding is a wholly-owned subsidiary of Heathrow (SP) which, via the ultimate parent entity, FGP Topco Ltd., is itself controlled by Hubco Netherlands B.V. (25.00%) (an indirect subsidiary of Ferrovial, S.A.); Qatar Holding Aviation (20.00%) (a wholly-owned subsidiary of Qatar Holding LLC); Caisse de dépôt et placement du Québec (12.62%); Baker Street Investment Pte Ltd (11.20%) (an investment vehicle of the Government of Singapore Investment Corporation); Alinda Airports UK L.P. and Alinda Airports L.P. (11.18%) (investment vehicles managed by Alinda Capital Partners); Stable Investment Corporation (10.00%) (an investment vehicle of the China Investment Corporation); and USS Buzzard Limited (10.00%) (wholly-owned by the Universities Superannuation Scheme).

The group structure is presented in chart 1.

The principal activity of Heathrow (SP) is running the operations of Heathrow Airport.

Asset Overview

Heathrow is the U.K.'s largest airport by passenger numbers and the primary airport for London, the world's largest aviation market. The combined passenger traffic at the five main London airports significantly exceeds that of any other city in the world, and the traffic at the top three airports (Heathrow, Gatwick, and Stansted) is still larger than New York. Heathrow handles 49% of traffic in the Greater London area. With 473 thousand ATMs and 75.7m passengers in 2016, Heathrow is Europe's busiest airport and the world's seventh largest airport globally based on the number of passengers (behind Atlanta, Beijing, Dubai, Chicago, Los Angeles, and Tokyo).

