BAA (SH) plc and BAA Funding Limited

Full Rating Report

Ratings

BAA Funding Limited	
Class A Bonds	A−/Stable
Class B Bonds	BBB/Stable
BAA (SH) plc	
High-Yield Bond	BB+/Stable

Related Research

BAA Funding Limited (August 2008)
BAA (SH) plc (November 2010)
Resilience of Infrastructure and the Role of Competition (November 2011)
European Airports' Performance Through the Crisis: Crisis Highlights Sharp Contrasts in Resilience (February 2011)
Gatwick Funding Limited (March 2011)

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Key Rating Drivers

Resilient Operating Performance: Operating company BAA (SP) Limited's performance is driven by that of Heathrow Airport, which accounted for 79% of the company's aggregate 87.8 million passengers (pax) and 90% of its aggregate GBP2.4bn revenue in the year to 30 June 2012 on a rolling basis.

Fitch Ratings considers Heathrow's operating profile to be strong, with pax growing again after modest declines in 2008-2010. Stansted Airport's operating profile has proved much less resilient, although this has only a limited effect on the borrower's overall risk profile because it is much smaller.

Stable Financial Performance: BAA (SP) steadily increased EBITDA through the 2008-2010 downturn and since at a CAGR of 14%. This positive financial performance has been achieved via a combination of scheduled tariff increases, strong growth in non-aeronautical revenue and careful cost management, largely negating the lower pax throughput than Fitch forecast at financial close in August 2008.

Sound Credit Ratios: Average rating case post-maintenance interest cover ratios (PMICRs) for each debt level to 2018 are in line with the ratings, under guidance in Fitch's New Issue reports on notes issuer BAA Funding Limited and holding company BAA (SH) plc. Average PMICRs are 1.93x at class A and 1.52x at class B for BAA Funding, and 1.40x at BAA (SH).

Refinancing Risk Manageable: Comfort on refinancing risk comes from the ability of BAA Funding and BAA (SH) to regularly access capital markets over the past two years, even at times of scarce liquidity. Combined with liquidity support, high quality of regulated asset base and high investor recognition, this provides comfort about BAA's ability to manage refinancing risk.

Appropriate Index-Linked Exposure: Fitch considers the borrower's index-linked debt exposure of around 65% of aggregate debt to be appropriate for a company whose revenue stream is largely correlated to inflation. However, it leaves BAA (SP) more vulnerable to refinancing risk as debt accrues in nominal terms than it would be with a lower such exposure.

Stansted Sale Probably Neutral: Any conceivable sale price for Stansted, when the airport is sold, would be likely to be ratings neutral for the borrowers in light of the airport's relative economic size compared with Heathrow.

Regulatory Changes Probably Neutral: The Civil Aviation Bill introduced to parliament in January 2012 considers a new regulatory framework for beyond 2014. Fitch believes that this draft regulation, if adopted, should prove broadly neutral for BAA (SP).

Figure 1

Summary of Fitch Key Rating Factor Assessments[a]

Revenue risk: Resilience	Revenue risk: Price	Debt structure	Debt service and counterparty risk	Infrastructure development/renewal
Stronger	**Midrange**	Class A: **Midrange** Class B: **Weaker** BAA (SH): **Weaker**	**Midrange**	**Stronger**

[a] As defined in *Rating Criteria for Airports*
Source: Fitch

What Could Trigger a Rating Action

Regardless of BAA (SP)'s financial performance, Fitch is unlikely to consider a positive rating action while there is still significant uncertainty about the regulatory environment and the government's aviation policy. The ratings could come under negative rating pressure if any of the following scenarios arises:

- the regulatory framework or Q6 settlement is more onerous than anticipated;
- the borrower's operational efficiency deteriorates dramatically or Heathrow experiences a prolonged fall in pax;
- the issuer or holding company face increased challenges in accessing the capital market, causing significant increases in the cost of debt.

