FitchRatings

FITCH AFFIRMS BAA FUNDING'S BONDS & BAA (SH'S) HIGH-YIELD BOND; OUTLOOK STABLE

Fitch Ratings-London-18 August 2011: Fitch Ratings has affirmed BAA Funding Limited's (BAA Funding or the issuer) bonds issued under its debt issuance programme and BAA (SH) Plc's (BAA (SH) or the HoldCo) high-yield bond, as follows:

Class A bonds: affirmed at 'A-', Outlook Stable
Class B bonds: affirmed at 'BBB', Outlook Stable
BAA (SH) high-yield bond: affirmed at 'BB+', Outlook Stable

The affirmations reflect BAA (SP) Limited's (BAA (SP), the borrower and the owner of both Heathrow and Stansted airports) stable performance and Fitch's assessment of its ability to service and refinance its issuer-borrower and HoldCo debt. They also reflect the different structural support available to both the issuer's and HoldCo's creditors.

BAA (SP) continued to demonstrate resilient performance during 2010 and H111. Having seen only a relatively small drop-off in passenger (pax) traffic during the 2008-10 recession, Heathrow airport is again seeing growth in pax numbers. The airport achieved record annual pax volume in the year to July 2011. Although Stansted airport has continued to see pax traffic decline over recent periods, it comprises around 10% of BAA (SP's) revenue and asset base and its continuing poor performance is more than off-set by Heathrow's strong performance.

The current regulatory period has proven difficult for both airports in light of the harsh economic developments over the period, which appeared to experience much weaker trading conditions that those assumed by the Civil Aviation Authority (CAA, the UK airport regulator) in its regulatory determination, set before the onset of the 2008-10 financial crisis. Nevertheless, BAA (SP) has managed to maintain positive EBITDA growth through the period, primarily as a result of tariff increases as allowed for under the regulation, an increase in retail spend per pax, and its management of operating costs.

Fitch believes that the worst is now over for the airports and that they should start to see performance stabilise. Nevertheless, Fitch has incorporated further pax volume declines into its rating case. In this scenario, Fitch forecasts that the company should be able to maintain post-maintenance and tax interest cover ratios (PMICR) for each class of debt at levels above Fitch's current rating thresholds - 1.5x-1.6x for a 'A-' rating of class A debt, 1.2x-1.3x for a 'BBB' rating of class B debt and 1.1x-1.15x for a 'BB+' rating of BAA (SH) debt. Furthermore, the average dividend/interest cover ratio at the BAA (SH) level is also in excess of the 3.0x that Fitch considers appropriate for a 'BB+' rating at HoldCo level.

Heathrow has been implementing a large capital investment programme (CIP) over the past 10 years, spending at least GBP1bn per annum during the current regulatory period (Q5). This programme has seen, amongst other things, the ground up construction of Terminal 5 as well as supporting infrastructure, and the airport is currently in the process of completely rebuilding Terminal 2, expected to be delivered in 2014. Once Terminal 2 has been delivered, it is expected that the airport's CIP will reduce significantly in terms of expenditure, and the airport will move towards a 'steady state' operating environment.

Fitch expects that BAA (SP) will be required to sell Stansted airport following confirmation in July that the Competition Commission stands by its initial decision reached in 2009 requiring this. Fitch's rating is primarily driven by the performance of Heathrow; as such, so long as the company is able to largely recoup the proportion of debt effectively allocated to Stansted from its sale of the airport (approximately 85% of its regulatory asset value), leaving the company broadly leverage-neutral following the sale, the sale of Stansted should not impact the ratings.

The airports' future performance will largely depend on the regulatory environment in place for Q6, and the assumptions made by the CAA with respect to each airport for Q6 - both currently unknown. Although the nature of the regulatory environment for Q6 and beyond is not yet certain, Fitch has seen recommendations made by the CAA as to what it believes the regulatory framework should seek to address, and the agency does not expect the government to implement a regulatory system vastly different from that proposed by the regulator. Unless the regulatory environment for Q6 is considerably more punitive towards BAA (SP) than the current regulation, its ratings should remain unaffected.

All BAA (SP), BAA Funding and BAA (SH) debt is in the form of interest-only bullets, and the company will face significant refinancing risk on an ongoing basis. In Fitch's opinion, this refinancing risk is mitigated by the company's relatively smooth refinancing schedule, the company's good access to capital markets as demonstrated by its numerous bond issuances over the past 18 months, full ownership of its airports (as opposed to a concession-type ownership), covenanted and structured debt programme which features, amongst other things, security over the airports, and a regulatory framework that provides for a relatively predictable asset valuation approach.

Fitch has also noticed that the company has increased its exposure to index-linked debt through a portfolio of index linked swaps (ILS) in recent years. While the agency remains comfortable that the company's target debt exposure to index-linked debt is appropriate for a company such as BAA (SP), should the exposure be raised significantly above the current target level this is likely to put some pressure on the rating. In addition, Fitch is aware that recent ILS contracted contain pay-as-you-go (PAYG) features, which have the effect of reducing accretion periods under the swaps. Fitch is currently comfortable that the use of such ILS by BAA (SP) continue to provide the company with the natural hedge against inflation that is intended. However, if Fitch forms the view that the further use of ILS with PAYG provisions is simply re-characterising interest expense as principal accretion payments, it will make adjustments to the ratios used in its analysis accordingly.

Fitch will continue to closely monitor developments regarding regulation, the sale of Stansted, general operating performance of the two airports and the company's index-linked debt exposure.

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Additional information is available at www.fitchratings.com.

Applicable criteria, 'Rating Criteria for Infrastructure and Project Finance', dated 16 August 2011, and 'Rating Criteria for Airports', dated 29 November 2010' are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Rating Criteria for Infrastructure and Project Finance
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648832
Rating Criteria for Airports
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=578745