Chart 1 – Heathrow Group Structure

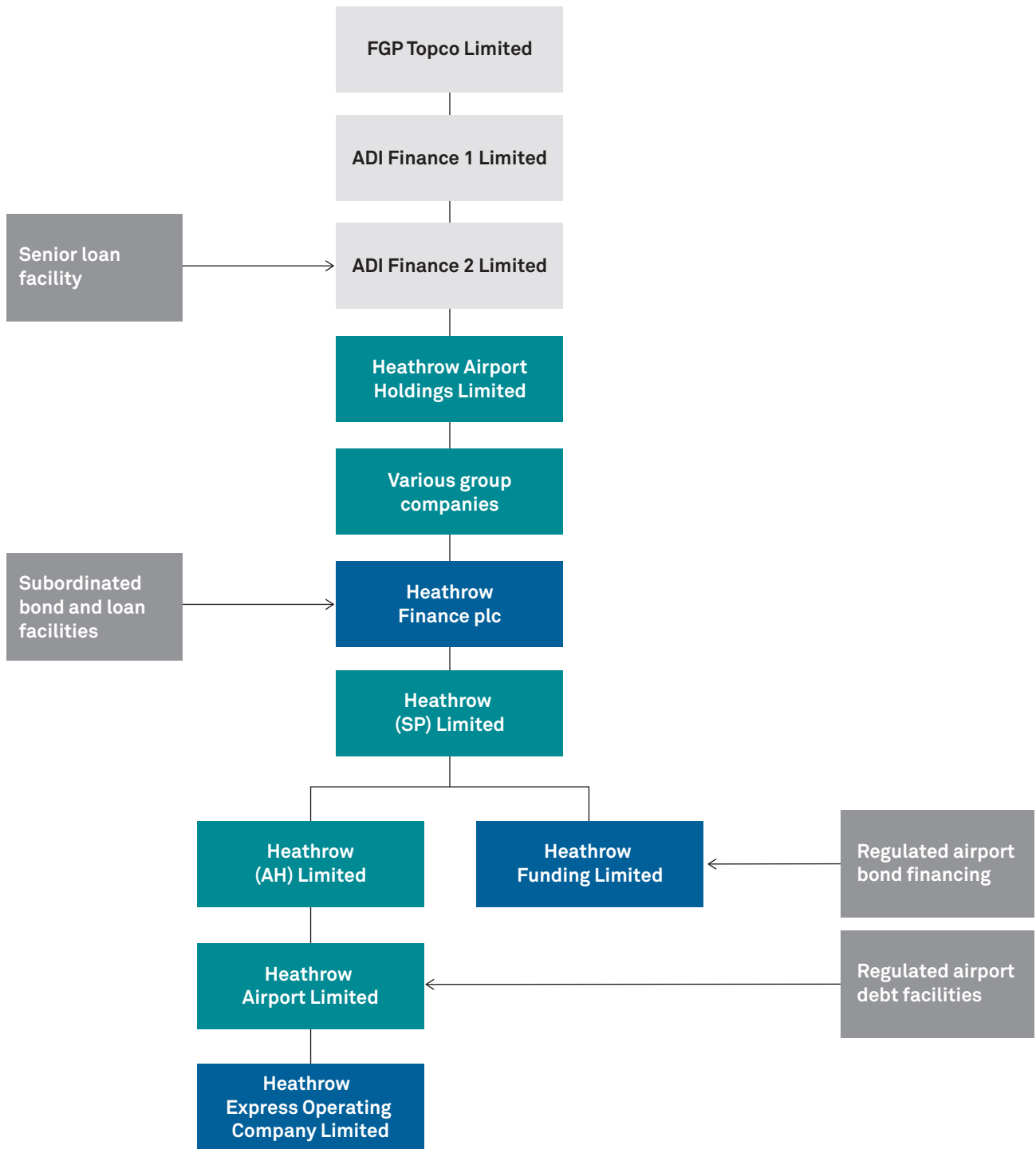


Table 1 – Peer Comparison of London and selected European Airport Groups

	Heathrow SP Ltd	Gatwick Funding Ltd.	Stansted Airport Limited	London		London City Airport Ltd.	N.V. Luchthaven Schiphol	Flughafen Zurich AG	Avinor AS	daa Pic	Aeroporti di Roma SpA	DME Ltd*
				Luton Airport Limited	Aeroports de Paris							
Passengers (min) (FY2015)	75	40.8	22.6	12.3	4.3	64	26.3	50.1	25	46.2	30	
% O&D	68	95	N/A	N/A	N/A	61	72	85	95	72	75	
% of transfer traffic	32	5	N/A	N/A	N/A	39	28	15	5	28	25	
No. ATMs (ths)	472	266	166	116	79	500	265	850	191	360	N/A	
Runways	2	1	1	1	1	6	3	46	4	5	2	
Destinations	185	220	185	70	40	322	169	200	180	230	239	
Long Haul Passengers (%)	52	25	8	13	13	19	14	N/A	13	18	N/A	
Short Haul Passengers (%)	48	75	92	87	87	81	86	N/A	87	82	N/A	
% of Greater London traffic	49	26	15	8	3	N/A	N/A	N/A	N/A	N/A	N/A	
Top Airlines	British Airways	easyJet British Airways	Ryanair easyJet	easyJet Monarch Airlines Thomson Airways	British Airways	Air France- KLM	Swiss Airlines	SAS Norwegian Air	Ryanair	Alitalia	S7	
Business Risk Profile	Excellent	Strong	NR	NR	NR	Excellent	Strong	Strong	Strong	Strong	Fair	
No of Airlines	80	50	23	11	11	109	74	N/A	34	100	85	
% of business pax	36	17	20	19	63	31	33	N/A	18	32	N/A	
% of leisure pax	64	83	80	81	37	69	67	N/A	82	68	N/A	
Revenue (GBP mln)	2,765	673	271.7	147	102.9	1,049	663.3	821.2	500.9	591	366	
EBITDA (GBP mln)**	1,660	337	114.5	50	45.8	476	367	269.6	166.7	314.1	143	
EBITDA margin (%)**	60	50	42	34	45	45	55	33	33	53	39	
Revenue / pax (GBP)	36.9	16.5	12.0	11.9	25.3	16.4	25.2	16.4	20	12.8	12.2	
EBITDA / pax (GBP)**	22.2	8.3	5.1	4.1	12.6	7.4	14	5.4	6.7	6.8	4.8	

mln-Millions, ths-Thousands. N/A-Not available. O/D-Origin-destination.

* DME Limited, together with subsidiaries, manages, operates, and develops Domodedovo airport in the Moscow region, Russia.

** S&P Global Ratings-adjusted EBITDA).

Business Risk Profile

Heathrow's business risk profile is supported by its excellent competitive position, favorable passenger mix, supportive regulatory environment, above-average profitability compared to peers, our view of its resilience to Brexit, and the growth prospects related to the approval of the third runway.

Competitive Position: Excellent

Heathrow is the U.K.'s only hub airport, with near monopoly (85%) for long-haul flights. In FY2015 it was serving 80 airlines operating scheduled flights to 185 destinations in 84 countries.

Demand for landing slots at Heathrow continues to outstrip supply with 30 airlines waiting for slots as of June 2015. Competition to air traffic from other means of transportation is limited as rail and bus services serve mainly national destinations, with international rail services limited to countries close to the U.K. such as France and Belgium.

Heathrow's catchment area is large and affluent. Proximity to London underpins its long-term viability given that it is a location with a significant number of major global companies and the administrative center of the U.K. government. The catchment area covers 25 million people (38% of the U.K. population) within a two-hour drive.

The airport is convenient to access. It is connected to central London via a rail link, offering connection from Paddington Station to Heathrow in about 15 minutes. High Speed 2 (HS2) high-speed railway will increase its rail connectivity with the Midlands while Cross Rail—a new high frequency, high capacity railway for London and the South East expected from 2018—will facilitate accesses to Heathrow from the east of London. Road connections by the M4 to London and M25 to outer London are available, although can get overcrowded at times.

Favorable Passenger Mix

As of FY2015, the majority (68%) of travelers are origin-destination (O&D) passengers which

we see as less volatile as their demand is driven by a need to travel, rather than availability of connections. Only 32% of passengers are transferring between flights at the airport. In addition, 36% of passengers are less price sensitive business travelers while 64% are traveling for family and leisure.

Supportive Regulatory Environment

We consider the regulatory environment as stable, predictable and supportive. It is based on the RAB concept, which reflects the value of the airport's past investments and subsequent capex, adjusted for depreciation. The duty of an independent regulator, Civil Aviation Authority (CAA), to ensure Heathrow's ability to finance the airport's operations, strongly supports availability of cash flows to finance investments, operating costs, and tax via aeronautical charges. A fair return over the RAB ensures profitability of the business and shareholder returns which will grow in line with capex.

The five-year regulatory resets allow for an adjustment of the aeronautical charges to reflect changes in costs and revenues and in assumed traffic volumes, and in case of any underperformance against the settlement terms.

The ability to pass costs onto the customer is limited by capping the user prices. Heathrow was permitted by the CAA to increase its aeronautical charges in each year of the regulatory period Q5 (originally April 1, 2008 to March 31, 2013, ultimately extended by a year) at RPI plus 7.5%, from an initial base of £12.80 per passenger to support a significant capex during that regulatory period. (£4.1 billion in 2008/2009 prices). In Q6 (April 1, 2014 to Dec. 31, 2019), the prices are allowed to grow by a much lower rate, RPI minus 1.5% per year, as the capex planned for Heathrow Airport in Q6 is significantly lower (£2.9 billion in 2011/12 prices), similarly as operating costs given the CAA requirement of achievement of over £630 million savings over the regulatory period. Lower tariff reflects also an expectation of higher commercial income and a reduced weighted-average cost of capital (real pre tax 5.35% in Q6 versus 6.2% in Q5).

Under a “single till”, revenues from the airport’s unregulated nonaeronautical activities (e.g. retail, car parking, etc.), are deducted from the revenue requirement for aeronautical services before determining the level of aeronautical charges. The revenues from such activities, in particular some profitable commercial activities, effectively reduce the level of airport charges to airlines. The share of nonaeronautical revenues relative to total revenues declined to 39% in FY2015 from 46% in FY2010.

