



RATING ACTION COMMENTARY

Fitch Revises Outlook on Heathrow Funding and Heathrow Finance Notes to Stable; Affirms Ratings

Tue 04 Apr, 2023 - 11:00 AM ET

Fitch Ratings - London - 04 Apr 2023: Fitch Ratings has revised the Outlook on Heathrow Funding Limited's class A and class B bonds to Stable from Negative and affirmed the ratings at 'A-' and 'BBB', respectively. Fitch has also revised the Outlook of Heathrow Finance plc's (Holdco) outstanding notes (HY notes) to Stable from Negative and affirmed the ratings at 'BB+'.

RATING RATIONALE

The revision of the Outlooks to Stable reflects Heathrow's strong traffic recovery, decreased uncertainty regarding the tariff framework in 2022-2026 regulatory period and normalisation of group operations.

The affirmation of notes reflects our expectation that Heathrow's leverage will be sustained below our rating sensitivities of 8x, 9x and 10x for the class A, class B and consolidated credit profile, respectively, mostly due to stronger than expected traffic recovery.

Heathrow's liquidity position remains strong. As of end-2022, liquidity available to the class A and B notes consisted of GBP1.8 billion in cash and term deposits, as well as committed

fully undrawn liquidity line facilities of around GBP1.4 billion. This compares with debt service (maturity and interest) of GBP1.3 billion and GBP1.4 billion due in 2023 and 2024. Holdco also has significant cash reserves of around GBP1.2 billion covering debt service until 2025.

KEY RATING DRIVERS

Large Hub with Resilient Traffic: Volume Risk - Stronger

Heathrow is a large hub airport serving a strong origin and destination market within a wealthy catchment area. Its traffic demonstrated strong resilience to economic downturns, namely during the global financial crisis. Heathrow's traffic peak-to-trough of only 4.4% through the 2008 economic crisis reflects a combination of factors: the attractiveness of London as a world business centre; the role of Heathrow as a primary hub offering strong yield for its resident airlines; the location and connectivity of Heathrow with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint, which also helps absorb shocks.

During the pandemic, LHR's traffic performance was similar to other UK airports, mostly driven by policy on travel restrictions. The post-pandemic recovery was a par with European peers.

Regulated and Inflation-Linked: Price Risk - Midrange

Heathrow is subject to economic regulation, with a price cap calculated under a single till methodology. The price cap, set by the Civil Aviation Authority (CAA), is established to offset Heathrow's significant market power and is highly sensitive to the assumptions made by the regulator on several building blocks, such as cost of capital, traffic forecast and operational efficiency. The regulatory process that leads to the cap determination is transparent but creates material uncertainty each time it is reset.

The CAA's final decision for the new H7 regulatory period (2022-2026) is substantially in line with our previous assumptions.

Unconstrained Medium-Term Capacity: Infrastructure Development/Renewal - Stronger

Heathrow has a proven record of maintaining and developing its infrastructure to a high level. There are no medium-term constraints in terms of terminal and runway capacity as the airport's traffic recovers after the pandemic. Heathrow has stable and predictable

maintenance capex requirements while growth capex is mostly uncommitted, which allows for flexibility in response to market conditions and trends.

Obsolescence risk is minimised through LHR's competitive position in the area and its role as a global hub. Heathrow has a record of successfully accessing capital markets to secure funding and of delivering capex projects. We also note the regulator's mandate to ensure financeability of capex in addition to affordability to end-users as supportive, despite some uncertainty regarding timing and price-recovery of the investment.

As a result of the coronavirus pandemic, Heathrow postponed almost all investments on the third runway expansion project beyond 2026. Therefore, the airport's current regulatory period comes with less uncertainty relating to the approval, planning, funding and execution of this project.

Refinancing Risk Mitigated: Debt Structure - Midrange (Class A); Midrange (Class B); Midrange (HY notes)

The class A debt benefits from its seniority, security, and protective debt structure (ring-fencing of all cash flows and a set of covenants limiting leverage). It is exposed to some floating-rate risk, with at least 75% being fixed, in addition to some refinance risk, which is mitigated by the issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities. The class B notes benefit from many of the strong structural features of the class A notes.

The HY notes have a midrange debt structure, but are rated lower due to their deep structural subordination to the class A and B notes.

Rating Approach For HY Notes

We notch the HY notes' rating down from the consolidated group profile, which includes Holdco, Opco and Opco's subsidiaries. Holdco's full ownership of and dependency on the group, underlined by the one-way cross-default provision with the group as well as Holdco's covenants tested at the consolidated level, drive the consolidated approach.

We assess the group's consolidated rating at 'BBB' and apply a two-notch downward adjustment to arrive at Holdco's HY notes' 'BB+' rating. The two-notch difference reflects the ring-fencing structure in place at Heathrow Funding PLC, which may restrict distributions to Holdco level, but also the existing buffer against the lock up levels, as well as

the security available to HY noteholders and the high liquidity buffer available at Heathrow Finance Plc.

Financial Profile

Under the Fitch base case (FBC) and Fitch rating case (FRC), the projected net debt to EBITDA in 2022-2026 is sustained below the downgrade sensitivities of 8x, 9x and 10x for the class A notes, class B notes and consolidated profile, respectively. This supports the Stable Outlooks.

Finance and operating leases are captured as an operating expense, reducing EBITDA.

PEER GROUP

Heathrow is one of the most robust assets in the sector. Historically, it has higher leverage than its European peers, albeit with a much better debt structure for senior debt. Heathrow's closest peers are Aeroports de Paris S.A. (ADP; BBB+/Negative) in terms of hub status in EMEA and Gatwick Funding Limited (BBB+/Negative) and Manchester Airport Group Funding PLC (MAG, BBB/Negative) in terms of catchment area.

