

Research Update:

Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Affirmed On CAA Decision; Off CreditWatch; Outlook Stable

March 22, 2023

Rating Action Overview

- On March 8, 2023, the Civil Aviation Authority (CAA or the regulator) published its final decisions for Heathrow Airport (Heathrow)'s regulatory period (H7), which runs from 2022 to 2026.
- Our revised forecasts incorporating the final decisions show Heathrow's metrics will deteriorate from 2024 once the charge cap declines by about 20%, although partially offset by a stronger passenger recovery path. That said, we continue to expect Heathrow will be able to achieve and sustain credit metrics commensurate with the current ratings--notably funds from operations (FFO) to senior debt of 7% for the Class A notes and FFO to junior debt of 5% for Class B--but will have no significant cushion.
- We understand Heathrow will continue to actively work on its financial discipline to protect its balance sheet, in line with its firm commitment to the ratings.
- We therefore affirmed our 'BBB+' issue rating on Heathrow Funding Ltd. (HFL)'s senior secured Class A debt and our 'BBB-' issue rating on the junior Class B debt. We removed the ratings from CreditWatch, where they were placed with negative implications on Feb. 24, 2022.
- The stable outlook reflects our expectations that Heathrow will continue demonstrating a solid operating performance on the back of its importance as the main airport hub for Europe and its regulated nature. This should allow the airport to achieve and sustain credit metrics in line with the current ratings.

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Rating Action Rationale

On March 8, 2023, U.K. airport regulator CAA announced its final decisions for Heathrow's H7 regulatory period spanning from 2022 to 2026. The affirmation reflects our expectation that Heathrow's credit metrics will remain commensurate with the ratings over H7. Specifically, from 2024 when new charges will be applied, we expect FFO to senior debt between 7%-8% and FFO to junior debt between 5%-6%.

Heathrow will charge less from 2024, while adhering to a tough regulatory period. The CAA defined a charge cap of £21.03 per passenger (as of 2020 prices) from 2024, annually adjusted by the consumer price index (CPI), which results in a fall of almost 20% of the current £31.57 tariffs (£26.06 as of 2020 values). We expect the reduction in the pre-tax weighted average cost of capital (WACC) to 4.04% from 5.35% will hinder Heathrow's profitability during H7. The lower WACC incorporates that the airport will be subject to more efficient operating expense targets, which--in our view--it may be able to achieve from 2024. In the short term, we still expect increasing staff costs to face the airport's rebuilt demand. As a secondary step, the airport could focus on increasing employee productivity.

While we expect H7 will be tougher, we think Heathrow will maintain good access to global capital markets. Its regulation retains a long and stable record of an independent framework that allows operating, capital, and financing cost recovery, alongside strong ring-fencing conditions. We continue to assess Heathrow as one of the most efficient airports in Europe. We believe savings obtained during the pandemic should allow it to sustain EBITDA margins between 50%-55% from 2024, still below its pre-pandemic margins of above 60%. At the same time, the airport should be well positioned to remain a strategic hub and the busiest airport in the continent.

We expect Heathrow's financial performance to be aligned with the issue ratings on the debt, albeit with reduced headroom. As tariffs are higher--at £31.57 per passenger in 2023--and passengers, which we expect to be at least 90% of 2019 levels, Heathrow should post strong credit metrics, such as FFO to senior debt between 8.5%-9.5% and FFO to junior debt of 6.5%-7.5%. However, lower tariffs for the remainder of H7, coupled with incremental investments, could result in negative free cash flows and credit metrics with no significant cushion for the current ratings. We expect Heathrow will have close to £4.0 billion in capital expenditure (capex) during the remainder of H7, mainly related to upgrading security scanners and the baggage system at Terminal 2. This capex should represent roughly £1.6 billion. As a result, from 2024, we forecast FFO to senior debt will reach 7%-8% and FFO to junior debt will be between 5%-6%.

At this stage, the third runway project is on hold and was not incorporated in the H7 investment plan. Finally, we think Heathrow is committed to maintaining its financial flexibility, so we do not expect material cash outflows from the ring-fenced structure in subsequent years. As per management's announcement, it does not plan on distributing dividends to shareholders in 2023, and remains firmly committed to the current rating with an unchanged financial policy.

