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Credit Opinion: Heathrow Finance plc

Global Credit Research - 11 Jun 2013

London, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1
Senior Secured -Dom Curr	Ba3/LGD5

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Key Indicators

Heathrow Finance plc

	12/31/2012	12/31/2011	12/31/2010
FFO Interest Coverage [1]	1.5x	1.5x	1.3x
FFO / Debt	3.4%	3.1%	1.9%
Debt Service Coverage Ratio	1.5x	1.5x	1.4x
Implied Concession Life Coverage Ratio	65.7%	64.7%	74.1%
Net Debt / RAB	82.1%	79.7%	81.9%
Adjusted Interest Cover Ratio	0.9x	0.9x	0.8x

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3". In addition, Moody's adjusts for one time items.

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

The only asset of Heathrow Finance plc ("HF") is its shares in Heathrow (SP) Limited ("HSP"). HSP is a holding company which owns the company that owns London Heathrow Airport ("LHR"). LHR is subject to economic regulation on the UK regulated price-cap utility model, with charges set by the UK Civil Aviation Authority (the "CAA"). HF reported 2012 pre-exceptional EBITDA of GBP1,170m and 31 Dec 2012 RAB of GBP13,471m for LHR. HF is indirectly owned by Heathrow Airport Holdings Limited ("HAH"). HAH is ultimately owned 33.65% by Ferrovial S.A. (a Spanish infrastructure & construction company), 20.00% by Qatar Holding LLC (a sovereign wealth fund), 13.29% by Caisse de dépôt et placement du Québec, 11.88% by the Government of Singapore investment Corporation (a sovereign wealth fund), 11.18% by Alinda Capital Partners (an infrastructure fund), and 10.00% by China Investment Corporation (a sovereign wealth fund).

The HSP group is financed via debt provided through a ring-fenced secured debt financing structure (the "HSP SDF"). HSP can only provide cash to service debt at HF if it complies with the financial terms of the HSP SDF. HF debt holders benefit from a security interest in HF's shares in HSP. HF is currently financed by (i) GBP325m 7.125% Senior Secured Notes due Mar 2017 and (ii) GBP275m 5.375% Senior Secured Notes due Sep 2019, (together the "HF Notes"), as well as (iii) a GBP85m loan facility due May 2016, and (iv) a GBP77.5m loan facility due Dec 2019 (together with the HF Notes the "HF Debt"), which together rank pari passu among themselves.

Rating Rationale

The Ba1 Corporate Family Rating (CFR) of HF reflects a Probability of Default Rating of Ba2 and a 35% Family-wide loss given default assumption. The CFR is an opinion of the HF group's ability to honour its financial obligations and is assigned to HF as if it had a single class of debt and a single consolidated legal structure. The Ba3 / LGD-5(85%) rating of the HF Notes reflects the structural subordination of the HF Notes and the other HF Debt in the HF group structure versus the HSP SDF.

HF's Ba1 CFR reflects (i) its ownership of Heathrow, which is one of the world's most important hub airports and the largest European airport, (ii) the relatively resilient traffic characteristics of Heathrow, (iii) the long established framework of economic regulation that pertains to Heathrow which is to be carried forward into the next 5 year regulatory period commencing April 2014, (iv) the significant but declining capital expenditure programme at Heathrow, (v) an expectation that the HF group will maintain Net debt : RAB in the 80s per cent, and (vi) the features of the HSP SDF which puts certain constraints around management activity together with the protective features of the HF Debt which effectively limits HF's activities to its investment in HSP.

Structural Considerations

The HF Notes and the other HF Debt rank pari passu and are subject to the terms of an Intercreditor Agreement which regulates their rights with regard to each other and any future holder of HF Debt, and provides for the sharing of the security granted to the HF Debt holders. HF Debt holders benefit from a pledge of all of the shares in HSP (HF's only material asset) and a pledge of shares in HF. Moody's considers that the HSP SDF isolates the credit profile of LHR from that of the wider HAH group. While there is a certain reliance on HAH for operational support, this is considered acceptable within the context of the rating levels. This together with the security granted to the HF Debt holders should isolate HF from the risks of failure of the wider HAH group, and enables Moody's to ignore any debt in the wider HAH group when assessing the rating of HF. There are certain restrictions on the raising of further debt by HF.