Operating Performance Update

Heathrow: Capacity-Constrained and Resilient

Operational Performance Buoyed by Improving Pax

- Lack of capacity headroom supporting resilience but capping volume growth
- EBITDA growth to come from tariff increases and retail optimisation
- Large renewal projects not a risk

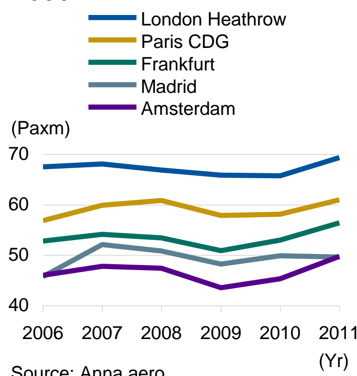
Heathrow's pax traffic has returned to growth after a small decline during 2007-2010. During FY11 Heathrow attracted its highest ever number of pax, with 69.4 million travellers using the airport during the year and reflecting a year-on-year growth rate of 5.5%. The airport experienced its busiest month in its history in July 2011, when 6.9 million people used it. Strong performance in FY11 continued through H112, and the airport recorded over 70.0 milion pax on a 12-month rolling basis in each of March, April, May and June 2012.

Heathrow's recent traffic performance is in line with Fitch's expectations. In March 2011 the agency's Special Report *Infrastructure Ratings Prove Resilient Through the Downturn* detailed the characteristics of core infrastructure facilities that have shown the highest degree of operating performance resilience. In the report, Fitch stated that "larger or more essential assets have in most cases demonstrated stronger resistance to economic downturns." The agency considers Heathrow to fit this profile.

London is also served by a number of other airports, including both of the other two UK airports subject to price regulation, Gatwick and Stansted. Despite their proximity, but because of their very different operating profiles, these airports offer only limited direct competition to Heathrow. This is corroborated by the relative performance of the airports during the 2008-2010 downturn (see Figures 2 and 4); while Heathrow had a peak-trough fall of 3.4% over the period, Gatwick and Stansted experienced peak-trough traffic falls of 10% and 24%, respectively.

Figure 2

Heathrow Pax vs. Peers 2006-11



Source: Anna.aero

Heathrow is the preferred London airport for full-service airlines because of its favourable location, good transport links and relatively large capacity suitable for hubbing activities. Hubbing remains an attractive operational model for full-service airlines, because it drives higher load factors on lucrative long-haul routes, thereby offering such airlines the best opportunity to maximise yields. Traffic at hub airports tends to be more stable than at competing origin and destination (O&D) airports, because during periods of declining traffic airlines will consolidate services through their existing hubs. This gives Heathrow a significant advantage over local peers.

Furthermore, and for the same reasons, Heathrow is also the preferred airport for business travellers to and from London. Airlines are able to charge significantly higher prices for business class travel, and this also helps explain the airport's attractiveness to such airlines.

Although Gatwick (and, to a much lesser extent, Stansted) also capture some business traffic, this is a small part of their businesses. Both Gatwick and Stansted are much more successful at attracting short-haul leisure travellers, who are likely to be influenced by the lower ticket prices that airlines can charge and the large number of leisure destinations served on a point-to-point basis, and are likely to be less concerned with the airports' weaker locations and transport links. Exposure to leisure traffic, which is more closely linked to regional economic conditions, partly explains the relative volatility of traffic at these airports.

Related Criteria

Rating Criteria for Airports (November 2011)

Rating Criteria for Infrastructure and Project Finance (July 2012)

Under new management, Gatwick has increased full-service long-haul routes, with direct flights to Vietnam, China and several Caribbean islands among others added to its schedule since FY10. Fitch considers Gatwick likely to provide increased competition to Heathrow for O&D traffic, particularly related to leisure travel but also for business travel on certain routes. However, the limited size of its infrastructure, and its weaker location and ground transport links will limit the amount of long-haul services that Gatwick can offer, and will also prevent it from offering a viable alternative to Heathrow for hub traffic.

When Stansted is sold, it is feasible that it will also offer more full service routes that directly compete with Heathrow. However, Fitch does not believe this is likely because the airport has never had a footing in the full-service air travel market due to its peripheral location, relatively weak public transport connections, and limited capacity.