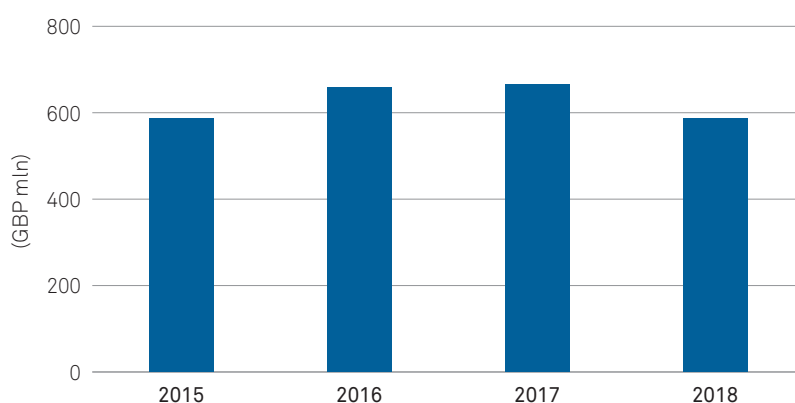
Aeronautical Charges Framework

The tariff calculation formula set by the CAA determines the level Heathrow cannot exceed in charging its airlines on a per passenger basis, referred to as the “maximum allowable yield”. The maximum allowable yield is calculated taking into account the regulatory assets base intended to represent the economic value of the business, a return on investment (real pre tax WACC) of 5.35% in Q6, a depreciation allowance, CAA’s forecast non-aeronautical income, and CAA’s costs forecasts which require the achievement of certain cost efficiencies or targets during the regulatory period. Although they encourage operational expenditure (opex) cost control (for instance over £630 million reduction in opex in Q6), the regulation allows for recovery or the pass-through of certain cost items over which Heathrow has little control such as additional capex related to security (90% of cost above £20 million are passed through to passengers), business rates (80% of the excess or 80% of the saving below certain amount), or preparatory costs of the airport expansion.

The tariff formula includes a retrospective true-up mechanism (the “K” factor) to adjust for differences between actual per passenger charges and the price cap to allow for differences between the assumed and actual passenger and aircraft mix that arise as charges for each year are set in advance. The K factor is applied two years later. Also, the CAA has permitted allowances in the traffic forecast for aviation related demand shocks (such as the 2010 volcanic ash).

Chart 2 – Heathrow Q6 Capex

Capex as per the Management's forecast



Capex Recovery

In order to add flexibility to respond to the dynamic nature of the airport industry, capex is classified as either core or development. The initial capex envelope comprises fixed allowance for core capex and an indicative allowance for development capex. Development capex is recovered only if actually spent.

During Q6, Heathrow’s planned capex of £3.2 billion in outturn costs is aimed at improving the airport’s operational resilience and efficiency under four strategic programs: airport resilience (e.g. taxiway widening, enhancement to runway landing systems); passenger experience (e.g. parallel loading security lanes, additional body scanners, expanded retail offering, new business car park); baggage handling (automated baggage handling system, baggage screening equipment); and asset management (Terminal 4 refurbishment, northern runway resurfacing, strengthening of tunnels). The chart above presents capex forecast by the management excluding the expenditure related to the third runway. Additional capex in 2017 related to the runway amounts to £110 million, comprising approximately £75 million of costs associated with planning (“Category B costs”) with the rest being construction enabling costs (e.g. related to design work) (“Category C costs”). However, these costs will only be incurred once satisfactory arrangements for their recovery have been agreed with airlines and the CAA. In FY2015, Heathrow spent £627 million.

Above Average Profitability

Heathrow (SP)'s profitability measured by S&P Global Ratings-adjusted EBITDA margin increased to 60.0% in FY2015 from 48.7% in FY2010.

The growth has resulted primarily from an increase in aeronautical charges which, given the constrained capacity (ATM growth at compounded average growth rate (1.0% CAGR over 2010-2015)), and relatively small growth in passenger numbers (2.7% CAGR over 2010-2015) was the main factor pushing the revenue growth (5.9% CAGR over 2010-2015).

Heathrow's aeronautical revenues represented 61% of total revenues in FY2015, up from 54% in FY2010 (see table 2).

We believe Heathrow's above-average profitability versus peers is the result of the high level of recent investments in the airport's infrastructure, and Heathrow's ability to recover it. The delivery of Terminal 5, redevelopment of Terminal 2, and baggage infrastructure investment has increased the level of RAB and affected the level of revenues Heathrow is able to claim under the aeronautical charges. Heathrow is able to support these high tariffs—the highest amongst European airports, see table 2—due to its favorable passenger mix.

Profitability has also been supported by Heathrow's success in increasing its commercial revenues, in particular retail (5.5% CAGR over 2010-2015) and car parking (7.7% CAGR over 2010-2015). These revenue increases followed initiatives implemented such as an expanded World Duty Free store and the extension and refurbishment of retail offering in Terminal 5; refurbishment of the airside specialist shops and the new walk through area in the World Duty Free store in Terminal 3; new independent lounges in Terminals 3, 4 and 5; car park yield management and a new business car park for Terminal 5; as well as the increased use of media space. As a result of these investments, Heathrow has for many years led its European peers in commercial revenue per passenger, despite its car park revenue per passenger being in-line with its peers, and lower than at Gatwick (see table 3).

Table 2 – Aeronautical Charges Per Pax

	Aeronautical charges (GBP per pax)
Heathrow SP Ltd	22.7
Gatwick Funding Ltd.	8.6
Avinor AS	8.0
Aeroports de Paris	13.2
N.V. Luchthaven Schiphol	9.6
Flughafen Zurich AG	15.0
daa Plc	6.9
Aeroporti di Roma SpA	9.2
Average	11.2

Source: Companies' websites. Data for FY2015 or a financial year most closely aligned to Heathrow's December year end. Euro/GBP average exchange rate for 2015 of 0.7262

Table 3 – Car Parking And Retail Revenue Per Pax

FY 2015	Car parking revenue (GBP per pax)	Retail revenue per (GBP per pax)
Heathrow SP Ltd	1.4	6.2
Gatwick Funding Ltd.	1.9	3.7
Avinor AS	1.4	5.2
Aeroports de Paris	1.3	3.3
N.V. Luchthaven Schiphol	5.7	10.5
Flughafen Zurich AG	1.9	2.9
daa Plc	n/a	3.5
Aeroporti di Roma SpA	0.4	1.7
Average	2.0	4.6

Source: Companies' websites. Data for FY2015 or a financial year most closely aligned to Heathrow's December year end. Euro/GBP average exchange rate for 2015 of 0.7262

There has also been a continued focus on delivering operating efficiencies, in particular employment costs (via take-up of a voluntary severance programme, improvements in new entrant pay levels, automation and other workforce efficiencies like changes made to the defined benefit pension scheme) and reductions in energy consumption, although they were partially offset by cost competition from rent and rates, maintenance, utilities, and general expenses, as well as from new infrastructure (e.g. baggage facilities). Heathrow has also conducted extensive renegotiations of contracts with strategic suppliers (such as Babcock, NATS, and UK Power Networks) which delivered significant savings.