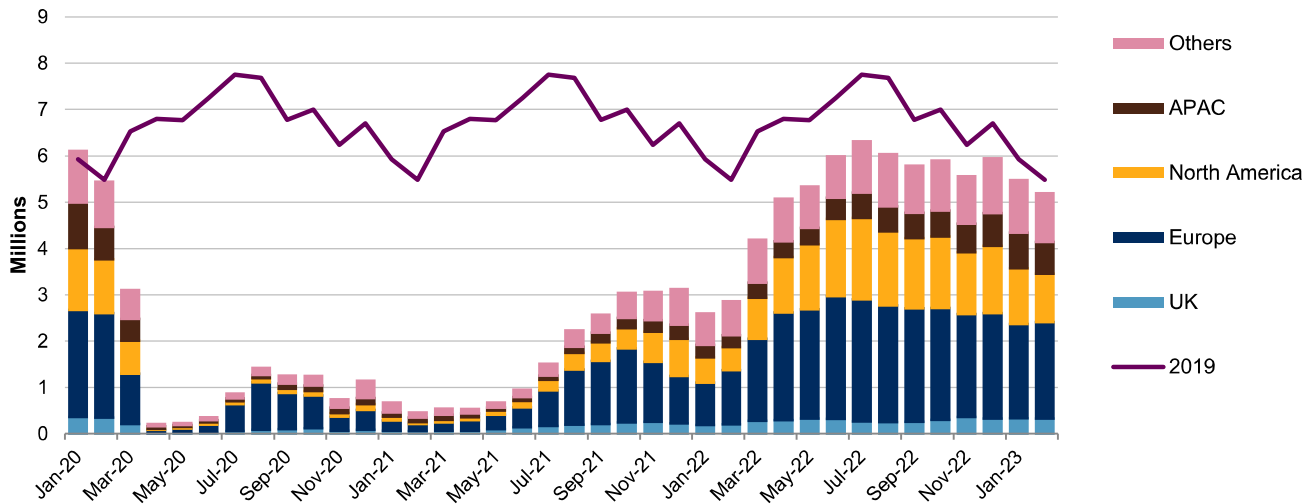
Heathrow is seeing consistent passenger recovery at its terminals, which will partially offset the effect of lower charges. After travel restrictions were lifted in 2022, pent-up demand boosted travelers in the airport and reached 61.6 million--equal to 76.2% of 2019 levels. During the first two months of 2023, the number of passengers at Heathrow reached about 93% of 2019 levels, mostly for leisurely travel. We expect passenger volumes will continue growing in 2023, mainly on the back of no current additional global travel restrictions.

However, currently high inflation and interest rates, and more expensive ticket prices may negatively affect consumers' discretionary spending, such as on travel. Whilst we forecast higher levels of passengers than previously, we think these factors could hinder the strong passenger recovery at Heathrow. We now forecast up to 75 million passengers in 2023 (92.5% of 2019 levels), no more than 80 million in 2024, and up to 81 million by 2025.

We will monitor how these factors could influence Heathrow's retail revenues because, as an airport under a single-till regulatory mechanism, they are an important component to the airport's net total expenditure and assure that tariffs are sufficient to maintain credit metrics.

Chart 1

Monthly Passengers At Heathrow's Terminals
Comparison versus 2019



Source: S&P Global Ratings.

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Different inflation adjustments for tariffs and debt could further pressure credit metrics. As mentioned, during H7 tariffs will be adjusted by CPI, while Heathrow's inflation-linked debt, which represents about 15% of its total debt, is still adjusted by the retail price index (RPI). Historically, RPI has been higher than CPI, so if this trend remains, total debt could increase at a faster pace than Heathrow's cash flow generation if no further mitigating actions are taken, resulting in a deterioration of expected credit metrics.

Outlook

The stable outlook reflects our view that, despite lower tariffs and higher investments, Heathrow will be able to deliver metrics in line with the current ratings--notably FFO to senior debt of at least 7% and FFO to junior debt of at least 5% until the end of H7. This is based on more certainty on the tariff for H7, passenger recovery, and Heathrow's financial discipline.

Downside scenario

We could take a negative rating action on the Class A and Class B debt if Heathrow is not able to achieve and sustain FFO to senior debt at 7.0% or FFO to junior debt at 5.0% with no immediate likelihood of recovery. This could occur, for example:

- In case of an appeal, if the Competition and Markets Authority (CMA) decides Heathrow's tariffs should be lowered further, and if Heathrow takes no further mitigating actions.
- If there are significant cash outflows from the ring-fenced structure, in addition to the interest payments related to the debentures with Heathrow Finance PLC, such as partial repayment of

the debentures with Heathrow Finance, or distributing dividends to shareholders resulting in a less supportive financial policy.

- If inflation fails to return to a long-term average of 2.0% and Heathrow is not able to mitigate the negative effect of this.