The HSP group is financed via the HSP SDF. HSP can only provide cash to allow debt at HF to be serviced if it complies with the financial terms of the HSP SDF. The HSP SDF provides for the issuance of two tranches of debt, called ("Class A Debt") and ("Class B Debt"). Class B Debt is subordinated to Class A Debt. The terms of the HSP SDF limit the amount of Class A Debt and Class B Debt that can be issued by HSP through a requirement to maintain certain Net Debt to RAB ratios and interest cover ratios.

Recent Developments

Civil Aviation Act 2012

The Act was passed in December 2012 and has made some changes to the way in which airports are regulated in the UK. The Act provides for the CAA to regulate what are defined as Dominant Airports, i.e. those that have an element of monopoly power in their service areas. This is determined by the CAA doing a Market Assessment Test. If an airport is considered dominant it is issued a Licence and is subject to economic regulation in the way that the CAA deems appropriate. Understandably, the CAA has determined that LHR is dominant. The Licence for LHR will come into force on 1 April 2014 in line with the start of the next regulatory charging period in accordance with the Act. The CAA has the power to determine what goes into the Licence and any subsequent amendments. A smaller point is that the Act now provides for the Competition Commission to be the body to whom any Dominant Airport may appeal a regulatory decision rather than an automatic referee as part of the regulatory process as currently (under the old regime because the Competition Commission was part of the regulatory process any appeal by an airport of the CAA final decision effectively required a Judicial Review).

CAA Initial Proposals for Q6

On 30 April 2013, the CAA published its initial proposals for the economic regulation of LHR for the 5 year regulatory period commencing 1 April 2014 (known as Q6). The Initial Proposals essentially continue the same framework of economic regulation for LHR, namely a RAB based cost input defined regulatory single-till- charging model with a 5 year regulatory period. This represents continuity of approach. The following elements are highlighted:

1. The passenger volume numbers used by the CAA to calculate aeronautical charges are rebased to a level somewhat in line with current passenger volumes and only assume modest growth rates over Q6. This reflects the view that assumed passenger volumes should have built-in contingencies, and represents a change from past regulatory assumptions. This is considered a de-risking for LHR in terms of future traffic volumes (but not an elimination of passenger volume risk) and is considered a credit positive.

2. LHR's business plan assumes a step up in costs in the first year of Q6 as the new Terminal 2 becomes operational. The assumed airline moves to the new Terminal 2 will be phased over a number of months so there will be a period of relatively inefficient double running of Terminal 1 and terminal 2. From 2016 onwards as the old Terminal 1 space is closed down costs are assumed to reduce and efficiencies reduce the cost base progressively over the remainder of Q6. The CAA assumes a similar trajectory except that it assumes that efficiencies can be greater, so that by the end of Q6 CAA assume that LHR will operate on a materially lower cost base . This represents an area of risk for LHR.

3. The CAA has reduced LHR's cost of capital to reflect an actual and expected lower interest rate environment. The cost of debt assumption is materially lower than the previous LHR regulatory assumptions and lower than the relatively recent Ofgem assumptions for gas distribution and transmission (although the CAA has maintained the WACC gearing level at 60% and the assumed cost of equity is very marginally higher). HF's 2012 nominal average cost of debt was 5.86% when counting the indexation under index-linked instruments as a cost of debt. With an assumed 2-5%-2.8% RPI assumption the pre-tax nominal cost of debt assumed by the CAA in Q6 would be 5.15%-5.45%. The Initial Proposals pre-tax real WACC of 5.35% is lower than Q5's 6.19%. Note that corporate tax rates are now lower, pre-tax real WACC for Q6 would likely have been 5.72% had corporate tax rates remained at 28%. Note that LHR's recent pre-tax return on RAB, discounting the effect of revenue profiling, has been around 5%, marginally lower than the Q6 Initial Proposals (although the un-profiled revenue returns have been materially lower). The lower cost of capital assumption is a credit negative for LHR but not an unexpected one in Moody's view.

4. The CAA included a draft Licence in the Initial Proposals for discussion. It is very much in early draft form. The CAA recognises that LHR is subject to the HSP SDF and that many of the provisions that might otherwise be included in a licence are contractuallised in the HSP SDF. Therefore there are no specific financial tests or other financial conditions required to be maintained in the Licence. However, on a positive note the CAA is looking to introduce some form of "regulatory re-opener" but what may be covered by such opener is as yet unclear.

