FITCH REVISES HEATHROW OUTLOOK TO POSITIVE; RATINGS AFFIRMED

Fitch Ratings-London-10 October 2016: Fitch Ratings has revised the Outlook on Heathrow Funding Limited's class A and B bonds to Positive from Stable. The Outlook on Heathrow's high-yield (HY) notes remains Stable. All ratings are affirmed. The ratings actions are as follows:

Heathrow Funding Limited:
Class A bonds: affirmed at 'A-', Outlook Positive, revised from Stable
Class B bonds: affirmed at 'BBB', Outlook Positive, revised from Stable

Heathrow Finance plc:
High-yield bonds: affirmed at 'BB+', Outlook Stable

Heathrow (LHR) is a major global hub airport with significant origin and destination (O&D) traffic and resilience due to its status as the preferred London airport and capacity constraints. Peers include Aeroports de Paris in terms of size and Gatwick in terms of location and debt structure.

Revenues are regulated and subject to an inflation price cap on a single till basis. We view the structured, secured and covenanted senior debt as offsetting some of the higher expected five-year average leverage under Fitch's rating case (net debt to EBITDA) of 6.2x for the class A bonds and 7.1x for the class B bonds compared to peers. The HY bonds are, by nature, structurally subordinated.

Heathrow's strong credit metrics, which on their own could warrant an upgrade, underpin the Positive Outlook on the class A and B bonds. However, the uncertainties with regard to the new regulatory regime 'H7' with the current 'Q6' ending in 2018, and the full impact of Brexit prevent immediate rating actions. The deeply structural and contractual subordinated nature of the HY bonds prevents any foreseeable upgrades.

Performance Update
LHR's strong operational and financial performance is in line with Fitch's base case. Traffic improved again this year rising by 0.7% in the first eight months of 2016. This compares more modestly to growth rates of 2.2% in 2015, 1.1% in 2014 and 3.4% in 2013. As a result of this growth and to a lesser extent to the efficiencies achieved in operating costs, Fitch expects EBITDA to reach GBP1.68bn in 2016, growing at a CAGR of 1.6% between 2015 and 2018 to GBP1,681m. Lower cost of debt has also contributed to the expected lower net leverage than previously and higher 5-year average PMICR of 2.0x (vs. 1.8x previously) for the class A bonds and 1.6x (1.5x) for the class B bonds under Fitch's rating case.

KEY RATING DRIVERS
Large Hub With Resilient Traffic: Volume Risk - Stronger. LHR is a large hub/gateway airport serving a strong origin and destination market. LHR benefits from resilient traffic performance with a maximum peak-trough fall in annual traffic of just 4.4% through the last major economic crisis in 2008, one of the lowest declines in the industry, due to a combination of factors. This includes 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.

Regulated and Inflation-Linked: Price Risk - Midrange. LHR is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, currently set by the Civil Aviation Authority (CAA) at RPI-1.5% for the five-year 'Q6' regulatory period ending December 2018. Although part of the CAA duties is to ensure that airport operations and investments remain financeable, the price cap is highly sensitive to assumptions on cost of capital, traffic and operational efficiency. For example, the traffic forecast for Q5 calculated before the 2007-2008 crisis proved overly optimistic. However, this was partly offset by higher than planned inflation.

Well Maintained but Capacity Constrained: Infrastructure Development/Renewal - Stronger. LHR agrees a detailed capital investment plan with the regulator. Fitch believes that LHR will be able to deliver the GBP3.5bn 'Q6' capital plan based on its track record to date such as the successful delivery of the brand new terminal T2 in 2014. The regulated asset base approach allows for the self-financing of the investments through tariffs.

Refinancing Risk Mitigated: Debt Structure - Midrange (Class A)/Weaker (HY); Midrange (Class B) changed from Weaker. The issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities mitigates the hedging and refinancing risk. Class A debt benefits from its seniority, security, and protective debt structure with covenants ring-fencing of all cash flows from LHR and limiting leverage. We revised the class B bonds assessment to 'midrange', aligning it better with peers as they benefit from many of the strong structural features of the class A bonds. The HY bonds have a weaker debt structure due to their deep structural and contractual subordination.

Credit Metrics
Fitch's rating case between 2015 and 2020 conservatively reflects the traffic five-year CAGR of 0.6% which occurred through the last economic cycle between 2006 and 2011. We assumed fewer efficiency savings in addition to increasing the cost of new debt by 200bp in year 2017 and 2019 to reflect adverse financing conditions. Heathrow outperformed the CAA's 'Q6' final decision for traffic which assumed potential traffic shocks.

The dividend/interest cover ratio at Heathrow Finance level also far exceeds the 3.0x typically observed for BB+ utilities holdco debt rating. The HY bonds five-year average net debt to EBITDA is at 7.8x and 5-year average PMICR at 1.4x (vs. 1.3x previously) under Fitch's rating case.

Peer Group
Heathrow is one of the most robust assets in the sector globally. It features higher leverage than its European peers (ADP at 'A+'), albeit with a better debt structure for senior debt. Compared to Gatwick (at 'BBB+'), Heathrow's class A and B bonds benefits from a stronger revenue risk profile.

RATING SENSITIVITIES
Future developments that may, individually or collectively, lead to negative rating action include:
Class A bonds: net debt to EBITDA consistently above 8x and average PMICR below 1.6x.
Class B bonds: net debt to EBITDA consistently above 9x and average PMICR below 1.3x.
HY notes: net debt to EBITDA above 10x, PMICR below 1.15x and dividend cover below 3.0x.

Future developments that may, individually or collectively, lead to positive rating action include:
Class A bonds: net debt to EBITDA below 7x and average PMICR above 1.8x.
Class B bonds: net debt to EBITDA below 8x and average PMICR above 1.5x.
HY bonds: An upgrade is unlikely given LHR's management of its capital structure and subsequent targeting of HY investors.

Exposure to Aviation Downturn
The Positive Outlook reflects the expectation that LHR will continue to post a stable performance, despite economic prospects. A marked and durable degradation of the British economy as a result of uncertainties Brexit negotiations, among others, could derail LHR good record of resilience. Evidence of recessionary prospects over a prolonged horizon (two years) could prompt a Stable or Negative Outlook.

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Applicable Criteria
Rating Criteria for Airports (pub. 25 Feb 2016)
https://www.fitchratings.com/site/re/877676
Rating Criteria for Infrastructure and Project Finance (pub. 08 Jul 2016)
https://www.fitchratings.com/site/re/882594

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