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Research Update:

Heathrow Funding Ltd. Class A Debt Affirmed At 'A-' And Class B Debt Affirmed At 'BBB'; Outlook Stable

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Overview

- Heathrow Airport Ltd., the operating company guaranteeing the debt issued by Heathrow Funding Ltd., achieved very good operating and financial performance in the year ended Dec. 31, 2017.
- We expect ratios will remain in the range of 6%-7% adjusted funds from operations to debt for total class A and Class B debt, and above 8% for class A debt, only likely supported by increasing retail revenue despite relatively flat passenger volume due to the airport capacity constraints.
- As a result, we are affirming all class A issue ratings at 'A-' and all class B issue ratings at 'BBB'.
- The stable outlook reflects our expectation that Heathrow Airport will continue to benefit from its excellent competitive position supporting the resilience of traffic, as well as the group's ability to maintain ratios commensurate with the current ratings over 2018-2020.

Rating Action

On May 4, 2018, S&P Global Ratings affirmed its issue ratings on the class A debt and class B debt issued by Heathrow Funding Ltd. (HFL).

The issuer is a debt-issuing vehicle and a subsidiary of the operating company, Heathrow (SP) Ltd., the principal activity of which is running the operations of Heathrow Airport (Heathrow) and the Heathrow Express rail link. The class A debt is rated 'A-' and the class B debt is rated 'BBB'. We are assigning a stable outlook to the debt.

The financing group (Heathrow Airport Group) includes Heathrow (SP) Ltd., Heathrow (AH) Ltd., and Heathrow Airports Ltd. (HAL), with Heathrow Airport its main asset along with Heathrow Express Operating Co. HFL 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.

Rationale

The affirmation follows Heathrow Airport's very good operating and financial performance in the year ended Dec. 31, 2017. Revenues were up 2% to £2,884 million, driven by growth in commercial revenues thanks to surging traffic, redevelopment of the terminals, and pound sterling depreciation following the U.K.'s referendum vote to leave the EU. Despite record traffic volumes of 78 million passengers on the back of high load factors, Heathrow Airport maintained good punctuality, security checks, and baggage delivery. That said, the ratio of S&P Global Ratings-adjusted funds from operations (FFO) to total rated debt declined to 6.9% in 2017 from 7.4% in 2016 on a like-for-like basis, primarily due to a higher retail price index (RPI), which increases interest expense related to the group's £1.3 billion index-linked debt and £5.2 billion index-linked swaps.

We expect ratios will remain at levels similar to 2017 by the end of the regulatory period. We now expect the current regulatory period will be extended until 2021 to align it with the third runway expansion timetable. Despite initial consultations by the regulator, the Civil Aviation Authority (CAA), and the government's support for the project, there are still uncertainties as to its political backing in parliament, as well as the cost and the cost recovery of the project via regulation. Therefore, we do not consider its impact in our base-case forecast. In the preparatory phase, we view positively CAA providing for adequate cost recovery of advance costs in connection to obtaining the planning application, as well as the confirmation of recoverability of early category 'C' costs.

Furthermore, we now treat the £1.8 billion intercompany loan between Heathrow (SP) Ltd. and Heathrow Finance PLC--a holding company outside Heathrow Airport Group--as equity following the extension of its maturity to December 2030 (the original maturity of the loan was May 2011). The equity treatment reflects that this loan is subordinated and cannot cause a default on the group's secured debt, and that payments are restricted to distribution and event of default covenants in favor of the secured creditors.

The senior stand-alone credit profile (SACP) reflects our expectation of FFO to debt based on class A debt only above 8% while the subordinated SACP reflects FFO to debt based on total class A and class B debt of 6%-7% over 2018-2020. This corresponds to our calculation of a senior net debt to regulated assets base (RAB) of 68% in 2017, increasing to about 70% in 2020, and total net debt to RAB of about 78%-79% in 2018-2020.

In our base case we assume:

- Growth in passenger numbers to be limited by the capacity constraints that Heathrow continues to experience. In financial year (FY) 2018-FY2019, a slight passenger decline (0.1% on average) will reflect Heathrow's capacity constraints, but also a one-off disruption in 2019 (for instance due to Brexit, BA strikes, or weather events).

- Aeronautical tariff growth at RPI minus 1.5%. We expect RPI growth will be 3.6% in 2018, 3.3% in 2019, and 3.2% in 2020.
- Growth in retail revenue per passenger on sterling depreciation, retail offering development, and increasing catering income thanks to growth in food outlets and an increasing number of airlines not offering free food on board. In FY2018-FY2020, we assume 3%-4% per year growth rates, based on the combined effect of S&P Global Rating's forecast GDP and the RPI growth.
- Car parking revenue growth at RPI growth rates. Heathrow Express revenue growth in line with passenger growth, except in 2020 when it drops following the launch of competing Crossrail services from end-2019.
- EBITDA margin of about 63%-64%, driven largely by retail on the revenue side and cost efficiencies.
- Capital expenditure (capex) of £800 million-£900 million in FY2018-FY2020.
- Costs incurred in connection with obtaining planning consent capitalized into Heathrow's RAB and recovered through charges from 2020 onward (only 85% of these costs if the planning consent is not granted, leaving it exposed to about £50 million).