These initiatives have enabled Heathrow to grow its EBITDA margin to the highest level out of its European peers and what we consider as above average in the transportation infrastructure sector (see table 1).

Peer Comparison

Despite operating only one airport (compared to Aeroports de Paris' [AdP] three: Charles de Gaulle, Paris-Orly, Paris Le-Bourget, and Schiphol's four) with only two runways, and serving less passengers than AdP, Heathrow is the biggest out of these three European hubs in terms of revenue and profitability. Heathrow has been charging premium rates with no detrimental effect on demand. Indeed, although Heathrow's charges grew significantly in Q5, demand appeared to be price inelastic (see chart 3) as passenger growth continued despite raising charges.

Heathrow has the highest percentage of business passengers out of the three hubs (36%), and the highest share of full-cost compared to low-cost carriers. In FY2016, AdP had 18% and Schiphol had 12% of low cost traffic compared to Heathrow's 3%.

Heathrow has a high exposure to transfer traffic (32% at Heathrow, 24% at AdP, and 39% at Schiphol) which could be more volatile as transfer traffic tends to follow convenience of connections (choice, frequency, flight timetable, and price). That said, transfer traffic has grown as a percentage of total traffic in the main European hubs over the 2009 economic slowdown, thus showing features of contra cyclical.

Heathrow also has a high proportion of long-haul traffic (52% in FY2015). Long-haul services mean more passenger numbers per slot due to larger planes used, and are associated with higher retail revenues as passengers spend more time at the airport before boarding. Long-haul passengers also tend to be less price sensitive.

The constraining factor for Heathrow is its capacity under Terminal 5 planning

Chart 3 – Aeronautical Tariff And Passenger Numbers

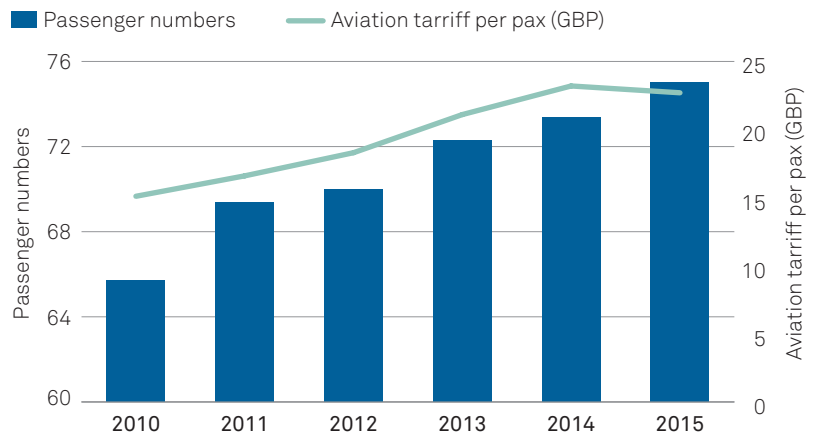
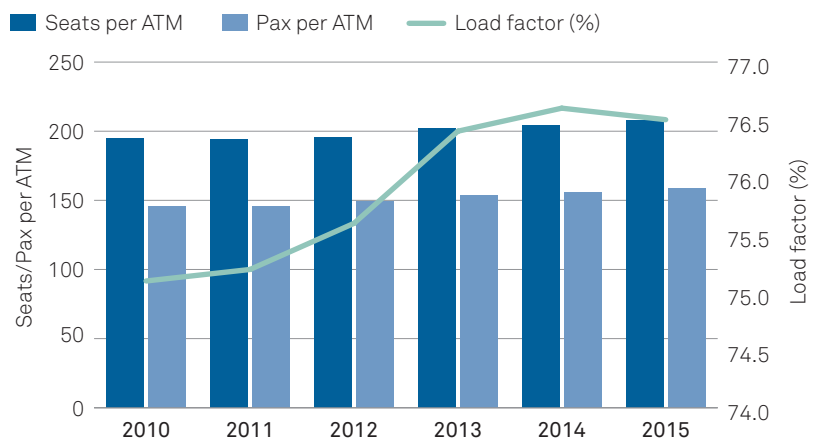


Chart 4 – Heathrow Aircraft Sizes And Average Load



permission, limiting traffic to 480 thousand ATMs per year. Before the opening of the third runway (currently planned in 2025), more capacity could only be released by lifting this limit. Until then, Heathrow's only means of passenger growth is by attracting aircraft with more seats and increasing the load factor. Although Heathrow serves larger aircrafts (208 average seats per ATM in FY2015 compared to 181 per ATM at Gatwick), load factors at Heathrow are lower. Heathrow's load factor has increased very little, to 76.5% in FY2015 from 75.1% in FY2010 (see chart 4), while the load factor at Gatwick increased to 84.5% from 78.7% during the same period. Heathrow would like to lift the ATM cap by about 25,000 per annum once expansion planning permission is obtained (around 2021).

Heathrow's Resilience To Brexit

U.K.'s vote to leave the EU (Brexit) creates uncertainty, but a significant drop in passenger numbers is unlikely in our view. During the 2008-2010 economic slowdown, there was only a 3.4% peak to trough drop. Even if a similar drop took place within the next couple of years, its impact would be mitigated by traffic being currently above the CAA forecast (4% higher in FY2015), which was used to set maximum regulated charges, and that a regulatory reset will take place in three years. If passenger numbers declined as a result of Brexit, this would be reflected in higher aeronautical revenues in the next regulatory period. Also, the financial impact of the relative slowdown in the traffic growth (FY2016: 1% versus FY2015: 2.2%) to date has been offset by increased commercial revenue attracted by weaker pound sterling.

An additional long-term impact of Brexit could result from changes in the aviation policy. However, we believe bilateral trade agreements with 8-10 countries would be sufficient to ensure terms of operations for the vast majority of Heathrow's long-haul traffic, which forms the fundamental base of its business.

Impact Of Third Runway At Heathrow

Additional capacity at Heathrow will open the possibility of new long haul routes, enable Heathrow to connect to more destinations, and serve more transfer passengers thus reinforcing its position as the U.K.'s hub airport. Heathrow will likely attract a higher share of traffic from other European hubs, with which Heathrow competes for long-haul traffic, especially for connections between Europe, Asia, Africa and North America. We expect that foreign carriers, in particular members of alliances currently present at Heathrow—such as One World, Star Alliance, and SkyTeam—will be interested in expanding their operations, and British Airways (BA), which is by far the largest hub carrier at Heathrow in terms of passengers will continue to operate its hub from Heathrow. While Heathrow's earnings will benefit, increased

transfer traffic could expose Heathrow to greater volatility, although its wide spread of connecting destinations is expected to provide a natural hedge.

