

Research Update:

Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Taken Off CreditWatch Negative And Affirmed; Outlook Negative

March 4, 2021

Rating Action Overview

- Stringent restrictions on international travel across European countries will result in Heathrow Airport's (Heathrow) passenger numbers totalling about 40% of 2019 levels in 2021, which is lower than we previously expected. The vaccine rollout will then lead to a meaningful recovery to about 70% of 2019 levels in 2022.
- We think the U.K. aviation regulator, the CAA, will take a balanced approach that will support Heathrow Funding Ltd.'s (HFL) financeability. We therefore think the regulatory framework in the period starting January 2022 (H7: 2022-2026) should remain supportive and transparent, but it is unclear whether the support will benefit aeronautical tariff levels and, therefore, Heathrow Funding Ltd.'s (HFL) cash flows.
- We note that HFL limited cash burn and made additional interest cost savings through swap transactions in 2020, which should result in weighted average funds from operations (FFO) to senior debt of 5%-7% and weighted average FFO to total debt of 3%-5% over 2021-2023
- We are taking our 'BBB+' Class A issue ratings and 'BBB-' Class B issue ratings off CreditWatch, where we placed them with negative implications on Sept. 30, 2020, and affirming them.
- The negative outlook reflects that we could downgrade HFL's debt by one notch if traffic levels are worse than we forecast, or the H7 regulatory package is such that the company cannot achieve weighted average FFO to senior debt of at least 7% and weighted average FFO to total debt of 5%.

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Rating Action Rationale

Despite the efficient vaccine rollout in the U.K., travel restrictions to prevent the spread of COVID-19 variants continue to delay the start of traffic recovery for European airports. We recently revised downward our passenger traffic estimates for European aviation (see "Europe's 2021 Air Passenger Traffic Likely To Stall At 30%-50% Of 2019 Level," published Feb. 18, 2021),

which included lower traffic assumptions for Heathrow than we previously anticipated. We now expect Heathrow Airport will only experience 40% of 2019 passenger levels in 2021, up slightly from 27% in 2020, before rising to about 70% in 2022. We expect a slow recovery to pre-pandemic levels no sooner than 2024. Our traffic assumptions for Heathrow Airport after 2022 are in line with our expectations for other European airport hubs, somewhat above what the company published in its revised business plan in December 2020.

In our view, there remains considerable uncertainty regarding the outlook for air travel, but the rollout of several vaccines has strengthened the path back to recovery. We assume vaccine production will ramp up, rollouts will gather pace, and widespread immunization across Europe will be achieved by end-September 2021. That said, we think the U.K. government will open borders to international travel only when it is confident about the advancement of the vaccination rollout and the efficacy of the vaccines against various virus strains emerging globally.

We view positively Heathrow Airport's attraction as a hub. There could be some permanent loss of business travel income, which accounted for more than 30% of Heathrow's traffic mix in 2019. However, we recognize Heathrow's attraction as a hub, and it should continue benefiting from London's attractiveness as a tourist destination, resulting in more leisure traffic. Furthermore, Heathrow has a strong hold of the attractive New York to London route, which could open first if vaccination efforts in the U.K. and U.S. continue at the current pace--half of Heathrow Airport's passengers in 2019 were long-haul.

Mitigating actions support credit metrics in line with our previous expectations. Although our traffic assumptions for 2021 have decreased, we assess airports over a longer-term horizon due to their essential infrastructure status and often regulated earnings. Heathrow successfully implemented a number of operating and capital cost savings that partly mitigated its losses in 2020. We expect some of these initiatives to continue in 2021 and beyond, limiting further increases in Heathrow's adjusted debt, which stood at about £14 billion in 2020. In addition, HFL reprofiled a proportion of its existing interest rates and inflation swaps and completed a series of new interest rate swap transactions. This will help reduce interest payments over the next few years, supporting the company's credit metrics while traffic levels recover. With this transaction, we expect the company to save about £200 million-£300 million of interest expenses per year in 2021 and 2022. We still expect HFL to deliver its weighted average FFO to senior debt of 6%-7% during 2021-2023 and FFO to total debt of 4%-5%. We consider these ratios to be very tight for the rating, limiting the company's financial flexibility given the high level of debt issued by entities outside the group ring fence. However, we expect these ratios to improve in 2022, subject to the outcome of the regulatory reset in 2022.