The ratings on HFL continue to be supported by Heathrow's excellent competitive position 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. The ratings also reflect a supportive regulatory environment, based on the 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.

Heathrow also benefits from an above-average profitability among transportation infrastructure companies, with an S&P Global Ratings-adjusted EBITDA margin of 62.8% in FY2017, 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. Heathrow also proved resilient to economic downturns thanks to high exposure to long-haul routes and business traffic.

One of the uncertainties for Heathrow could come from Brexit, but in our view a significant drop in passenger numbers is unlikely given only 34% of traffic served by Heathrow is EU-bound. If an economic downturn followed, we believe the impact on traffic would also be limited. Historically, the airport has shown significant resistance to economic downturns; in 2009, passenger numbers fell by only 1.5% in response to a 5% drop in GDP--the lowest passenger drop among U.K. airports. Long-term effects of a drop could be partially mitigated by a regulatory reset due at the end of 2020.

Liquidity

We assess HFL's liquidity position as adequate, supported by our view that its liquidity resources will exceed its funding needs by more than 1.2x in the 12 months from March 31, 2018.

We anticipate the following liquidity sources over the period:

- Unrestricted cash and short-term investments of about £145 million;
- FFO of about £990 million; and
- Access to about £1,395 million of undrawn credit facilities expiring in 2021 and beyond.

We estimate the following liquidity needs over the same period:

- Expected capex of approximately £800 million;
- Working capital outflows of about £15 million;
- Upcoming short-term debt maturities of approximately £840 million; and
- Dividends amounting to about £460 million.

Outlook

The stable outlook on debt issued by HFL and secured on the assets of Heathrow (SP) Ltd. reflects our expectation that the weighted-average FFO to debt in the reminder of the current regulatory period until 2020 is likely to stay above 6% for total class A and class B debt and above 8% for the class A debt. Heathrow is likely to benefit from the excellent competitive position supporting the resilience of its traffic volumes and strong management team, which is focused on increasing retail revenue and delivering cost efficiencies.

Downside scenario

We could lower the ratings if weighted-average adjusted FFO to debt on a consolidated basis were to deteriorate to below 8% for the class A debt or below 6% for the class B debt, or if adjusted debt to EBITDA were to increase above 7.0x for the class A debt or above 8.0x for the class B debt. This could happen if the company's financial policies were more aggressive than we currently expect, leading to higher leverage or higher distributions than we currently expect. This could also happen if the operating performance was not as strong as we currently envisage, or if passenger volumes were to drop, unmitigated by lower distributions.

Upside scenario

In our view, the upside for the ratings is limited, because we expect HFL will issue more debt to fund capex, including to cover the preparatory cost of the third runway. It will also likely increase distributions to its holding companies, including Heathrow Finance PLC, to allow them to fund their debt service.

Rating Methodology

HFL's class A debt rating incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s senior SACP to reflect structural features designed to increase cash flow certainty for debtholders. Due to the stronger senior-only ratios, senior SACP of 'bbb+' is one notch higher than our assessment of its subordinated SACP. The rating on the subordinated class B debt reflects its subordinated SACP. HFL's structural features include:

- Restrictions on business activities, mergers, acquisitions, and business transformation.
- Covenants restricting dividends and other subordinated payments from the financing group and restriction on raising further additional senior debt.
- Dedicated liquidity facility sized to cover 12 months of senior interest and six months of junior interest available to the issuer, HFL, and the borrower, HAL.
- Prudent hedging policy and provisions mitigating refinancing risk.

We apply our rating-to-principles approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published on Feb. 24, 2016 (the SED criteria). HFL is not in scope of the SED criteria due primarily to higher risk of competition and the absence of a credit remedy period during which creditors take control of the business and either stabilize its credit quality or sell the company's shares. However, HFL benefits from the majority of the structural enhancements listed in the SED criteria, and has additional risk mitigating factors such as the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value. The combination of these factors leads, in our view, to a marginal reduction in the default risk of HFL, similar to the marginal default risk reduction that SED senior bondholders can benefit from.

Ratings Score Snapshot

Class A issue credit rating: A-/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive
- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Senior SACP: bbb+

Structural features: +1 notch

Issue credit rating: A-

Class B issue credit rating: BBB/Stable

Business risk: Excellent
- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive
- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

SACP: bbb

Structural features: Not applicable
Issue credit rating: BBB

Related Criteria

- Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Heathrow Funding Ltd.	
Senior Secured Class A	A-/Stable
Senior Secured Class B	BBB/Stable

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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