As for the impact on other London airports, in our opinion, airlines whose value proposition is based on price, and those carriers whose destinations—both short haul and long haul—are focused on more price sensitive leisure passengers, are not likely to increase or establish presence at Heathrow due to its premium airport charges. We also do not expect easyJet to establish a significant presence at Heathrow. Although easyJet is attracting an increasing share of business passengers (in FY2016 20% of its passengers were business travelers), a move to Heathrow would, in our opinion, increase its costs, as well as exposing it to more competition with BA's loyal customer base and alliances. In our opinion, easyJet could have only limited services from Heathrow. As for the long-haul destinations serviced by traditional operators, some of the holiday destinations are likely to also remain at other airports, as holiday destinations tend to be O&D, hence there is no rationale for paying higher aeronautical fees for the benefit of operating from a hub.

Given uncertainties surrounding the timing and cost of the third runway construction, we currently do not incorporate its impact on Heathrow's competitive position in our analysis. At present, we expect a Draft National Policy Statement (NPS) in early 2017, followed by public consultation and a Transport Select Committee scrutiny with a final NPS likely in late 2018, and a final decision announced by the Secretary of State in approximately two years time. Also, the construction costs and funding of the recently approved third runway are still to be decided and are not yet included in our base case. For further information, please refer to "*Ratings On Heathrow Remain Unchanged By Third Runway Announcement Pending Details On Construction Funding*," published on Oct. 28, 2016.

Financial Risk Profile

Our assessment of Heathrow (SP)'s financial profile is constrained by its aggressively leveraged balance sheet, with a forecast ratio of debt to S&P Global Ratings-adjusted EBITDA of 7.5x-8.2x over FY2016-FY2019 and, a significant, although predominantly cash flow-funded capex plan and forecast distributions to serve subordinated debt and shareholders dividends of £400 million-£500 million per year. The fixed-rate debt after hedging with derivatives represented 96.3% of the group's total external debt. We expect the ratio of S&P Global Ratings-adjusted funds from operations to debt to remain between 6%-7% over FY2016-FY2019.

Financial Performance

In FY2015, Heathrow Airport handled 75.0 million passengers (2.2% over FY2014), generated £2,765 million in revenue, and posted adjusted S&P Global Ratings-adjusted EBITDA of £1,660 million (see table 4 and chart 5).

Since traffic drops experienced in 2008-2010, Heathrow has been growing passenger numbers at a CAGR of 2.7% in 2010-2015.

During the same period (2010-2015), Heathrow's revenue grew at 5.9% CAGR. Profitability grew faster than pax numbers and revenue, adjusted EBITDA grew at 10.5% CAGR, and the S&P Global Ratings-adjusted EBITDA margin grew at 4.3% CAGR. These growth rates include Stansted Airport until it was sold in 2013.

Debt Maturities

We assume that Heathrow will have continued access to the markets to refinance debt coming due and make restricted payments. Refinancing risk is therefore one of the main risk factors in our analysis. We consider that it is partly mitigated by a set of covenants that give the management an incentive to keep debt under a predetermined proportion of RAB. This makes for a relatively stable and predictable asset valuation proxy.

Furthermore, the refinancing risk is mitigated by a very spread maturity profile with a maximum

Table 4 – Key Financial Data

	2010	2011	2012	2013	2014	2015
Pax number (mln)	65.7	69.4	70.0	72.3	73.4	75.0
Total ATM (thousands)	449.2	476.2	471.3	469.5	470.7	472.1
Seats per passenger ATMs	195	195	197	203	204	209
Load factor (%)	75.1	75.2	75.6	76.4	76.6	76.5
Revenue (GBP mln)*, **	2,074	2,280	2,464	2,474	2,692	2,765
EBITDA (GBP mln)*, **	1,090	1,154	1,449	1,432	1,594	1,660
EBITDA margin (%)*, **	48.7	50.6	58.8	57.9	59.2	60.0

Seats per passenger ATMs and Load factor refer to Passenger ATMs and not total ATMs

*The figures include Stansted Airport until it was sold in 2013.

**S&P Global Ratings-adjusted EBITDA.

Chart 5 – Heathrow Performance

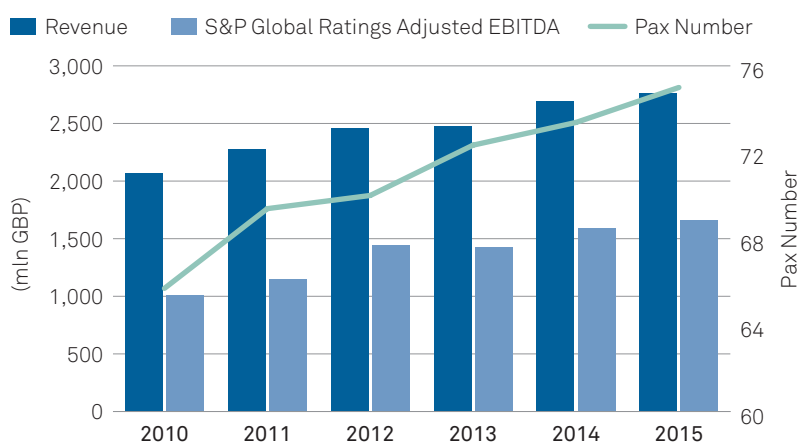


Chart 6 – UK GDP And London Airports Traffic Growth



10% of debt maturing in any year, and also by the fact that Heathrow has a well-established program for debt issuance, having already issued in six currencies. Between 2010 and 2016, Heathrow SP issued £1.6 billion per year

Transaction Update: Heathrow Funding Ltd.

on average in term debt. Heathrow maintains reasonable buffers to leverage triggers and covenants, and has been focused on extending its average life of debt. As at Dec. 31, 2015, the average debt life was 11.5 years. Even though cost of debt is likely to increase from currently very low rates, the regulatory construct allows capturing it in the WACC. We believe the regulator would allow the recovery of a higher cost of debt via aeronautical charges as it allowed Heathrow to recover the cost of Terminal 5 construction via charges in Q4.

