

## RATING ACTION COMMENTARY

# Fitch Affirms Heathrow Funding and Heathrow Finance Notes; Outlook Stable

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Fitch Ratings - London - 24 May 2024: Fitch Ratings has affirmed Heathrow Funding Limited's class A bonds at 'A-' and class B bonds at 'BBB'. Fitch has also affirmed Heathrow Finance plc's outstanding high-yield (HY) notes at 'BB+'. The Outlooks are Stable.

## RATING RATIONALE

The affirmation and Stable Outlook reflect Heathrow's high asset quality and its strong traffic recovery, finalisation of the tariff framework in 2022-2026 regulatory period and normalisation of group operations. As a result, Heathrow's leverage profile will remain consistent with the ratings under Fitch rating case (FRC). For the HY notes, it also reflects the release of locked-up distribution at Heathrow (SP) Limited (opco), which allows payments to Heathrow Finance plc (holdco) to support HY notes servicing.

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.

## KEY RATING DRIVERS

Volume Risk - 'Stronger'

Large Hub with Resilient Traffic

Heathrow is a large hub airport serving a strong origin and destination (O&D) market within a wealthy catchment area. Its traffic demonstrated strong resilience to economic downturns with peak-to-trough decline of only 4.4% through the 2008 economic crisis. This reflects 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 capacity constraint, which also helps absorb shocks.

## Price Risk - 'Midrange'

### Regulated and Inflation-Linked

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 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 final regulatory framework for 2022-2026 (H7) is in line with our previous assumptions.

### Infrastructure Development/Renewal - 'Stronger'

#### Sufficient Medium-Term Capacity

Heathrow has maintained and developed its infrastructure to a high level. Medium-term capacity growth of terminal and runway can be achieved with focused incremental projects. Heathrow has predictable maintenance capex requirements while growth capex is mostly uncommitted and flexible. Obsolescence risk is minimised through its competitive position in the area and its role as a global hub.

Heathrow has a record of delivering capex projects with market funding. The regulator's mandate to ensure financeability of capex in addition to affordability to end-users is supportive, despite some uncertainty on timing and price-recovery of the investment. Heathrow postponed almost all investments on the third runway expansion beyond 2026, removing from H7 the uncertainty relating to the approval, planning, funding and execution of this project. However, this project will be essential to remove capacity constraints in the long run.

### Debt Structure - 'Midrange' (Class A, B and HY)

#### Refinancing Risk Mitigated

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 Heathrow'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 are rated lower for 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 liquidity buffer available at Heathrow Finance Plc.

## Financial Profile

Under the Fitch base case (FBC) and Fitch rating case (FRC), projected net debt/EBITDA in 2024-2028 averages 7.5x, 8.6x and 9.8x for the class A notes, class B notes and HY notes, respectively. This supports the Stable Outlooks.

## 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+/Stable) in terms of hub status in EMEA and Gatwick Funding Limited (BBB+/Stable) and Manchester Airport Group Funding PLC (MAG, BBB+/Stable) 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. 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's and MAG's 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 Heathrow Funding entering dividend lock-up with insufficient liquidity at Heathrow Finance level

### **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 provided Heathrow Finance maintains adequate liquidity and no dividend lock-up is triggered at Heathrow Funding

### **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 reached 98% in 2023 and 102% in 1Q24, in line with the European peers'. This was supported by North America and Europe volumes. New York maintained its position as the most popular destination. Latin America, Africa and Asia Pacific also showed strong growth, in particular the Asia Pacific region, considering that China's borders only reopened in 2023. Aircraft operated with slightly higher seats and higher load factors.

Business traffic remains below pre-pandemic levels. During 1Q24, business travel reached 27% 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 challenged by both air carriers and Heathrow. This required arbitration of Competition and Markets Authority (CMA). The final price cap per passenger decreases around GBP1.5 and GBP1.6 in 2025 and 2026, respectively. In Fitch's opinion

this decision is credit-negative for the airport but largely in line with our expectations and included in the ratings.

## Liquidity

Heathrow maintained strong liquidity throughout the pandemic. It also retained strong market access. In 1Q24 Heathrow placed GBP350 million class B notes and GBP400 million HY notes. We expect management to scale down liquidity from pandemic to normalised levels, therefore we forecast decrease in available cash.

As of 1Q24, cash and term deposits available to class A and B notes were GBP1.9 billion, which add to undrawn liquidity facilities of GBP1.4 billion. This would be sufficient to cover debt maturities until end-2026 under the FRC. Another GBP0.5 billion cash available at Heathrow Finance would itself be enough to service debt until end-2025, while Heathrow (SP) Limited can also upstream cash to support holdco's liquidity as needed.

## FINANCIAL ANALYSIS

Under the FRC, we assume traffic in 2024 to recover to 100% of 2019 levels and then grow at a multiple of blended GDP growth (90% world's GDP and 10% UK's). Aero-yield is assumed as per the final price cap after CMA ruling in 2024-2026 and flat in real terms in 2027-2028. Non-aero yield grows at inflation rate. As a result, we forecast EBITDA at around GBP1.8 billion in 2024, increasing to GBP2.0 billion in 2028, 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 and medium-term capacity expansion within current assets. 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.

## 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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕		PRIOR ↕
Heathrow Finance plc			
Heathrow Finance plc/Airport Revenues - Subordinate/2 LT	LT	BB+ Rating Outlook Stable	BB+ Rating Outlook Stable
		Affirmed	
Heathrow Funding Limited			
Heathrow Finance plc/Airport Revenues - Senior Secured Debt/1 LT	LT	A- Rating Outlook Stable	A- Rating Outlook Stable
		Affirmed	
Heathrow Finance plc/Airport Revenues - Junior Secured Debt/2 LT	LT	BBB Rating Outlook Stable	BBB Rating Outlook Stable
		Affirmed	
Heathrow Finance plc/Airport Revenues - Junior Secured Debt/2	LT	BBB Rating Outlook Stable	BBB Rating Outlook Stable
		Affirmed	

[VIEW ADDITIONAL RATING DETAILS](#)

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**APPLICABLE CRITERIA**

[Infrastructure & Project Finance Rating Criteria \(pub. 17 May 2023\) \(including rating assumption sensitivity\)](#)

[Transportation Infrastructure Rating Criteria \(pub. 18 Dec 2023\) \(including rating assumption sensitivity\)](#)

## 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)

## ADDITIONAL DISCLOSURES

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## ENDORSEMENT STATUS

Heathrow Finance plc	UK Issued, EU Endorsed
Heathrow Funding Limited	UK Issued, EU Endorsed

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