FITCH ASSIGNS HEATHROW'S NOTES FINAL RATINGS; AFFIRMS EXISTING NOTES

Fitch Ratings-London-16 October 2014: Fitch Ratings has assigned Heathrow Finance plc's new GBP250m high yield (HY) bonds a 'BB+' final rating with Stable Outlook. Fitch has also affirmed Heathrow Funding Limited's class A and B bonds at 'A-' and 'BBB', respectively, and Heathrow Finance plc's existing HY bonds at 'BB+', all with Stable Outlooks.

The rating actions reflect London Heathrow airport's (LHR) on-going solid operational performance and lower than expected cost of debt (driven by the current benign credit markets), notably since Fitch's last review in June 2014.

Fitch understands that the proceeds of the new HY issuance will be used to refinance some of the existing term loan at Heathrow Finance plc and for general corporate purposes. The new HY notes contain a higher covenanted debt to regulatory asset base (RAB) ratio of 92.5%, compared with 90% for the existing notes (which have maturities in 2017 and 2019). As a result, Fitch has also reviewed the option available to management to gradually increase the existing ratio - currently at 85% for the HY notes - to 87.5% in the medium term, in line with management's current guidance to maintain headroom of five percentage points below the covenant level.

KEY RATING DRIVERS
Fitch's ratings are based on the following factors, among others:

Volume Risk - Stronger
LHR is a large hub/gateway airport serving a strong origin and destination market. It experienced strong traffic growth of 3.4% in 2013 (up from 0.9% in 2012), and so far this year has shown continued signs of positive trend as traffic rose year-on-year 1.5% in the first nine months of 2014.

From a long-term perspective, LHR benefits from resilient traffic performance with a maximum peak-trough fall in traffic of just 4.4% through the recent economic crisis (which was one of the strongest in the industry). This is due to a combination of factors which Fitch views as stable over time, namely: the attractiveness of London as a world business centre; the role of LHR as a hub offering strong yield for its resident airlines; the location and connectivity of LHR with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint at LHR (with only two runways), which also helps absorb shocks.

Price Risk - Midrange
LHR is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, and is currently set at RPI-1.5% for the new five-year regulatory period, which started in April 2014 (down from RPI+7.5% in the previous Q5 period). The cap is set for five years by an independent regulator, the CAA, which, among its duties, ensures that airports' operations and investments remain financeable.

The price cap is established to offset LHR's significant market power and is highly sensitive to the assumptions made by the regulator on several building blocks such as cost of capital, traffic forecast and operational efficiency. The regulatory process that leads to the cap determination is transparent but creates material uncertainty every five years. Price cap settlements can prove detrimental to the airport, as CAA's assumptions can be aggressive. For example, the traffic forecast for Q5 was calculated before the 2007-2008 crisis and proved overly optimistic. However, this was partly offset by higher than planned inflation.

Infrastructure Development / Renewal - Stronger

LHR aims to implement a detailed capital investment plan, agreed by the regulator. The new plan for Q6 with around GBP3.5bn of investment is more modest than Q5 (at over GBP5bn) and Fitch does not expect any major issues, particularly in light of LHR's overall sound track record of delivering projects on time and on budget. The regulated asset base approach allows for the self-financing of the investments through tariffs. After the delivery of a brand new T2 in 2014, LHR will mostly feature state-of-the art terminals. The building of a third runway is currently being reviewed (among other options from other airports) by the Airports Commission with the final recommendation due in summer 2015.

Debt Structure - Midrange (Class A) / Weaker (Class B and HY)

Class A debt benefits from its seniority and protective debt structure (ring-fencing of all cash flows from LHR and a set of covenants limiting leverage). It is exposed to some hedging and refinancing risk, which is mitigated by the issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities. The class B and HY notes have a weaker debt structure due to their subordination.

Credit Metrics

Fitch's rating case reflects CAA's final decisions for Q6, in particular with regard to traffic growth with a five-year CAGR of 0.5%. The notable differences are with regard to inflation with the RPI over the forecast horizon lower by 100bps (at 2.4% on average in Q6, in line with current RPI), fewer efficiency savings achieved (with over GBP200m higher opex in Q6) and new debt cost higher by 200bps in year two and five (with senior debt all-in-cost at 7.3%), reflecting adverse financing conditions.

Under Fitch's rating case, EBITDA is expected to grow at a five-year CAGR of 3.3% (from GBP1,421m in 2013), which should allow LHR to maintain post-maintenance and tax interest cover ratios (PMICR) for each class of debt at levels above Fitch's rating thresholds. The average PMICR over Q6 for the 'A-' rated class A bonds is around 1.71x, for the 'BBB' rated class B bonds 1.39x and the 'BB+' rated HY bonds 1.25x with dividend cover at holdco level over 3.0x. The Fitch-calculated net senior leverage ratio remains at around 7x for the next five years, well within criteria guidance for strong hub airports.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's expectation that LHR will continue to see stable performance, despite challenging economic prospects. A marked and sustained slowdown of the UK economy could derail LHR's record of resilience. Evidence of recessionary prospects over a prolonged horizon (two years) or failure to achieve operational efficiency gains could prompt a revision of the Outlook to Negative.

Conversely, a material and sustainable improvement in the economic environment could support higher load factors and use of larger aircrafts by airlines, in turn improving the passenger throughput at LHR with a favourable impact on credit ratios.

Downgrade triggers

Class A notes: net debt / EBITDA above 8.5x or average PMICR below 1.6x

HY notes: net debt / EBITDA above 9x or PMICR below 1.15x or dividend cover below 3.0x

Upgrade triggers

Class A notes: net debt / EBITDA below 7x or average PMICR above 1.8x

HY notes: An upgrade is unlikely given LHR's management of its capital structure and subsequent targeting of HY investors

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Applicable criteria, 'Rating Criteria for Infrastructure and Project Finance' dated 11 July 2012, and 'Rating Criteria for Airports', dated 13 December 2013 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=682867
Rating Criteria for Airports
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