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Heathrow Funding's CAD500 Million Class A-34 Fixed-Rate Notes Assigned 'A- (sf)' Rating; Outlook Stable

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OVERVIEW

- We have assigned our 'A- (sf)' rating to Heathrow Funding's Canadian dollar (CAD) 500 million class A-34 fixed-rate notes, due 2027.
- Heathrow Funding will onlend the net issuance proceeds to Heathrow Airport, the borrower in the corporate securitization. The borrower intends to use the proceeds for general corporate purposes.
- The stable outlook reflects our view that Heathrow Airport will perform robustly over the next two years in terms of passenger numbers, regulatory performance, and profitability, while maintaining a debt-to-regulatory asset base ratio of about 78%.
- Heathrow Funding is a corporate securitization, which provides first-ranking security over Heathrow Airport and the Heathrow Express rail link.

STOCKHOLM (Standard & Poor's) May 21, 2015--Standard & Poor's Ratings Services today assigned its 'A- (sf)' credit rating to Heathrow Funding Ltd.'s Canadian dollar (CAD) 500 million class A-34 fixed-rate notes. The outlook on our rating on the notes is stable.

Under Heathrow Funding's transaction documents, further debt issuance, including bank debt and rated notes, is permitted, provided that:
- The total ratio of senior net debt to the regulatory asset base (RAB) is lower than 72.5%. Total senior net debt comprises the class A notes, plus

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any senior debt issued by the borrower group and ranking pari passu with the class A notes (including accretion on retail price index [RPI] swaps), less any cash or amounts held in authorized investments; and
- The total net-debt-to-RAB ratio is below 90%. Total net debt is senior net debt together with the class B notes, plus any junior debt issued by the borrower group and ranking pari passu with the class B notes.

However, we note that:
- Before 2018, the total senior net-debt-to-RAB is unlikely to exceed 70% as a result of further debt issuance, as this would lead to a dividend lock-up at Heathrow Funding;
- As long as certain additional debt exists outside the securitization group at Heathrow Finance PLC (beyond the scope of our rating), the total net-debt-to-RAB ratio would be unlikely to exceed 82% as a result of further debt issuance, as this would lead to a dividend lock-up at Heathrow Finance; and
- Independent of the financing arrangements outside of the securitization, a total net-debt-to-RAB ratio above 85% would also lead to a dividend lock-up at the securitization group level.

Our base-case assumption is therefore an increase in leverage as a result of additional debt, while maintaining headroom under the financial covenants.

According to the transaction documents, Heathrow Funding cannot bear currency risk in respect of any foreign currency-denominated debt instruments. Therefore, in conjunction with the bond issuance, Heathrow entered into currency hedges to convert CAD-denominated liabilities into British pound sterling.

Heathrow Funding will onlend the issuance proceeds to Heathrow Airport Ltd., the borrower in the corporate securitization. We have been informed that the borrower intends to use the proceeds for general corporate purposes. As long as the proceeds are retained in cash or authorized instruments, the issuance of the new class of notes will not lead to a material increase in leverage within the securitization.

The CAD500 million fixed-rate notes have an annual coupon rate of 3.25%. In line with the other rated senior bonds issued by Heathrow Funding, the class A-34 notes have a scheduled redemption maturity in 2025 and a legal maturity two years after that. The borrower's failure to repay the full principal on the scheduled redemption date would trigger a loan event of default under the issuer-borrower loan, and could ultimately lead to an enforcement of the security by the noteholders.

The ratings assigned to the notes issued by Heathrow Funding, including the class A-34 notes, reflect our opinion that Heathrow Airport is capable of servicing and refinancing its debt under adverse conditions, which are commensurate with 'A-' and 'BBB' rating scenarios, respectively. This, in conjunction with the structural and liquidity enhancements, supports our view that the issuer would be able to meet its obligations at the currently assigned rating levels.

We continue to assess Heathrow Airport's business risk profile as "excellent," reflecting its strong competitive position and supportive regulatory regime. These positive features have made Heathrow Airport's performance less vulnerable to economic conditions and operational disturbances, in our view.

Our base-case assumption for Heathrow Airport anticipates passenger volumes increasing by between 0.5% and 1.5% in 2015, and by approximately 1.0% in 2016. We base our passenger growth forecasts on our view of U.K. GDP growth. Specifically, we expect the U.K.'s GDP to increase by about 2.8% in 2015, and GDP in the eurozone (European Economic and Monetary Union) to rise by 1.5% (see "Credit Conditions: The Eurozone Is Looking Up, For Now," published on March 31, 2015). However, Heathrow continues to experience capacity constraints, leading to lower passenger growth than would otherwise be the case, in our opinion.

