

## Heathrow Funding Ltd. Class A And Class B Debt Affirmed At 'A-' And 'BBB' On Criteria Revision; Outlook Stable; Off UCO

**Primary Credit Analyst:**

Beata Sperling-Tyler, London (44) 20-7176-3687; beata.sperling-tyler@spglobal.com

**Secondary Contacts:**

Michela Bariletti, London (44) 20-7176-3804; michela.bariletti@spglobal.com

Tania Tsoneva, CFA, London (44) 20-7176-3489; tania.tsoneva@spglobal.com

OVERVIEW

- S&P Global Ratings published its revised criteria for rating corporate securitizations, "Global Methodology And Assumptions For Corporate Securitizations," On June 22, 2017.
- Under the revised criteria, U.K. airport financing group Heathrow Funding Ltd. (HFL) no longer meets the eligibility conditions to be rated as a corporate securitization due to the presence of refinancing risk. We are therefore applying our "rating to principles" approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities and Transportation Infrastructure Businesses," published Feb. 24, 2016.
- As a result we are affirming all Class A and Class B issue credit ratings at 'A-' and 'BBB', respectively, based on our reassessment of HFL's credit profile under the rating to principles approach.
- At the same time we removed the ratings under criteria observation (UCO) identifier we applied June 22, 2017.
- We assigned a stable outlook, which reflects our expectation that the weighted average funds from operations to debt in the remainder of the current regulatory period (Q6) is likely to stay above 6% for consolidated debt and above 8% for the Class A debt, as Heathrow Airport is likely to benefit from increasing retail revenue while managing its operating costs to deliver the efficiencies required under the Q6 economic regulation, and debt issuance needs in the current regulatory

period remain moderate.

#### RATING ACTION

On June 26, 2017, S&P Global Ratings affirmed its issue ratings on the Class A debt and Class B debt issued by Heathrow Funding Ltd. (HFL) and removed the ratings under criteria observation (UCO) identifier we applied June 22, 2016.

The issuer is a debt issuing vehicle and a subsidiary of the operating company, Heathrow (SP) Ltd., the principal activity of which is running the operations of Heathrow Airport (Heathrow) and the Heathrow Express rail link. The Class A debt is rated 'A-' and the Class B debt is rated 'BBB'. We assigned a stable outlook to the debt.

The financing group (Heathrow Airport Group) includes Heathrow (SP) Ltd., Heathrow (AH) Ltd., and Heathrow Airports Ltd. (HAL) with Heathrow as its main asset together with Heathrow Express Operating Co. HFL grants bondholders first-ranking security over Heathrow Airport Ltd. (HAL) and the Heathrow Express rail link. Principal and interest for the financing group's obligations is serviced through various revenue sources, but primarily through passenger charges.

#### RATIONALE

The affirmation follows our publication of revised criteria for rating corporate securitizations ("Global Methodology And Assumptions For Corporate Securitizations," June 22, 2017). Under the revised criteria, U.K. airport financing group Heathrow Funding Ltd. (HFL) no longer meets the eligibility conditions to be rated as a corporate securitization mainly due to the presence of refinancing risk.

We are therefore applying our rating to principles approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities and Transportation Infrastructure Businesses," published on Feb. 24, 2016 (the SED criteria). HFL is not in scope of the SED criteria due to primarily higher risk of competition and the absence of a credit remedy period during which creditors take control of the business and either stabilize its credit quality or sell the company's shares. However, HFL benefits from the majority of the structural enhancements listed in the SED criteria, and has additional risk mitigating factors such as the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value. The combination of these factors leads, in our view, to a marginal reduction in the default risk of HFL similar to the marginal default risk reduction which SED senior bondholders can benefit from.

More specifically:

- Heathrow Airport faces higher risk of competition than transactions in the regulated water and network utility sector currently rated under the SED criteria. It does, however, hold a dominant market position as the

global hub in the largest aviation market globally (London) and provides an essential service given few alternative means for long-distance international transport in the U.K., an island country. To prevent abuse of its market position, Heathrow Airport is one of two airports in the U.K. whose returns and revenues are regulated under what we see as the supportive framework of the Civil Aviation Authority. Furthermore, the high barriers to entry given the high capital intensity of the industry limit competitive pressures, in our view.