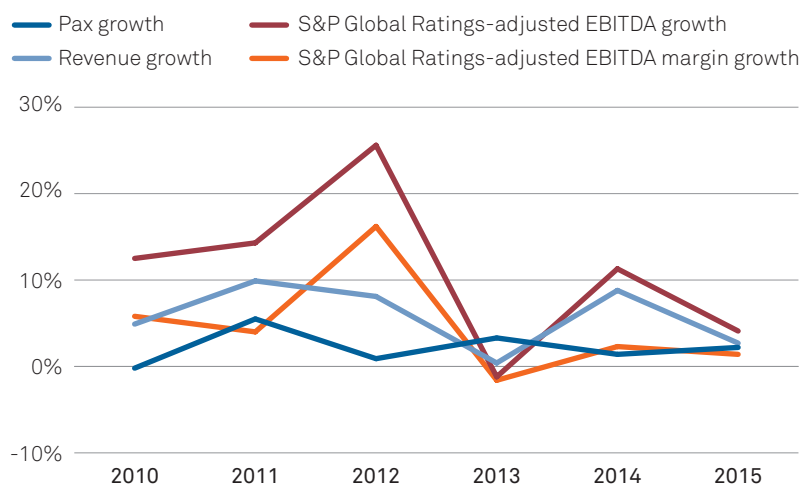
S&P Base Case

We expect the growth in passenger numbers to be limited by the capacity constraints that Heathrow continues to experience. In FY2015, the number of passengers grew by 2.2%. In FY2016 the number of passengers increased further by 0.9% to 75.7 million. Another consideration is that, after a period of significant growth at peer airports (Frankfurt am Main, Paris Charles de Gaulle, Istanbul's Atatürk, Amsterdam's Schiphol, and Adolfo Suárez Madrid-Barajas), the market may be reaching saturation, with slowdowns in 2016 in many European airports.

Tariffs at Heathrow declined by 0.6% in FY2016 because Heathrow is allowed to increase aviation fees by RPI minus 1.5%, and RPI as of April 2015 was 0.9%. In FY2017 tariffs will decrease by 0.2%, as April 2016 RPI was 1.3%. We expect that Heathrow's commercial income per passenger will increase by between 4.5%-6.5% in FY2016, reflecting primarily the performance of the refurbished and expanded Terminal 5 luxury retail space and the continued growth in car parking. In FY2017, we project that commercial income per passenger will grow nominally by between 5.0%-6.0% after giving credit to expected returns on the company's investment in the retail experience. Based on these forecasts, we expect Heathrow's revenues to increase by between 1%-2% in FY2016.

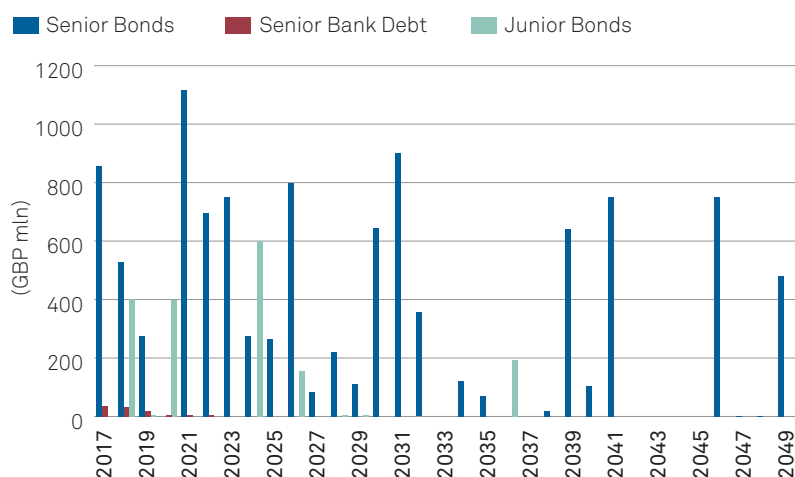
Heathrow made significant progress in reducing its operating costs in 2015 and, in our base-case, we expect further reductions in 2016. In our view, this will likely lead to an improvement in

Chart 7 – Key Metrics Growth Rate



Note: Growth rates include an impact of the disposal of Stansted airport in 2013.

Chart 8 – Debt Maturities (GBP mln)



S&P Global Ratings-adjusted EBITDA margins to 61.0%-62.0% in FY2017 from 60.0% in FY2016. We expect capex to be about £620 million-£650 million in FY2016 and £690 million-£720 million in FY2017.

Structural Features

Structural enhancements include financial covenants, a hedging policy, and restrictions on permitted disposals, acquisitions, and businesses. In addition, we view the combination of loan events of default that allow noteholders to take control of the business ahead of an insolvency of HAL, the two-year tail period on the senior notes, and the liquidity facility as critical to ensure the repayment of the notes in accordance with their terms.

Financial Covenants

Under its financing platform, HAL is only able to incur additional senior debt up to a level of senior net debt of 72.5% of RAB, provided that it also continues to meet other financial covenants, including interest coverage and leverage tests. HAL may incur additional junior debt up to a level of junior net debt of 90.0% of RAB. Total senior net debt comprises the class A notes, any senior debt issued by the borrower group having the same seniority as the senior notes, and accumulated accretion balances on the retail price index swaps, net of cash. The financing platform's trigger events, which affect the HAL's ability to make restricted payments to Heathrow Finance, include a level of senior net debt of 70.0% of RAB (72.5% from 1st April 2018) and of junior net debt of 85.0% of RAB (see table 5).

The senior regulatory asset ratio (RAR), calculated as senior net debt to RAB was 0.675x in FY2015 and, according to the management projections, will be 0.66x and 0.67x in FY2016 and FY2017, respectively. The second covenant, the senior interest coverage ratio (ICR), was 2.90x in FY2015 and management expects it to remain at above 3.10x through FY2017. We expect both covenant ratios to remain at levels providing significant headroom to their respective trigger and default levels (senior RAR: trigger event ratio of 0.70x and event of default ratio of 0.925x; senior ICR: trigger event ratio of 1.40x).

Interest, Currency, And Inflation Risk

Under its hedging policy, the issuer (HFL) is required to have 75% of current debt that is fixed or linked to inflation for the current

regulatory period. Covenants are also a minimum of 50% of its debt to be either fixed- or inflation-linked in the following regulatory period to December 2024. At the same time, the total notional hedged amounts must not exceed 102.5% of debt.