However, Heathrow is operating very close to runway capacity of 480,000 aviation transit movements (ATMs) a year, and the airport does not have any additional take-off or landing slots available. Therefore, unless the UK government reverses its policy of blocking a third runway at Heathrow or eases night flight restrictions, the airport will only be able to increase pax volume further by encouraging airlines to use larger aircraft and operate at higher load factors, using existing slot capacity more efficiently.

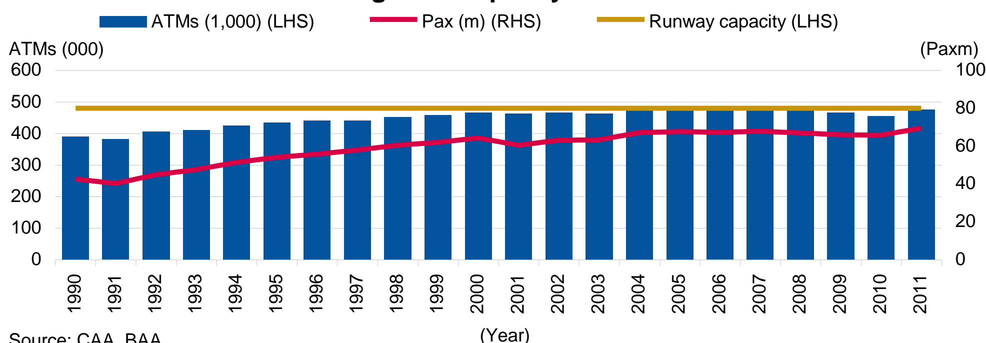
Revenue Growth Modest

Fitch regards Heathrow's constrained capacity as indicative of pent-up demand from airlines for its services, and therefore supportive of the airport's resilience to a deteriorating operating environment. The agency considers resilience to downturn to be fundamentally important for creditworthiness.

Fitch's analysis also takes into account potential sources of revenue growth, although these are only of secondary importance. As a result of its constrained capacity, the main sources of this growth at Heathrow will be increases to airline charges and the optimisation of non-aeronautical revenue. Under the CAA's regulations, BAA group is allowed to earn a specified return on capital invested at Heathrow, and in exchange for agreed capital improvement works undertaken at the airport it is allowed to increase aeronautical tariffs (also taking inflation into account). In light of the large capital investment programme undertaken over the 2000s, tariffs charged to airlines using the airport have increased significantly. However, in the long term these increases are unlikely to allow the group more than a steady return. Therefore, they should not be considered a driver of significant growth.

Figure 3

Heathrow ATMs Over Time Against Capacity



Source: CAA, BAA

As the CAA's regulation of Heathrow is undertaken on a "single till" basis, BAA's allowable return also takes into account revenue derived from non-aeronautical sources. Therefore, although the company may benefit in the short term from a drive to increase, for example, retail sales at Heathrow, any increase in sales revenue will be taken into account in the regulator's regulatory determinations.

Asset Renewal Not a Key Risk

BAA has a proven track record in delivering large capital improvement projects on its airports, and capital expenditure remained broadly in line with budget during regulatory period Q5. The capital investment programme for the regulatory period is extensive and involves certain highly visible and critical projects such as the rebuilding of Terminal 2, which Fitch understands is progressing on time and to budget, for completion in 2013 and to be operational in 2014.

BAA (SP) will face trigger penalty payments as a result of any delay to delivery of projects included in its capital improvement plan. However, Fitch considers that the overall impact of any such delays on BAA (SP)'s finances will be minimal.

BAA group has significantly improved its operating expenditure performance during Q5 compared with Q4, when it significantly underperformed the regulator's expectations.

IAG Exposure Significant

In 2011 British Midland Airways Limited (BMI), Heathrow's third-largest airline by pax (3.0 million; 4.2% of the airport's total) and second largest by ATMs (38,700 ATMs; 8.1%), was put up for sale by its parent, Lufthansa AG. Although challenged by Virgin Airlines on competition grounds, the sale to International Airlines Group (IAG) was completed in April 2012.