Overall the Q6 assumptions are marginally credit negative for HF but, if the Initial Proposals flow through to the final determination of charges, are not expected to be sufficiently negative as to warrant a ratings downgrade of themselves.

Traffic performance to May 2013

After a good recovery in traffic volumes in 2011 (+5.5%), the year ending December 2012 saw a relatively flat performance from LHR (+0.9%), reflecting the UK's modest economic recovery and the impact of the Olympics. Nevertheless, the 70million passengers for the year ending Dec 2012 was a historical record. In the 5 months ending May 2013 traffic is up a further 1.9% on the previous year's five months to May, and so a 1-2% annual growth rate for the whole of 2013 seems reasonable.

Sale of Stansted Airport

In February 2013, HF finalised the sale of Stansted Airport and received gross proceeds of GBP1.5 billion. This has initially reduced HF's debt. In the future this is expected to be used partially to meet capital expenditure commitments and partially distributed to shareholders.

Liquidity Profile

HF's first debt maturity will be a GBP85m loan in May 2016 (the next maturity beyond that is GBP325m due in March 2017). In the meantime, interest payments will need to be met from cash received from HSP, there are no other sources of cash available and no specific liquidity is kept at HF. HSP will not be permitted to upstream cash to HF if it fails to meet certain tests, generally performance related, but also related to the maintenance of adequate liquidity at HSP.

The liquidity of the HF group as a whole is considered good for at least the next 12 months to 18 months.

Operating cash flow after tax is significant and positive in each quarter, with a peak over the summer months of each year. HF consolidated 's liquidity position is currently very good as it had received the GBP1.5 billion of proceeds from the sale of Stansted Airport in Feb 2013 (albeit this will be reduced by the current significant capital expenditure commitments). As at 31 Mar 2013, HF group had GBP2 billion of undrawn revolving credit facilities in HSP maturing in June 2017 (mostly Class A Debt availability but some Class B Debt) with good covenant headroom and over GBP300 million cash. HSP has very successfully improved its debt maturity profile over the past couple of years with only moderate debt maturities in the remainder of 2013 and in 2014.

DETAILED RATING CONSIDERATIONS

The Corporate Family Rating of HF has been scored in accordance with Moody's rating methodology for operational airports outside of the US (May 2008). Scoring is as follows.

Governance & Rate Setting:

The company owning LHR is a general limited liability company that has no particular legal restrictions in relation to its business activities. It is also not subject to any particular provision that would imply bankruptcy remoteness. However, LHR is subject to regulatory oversight, which places some constraints on operations and capital expenditure. We therefore score HF "A" under the "Legal Status / Corporate Objectives" sub-factor.

LHR is subject to a framework of economic regulation that is considered appropriate and transparent. It is a form of price cap regulation that has proven to permit fair recovery of costs, is considered an appropriate mechanism for remunerating capital expenditure, and generates a reasonable return on capital. We therefore score HF "A" under the "Rate Setting Methodology" sub-factor.

LHR is owned in perpetuity and all key aviation infrastructure is controlled by management. We therefore score HF "Aaa" under the "Nature of Ownership / Control" sub-factor.

Market Position:

LHR serves London and the South east of England directly. However, LHR is also the UK's major gateway airport. For the 12 months ending March 2013, CAA report that LHR accounted for 32% of total UK passenger volumes. Its large route network underpins this position. LHR therefore serves a geographical area much wider than London. We therefore score HF "Aa" under the "Size of Service Area" sub-factor.

The London and south east economy represents one of Europe's most robust with GDP per capita above the European average. The economic base has a good level of diversity which is underpinned by London's status as one of the leading world cities from an economic, political and cultural perspective. We therefore score HF "Aaa" under the "Robustness & Diversity of Service Area" sub-factor.

As reported by the CAA, LHR accounts for approximately 52% of the London air travel market for the 12 months ending March 2013 (counting Luton Airport as serving London). It should be noted that this somewhat understates LHR's position because of its role as the UK (and Europe's) largest hub airport. Nevertheless, LHR is in competition with London Gatwick, London Luton, London Stansted and City Airport, at least for some traffic. LHR is also exposed to some trans-modal competition, in particular from rail. Domestic air services compete with rail, and the Eurostar rail service competes very effectively with airlines on the London-Paris and London-Brussels routes. Rail competition with airlines may increase in future as other high speed rail destinations are added to serve London in addition to Eurostar's route network and (in the longer term) there is potential for competition with domestic high speed rail services. We therefore score HF "Baa" under the "Competition for Medium to Long Distance Travel" sub-factor.