In 2015, tariffs at Heathrow are likely to increase by about 1%, in our view. Heathrow is allowed to increase aviation fees by RPI minus 1.5%. In conjunction with this, we forecast the consumer price index (CPI) for 2015 at about 1.5%, and we continue to expect RPI to rise above CPI. We consider that Heathrow's retail income per passenger will increase by between 2% and 3% in 2015, reflecting an outperformance of retail revenues against several European peers in previous years. However, this could be a conservative estimate if the retail offer in Terminal 2 is very successful. Based on these forecasts, we expect Heathrow's revenues to increase by up to 1% in 2015.

Heathrow made significant progress in reducing its operating costs in 2014, and in our base-case scenario we expect further reductions in 2015. In our view, this will likely lead to improving S&P-adjusted EBITDA margins of 56% to 58% in 2015. We forecast that capital expenditures will be about £550 million to £700 million in 2015.

In our downside rating scenarios, however, we only give credit to cost efficiencies that are either already achieved, or that we consider as having a high likelihood of being achieved. Therefore, we anticipate that the transaction would breach dividend lock-up triggers when a mix of stresses that we view as commensurate with the rating on the notes--including deflation, stressed cost of debt, and stressed RPI-hedging assumptions--are overlaid on a capital structure that we deem to be aggressive. These covenants are designed to support the transaction's credit quality during a stress scenario by limiting dividends and other subordinated payments from the structure. In none of these cases, however, would the notes be exposed to a payment default or a breach of the financial default ratios at the current rating levels and under the current regulatory framework.

Our analysis assumes that Heathrow Airport will have continued access to the markets to refinance debt coming due and make restricted payments. Refinancing risk is therefore the main risk factor in our analysis. We consider that it is partly mitigated by a set of covenants that give management an incentive to keep debt under a predetermined proportion of RAB. This makes for a relatively stable and predictable asset valuation proxy.

The stable outlook on the rating assigned to the notes issued by Heathrow Funding reflects our view that Heathrow Airport will perform robustly over the next two years in terms of passenger numbers, regulatory performance, and profitability. The stable outlook also reflects our expectation that the company would maintain a debt-to-RAB ratio of about 78%.

We could lower our rating on the notes if the regulatory framework changes substantially over time--becoming less supportive of Heathrow Airport's ability to finance its operations in the banking and capital markets. In such a scenario, we anticipate that the weaker debt structure of the class B notes would make them more exposed to a downgrade. We could also lower the rating if the company is faced with an operational shock that leads to a significant reduction in passenger volumes, or if it faces material regulatory penalties due to its failure to meet regulatory targets. We could also take a negative rating action if the company were to adopt more aggressive financial policies.

At this stage, we see limited scope for higher ratings on Heathrow Funding's notes, as the financial covenants set in the bond structure allow to operate at high leverage.

Heathrow Funding is a corporate securitization, which grants bondholders first-ranking security over Heathrow Airport and the Heathrow Express rail link. The transaction closed in 2008. Principal and interest for the financing group's obligations is serviced through various revenue sources, but primarily through passenger charges.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Global Framework For Assessing Operational Risk In Structured Finance Transactions, Oct. 9, 2014
- Assessing Bank Branch Creditworthiness, Oct. 14 2013
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology For Rating And Surveilling European Corporate Securitizations, Jan. 23, 2008
- Overview Of Legal And Analytical Challenges In Rating U.K. Corporate Securitizations, Jan. 18, 2007

Related Research

- Heathrow Funding's NOK1,000 Million Class A-33 Fixed-Rate Notes Assigned 'A- (sf)' Rating; Outlook Stable, April 1, 2015
- Credit Conditions: The Eurozone Is Looking Up, For Now, March 31, 2015
- European Structured Finance Scenario And Sensitivity Analysis 2014: The Effects Of The Top Five Macroeconomic Factors, July 8, 2014

- Global Structured Finance Scenario And Sensitivity Analysis: Understanding The Effects Of Macroeconomic Factors On Credit Quality, July 2, 2014
- Ratings On All Notes In Heathrow Funding Affirmed; Class A-24, A-25, A-26 Notes Rated 'A- (sf)'; Outlook Stable, Jan. 28, 2014
- Ratings On All Notes In Heathrow Funding Deal Affirmed; Outlook Stable, Oct. 25, 2013

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