The sale has resulted in some route consolidation with fellow IAG airline British Airways, already the largest airline at Heathrow by pax (41.6%) and ATMs (42.9%), and the enlarged airline has been required to dispose of some of its landing and take-off slots by regulators. Nevertheless, demand for relinquished slots from competing airlines is very high because of the airport's attractiveness and its very limited free capacity, and therefore Fitch considers the risk that disposed capacity will remain unused negligible.

After the merger, IAG controls around 50% of all take-off and landing slots at the airport, and the two airlines accounted for 46.0% of total airport pax between them in 2011. Heathrow is increasingly dependent on IAG's operating and financial performance. Nevertheless, even in a "doomsday" scenario in which the enlarged airline became insolvent and ceased operations immediately, Fitch believes that the airport would be able to refill capacity within six to 12 months because of London's heavily constrained airport capacity, the city's importance as a global financial and business centre, and the airport's advantages in terms of location and public transport.

Aviation Policy for London and South East England

The UK government will soon publish an aviation policy White Paper. On taking power in 2010 the government immediately ruled out the prospect of a third runway at Heathrow and additional runways at either Gatwick Airport or Stansted in the near term. Nevertheless, it is widely recognised that London's heavily capacity-constrained airport transport system will, if unaddressed, constrain the city's prospects for economic growth.

Suggested options for increasing capacity include reconsidering a third runway at Heathrow and/or additional runways at Gatwick and Stansted, connecting Heathrow and Gatwick with high speed rail to create a "virtual hub", building a new four-runway international hub airport in the Thames Estuary, and easing night flight restrictions to and from London's airports.

The impact of each of these would have widely different effects on the long-term viability of Heathrow. Fitch would therefore consider the likely impact if it felt that any of these (or any other) option had become more likely to be given the go-ahead. If an option detrimental to Heathrow's long-term prospects were to be selected, Fitch believes the delivery time would probably be sufficiently long for BAA group to unwind much of its outstanding debt, with residual debt supported by either its reduced ongoing operations or, if closed down, the value of its land and other assets.

- 24% peak-to-trough decline during downturn (2007-2011)
- Competition from Luton and Gatwick
- Heavy reliance on low-cost airlines, particularly Ryanair
- Free capacity and growth potential

Stansted: Low Resilience but Good Growth Prospects

In contrast to Heathrow, Stansted's traffic performance has continued to deteriorate over recent years, reflecting its less essential role in London's transport infrastructure system. Since peaking at 23.8 million pax in 2007, traffic contracted 24% to 18.0 million in 2011, and over the same period ATMs fell by 34.3%. Consequently, Stansted does not face the kind of capacity constraints that are hindering Heathrow's ability to achieve pax growth, meaning that although there is considerable room for growth in pax numbers, the airport does not benefit from surplus airline demand. To retain current airline clients and to try to attract new routes, the airport has not levied aeronautical charges at the maximum allowed level under its regulatory price cap mechanism for several years.

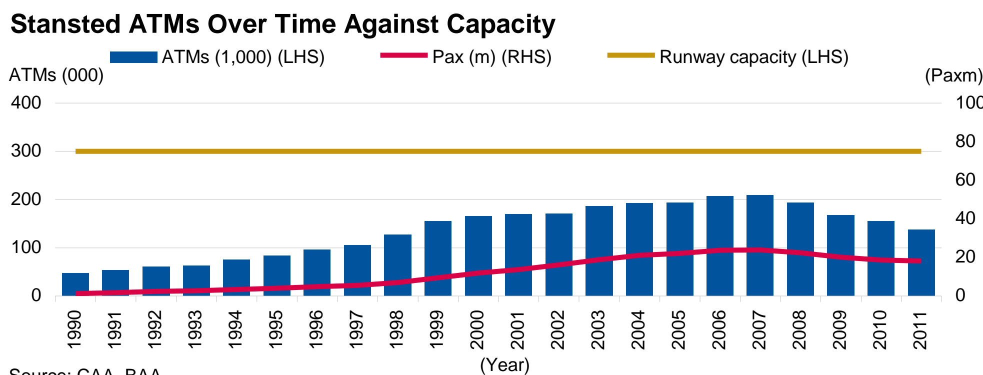
The issues faced by Stansted are quite different from those faced by Heathrow.