- Fixed and floating charges over the assets of Heathrow Airport, together with step-in rights under a strong covenant package, allow for the sufficiently early appointment of an administrative receiver--while there is still enough value in the business for senior creditors to be repaid in full. We believe that the administrative receiver has strong incentives to continue operating the airport over the long term, given its significance to the U.K. economy, allowing time for an operational turnaround, regulatory compensation, or sale of the shares in the operating company. We note that transactions for similar assets have historically yielded higher values than the covenant level leading to creditor enforcement (that is, 92.5% debt to regulated asset value [RAV] with the exception of the forced sale of Gatwick Airport in 2009 amid the post-global-financial-crisis recession).

In line with the SED approach, the Class A debt is rated on the basis of debt metrics including senior debt only, and Class B debt is rated on the basis of total debt metrics. This is because the subordinated Class B debt cannot cause payment default on the Class A debt due to its subordinated ranking and priority of payment, as well as the fact that it defers interest and principal in case of non-sufficient funds. The Class A debt rating reflects a one-notch rating uplift to the senior Class A stand-alone credit profile (SACP), which we assess at 'bbb+' to reflect structural features designed to increase cash flow certainty for debtholders. The rating on the subordinated Class B debt reflects its subordinated SACP, which we assess at 'bbb', and does not feature any benefit from structural enhancements despite a liquidity facility being available to cover six months of subordinated debt interest. HFL's structural features include:

- Restrictions on business activities, mergers, acquisitions, and business transformation. Operating covenants place restrictions on the activities that HAL can engage in, and decisions that may affect the value and credit quality of its assets. HAL is restricted from engaging in non-regulated businesses exceeding 2% of the regulatory asset base (RAB).
- Covenants restricting dividends and other subordinated payments from the financing group in a period of stress if senior net debt to RAB ratio exceeds 72.5% from April 2018 (prior to that below 70%).
- Restriction on raising further additional senior debt to a level of senior net debt of 72.5% of RAB and up to 90% of RAB for additional junior net debt.
- Dedicated liquidity facility sized to cover 12 months of senior interest and six months of junior interest available to the issuer, HFL, and the borrower, HAL, to allow repayment of the notes even if senior debt

exceeds the event of default covenant of 92.5% net debt to RAB. We believe the resulting credit protection available to HFL's senior creditors is comparable to a SED criteria requirement of 12 months for each class of debt, because interest and principal on HFL's subordinated debt is deferrable when HFL experiences a cash shortfall and the HFL senior debt is still outstanding.

- Prudent hedging policy with no tolerance for currency risk, no inflation swaps with breaks and counterparty risk in line with our SED criteria. The refinancing risk is mitigated by a very spread maturity profile with no more than 30% and 50% of RCV maturing in any two-year or any regulatory period (five years) respectively.

The ratings on HFL are supported by Heathrow's excellent competitive position as the largest airport in the London area, which itself is the largest aviation passenger market in the world and the most affluent U.K. region, and the only hub airport in the U.K. with near monopoly of long-haul flights. The ratings also reflect a supportive regulatory environment, based on the RAB concept, which ensures availability of cash flows to finance investments via aeronautical charges, while capping the user prices. The recovery of investment is strongly supported by the regulator's duty to ensure Heathrow's ability to finance the business. The five-yearly regulatory resets allow for an adjustment of the aeronautical charges in case of any underperformance against the settlement terms. Heathrow also benefits from an above average profitability among transportation infrastructure companies with an S&P Global Ratings-adjusted EBITDA margin of 61.9% in financial year (FY) 2016, up from 48.7% in FY2010. The increase in the margin reflects the high level of investments delivered over the period, and a return Heathrow is allowed to generate over its assets. Heathrow also proved resilient to economic downturns thanks to high exposure to long-haul routes and business traffic. In 2009, passenger (pax) numbers fell by only 1.5% in response to a 5% drop in GDP--the lowest pax drop among U.K. airports. We expect Heathrow performance to be resilient to Brexit, and benefits from the growth prospects related to the approval of the third runway.