Given the regulated income derived from the RPI plus or minus X% regime and the RPI-indexed RAB, the issuer uses index-linked swaps along with liabilities as a natural hedge. Such instruments have the effect of alleviating short-term constraints on the ICR, although the outstanding debt accretes year-on-year. We note that the accretion is included in the net debt calculation for the purpose of the financial ratios and is also capped at 8% of senior net debt under the trigger events.

As is common with utility corporate securitization transactions (now referred to as "structurally enhanced debt transactions"), the swaps rank senior to the class A debt, except for currency swaps which rank pari passu with the relevant class of debt that has been currency swapped.

The security group may not bear currency risk with respect to any foreign currency denominated debt.

Refinancing Risk

In our rating analysis we make the assumption that the borrower (HAL; the primary operating company) will have timely access to the capital markets in order to refinance its term loans owed to the issuer on their maturities and, in turn, allow the issuer to repay the notes on their

Table 5 - Financial Covenants

Debt	Restricted Payment Condition	Event of Default	Actual in FY 2014	Actual in FY 2015	Forecast in FY 2016	Forecast in FY 2017
RAB (GBP mln)			14,860	14,921	15,246	15,747
Senior RAR	>0.70x	>0.93x	0.68x	0.68x	0.67x	0.67x
Senior ICR	<1.40x	N/A	2.94x	2.90x	3.10x	3.22x
Junior RAR	>0.85x	N/A	0.78x	0.79x	0.78x	0.79x
Junior ICR	<1.20x	N/A	2.40x	2.36x	2.49x	2.55x

RAB-Regulatory asset base. RAR-Regulatory assets ratio. ICR-Interest coverage ratio. N/A-Not available.

scheduled redemption dates. The rationale that supports the assumption of continued and timely access to capital markets considers the following factors: Regulation; Operational Strength; and Financial Policy.

Regulation

Regulation by the CAA affords investors good visibility into the long-term nature of the operating assets through both pricing controls/flexibility and capital investment and controlling the risk taken on at the operating company despite its level of debt. This is achieved through the following:

- The resettable price cap offers creditors a clear outlook over the long-term cash flows and therefore high degree of confidence that debt can be serviced; and
- The RAB is (i) a relatively predictable and stable valuation proxy for the assets which the notes are secured on, (ii) allows a long-term view of the value of the business (and being the base for the price cap calculation, provides also comfort as to the ability to service long term debt) and (ii) gives confidence that, where new funding is raised to finance new projects, investments will be remunerated from when they are made rather than from when they begin to operate.

Operational Strength

Operational strength may be seen as a mitigating factor to leverage and allow for the assumption that a corporate issuer may refinance at a rating category above its ICR.

It is reflected in our assessment of HAL's excellent business risk profile (BRP).

Financial Policy

In addition to supportive regulation and operational strength, the assumption that HAL will be able to attract financing on an ongoing and frequent basis is supported by certain structural features embedded in the transaction documents and liquidity position of HAL.

Liquidity Facility

HAL, the borrower, and HFL, the issuer, each benefit from a dedicated liquidity facility available for the following purposes:

- The facility at the issuer level is available to cover the next 12 months interest on class A and the next six months' interest on class B, plus senior costs as per the issuer pre-enforcement priority of payments (for the avoidance of doubt, excluding unscheduled and termination payments due to the issuer hedge providers).
- The facility at the borrower level is available to cover the next 12 months interest payments under the European Investment Bank facility and an estimate of the scheduled payments due in respect of the borrower hedges over the next 12 months (for the avoidance of doubt, excluding unscheduled and termination payments due to the borrower hedge providers).

The committed balance is available to support the notes while they are outstanding.

In line with the liquidity facility agreement, the issuer and the borrower undertake to draw the commitment associated with any counterparty rated below the documented A-2 trigger within 60 calendar days or should one of the providers refuse to extend the facility on any yearly renewal date.

Cash Flow Analysis, Flat And Stressed Scenarios

In conjunction with our economic outlook for the UK (see "Europe Navigates Brexit Storm—For Now," published on Oct. 11, 2016), we have revised our assumptions for RPI that have been incorporated into the cash flow analysis. In our flat case, we assume that RPI will average 2.76% through 2021 (increasing to 3.41% in 2021 from 1.83% in 2016) and be 0.0% thereafter. Under stressed cash flow scenarios, we assume that each two-year recession is followed by a two-year recovery for which we increased our RPI assumptions to 3.0% from 2.0%. The effect

of the change in our RPI forecast is a higher cash flow available for debt service under the flat case, due to additional growth through 2020 owing to the effect of the higher RPI on aeronautical/passenger revenues.

Under stressed cash flow scenarios, we only give credit to cost efficiencies that either have already been achieved, or that we consider as having a high likelihood of being achieved. Therefore, we anticipate that the transaction would breach dividend lock-up covenants when a mix of stresses that we view as commensurate with the rating on the notes—including deflation, stressed cost of debt, and stressed RPI-hedging assumptions—are overlaid on the capital structure. These covenants are designed to support the transaction's credit quality during a stress scenario by limiting dividends and other subordinated payments from the structure. In none of these cases, however, would the notes be exposed to a payment default or a breach of the financial default ratios at the current rating levels.

Outlook

We could lower our rating on the notes if the regulatory framework changes substantially over time—becoming less supportive of Heathrow Airport's ability to finance its operations in the banking and capital markets. In such a scenario, we anticipate that the weaker debt structure of the class B notes would make them more exposed to a downgrade. We could also lower the rating if the company is faced with an operational shock that leads to a significant reduction in passenger volumes, or if it faces material regulatory penalties due to its failure to meet regulatory targets. We could also take a negative rating action if the company were to adopt more aggressive financial policies.

At this stage, we see limited scope for raising the ratings on HFL's notes, as the financial covenants set in the bond structure allow HAL to operate with high leverage.