- It is largely focused on the low-cost "no frills" leisure travel sector, which Fitch estimates accounts for around 97% of airport pax, and whose performance is highly correlated to regional economic performance. As the UK's economy has continued to falter, so has the propensity of UK citizens to travel for leisure purposes.
- Its location and transport links are weaker than those of Heathrow, Gatwick and London City. Therefore, all else being equal, its attractiveness to travellers is lower than for other London airports.
- It faces a tangible level of competition, not only from Luton, against which it has competed in the low-cost sector for many years, but also from Gatwick since the latter was sold by BAA group in 2009. Gatwick has undergone a turnaround in performance and has managed to attract several airlines from Stansted.

Stansted has become increasingly dependent on Ryanair, which carried around 68% of the airport's total pax in 2011. This high dependence on the airline leaves it exposed to changes in Ryanair's strategy and financial performance.

Figure 5

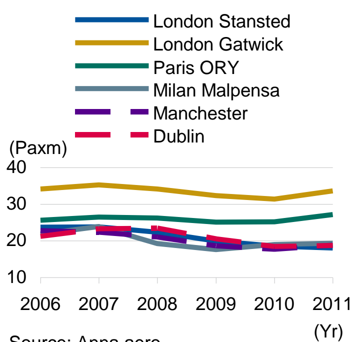
Stansted ATMs Over Time Against Capacity



Source: CAA, BAA

Figure 4

Stansted Pax vs. Peers 2006-2011



Source: Anna.aero

Although Stansted has had significantly worse performance during the recent downturn than Heathrow, it also offers much higher prospects for growth once the UK's economy returns to stability. Therefore, BAA (SP)'s capacity for traffic growth will be significantly reduced following a sale of Stansted. This is likely to be more of a concern for equity sponsors than for debtholders, for whom resilience to downturn is more important than growth prospects.

Regulation: No Rating Impact So Far from Uncertainty

Both Heathrow and Stansted are subject to price regulation by the CAA. Under the current framework, the regulator reaches its determination for each regulated airport to be implemented over a set period, usually of five years, after which there is a new regulatory determination. The current regulatory periods for Heathrow and Stansted end in 2014.

A Civil Aviation Bill before the UK parliament proposes changes to the UK regulatory framework for airports. Fitch expects it to be passed into law during 2012. The main changes proposed include the introduction of a licensing regime for UK airports, the elevation of airport

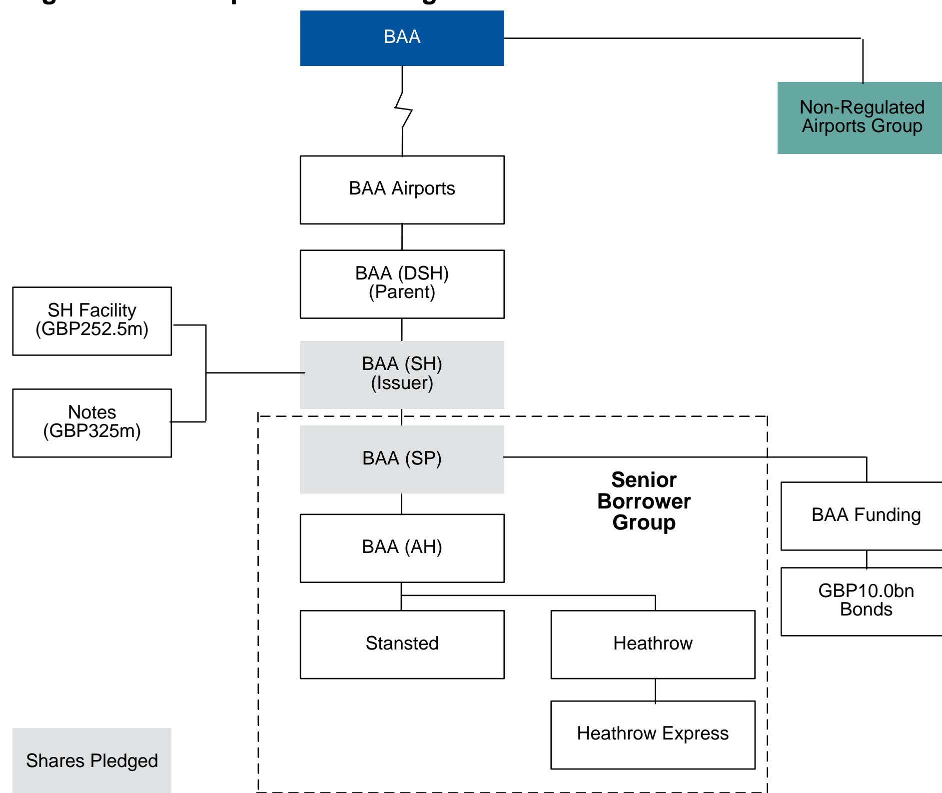
users' interests to be the regulator's primary duty of care and the removal of the right for security to be granted over physical airport assets (although debt-raising programmes for which such security arrangements have already been established will be exempt). No special administration regime is proposed.