Passenger & Airline Base:

For the purposes of the rating methodology, HF is defined as a Hub Airport given that British Airways plc (BA) operates a wide-ranging global route network from LHR that attracts connecting passengers from outside of the UK. LHR estimates that 35% of LHR's traffic is transfer traffic. We therefore score HF "Baa" under the "Passenger Mix (O&D / Transfer)" sub-factor.

LHR traffic has grown at reasonably constant growth rates over the past 10 years. The standard deviation of the long term average annual passenger growth rate for LHR is 2.7% which evidences low volatility compared to most rated airports in Europe. We therefore score HF "Aa" under the "Standard Deviation of Long term Average Annual Passenger Growth Rate" sub-factor.

BA is the main airline serving LHR and the main airline providing LHR's transfer traffic. It is currently rated B1 with a positive outlook. BA merged with Iberia in January 2011, creating the International Airlines Group (IAG). It is not known for certain the percentage of LHR's transfer traffic that comprises IAG passengers but it is expected to be more than 50%. The score of "Ba" for the "Carrier Base (Transfer Traffic)" sub-factor recognises that the percentage may be less than 75% given that LHR has a strong presence from the Star Alliance that may also account for a material share of transfer traffic. Following the sale of British Midland to IAG by Lufthansa, IAG will entrench its position at LHR.

Operating Environment & Capital Programme:

Given its location on the edge of a built up area of west London, there are a number of restrictions that pertain to the operation of LHR. There is a limit on the number of air traffic movements per annum and there is a night time curfew. In addition there is currently a restriction on the use of runways so that they can only be used in `segregated alternate mode'. In addition, in accordance with UK Government policy, future expansion at LHR (runways) could only be accommodated if noise and air quality targets can be met and public transport connections are improved. While this will not affect growth in passenger numbers in the short to medium term, it will impact growth levels in the future. Recognising the potential for an evolving position on the restrictions, LHR has been scored as having three restrictions ("Baa" score on the "Operational Restrictions" sub-factor).

LHR has a substantial, and somewhat complex construction programme, albeit that there is nothing in the programme that should overly stress management. This will include the construction of a new large terminal complex (Terminals 2A and 2B). This programme will involve construction within the airport boundary and the management of a number of airline moves around LHR. The terminal will be of significant size and will involve the construction of all major terminal sub-systems. However, given that Terminal 5 was completed on time to budget the programme is expected to be within LHR's capabilities. Furthermore, the construction of Terminal 2 will be completed by late 2013 and thereafter LHR's capital programme will step down in both complexity and size. We therefore score HF "Baa" under the "Complexity of Airport Capital Expenditure Programme" sub-factor.

Stability of Business Model & Financial Structure:

HF is prohibited from doing anything other than hold its investment in HSP. HSP may invest in activities outside of LHR provided that the amount of such expenditure is less than 2% of the LHR RAB. We therefore score HF "Aa" under the "Ability & Willingness to Pursue Opportunistic Corporate Activity" sub-factor.

Whether or not HF can raise additional debt is essentially determined by the Permitted Financial Indebtedness test in the HF Debt terms and conditions. The HF Notes' Permitted Financial Indebtedness tests are set at the following levels: (1) Group Net Debt: RAB <= 90%, and (2) Group Operating Cashflow to Group Net Interest Paid > = 1.0. HF is expected to maintain a financial profile someway better than would be evidenced by these ratios. Therefore there is reasonable headroom to raise more debt. We therefore score HF "Baa" under the "Ability & Willingness to Increase Leverage" sub-factor.

Following the sale of Gatwick and Stansted airports HSP has not invested outside of LHR. In fact the HAH group has been divesting non-core assets. Nevertheless, HSP has some flexibility to invest outside of the core operations. We therefore score HF "Aa" under the "Targeted Portion of Revenue Outside of Owned Airport Services" sub-factor

Financial Metrics:

HF has been scored on the basis of the financial metrics generated for illustrative purposes, from the consolidated audited financial statements for the year ending Dec 2012. These metrics produce a grid indicated rating of Ba2, one notch lower than the assigned CFR. HF's financial metrics in the near term should be somewhat higher as higher aviation charges benefit LHR, and, based on the assumptions set out in the CAA's Q6 Initial Proposals, key rating credit metrics should improve in Q6.