Upside scenario

In our view, ratings upside is somewhat limited until the end of H7. However, we could raise the ratings if we expect Heathrow could achieve and maintain FFO to senior debt consistently above 8.0% and FFO to junior debt above 6.0% from 2024. This could occur if:

- In case of an appeal, if the CMA decides Heathrow's tariffs should be higher than CAA's final decisions.
- If Heathrow can implement its strategy to increase commercial revenues and reduce the airport's operating expenses to operate in line with or more efficiently than the CAA anticipated in its final decisions.

Company Description

HFL is a wholly owned subsidiary of Heathrow (SP) Ltd., a debt-issuing vehicle in the ring-fenced financing group, which includes as obligors:

- Heathrow (SP) Ltd. as a holding company of the financing group;
- Heathrow (AH) Ltd. as an intermediate holding company; and
- Heathrow Airport Ltd. (HAL) as a borrower, an operating company that owns and operates the group's only asset, Heathrow Airport.

The group's companies are indirect subsidiaries of Heathrow Airport Holdings Ltd., which is indirectly owned by Ferrovial S.A. (25%), Qatar Holding LLC (20%), and other institutional investors.

For 2022, the group's total revenues were £2.9 billion, and S&P Global Ratings-adjusted EBITDA amounted £1.7 billion. The revenue base mainly comprises aeronautical revenues (about 65%), charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, revenues are subsidized by non-aeronautical income generated from retail, car parking, property rental, and Heathrow Express rail service.

Our Base-Case Scenario

Assumptions

We updated our assumptions to incorporate the CAA's final decisions and Heathrow's passenger-level recovery path, in addition to our updated macroeconomic forecasts.

Our main assumptions for 2023-2025 are:

- Passenger traffic recovery will reach 90%-92.5% of 2019 levels in 2023, 95%-97.5% in 2024, and 97.5%-100% in 2025.

- The charge cap in 2023 will remain at £31.57 per passenger. After, we incorporate the CAA's tariff of £21.03 as of 2020 values. The values will be adjusted to their nominal values by our CPI assumptions of 7.0% in 2023, 0.9% in 2024, and 1.6% in 2025.
- We still expect Heathrow's personnel-related expenses will grow above inflation during 2023, as the airport is still hiring new staff to face demand recovery. From 2024, we believe Heathrow's focus will be on efficiency gains to keep its profitability amid lower tariffs.
- Total investments, mostly focused on maintenance, ranging £650 million-£700 million in 2023, £850 million-£900 million in 2024, and £1.2 billion-£1.3 billion in 2025.
- Interest payments on the debentures from Heathrow Finance PLC between £150 million-£200 million annually as a cash outflow from the ring-fenced structure.

Heathrow Funding Ltd.--Key Metrics

	2022	2023e	2024e	2025e
Passengers (% of 2019 levels)	76.2	90-92.5	95-97.5	97.5-100
Passengers (million)	61.6	72.5-75.0	76.5-79.0	79.0-81.0
Charge cap (£ per passenger)	30.19	31.57	25.50-26.00	26.00-26.50
EBITDA (bil. £)	1.7	1.9-2.1	1.6-1.8	1.7-1.9
EBITDA margin (%)	57.8	55-60	50-55	50-55
FFO to senior debt (%)	6.5	8.5-9.5	7.0-8.0	7.0-8.0
FFO to debt (%)	4.5	6.5-7.5	5.0-6.0	5.0-6.0

e--Estimate. FFO--Funds from operations.

In our 2022 metrics we include £260 million related to accretion on index-linked bonds, and £490 million cash payment related to the early settlement of accretion on index-linked swaps, which were due to be settled within the next four years. If we were to exclude the early settlement from the 2022 metrics, which was an anticipation of future cash payments, we would arrive at FFO to senior debt of 10.3% and FFO to junior debt of 7.8%.

Liquidity

We consider that Heathrow's liquidity position remains strong, with its liquidity sources surpassing uses by about 2.0x in the next 12 months and by more than 1.2x in the next 24 months. This is a result of Heathrow's efforts to contain cash burns as the airport has not yet fully recovered its passenger volume. Additionally, because Heathrow will focus its investments on maintenance in the coming years, we expect the airport to maintain its financial flexibility.

We expect principal liquidity sources over the 12 months from Dec. 31, 2022, will include:

- Unrestricted cash and short-term investments of about £1.8 billion;
- £1.4 billion undrawn credit facilities; and
- Cash FFO of about £1.2 billion.