The next regulatory period for both airports will start in 2014, and the CAA will form its assumptions for the determination once the Bill has been passed into law and it is clear what the regulatory framework will be. As the CAA will continue to have a duty of care to ensure that regulated UK airports can finance their activities, Fitch takes the view that the impact of the proposed regulatory changes should be broadly neutral for BAA (SP).

Financing Overview

Figure 6

Ring-Fenced Group Structure Diagram



Source: BAA

Post maintenance interest cover ratios (PMICR), explained below, across the capital structure improved in 2011 from historic lows in 2010 (see Figure 8), reflecting improving EBITDA, the historically low cost of new debt raised during the year as well as the increased use of index linked swaps (ILS) on cash flows – see the separate section below for further discussion of this.

Figure 8 shows that actual Class A and Class B PMICR during 2009 and 2010 was below guidance levels. However, this metric takes regulatory depreciation as an estimate of the capital expenditure required to maintain asset value, an assumption the agency considers appropriate in the long term, but, in light of the flexibility the company has in maintaining its assets, unlikely to reflect reality in any given year. Fitch looks at average PMICR as the most important metric in its analysis, and has considered the higher metric levels from 2011 in its projections to outweigh the lower levels in 2009 and 2010, which were expected.

Fitch's preferred financial metric when analysing debt raised by RAB-regulated companies such as those in the BAA group is PMICR, which reflects an estimate of maintenance capex equivalent to the regulator's determination of depreciation of the company's asset base. This is

generally more conservative than the covenanted ICR, which includes a deduction of 2% of RAB as an estimate of maintenance capex. In addition, when assessing the structurally subordinated BAA (SH) debt, Fitch takes into account BAA (SP)'s ability to pay its parent a sufficient dividend to meet the holding company's debt service.

BAA (SH) refinanced its entire debt package on five- and seven-year terms during 2010, meaning that it had no need to access debt markets during 2011 or H112, although it did raise an additional term loan of GBP77.5m. Likewise, BAA (SP) faced no refinancing needs at the Class B level during the period. However, at the Class A level the company was very active in issuing debt denominated in Sterling, US dollars, euros, Canadian dollars and Swiss francs, partly in order to refinance some of its nearer-dated maturities, but also to strategically increase leverage and move towards a position of paying regular dividends from 2012.

Fitch takes comfort from the good access to market that BAA Funding demonstrated through 2011 and H112, and considers its moves to diversify funding sources by currency and region as positive for the rating because they should improve its access to a range of capital markets. As long as the company continues to have good access to market, and as long as PMICR remains broadly in line with Fitch's expectations at each debt level, the agency remains sanguine about the company's ambition to introduce a dividend to its shareholders.

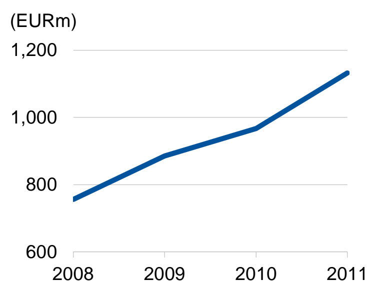
Index-Linked Debt Exposure Broadly Consistent with Revenue Structure

Fitch believes that BAA (SP)'s increased index-linked debt exposure in the form of index-linked bonds (ILB) and ILS is appropriate in light of its highly inflation-linked revenue base, and that the use of such instruments is prudent for it to protect itself against a possible low-inflation scenario arising. By end-2011 about 65% of BAA (SP)'s net debt exposure was in the form of ILB or hedged using ILS.