The ratings on HFL also depend on the H7 regulatory reset, which includes the pandemic-related regulatory asset base (RAB) adjustment that HFL has requested. It is uncertain whether the regulatory support will directly benefit aeronautical tariff levels, and, therefore, the company's cash flow. The subsequent consultations will provide more details, and the CAA is likely to announce the final determination toward the end of 2021. That said, the CAA has acknowledged the pandemic's impact and the importance of RAB adjustments to Heathrow's future plans. Therefore, it has not considered a "no intervention" option in its consultation, published in February 2021.

Based on the CAA's track record and statutory duty, we think it will take a balanced approach such that HFL can sustain credit metrics at least commensurate with the current ratings, considering our traffic assumptions. We think the CAA will support HFL's financeability while considering the

affordability of charges for airlines and ultimate customers, as well as future expansion needs. The regulatory framework for Heathrow stipulates that the aeronautical tariffs are set at a level enabling the company to cover its operating expenditure and capital expenditure (capex) needs. There is high uncertainty regarding the level of return on capital for investors. This may differ from what Heathrow requested in its revised business plan, and it may also depend on the CAA's use of tools such as traffic risk-sharing mechanisms. The tools also include the adapting or allowing of holidays in regulatory depreciation. Although these are indirectly supportive of tariff levels because they increase the RAB, they do not provide immediate cash flow support.

In 2021, the CAA will likely provide some recovery of cash flows HFL lost in 2020 due to the pandemic. We think this will raise HFL's RAB by less than the £2.8 billion that the company has requested, with a corresponding lower impact on future tariffs. The CAA is considering an uplift of £200 million-£600 million, and we expect an announcement in late March 2021. Positively, the CAA has already approved the additional charge of £8.90 per passenger that will apply in 2021 and will cover the cost of certain services, such the baggage system, staff car parks, airline check-in desks, and utilities used by the airport's tenants.

Heathrow benefits from strong liquidity. The operating company within the group, Heathrow (SP) Ltd. reported £3.5 billion cash as of Dec. 31, 2020. Excluding proceeds from any further issuance, this should provide for a year of operations under the extreme stress test scenario of minimal or no revenue into April 2022. This takes into account cash burn--the rate at which the company uses up its cash balances to fund operations and capital and service debt of £150 million per month with cost containment measures in place. Before the COVID-19 outbreak, Heathrow burned £240 million per month.

Our base case assumes Heathrow (SP) Ltd. will comply with all of its covenants thanks to its mitigating actions to offset the effect on cash flow. Nevertheless, we understand HFL is not planning any dividends until it rebounds to profitability.

Outlook

The negative outlook reflects that we could lower the ratings on HFL's Class A and Class B debt by one notch if traffic recovery is worse than our forecast, resulting in higher cash burn and increase in HFL's adjusted debt.

Downside scenario

We would also downgrade the Class A and Class debt if the regulatory tariff set for H7 is such that HFL cannot achieve weighted average FFO to senior debt of at least 7% and weighted average FFO to total debt of at least 5%.

Upside scenario

We would revise the outlook to stable if COVID-19-related traffic disruption is contained, with the company sustainably maintaining FFO to senior debt above 7% and FFO to total debt above 5%.

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.

In 2020, the group's total reported revenue was £1.2 billion, down 62% on 2019. S&P Global Ratings-adjusted EBITDA amounted to £193 million, down 90% on 2019. The revenue base mainly comprises aeronautical revenue--approximately 55%--charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, they are subsidized by non-aeronautical income that is generated from retail, car parking, operating the Heathrow Express rail service, and property rental.