The Class A SACP reflects funds from operations (FFO) to debt excluding subordinated debt above 8% while the Class B SACP reflects FFO to debt based on total debt of 6%-7% over 2017-2019. This corresponds to our calculation of a senior net debt to RAB of 68% in 2017, increasing to about 72% in 2020, and net debt to RAB of about 78%-79% in 2017-2020. Due to the stronger senior-only ratios, our assessment of Heathrow Airport's SACP of 'bbb+' is one notch higher than our assessment of its subordinated SACP. In our base case, we assume:

- Growth in passenger numbers to be limited by the capacity constraints that Heathrow continues to experience. In FY2015, the number of passengers grew by 2.2%. In FY2016, the number of passengers increased further by 0.9% to 75.7 million. Another consideration is that, after a period of significant growth at peer airports (Frankfurt am Main, Paris Charles de Gaulle, Istanbul's Atatürk, Amsterdam's Schiphol, and Adolfo Suárez Madrid-Barajas), the market may be reaching saturation, with

slowdowns in 2016 in many European airports.

- Tariffs at Heathrow to decline by 0.2% in FY2017, because Heathrow is allowed to increase aviation fees by RPI minus 1.5% and April 2016 RPI was 1.3%. In FY2016 tariffs decreased by 0.6% as RPI of April 2015 was 0.9%.
- Heathrow's commercial income per passenger increased by 6.7% in FY2016, reflecting primarily the performance of the refurbished and expanded Terminal 5 luxury retail space and the continued growth in car parking. In FY2017, we project that commercial income per passenger will grow nominally by between 5.0%-6.0% after giving credit to expected returns on the company's investment in the retail experience.
- We view as subordinated debt the £1,343 million subordinated shareholder loan provided by LHR Airports Ltd. to Heathrow SP Ltd.

Based on these forecasts, we expect Heathrow's revenues to increase by between 1%-2% in FY2017. Heathrow made significant progress in reducing its operating costs in 2015 and 2016 and we expect that it will maintain the improvement in S&P Global Ratings-adjusted EBITDA margins at 61%-62% in FY2017, compared with 60.0% in FY2015. We expect capital expenditure (capex) to be about £800 million-£830 million in FY2017 and £840 million-£870 million in FY2018.

#### Liquidity

We assess the HFL's liquidity position as adequate, supported by our view that its liquidity resources will exceed its funding needs by more than 1.2x in the 12 months to March 31, 2018.

We anticipate the following liquidity sources over the period:

- Unrestricted cash and short-term investments of about £317 million;
- FFO of about £990 million;
- Access to about £845 million of undrawn credit facilities expiring in 2020; and
- About £580 million issued in June 2017.

We estimate the following liquidity needs over the same period:

- Expected capex of approximately £800 million;
- Working capital outflows of about £15 million;
- Upcoming short-term debt maturities of approximately £840 million; and
- Dividends amounting to about £460 million.

#### OUTLOOK

The stable outlook on debt issued by HFL and secured on the assets of Heathrow (SP) Ltd. reflects our expectation that the weighted-average FFO to debt in the remainder of the current regulatory period (Q6) is likely to stay above 6% for consolidated debt and above 8% for the class A debt. Heathrow is likely to benefit from increasing retail revenue, in our view, while managing its operating costs to deliver the efficiencies required under the Q6 economic regulation, and debt issuance needs in the current regulatory period remain

moderate.

#### Upside Scenario

The upside for the ratings is limited in our view as we expect Heathrow Funding Ltd will be issuing more debt to fund capital expenditure, including to cover preparatory cost of the third runway, also it will likely be increasing distributions to its holding companies, including Heathrow Finance PLC, to allow them to fund their debt service.

#### Downside Scenario

We could lower the ratings if weighted-average adjusted FFO to debt on a consolidated basis was to deteriorate to below 8% for the Class A debt or below 6% for the Class B debt (excluding the shareholder loan), or if adjusted debt to EBITDA were to increase above 7x for the Class A debt or above 7.5x for the Class B debt (excluding the shareholder loan). This could happen if the company's financial policies were more aggressive than we currently expect, leading to higher leverage or higher distributions than we currently expect, and/ or the operating performance was not as strong as we currently envisage, and if passenger volumes were to drop, unmitigated by lower distributions.

#### RATING SCORE SNAPSHOT

Class A issue credit rating: A-/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

#### Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Senior SACP: bbb+

Structural features: +1 notch

Issue credit rating: A-

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Class B issue credit rating: BBB/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

SACP: bbb

Structural features: N/A

Issue credit rating: BBB

#### RELATED CRITERIA

- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses , Feb. 24, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

RATINGS LIST

Ratings Affirmed

Heathrow Funding Ltd.

Class A issue credit rating	A-/Stable
Class B issue credit rating	BBB/Stable

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.



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