S&P Global Ratings

# Research

## Bulletin:

# Brexit Still Weighs On Heathrow Rating, Despite Strong Earnings In 2018

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LONDON (S&P Global Ratings) Feb. 25, 2019--S&P Global Ratings said today that the strong operating and financial performance reported by Heathrow could provide a buffer ahead of a disruptive Brexit. Heathrow (SP) Ltd., the holding company in the ring-fenced financing group, whose main asset is Heathrow airport, reported earnings for 2018 that were somewhat stronger than we had forecasted.

Based on the preliminary results, and subject to full adjustments, we estimate that S&P Global Ratings-adjusted funds from operations (FFO) to debt for the ring-fenced group issuer Heathrow Funding Ltd. (HFL) was 7%-8% for 2018, based on the class A and class B debt it has issued. Based on only the class A debt, we estimated adjusted FFO to debt at 9%-10%. These ratios are in line with the rating guidelines.

The stronger-than-expected earnings follow a rise in passenger numbers to a record 80.1 million (2.7% higher than the previous year) where we had predicted flat growth. Because the number of air traffic movements is constrained by the airport's capacity, Heathrow achieved this strong passenger growth through larger and fuller planes.

Although retail in the airport sector has been strained, Heathrow airport also saw an 8.6% growth in retail income, reflecting higher passenger numbers, its reliance on long-haul versus budget airlines, luxury products, and British pound sterling's continued weakness. Aeronautical revenues grew by only 1.7% because of lower inflation. Charges per passenger are calculated under a regulatory formula of Retail Price Index (RPI) minus 1.5%.

The EU is in the process of approving contingency plans for uninterrupted aviation, which are intended to run until the end of 2019 and are subject to reciprocity by the U.K. Despite these, negative pressure on financial performance could build if passenger traffic weakens as a result of a potential economic slowdown triggered by a no-deal Brexit. Of Heathrow's traffic, 36% is EU-bound.

To strengthen its liquidity and refinance ahead of Brexit, Heathrow raised close to £2.3 billion of debt in 2018. Cash requirements for the ring-fenced group were lower in 2018 because the group issued £786 million of new debt at Heathrow Finance, a holding company outside the ring-fence. Some of this debt was used to fund the dividend to ultimate shareholders.

In addition to its regular investments, Heathrow continued to develop its expansion plan for constructing a third runaway, in preparation for which it spent an additional £127 million in 2018. We will monitor the various regulatory, statutory, and other consultations on the expansion plan in 2019 to gain more clarity on the cost and the cost recovery of the project via regulation.

This report does not constitute a rating action.