We expect principal liquidity uses over the same period will include:

- Debt maturities of about £750 million;

- Investments between £650 million-£700 million; and
- Interest payments on the debentures to Heathrow Finance ranging £150 million-£200 million.

Covenants

The Class A debt has financial covenants measured at Heathrow (SP) Ltd.'s level that could lead to an event of default if not in compliance, as follows:

- Senior interest coverage ratio of at least 1.05x, calculated based on the average of the three previous years; and
- Senior regulatory asset ratio below 92.5%.

In our base-case scenario, we expect these financial covenants will be compliant in the next 24 months, because passenger volumes will be equivalent to at least 90% of 2019 levels, so that Heathrow's cash flow generation would be closer to normal periods.

Additionally, both the Class A and Class B debt must comply with the following ratios, otherwise there would be a lock-up for distributions at Heathrow (SP) Ltd.:

- Senior interest coverage ratio higher than 1.40x;
- Junior interest coverage ratio higher than 1.20x;
- Senior regulatory asset ratio below 72.5%; and
- Junior regulatory asset ratio below 85.0%.

Environmental, Social, And Governance

ESG credit indicators: To E-2, S-3, G-2; From E-2, S-4, G-2

Social factors are now a moderately negative consideration in our credit analysis. Passenger recovery is still underway as COVID-19 related travel restrictions are lifted. In February 2023, passenger volume reached 94.5% of 2019 levels, thanks to a recovery in both short- and long-haul flights. Travel restrictions were lifted worldwide as China reopened its borders, which should contribute to an increase in long-haul passengers at Heathrow. On the other hand, macroeconomic headwinds leading to the rising cost of living could drag the passenger volume recovery path.

Structural Features

The ring-fence includes approximately 10% of junior debt (Class B) that protects senior debtholders. HFL will continue to service Class B debt as long as there is cash. Given the Class B debt's subordinated status, HFL can defer the principal and interest on Class B indefinitely if there is cash shortfall. Furthermore, the Class A debt benefits from stronger senior-only credit metrics. This supports our assessment that the 'bbb' senior stand-alone credit profile (SACP) is one notch higher than the 'bbb-' subordinated SACP.

Our 'BBB+' rating on HFL's Class A debt also incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s 'bbb' senior SACP, reflecting structural features designed to increase cash-flow

certainty for debtholders. The 'BBB-' rating on the subordinated Class B debt reflects its 'bbb-' subordinated SACP.

HFL's structural features include:

- Restrictions on business activities, mergers, acquisitions, and business transformation;
- Covenants restricting dividends and other subordinated payments from the financing group, and a restriction on raising additional senior debt;
- A 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 Heathrow; and
- A prudent hedging policy and provisions, mitigating refinancing risk.

We apply our ratings-to-principles approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published Feb. 24, 2016. HFL does not meet all the requirements to be rated under our structurally enhanced debt criteria, due primarily to higher volume risk and the absence of a credit remedy period after triggering an event of default on the intercompany loan, during which creditors take control of the business and stabilize its credit quality or sell the company's shares. However, HFL benefits from the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value before default on HFL's debt.

Ratings Score Snapshot

Senior secured debt (Class A)

Issue rating: BBB+/Stable

Business risk: Excellent

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

Financial risk

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

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

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Junior debt (Class B)

Issue rating: BBB-/Stable

Business risk: Excellent

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

Financial risk

- Cash flow/Leverage: Highly leveraged

Anchor: bbb-

Modifiers

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

Senior stand-alone credit profile: bbb-

Structural features: None

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

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- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, 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

Related Research

- Higher Passenger Volumes Improved Heathrow's 2022 Performance But Regulatory Decisions Cloud The Horizon, Feb. 23, 2023
- Industry Top Trends 2023: Transportation Infrastructure, Jan. 23, 2023
- EMEA Infrastructure: Handbook, January 2023
- Inflation And Rising Yields: EMEA Infrastructure: Well Positioned To Pass On Higher Costs Through Tariffs, Nov. 22, 2022
- Europe's Remarkable Air Passenger Traffic Recovery Faces A Trickier 2023, Nov. 21, 2022
- Heathrow Funding Ltd. Class A And Class B Ratings Remain On CreditWatch Negative After Regulator's Final Proposals, July 7, 2022

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Heathrow Funding Ltd.		
Senior Secured	BBB+/Stable	BBB+/Watch Neg
Subordinated	BBB-/Stable	BBB-/Watch Neg

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 for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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; or Stockholm (46) 8-440-5914

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