Index-linked debt instruments generally attract a lower interest rate coupon than traditional fixed or floating rate (nominal) debt, instead featuring an increased refinancing burden as a result of the accretion over time of the principal or swap notional balance in line with RPI. The use of ILB and ILS therefore allows BAA (SP) to reduce its interest burden, and therefore to report higher ICR and PMICR. As Heathrow and Stansted's RAB is also linked to RPI, leverage should not increase as a result of index-linked debt accretion. However, the natural deleveraging over time with respect to nominal debt would have less of an overall effect the higher the index-linked debt exposure. Therefore, by adopting a significant amount of index-linked debt the company prevents its exposure to refinancing risk decreasing over time, while its ability to service periodic coupon obligations out of cash flow increases.

Figure 7

BAA (SP) Adjusted EBITDA
2008-2011



Source: BAA

Figure 8

BAA (SP) and BAA (SH) Combined Capital Structure June 2012

Debt class	Bond debt (GBPm)	Bank debt (GBPm)	Total debt (GBPm)	ICR (actual Dec 11) (x)	PMICR (actual Dec 11) (x)	Net debt/RAB (actual Dec 11) (%)	Net debt/EBITDA (actual Dec 11) (x)
BAA (SP)							
Cash			-4.2				
Class A ILS Accretion			448.2				
Class A debt	8,579.8	382.9	8,962.7				
Net class A debt			9,406.7	2.76	1.68	68.0	8.3
Class B debt	1,400.0	225.0	1,625.0				
BAA (SP) net debt			11,031.7	2.34	1.43	75.4	9.2
BAA (SH)							
Subordinated HoldCo debt	325.0	252.5	577.5				
BAA (SP) + BAA (SH) net debt			11,609.2	2.17	1.32	79.4	9.7

Note: The net debt amount should be considered against the company's RAB of GBP13,849.7m, implying leverage (defined as net debt/RAB of 68.07.9% at Class A, 75.479.7% at Class B and 79.483.6% at BAA (SH) levels at end-H112. These are comparable with covenanted trigger threshold levels of 70.0%, 80.0% and 85.0%, respectively
Source: BAA, Fitch

However, in the agency's opinion if a company adopts an index-linked debt exposure with a very smooth repayment profile, its ICR and PMICR may overstate the reduction in debt service made from periodic cash flows arising as a result of the use of such instruments. This is because in such a scenario the amount of principal or swap notional accretion the company would be required to repay each year, along with the annual coupon payable on such debt, would together broadly equal the higher coupon that would have been payable on a notional debt exposure.

It is debatable in such a scenario whether the repayment of accretion would be likely to occur via a refinancing through debt markets or whether it would be repaid out of cash flow. If the latter, the debt service paid out of cash flow on its index-linked debt exposure would be broadly the same as if the company's entire debt exposure were notional debt. However, ICR and PMICR would both be higher because debt service would be partly characterised as interest and partly as principal (or swap notional) accretion. In such a scenario, Fitch would adjust ICR and PMICR to reflect principal or swap notional repayments it believes to be akin to interest payments.