Compared with ADP's senior unsecured debt, Heathrow's class A and B notes have stronger and more protective features, which explain Heathrow's higher debt capacity for any given rating level. Compared with Gatwick and MAG, Heathrow's bonds benefit from a stronger revenue risk profile, justifying the rating differentials.

Heathrow's class B is a notch below Gatwick as Heathrow's stronger operations are offset by higher leverage. The HY notes at Heathrow Finance plc have a lower rating due to deep structural subordination and high leverage among peers.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Class A notes: projected Fitch net debt/EBITDA above 8.0x on a sustained basis.

Class B notes: projected Fitch net debt/EBITDA above 9.0x on a sustained basis.

HY notes: projected Fitch net debt/EBITDA above 10.0x on a sustained basis at consolidated group level or standalone liquidity at Holdco level at below 24 months of debt service (principal and interest).

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Class A notes: projected Fitch net debt/EBITDA below 7.0x on a sustained basis.

Class B notes: projected Fitch net debt/EBITDA below 8.0x on a sustained basis.

HY notes: projected Fitch net debt/EBITDA below 9.0x on a sustained basis at consolidated group level and standalone liquidity at Holdco level at above 24 months of debt service (principal and interest).

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

TRANSACTION SUMMARY

The transaction is Heathrow's ring-fenced financing. The class A and B bonds are structured, secured and covenanted senior debt. The HY bonds are structurally subordinated.

CREDIT UPDATE**Operational Performance**

Heathrow's traffic recovery improved from 44% of the 2019 level in January 2022 to 95% in February 2023 (compared with 24% for full year 2021, 76% in 2022). This was supported by the relaxation of international travelling rules since January 2022, including the removal of all UK travel restrictions on 18 March 2022 and release of pent-up demand.

Traffic recovery was driven by European traffic and other international traffic, while domestic was slightly lagging. Closer to the end-2022, business traffic started to catch up with leisure traffic. During 4Q22, business travel reached 28% of overall traffic, compared with 32% in the same period pre-pandemic.

Regulatory Update

The final decision on the tariff framework for 2022-2026 presented by the regulator in March 2023 was largely in line with our expectations. The 2023 charges increased to GBP31.3/pax from GBP29.7/pax compared with the final proposal published in June 2022. The nominal charges per passenger will decline to GBP25.3 in 2026, featuring a flat yield profile in real terms of GBP21.0/pax in 2024-2026. This is an equivalent to an average yield of GBP26.8/pax in 2024-2026 (compared to GBP27.9/pax as per the final proposal). The key driver of a lower price cap compared with the final proposal is mostly expectation of faster traffic recovery.

The traffic risk sharing (TRS) mechanism introduced in the final proposals is unchanged. The TRS purpose is to mitigate effect of pandemic-like events or significant overperformance. TRS is set to compensate lost revenue resulting from lower-than-expected passenger volumes. The provision is credit positive in the long term, given it sets a floor to the downside. However, we see the overall effect on recoverability timing (up to 12 years) and lower weighted average cost of capital (due to lower asset beta) as insufficient to sustain a quick recovery in financial metrics following a pandemic-like shock.

Liquidity

Heathrow maintained strong liquidity throughout the coronavirus pandemic. It also retained strong market access, which we expect to support continued strong liquidity.

As of end-2022, cash and term deposits available to class A and B notes were GBP1.8 billion, which adds to undrawn liquidity facilities of GBP1.4 billion. This would be sufficient to cover debt maturities until 2025 under the FRC. GBP1.2 billion cash available at Heathrow Finance would itself be enough to service debt until 2025, even assuming no cash is unstreamed from Heathrow (SP) Limited.

FINANCIAL ANALYSIS

Under the FRC, we assume traffic in 2023 to recover to 87% of 2019 level and full gradual recovery by 2025. Aero-yield is assumed as per the CAA's final decision price cap. Non-aero yield significantly decreases due to the dilution effect of higher numbers of passengers, lower capex in commercial offerings and macroeconomic pressure on demand. As a result, we forecast EBITDA to be at around GBP1.8 billion by 2025, compared with GBP1.9 billion in 2019.

Almost all investments related to the third runway expansion has been deferred to beyond H7, meaning capex assumed under the Fitch cases is more focused on maintenance. We expect dividend payments to ultimate shareholders within the forecast period, which we assume will be subject to maintaining the current ratings on the class A and B notes.

Fitch also ran additional sensitivities, testing a downside case with a longer traffic recovery. The sensitivities demonstrate that the issuer's credit profile would be impaired under the downside case with metrics remaining elevated and returning to below the rating thresholds only by 2026.

Summary of Financial Adjustments

Finance and operating leases are removed from financial liabilities. Lease expenses are captured as an operating expense, reducing EBITDA.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ⇅	RATING ⇅		PRIOR ⇅
Heathrow Finance plc			
Heathrow Finance plc/Debt/3 LT	LT	BB+ Rating Outlook Stable	Affirmed BB+ Rating Outlook Negative

Heathrow Funding Limited

Heathrow Finance plc/Debt/1 LT	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Negative
Heathrow Finance plc/Debt/2 LT	LT	BBB Rating Outlook Stable		BBB Rating Outlook Negative
		Affirmed		
Heathrow Finance plc/Debt/5 LT	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Negative

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Transportation Infrastructure Rating Criteria \(pub. 16 May 2022\) \(including rating assumption sensitivity\)](#)

[Infrastructure & Project Finance Rating Criteria \(pub. 20 Jul 2022\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

GIG InForM Model, v1.1.0 (1)

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UK Issued, EU Endorsed

Heathrow Funding Limited

UK Issued, EU Endorsed

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Infrastructure and Project Finance Europe Jersey United Kingdom
