MOODY'S INVESTORS SERVICE

Rating Action: Moody's changes to negative outlook on Heathrow Finance's ratings

31 Mar 2020

London, 31 March 2020 -- Moody's Investors Service (Moody's) has today changed to negative from stable the outlook on the ratings of Heathrow Finance plc (HF). The company's Ba1 Corporate Family Rating (CFR), the Ba2-PD Probability of Default Rating (PDR) and the Ba3 senior secured debt rating were affirmed. HF, through its shares in Heathrow (SP) Limited (HSP), owns London Heathrow Airport (LHR).

RATINGS RATIONALE

The rapid and widening spread of the coronavirus (COVID-19) outbreak, the deteriorating global economic outlook, falling oil prices and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. The airport sector is among the most significantly affected by the shock given its exposure to travel restrictions and sensitivity to consumer demand and sentiment.

Moody´s regards the coronavirus outbreak as a social risk under its ESG framework, given the substantial implications for public health and safety. In addition to the immediate reduction in passenger volumes as a result of the coronavirus epidemic, airports may need to implement new health and safety standards and regulation can result in business practices related to this matter changing over time, leading to some compliance expenses and potential non-compliance costs in the form of fines.

Moody's base case assumption is that the coronavirus pandemic will lead to a period of severe cuts in passenger traffic over the upcoming weeks but that there will be a gradual recovery in passenger volumes starting by the third quarter 2020.

Unlike previous negative shocks such as the SARS epidemic in 2003, the prospects for traffic rebound is more uncertain because (1) travel restrictions in some form may continue for some time even if the spread of the virus seems contained; (2) the deteriorating global economic outlook would likely slow the recovery in traffic and consumer spending, even if travel restrictions are eased; and (3) the coronavirus outbreak is also weakening the credit profile of airlines, which have been drastically cutting capacity. As events continue to unfold, there is a higher than usual degree of uncertainty around the length of travel restrictions and drop in travel demand. Hence, it is difficult to predict the overall traffic volumes for 2020.

Nevertheless, Moody's currently assumes that the decline in passenger traffic at LHR will be at least 30% in the financial year ending December 2020, driven by dramatic declines in the first half of the year and a recovery in the second half, albeit phased over the period. There are, however, high risks of more challenging downside scenarios. The negative outlook assigned to HF's ratings reflects the company's rising credit and liquidity risks due to the sharp decline in traffic as a result of the implementation of travel restrictions and the uncertainties around traffic rebound prospects. The negative rating outlook also reflects Moody's expectation that the contraction in cash flow generation resulting from the declining passenger levels will result in a deterioration of key credit metrics in 2020, below the levels considered commensurate with current ratings, particularly in respect of Moody's Adjusted Interest Cover Ratio (AICR).

Notwithstanding the significantly reduced cash flow over at least the next few weeks, HF, through its ownership of LHR, remains a key infrastructure provider with a potential for a strong recovery once the coronavirus outbreak and its effects have been contained.

More generally, HF's Ba1 CFR continues to reflect (1) its ownership of LHR, which is one of the world's most important hub airports and the largest European airport, (2) its long established framework of economic regulation, (3) the historically resilient traffic characteristics of LHR, (4) the capacity constraints the airport faces, (5) the current period of lower capital expenditure levels, (6) an expectation that the HF group will maintain high leverage, with Net Debt/RAB in the high 80s percent, and (7) the features of the HSP secured debt financing structure, which puts certain constraints around management activity, together with the protective features of the HF debt, which effectively limit HF's activities to its investment in HSP. HF's Ba3 senior secured rating reflects the structural subordination of the HF debt in the HF group structure versus the debt at HSP.

LIQUIDITY AND DEBT COVENANTS

The HF group as a whole exhibits a good liquidity position, allowing for flexibility to cover its expenditure in the context of the significant deterioration in cash flows associated with the expected contraction in traffic levels. Moody's understands that, as of 26 March 2020, the HF group had approximately GBP2.8 billion of cash on balance sheet (of which GBP245 million at the level of HF). Within the group, HSP also maintains liquidity arising from delayed drawdowns under previously issued bonds (GBP155 million). Whilst HF's only source of cash flow remains dividends upstreamed from HSP, HF currently has availability under undrawn committed loans (GBP273 million), which provide additional flexibility to support its debt service requirements. HF's next debt maturity is in 2024. In addition, the HF group is assessing initiatives aimed at reducing, where possible, its cost base and optimising its investment spend, with the objective of further supporting its liquidity profile in the short term.

Given the currently assumed magnitude of the reduction in earnings, Moody's expects a reduction in the headroom against financial covenants included in HF's debt documentation, namely group Net Debt/RAB of 92.5% and Interest Cover Ratio of 1.0x. In addition, the group's debt documentation includes covenants at the level of HSP, which would not be permitted to upstream cash to HF if it fails to meet certain tests, generally linked to financial metrics, but also related to the maintenance of adequate liquidity at HSP. Nevertheless, on the assumption of a traffic rebound, Moody's currently expects the group as a whole to maintain sufficient headroom against its financial covenants at least for the next 12 months.

FACTORS THAT WOULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

In light of the current negative outlook, upward rating pressure on HF's ratings is unlikely in the near future. The outlook could be stabilised if, following the lifting of border and travel restrictions and a return to normal traffic performance, the company's financial profile and key credit metrics sustainably return to levels commensurate with the current rating, while continuing to maintain a good liquidity profile.

Downward pressure on HF's ratings could develop if (1) it were to exhibit a materially reduced headroom under its Net Debt/RAB covenant of 92.5% or an AICR that is consistently less than 1.0x times; (2) the group's liquidity profile deteriorates; (3) there was an increased risk of covenant breaches; or (4) it appeared likely that the coronavirus outbreak had a more sustained detrimental impact on traffic levels, either because of travel restrictions or potential airline failures.

The principal methodology used in these ratings was Privately Managed Airports and Related Issuers published in September 2017 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1092224. Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The only asset of HF is its shares in HSP, a holding company which in turns owns the company that owns LHR, Europe's busiest airport in terms of total passengers. HF is indirectly owned by Heathrow Airport Holdings Limited (HAH). HAH is ultimately owned 25% by Ferrovial S.A. (a Spanish infrastructure & construction company), 20% by Qatar Holding LLC (a sovereign wealth fund), 12.62% by Caisse de depot et placement du Quebec (a pension fund), 11.2% by the Government of Singapore Investment Corporation (a sovereign wealth fund), 11.18% by Alinda Capital Partners (an infrastructure fund), 10% by China Investment Corporation (a sovereign wealth fund) and 10% by the University Superannuation Scheme (a pension scheme).

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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At least one ESG consideration was material to the credit rating outcome announced and described above..

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