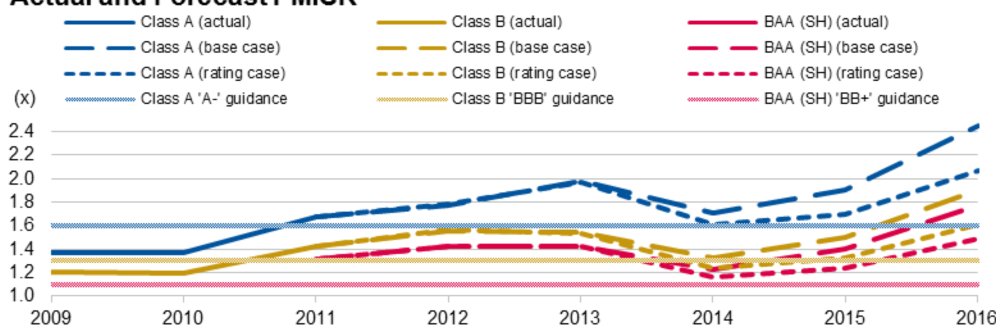
Fitch has analysed BAA (SP)'s ILB and ILS portfolio and believes that its use of such instruments does not simply recharacterise interest as principal or swap notional amounts to be serviced out of cash flow. Nevertheless, the agency will monitor the development of the company's debt exposure and, if it considers it necessary, will adjust PMICR and ICR accordingly in its analysis.

Transaction Background

BAA Funding is a special-purpose vehicle whose sole purpose is to raise capital-market debt on behalf of BAA (SP), the ultimate owner and operator of Heathrow and Stansted. It shares in a security package along with the borrower's bank lenders that includes security over all the borrower's assets, bank accounts, contracts and cash flows.

BAA (SH)'s rated debt was used to refinance the acquisition debt put in place when BAA (SP) was acquired by its current ultimate owners in 2006.

Figure 9



Source: BAA, Fitch

Based on the key risk factors analysed above, and particularly the resilience demonstrated by the cash flow, Fitch considers an average PMICR at the Class A level of 1.60x as commensurate with an 'A−' rating, and at the Class B level of 1.30x as commensurate with a 'BBB' rating. At the holding company level, Fitch considers an average PMICR of 1.10x combined with a capacity-to-pay dividend ICR of 3.0x as commensurate with a 'BB+' rating. Fitch will continue to monitor the environment in which BAA group's airports operate, and will modify these thresholds accordingly if it considers this necessary.

Fitch also considers the company's leverage, defined as the net debt/EBITDA ratio at each debt level in order to gauge better the sustainability of its debt burden and in order to help compare it with peers. Fitch views the company's leverage profile as in line with criteria guidance.

Figure 10
Peer Analysis

Project	BAA (Class A)	BAA (Class B)	Sydney Airport	Gatwick Airport
Rating date	Aug 2012	Aug 2012	Jun 2012	Feb 2012
Rating	A-	BBB	BBB	BBB+
Outlook	Stable	Stable	Stable	Stable
Country	UK	UK	Australia	UK
Concession maturity	Perpetual	Perpetual	2048 with an option to extend by 49 years	Perpetual
Asset type	Hub	Hub	O&D (80%)	O&D (92%)
Throughput (pax m)	87.4	87.4	35.6	33.1
Airline concentration (%)	42	42	27	35
2008 crisis peak-to-trough (%)	-4.5	-4.5	+7.8	-11.1
Volume attribute	S	S	S	M
Charge setting flexibility	Regulated	Regulated	Airline use & lease agreement	Regulated
Price attribute	M	M	M	M
Capex renewal attribute	S	S	M	S
Debt structure attribute	M	W	M	M
Ave PMICR	1.81x / 2.00x[a] 1.68x act 2011	1.51x / 1.55x[a] 1.43x act 2011	1.97x CFCR inc. sub debt	1.98x / 1.69x[a] 1.76x est 2011
Net debt/EBITDA or CFADS	7.8x / 6.4x[a] 8.3x	9.1x / 7.4x[a] 9.7x	7.5x	6.5x / 5.4x[a] 5.3x
Projected ratios based on	FRC	FRC	FRC	FRC
Max net debt/EBITDA to 2015	8.3x	9.7x	7.3x	7.0x

[a] Average PMICR and net debt/EBITDA for BAA and Gatwick have been quoted for Q5 and Q6 separately
S, M and W are attribute scores and refer to Stronger, Midrange and Weaker, respectively
FRC stands for Fitch Ratings Case
Source: Fitch

Fitch has conducted a Rating Assessment Service for BAA (SH) plc and BAA Funding Limited.
The ratings above were solicited by, or on behalf of, the issuer, and therefore,
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