Uplift for Debt Structural Features and Rating Positioning:

Moody's has not given any specific additional uplift for debt structural features as these are minimal at the HF level. However, the terms of the HSP SDF contain constraints on management such as a requirement to comply with a hedging policy, liquidity dedicated to meeting interest payments on HSP SDF debt, and reporting requirements. While such protections only benefit HSP debt holders directly, and they could in theory be waived by HSP financiers, they do provide some element of protection to HF creditors by helping to protect the financial profile of HSP.

In addition, Moody's recognises that LHR benefits from a long standing framework of economic regulation that may not be fully captured by the rating methodology, and the capacity constrained nature of LHR should suggest a robustness to downside traffic scenarios.

Furthermore, given the form of economic regulation, which is applied across many price capped entities in the UK, Moody's is able to make comparisons of relative credit quality between LHR and the UK regulated utilities. Moody's employs credit metrics uniformly across such borrowers when measuring debt burdens, in particular focusing on two metrics, namely Net Debt/ Regulatory Asset Base ("RAB") and an Adjusted Interest Cover Ratio, namely (FFO less amounts needed to maintain the value of the RAB + Net Interest) / Net Interest. Moody's concludes that HF's credit profile for any given amount of debt is similar to, but marginally lower than, that exhibited by the typical UK water utility. Given the level of debt the HF group is expected to carry in the future, a rating of Ba1 would be suggested when making such comparisons.

Rating Outlook

The rating outlook is stable. This reflects Moody's expectation that LHR will see low single digit growth overall in passenger volumes and assuming that the assumptions in the CAA's Initial Proposals for Q6 follow through to its final determination of charges, HF will maintain a credit profile commensurate with the current rating category.

The outlook further assumes that HSP will continue to manage its debt raising programme in a way that minimises refinancing risk and allows it to comfortably meet new funding requirements.

What Could Change the Rating - Up

The Corporate Family Rating and rating of the HF Notes could move up if the HF group were to exhibit a financial profile that evidenced materially lower leverage than currently expected. This could be suggested by a Net Debt to RAB ratio likely to be permanently below 80% and an Adjusted Interest Cover Ratio of permanently more than 1.2 times.

What Could Change the Rating - Down

The Corporate Family Rating and rating of the HF Notes could move down if the HF group were to exhibit a financial profile that evidenced materially higher leverage than currently expected. This could be suggested by a Net Debt to RAB ratio consistently in the high 80s and an Adjusted Interest Cover Ratio of less than 1.0 times.

Rating Factors

Heathrow Finance plc

Airports Industry	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Governance and Rate Setting (15%)							
a) Legal Status / Corporate Objectives			X				
b) Rate Setting Methodology			X				
c) Nature of Ownership / Control	X						
Factor 2: Market Position (15%)							
a) Size of Service Area		X					
b) Robustness & Diversity of Service Area	X						
c) Competition for Medium to Long Distance Travel				X			
Factor 3: Passenger & Airline Base (10%)							
a) Passenger Mix (O&D / Transfer)				X			
b) Standard Dev of Long Term Average Annual Passenger Growth Rate		X					
c) Carrier Base (Transfer Traffic)					X		
Factor 4: Operating Environment & Capital Programme (10%)							
a) Operational Restrictions				X			
b) Complexity of Airport Capital Expenditure Programme				X			
Factor 5: Stability of Business Model & Financial Structure (10%)							
a) Ability and Willingness to Pursue Opportunistic Corp		X					

Activity							
b) Ability and Willingness to Increase Leverage				X			
c) Targeted Proportion of Rev outside of Owned Airport Services		X					
Factor 6: Key Credit Metrics (Hist & Projected) (40%) [1][2]							
a) (FFO + Interest Expense) / (Interest Expense - Non-Cash Int)						X	
b) FFO / Debt						X	
c) Debt Service Coverage Ratio		`				X	
d) Implied Concession Life Coverage Ratio						X	
Rating:							
Indicated Rating from Grid Factors 1-6					Ba2		
Rating Lift					-		
a) Indicated Rating from Grid					Ba2		
b) Actual Rating Assigned					Ba1		

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3". In addition, Moody's adjusts for one time items. [2] Based on financial data as of 12/31/2012; Source: Moody's Financial Metrics

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