FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Heathrow's Funding's Outlook to Negative on Coronavirus Disruptions

Tue 21 Apr, 2020 - 2:30 PM ET

Fitch Ratings - London - 21 Apr 2020: Fitch Ratings has revised the Outlook on Heathrow Funding Limited's class A and B bonds to Negative from Stable and affirmed the ratings at 'A-' and 'BBB', respectively. Fitch has also revised the Outlook of Heathrow Finance plc's outstanding notes to Negative from Stable and affirmed the ratings at 'BB+'.

RATING RATIONALE

The Negative Outlook reflects the ongoing uncertainty relating to the timing and duration of the traffic shock and recovery triggered by the COVID-19 pandemic, together with uncertainties relating to the tariff regime and capex programme in the next regulatory period, H7, starting in 2022.

The affirmation of Heathrow reflects our expectation that its financial flexibility in the form of largely deferrable shareholder distributions, together with its ability to reduce its cost base, will enable it to deleverage below our rating sensitivities after a severe COVID-19-related volume shock in 2020, followed by gradual recovery between 2021 and 2024. Heathrow's liquidity position is solid in part due to significant debt issuance in 2019 ahead of anticipated capex related to the third runway project, which we now expect to be significantly delayed.

Heathrow Funding Limited is the issuer of the class A and Class B debt and Heathrow Finance Plc is the holding company and a high-yield issuer.

We currently assume the 2020 shock to be progressively recovered but if the severity and duration of the outbreak is worse-than-expected we will revise our rating case accordingly.

KEY RATING DRIVERS

Coronavirus and Travel Restrictions Affecting Demand: The rapid spread of coronavirus is leading to an unprecedented impact on travellers' mobility. Under the revised Fitch rating case (FRC), we assume traffic to fall around 47% in 2020, and remain around 22% below 2019 levels in 2021 before gradually recovering by 2023-2024. Heathrow's role as a primary hub offering strong yield for its resident airlines, its location and connectivity and the attractiveness of London as an international business center, together with the capacity constraint due to which demand for slots exceeds supply, all support Heathrow's resilience to shocks.

Defensive Measures Provide Flexibility: Heathrow's significant balance-sheet flexibility, together with our expectation of management's commitment to the current rating, provides some support. Operating costs are partly variable. We continue to expect significant delays in expansionary capex and limited spending on the third runway project in 2020-2021, which should support liquidity during this period. Heathrow also has the capacity to reduce maintenance capex significantly while ensuring that safe and secure operations are maintained in case of prolonged traffic reduction.

Credit Metrics Recovery from 2022: Under the updated FRC, after the 2020 shock causing a large peak in Fitch-adjusted net debt-to-EBITDAR well above our downgrade sensitivities of 8x, 9x and 10x respectively for all three classes, it will fall back under the thresholds by 2022. This suggests only a temporary impairment of its credit profile. We are closely monitoring developments in the sector as airports' operating environment has substantially worsened and will revise the FRC in case the severity and duration of the pandemic is worse-than-expected.

We ran two versions of the FRC: with a lower (3.6%) and a higher (5.3%) weighted-average cost of capital (WACC) assumption for the H7 period starting in 2022. We note that under our lower WACC scenario, management may not choose to undertake the third runway expansion as due to inadequate returns to shareholders from the substantial investment.

Solid Liquidity: Heathrow had cash and committed undrawn liquidity of about GBP3.2 billion at end-March 2020 including around GBP2.9 billion at Heathrow Funding Limited, providing sufficient liquidity in the FRC. Heathrow Finance has over GBP270 million in cash, plus significant additional facilities, which will be drawn between March and May 2020. The cash is expected to be retained to ensure sufficient liquidity at the Heathrow Finance level. It has no large debt maturities until 2024.

Sensitivity Case: We have also run a sensitivity case where Heathrow's traffic falls around 47% in 2020 with gradual recovery thereafter. Leverage for all three classes of debt have higher peaks in 2020 in this scenario and deleveraging is slower, returning to below downgrade thresholds by 2023. We ran both lower and higher WACC versions of this scenario as well; leverage under both scenarios assuming lower WACC starts rising towards 2024 due to expansion capex ramp-up. However, we assumed zero shareholder equity contribution to capex though we expect equity contributions sized to maintain Heathrow Funding's investment-grade ratings.

Risk Assessments: Fitch assesses Heathrow's volume risk as 'Stronger' and price risk, infrastructure renewal and debt structure all as 'Midrange' (for more information see "Fitch Affirms Heathrow Funding's Class A Notes at 'A-', Outlook Stable" dated 31 May 2019)

RATING SENSITIVITIES

Factors That May, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

-An upgrade is unlikely given our expectations of significant traffic reductions in 2020-2021, and the uncertainties around the runway expansion project as well as the WACC for H7.

Factors That May, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

-Net debt-to-EBITDA for class A consistently above 8x; for class B above 9x and for high-yield notes above 10x

-Deterioration of aviation industry beyond our current expectations due to a more severe or prolonged period of travel restrictions or consequent economic downturn due to the pandemic

-Weakening of Heathrow management and shareholders' commitment to the existing investment-grade ratings for class A and class B Debt

-Expansion plans that include a WACC and/or level of shareholder contribution insufficient to maintain leverage sustainably within our negative rating thresholds

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

TRANSACTION SUMMARY

Heathrow is a major global hub airport with significant origin-and-destination 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 the FRC for the class A and B bonds compared with peers'. The high-yield bonds are, by nature, structurally subordinated.

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

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Heathrow Finance plc			
• Heathrow Finance plc/Debt/3 LT	LT	BB+	Affirmed

ENTITY/DEBT	RATING
• Heathrow Finance	LT

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Infrastructure and Project Finance Rating Criteria (pub. 24 Mar 2020) (including rating assumption sensitivity)

Airports Rating Criteria (pub. 24 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Third-party Model (24 March 2020)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Heathrow Finance plc	EU Issued
Heathrow Funding Limited	EU Issued

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Infrastructure and Project Finance Europe Jersey United Kingdom