Moody's

Rating Action: **Moody's changes outlook on Heathrow Finance to stable; affirms Ba2/B1 ratings**

25 Apr 2023

London, April 25, 2023 -- Moody's Investors Service (Moody's) has today affirmed the Ba2 long-term Corporate Family Rating (CFR) of Heathrow Finance plc (HF). Concurrently, Moody's has affirmed the company's Ba3-PD probability of default rating and the B1 senior secured debt ratings. The outlook has been changed to stable from negative.

HF owns Heathrow Airport Limited (HAL), the airport company owning London Heathrow airport, through its shares in Heathrow (SP) Limited (HSP).

RATINGS RATIONALE

The change in the outlook to stable and the affirmation of HF's ratings reflects Moody's expectation that the Heathrow Finance group will be able to exhibit credit metrics with good headroom against its covenants as the continued recovery in traffic will support operating cash flow despite a reduction in the level of airport charges over the 2024-26 period.

Heathrow airport's traffic reached some 16.9 million passengers in the first quarter of this year. This corresponds to some 94.3% of pre-pandemic levels and is a significant improvement on the last year's performance, when total annual passenger volumes were only 76% of the 2019 level. While traffic is subject to a degree of seasonality during the year, Moody's expects positive traffic trends to continue, with passenger volumes reaching in excess of 90% of pre-pandemic levels this year and full recovery around 2025. There are some risks to this traffic recovery, given macroeconomic and cost of living pressures, but growing passenger volumes will be supportive of the airport's earnings against a backdrop of the regulatory determination that provides for a reduction in Heathrow airport's charges from next year.

In March 2023, the UK Civil Aviation Authority (the CAA) published the Final Decision on the level of charges applicable to HAL over the 2022-26 (H7) period. The regulatory decision provides for a reduction in the level of allowable aeronautical charges to GBP21.03 (2020 prices) per passenger in 2024 and until 2026. While these charges will be adjusted by the consumer price index (CPI), they present a material decrease in aeronautical tariffs from the current level of GBP31.57 per passenger. Among other things, the Final Decision incorporates a reduction in the (real) vanilla weighted average cost of capital (WACC) to 3.18% from 3.26% assumed in the Final Proposals and 4.65% in Q6. The regulatory decision assumes that traffic will remain slightly below pre-pandemic levels until 2025 but the CAA has also introduced a traffic risk sharing mechanism, which will provide protection to HAL if volumes are lower than those assumed by the regulator, and benefits to customers through lower charges if such volumes are higher.

Moody's notes that HAL, as well as three airlines, individually appealed the CAA's Final Decision to the Competition and Markets Authority (CMA), which has until 16 May to decide whether to grant permission for an appeal. Should permissions to appeal be granted, the statutory deadline for final determination is 22 August, but could be extended to 17 October 2023. While this presents uncertainty, Moody's currently assumes that the Heathrow Finance group will be able to navigate a range of plausible downside scenarios and specifically notes that the airlines' notice of appeal includes materially higher traffic assumptions, which are uncertain.

Against this backdrop, the Heathrow Finance group's financial profile will depend not only on the level of aeronautical charges and traffic, but also the company's ability to grow commercial revenue and deliver cost efficiencies. Inflation and interest rates will be a further factor. While charges are increased by the CPI, the regulated asset base and the group's index-linked debt and derivative portfolio are linked to the retail price index (RPI), which has been historically higher. More generally, HF's financial profile and liquidity will depend on the management's financial policies, including for the HSP group, on whose cash flow the company is reliant for its debt service. In this regard, Moody's expects management to follow prudent financial policies and manage capital structure across the wider Heathrow airport group without materially altering the balance of risks to individual companies.

Overall, HF's Ba2 CFR recognises (1) its ownership of London Heathrow airport, which is one of the world's most important hub airports and the largest UK airport; (2) its long established framework of economic regulation; (3) strong demand for the airport's services reflected in fairly resilient traffic characteristics excluding the period of the pandemic and travel restrictions; (4) its highly-leveraged financial profile; (5) 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; and (6) the group's strong liquidity.

HF's B1 senior secured rating reflects the structural subordination of the HF debt in the Heathrow Finance group structure versus the debt at HSP. The rating positively reflects the company's strong liquidity position and Moody's expectation that the HSP group will continue to be able to upstream cash flow under the terms of its debt structure or otherwise manage its liquidity to maintain sufficient coverage of the company's debt service obligations throughout the regulatory period.

LIQUIDITY AND DEBT COVENANTS

As of end-December 2022, the HF group held almost GBP3 billion of cash on balance sheet, of which GBP1.2 billion at the HF level. HSP also had GBP1.4 billion availability under credit facilities due in 2026. On a standalone basis, HF has currently sufficient liquidity to service its debt service obligations into 2025. Its next debt maturity of GBP300 million is in March 2024.

HF's debt documentation includes two covenants - Group Interest Cover Ratio (ICR) of 1.0x and Group RAR, calculated as net debt/regulated asset base (RAB), of 92.5% as events of default. In addition, the group's debt documentation includes covenants at the level of HSP. During the pandemic, HF received a covenant waiver with respect to its Group ICR ratio twice. In addition, the company's gearing covenant was temporarily relaxed. As of end-December 2022, the Heathrow Finance group's gearing amounted to 82.3%, which was well below the event of default level. Moody's expects the group to be able to manage its capital structure and cash flows so that the HSP group and the Heathrow Finance group comply with their respective covenants.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Positive rating pressure would develop if the group's financial profile and key credit metrics were to sustainably strengthen, such that it maintained an appropriate headroom under its covenants and an adjusted interest cover ratio (AICR) consistently higher than 1.0x, while continuing to maintain a good liquidity profile.

Downward pressure on HF's ratings could develop if (1) the group maintained a materially reduced headroom under its event of default financial covenants; (2) the HSP group's ability to upstream cash were significantly reduced, without adequate mitigating factors at the holding company; or (3) there were concerns about the group's or the company's liquidity.

The principal methodology used in these ratings was Privately Managed Airports and Related Issuers published in September 2017 and available at https://ratings.moodys.com/api/rmc-documents/63380. Alternatively, please see the Rating Methodologies page on https://ratings.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 Heathrow Airport, Europe's busiest airport in terms of total passengers before the pandemic. 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 Astatine Investment 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 on https://ratings.moodys.com/rating-definitions.

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