Our Base-Case Scenario

Assumptions

- Passenger numbers to be about 40%, 70%, and 85% of 2019 levels in 2021, 2022, and 2023, respectively.
- We expect the U.K. government's decision to withdraw the VAT retail export scheme and airside tax-free shopping will harm retail activities. As of Jan. 1, 2021, passengers departing to non-EU destinations no longer pay zero-rate excise duty. Furthermore, international visitors to the U.K. can no longer obtain a refund of 20% VAT on certain goods they buy in the U.K. This will reduce consumer interest in shopping at terminals and will likely result in decreased retail income revenue.
- Revenue in 2021 to remain at 55%-60% below 2019 levels as a result of slow recovery in passenger numbers and retail activities. This drop stems from lockdown measures in countries of operation. We anticipate revenue to increase by about 60%-65% year on year in 2022 and by 15%-20% in 2023 as traffic recovers. However, we do not expect revenue to return to 2019 levels until 2024.
- Charges of £28.50 per passenger in 2021, including the £8.90 per passenger charge covering the cost of services such as the baggage system, staff car parks, airline check-in desks, and utilities used by Heathrow's tenants.
- EBITDA of £400 million-£435 million in 2021 thanks to permanent cost savings implemented since 2020.
- We expect full interest cost savings from swap reprofiling of about £300 million in 2021 and £200 million in 2022.

- Total capex limited to maintenance capex of about £350 million-£375 million for 2021.
- No distributions planned in 2021.

Key metrics

Heathrow Funding Ltd. -- Key Metrics

	2019a	2020a	2021e	2022f	2023f
FFO to debt (%)					
Class A and B	9.0	NM	0.5-1.5	5.0-6.0	6.0-8.0
Class A only	10.0	NM	1.0-2.0	6.0-7.0	7.0-9.0
FFO to cash interest coverage (x)					
Class A and B	2.8	NM	1.5-2.0	2.0-3.0	2.0-4.0
Class A only	N/A	NM	2.5-3.0	3.0-4.0	3.0-4.0

a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. N/A--Not applicable. NM--Not meaningful.

Liquidity

We expect Heathrow (SP) Ltd. to maintain strong liquidity, with liquidity sources exceeding uses by more than 1.5x in the 12 months from Dec. 31, 2020 and by more than 1.0x in the subsequent 12 months from Dec. 31, 2021.

In our view, HFL has a high standing in credit markets, demonstrated by its well-established debt issuance program active in eight currencies and at the senior, junior, and holding company levels. It also has solid and well-established relationships with banks; its banking group includes over 30 banks providing either liquidity or hedging capacity. We think this would allow HFL to easily access funding if necessary, although possibly at a higher cost.

We expect principal liquidity sources over the 12 months from Dec. 31, 2020 will include:

- Unrestricted cash and short-term investments of about £3.5 billion;
- Cash FFO of £200 million-£250 million; and
- Positive working capital of £100 million-£200 million.

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

- Capex of approximately £350 million-£375 million;
- Debt maturities of approximately £1.5 billion; and
- No dividends.

Covenants

Trigger event ratios are tested twice a year--once in June, once in December. Each 12-month testing period ends on Dec. 31.

Our base case assumes Heathrow (SP) Ltd. will comply with all its covenants.

The event of default covenants are tested in June only, and on a past three years rolling-average basis. At the testing date on June 30, 2020, the interest coverage ratio-based event of default was comfortably above 1.05x.

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 to reflect 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, HAL; and
- A prudent hedging policy and provisions, mitigating refinancing risk.

We apply our rating-to-principles approach to HFL, using our criteria "Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published Feb. 24, 2016. HFL does not meet all requirements in order 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 prior to default on HFL's debt.

Ratings Score Snapshot

Senior Secured (Class A)

Issue Rating: BBB+/Negative/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Low

- Competitive position: Excellent

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: bbb-

Modifiers

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

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Subordinated (Class B)

Issue Rating: BBB-/Negative/--

Business risk: Excellent

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

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: bbb-

Modifiers

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

Junior stand-alone credit profile: bbb-

Structural features: None

Related Criteria

- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- 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

- Europe's 2021 Air Passenger Traffic Likely To Stall At 30%-50% Of 2019 Level, Feb. 18, 2021
- Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Ratings Remain On CreditWatch With Negative Implications, Sept. 30, 2020

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Heathrow Funding Ltd.		
Class A	BBB+/Negative	BBB+/Watch Neg
Class B	BBB-/Negative	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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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