Table 6 – Rating List As At 31 December 2016

Class	Rating	Issue date	Currency	Orig. Notional (Currency)	Notional as at 31 Dec 2016 (GBP)	Scheduled redemption date	Maturity date	Coupon (Fix-Float-Zero Coupon)	Interest Rate
A-2	A- (sf)	18-Aug-08	GBP	250	250	29-Mar-21	29-Mar-23	Fix	9.20%
A-3	A- (sf)	18-Aug-08	GBP	200	200	4-Aug-28	4-Aug-30	Fix	7.08%
A-4	A- (sf)	18-Aug-08	GBP	900	900	10-Dec-31	10-Dec-33	Fix	6.45%
A-8	A- (sf)	18-Aug-08	EUR	750	510	15-Feb-18	15-Feb-20	Fix	4.60%
A-9	A- (sf)	18-Aug-08	GBP	750	750	15-Feb-23	15-Feb-25	Fix	5.23%
A-10	A- (sf)	4-Dec-09	GBP	700	700	3-Dec-26	3-Dec-28	Fix	6.75%
A-11	A- (sf)	4-Dec-09	GBP	460	562	9-Dec-39	9-Dec-41	Inflation linked	3.33%+RPI
A-13	A- (sf)	10-May-10	GBP	750	750	13-May-41	13-May-43	Fix	5.88%
A-14	A- (sf)	22-Jun-11	USD	1,000	621	15-Jul-21	15-Jul-23	Fix	4.88%
A-15	A- (sf)	27-Jan-12	CHF	400	272	8-Feb-17	8-Feb-19	Fix	2.50%
A-16	A- (sf)	23-Jan-12	EUR	700	584	25-Jan-17	25-Jan-19	Fix	4.38%
A-17	A- (sf)	25-Jan-12	EUR	50	42	26-Jan-32	26-Jan-34	Zero Coupon	n/a
A-18	A- (sf)	25-Jan-12	EUR	50	42	2-Apr-32	2-Apr-34	Zero Coupon	n/a
A-19	A- (sf)	16-Apr-12	GBP	180	198	25-Apr-22	25-Apr-24	Inflation linked	1.65%+RPI
A-22	A- (sf)	3-Jul-12	CAD	400	250	3-Jul-19	3-Jul-21	Fix	4.00%
A-23	A- (sf)	24-Oct-13	GBP	750	750	31-Oct-46	31-Oct-48	Fix	4.63%
A-24	A- (sf)	28-Jan-14	GBP	75	78	28-Mar-32	28-Mar-34	Inflation linked	1.37%+RPI
A-25	A- (sf)	28-Jan-14	GBP	50	52	28-Jan-39	28-Jan-41	Inflation linked	1.38%+RPI
A-26	A- (sf)	28-Jan-14	GBP	75	78	28-Jan-49	28-Jan-51	Inflation linked	1.37%+RPI
A-27	A- (sf)	23-May-14	EUR	600	490	23-May-22	23-May-24	Fix	1.88%
A-28	A- (sf)	12-Jun-14	GBP	50	50	12-Jun-34	12-Jun-36	Fix	4.17%
A-29	A- (sf)	17-Jun-14	CAD	450	246	17-Jun-21	17-Jun-23	Fix	3.00%
A-30	A- (sf)	1-Jul-14	EUR	50	40	1-Jul-34	1-Jul-36	Zero Coupon	n/a
A-31	A- (sf)	24-Jul-14	GBP	100	102	22-Mar-40	22-Mar-42	Inflation linked	1.24%+RPI
A-32	A- (sf)	11-Feb-15	EUR	750	566	11-Feb-30	11-Feb-32	Fix	1.50%
A-33	A- (sf)	1-Apr-15	NOK	1,000	84	1-Oct-27	1-Oct-29	Fix	2.65%
A-34	A- (sf)	21-May-15	CAD	500	266	21-May-25	21-May-27	Fix	3.25%
A-35	A- (sf)	17-Feb-16	CHF	400	277	17-May-24	17-May-26	Fix	0.50%
A-36	A- (sf)	7-Dec-16	NOK	1,000	91	7-Dec-29	7-Dec-31	Fix	2.50%
A-37	A- (sf)	9-Aug-16	GBP	400	400	9-Aug-49	9-Aug-51	Fix	2.75%
B-1	BBB (sf)	10-Sep-10	GBP	400	400	10-Sep-18	10-Sep-18	Fix	6.25%
B-2	BBB (sf)	10-Feb-12	GBP	600	600	14-Feb-24	14-Feb-24	Fix	7.13%
B-3	BBB (sf)	13-Mar-12	GBP	400	400	20-Mar-20	20-Mar-20	Fix	6.00%
B-4	BBB (sf)	6-Aug-14	GBP	155	155	6-Aug-26	6-Aug-26	Fix	4.22%
B-5	BBB (sf)	21-Sep-15	GBP	180	182	21-Sep-36	21-Sep-36	Inflation linked	1.06%+RPI

Related Criteria

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Structured Finance - ABS: European Corporate Securitizations, Feb. 12, 2016
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- General Criteria: Understanding Standard & Poor's Rating Definitions, June 03, 2009
- Europe Navigates Brexit Storm—For Now, Oct. 11, 2016
- Heathrow Funding's £400 Million Class A-37 Fixed-Rate Notes Assigned 'A- (sf)' Rating; Other Ratings Affirmed, Aug. 9, 2016
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- Flying On One Engine: The Eurozone Economy Is Fighting For Altitude, March 30, 2016
- Corporate Securitizations Asset And Liability Model - Heathrow Funding, Feb. 26, 2016
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- Heathrow Funding's CAD500 Million Class A-34 Fixed-Rate Notes Assigned 'A- (sf)' Rating; Outlook Stable, May 21, 2015
- Eurozone Economic Outlook: Will the Catch-Up Lead to A Let-Down?, July 1, 2015

Related Research

- Heathrow Funding's NOK1.0 Billion Class A-36 Fixed-Rate Notes Assigned 'A- (sf)' Rating; Other Ratings Affirmed, Dec 7, 2016
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative On Brexit Uncertainties, Oct. 28, 2016
- Ratings On Heathrow Remain Unchanged By Third Runway Announcement Pending Details On Construction Funding, Oct. 28, 2016
- Ratings On All Notes In Heathrow Funding Affirmed; Class A-24, A-25, A-26 Notes Rated 'A- (sf)'; Outlook Stable, Jan. 28, 2014
- Ratings On All Notes In Heathrow Funding Deal Affirmed; Outlook Stable, Oct. 25, 2013
- European Structured Finance Scenario And Sensitivity Analysis 2014: The Effects Of The Top Five Macroeconomic Factors, July 8, 2014

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