Research Update:

Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Debt Ratings On CreditWatch Negative

February 24, 2022

Rating Action Overview

- Although the U.K. government recently announced test exemptions for fully vaccinated travellers, as well as the lifting of travel restrictions, the omicron variant of COVID-19 highlights volatility in recovery for European airports. We therefore expect the recovery of passenger volumes for Heathrow Airport (Heathrow) will take longer than previously anticipated, reaching about 55% of 2019 levels in 2022, 70% in 2023, and only reaching pre-pandemic levels in 2025.
- We are monitoring the ongoing regulatory process to determine the terms of Heathrow's regulatory period (H7), which is taking longer than we previously expected. We now expect a decision not before Q2 2022. Although we think an increase in airport charges will mostly offset slower traffic recovery, there remain ongoing discussions about the implementation of the risk-sharing mechanism, which could affect the airport's cash flow generation.
- There are significant uncertainties regarding Heathrow Funding's (HFL) ability to recover its credit metrics to a level commensurate with its credit ratings, notably 2022-2024 weighted-average funds from operations (FFO) to senior debt of at least 7.0% and FFO to total debt of at least 5.0%.
- We placed our 'BBB+' issue rating on HFL's senior secured Class A debt and our 'BBB-' issue rating on its junior Class B debt on CreditWatch with negative implications.
- The CreditWatch negative placement for both the senior and junior debt ratings indicates that we could lower the ratings if we deemed the H7 regulatory package to be less supportive in mitigating Heathrow's traffic risk exposure, along with tariffs that we considered insufficient for the company to sustain FFO to debt commensurate with the ratings.

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Rating Action Rationale

The ratings on HFL depend on the H7 regulatory reset. It is still uncertain whether the regulatory support will directly benefit aeronautical tariff levels throughout the regulatory period of 2022-2026, and, therefore, the company's cash flow. Based on the Civil Aviation Authority's (CAA) favorable track record and statutory duty, our ratings take into consideration that it will take a balanced approach such that HFL can recover and sustain credit metrics at least commensurate

with the current ratings, considering passenger volume recovery. That said, CAA's initial proposal published in October 2021 left questions about the tariff level for H7 and the methodology for risk-sharing mechanism that might not provide cash compensation in a timely manner.

Although Heathrow's H7 regulatory period started on Jan. 1, 2022, the current charge is only a one-year deal, with the four years thereafter yet to be finalized. In October 2021, the regulator Civil Aviation Authority (CAA) published its initial proposals for the next price control at Heathrow, and in December 2021 it set an interim price cap for 2022 of £30.19 per passenger, with the full proposals for H7 period to be finalized during the first half of 2022. The discussions have entailed wide tariff ranges, both from CAA (initial proposal of £24.50-£34.40 per passenger) and Heathrow (£34.00-£41.95, according to its latest revised business plan), which poses uncertainties regarding the final outcome for H7. In our base-case scenario, we assume tariffs will remain at the interim level during the entire H7 period, starting at £30.19 per passenger in 2022, with further adjustments for inflation. Considering the traffic levels in our base case, we expect Heathrow to post weighted-average FFO to senior debt close to 7.0% and FFO to total debt of about 5.0% between 2022 and 2024. These metrics have very limited headroom for the current rating, and we anticipate that the 2022 metrics will be below the weighted average, approaching it by the end of 2023, supported by a larger number of passengers in the airport because of fewer mobility restrictions, combined with the expected tariff increases.

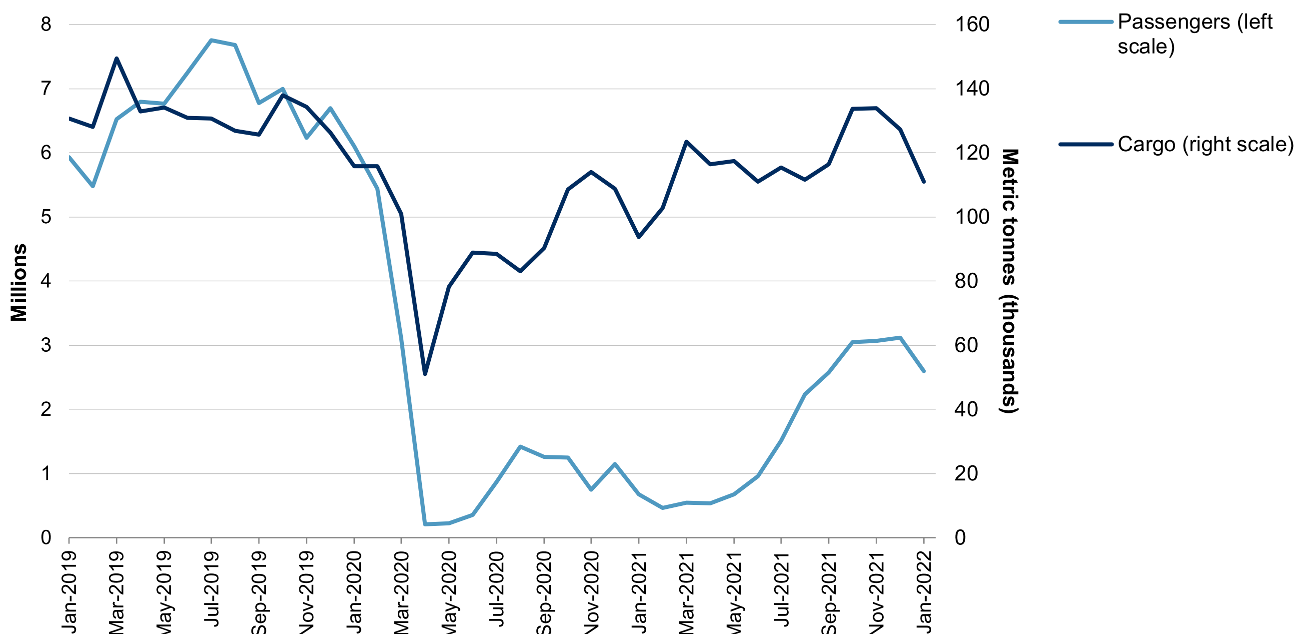
CAA has yet to define how it will implement the risk-sharing mechanism. We have a positive view of the traffic-sharing mechanism, which is already present in other rated European airports, since it aims to recover lost revenue due to lower traffic volumes, and unrecovered investments, and provides cash compensation for lost revenue. So far, Heathrow does not include this feature in its regulatory framework. Under the preliminary proposal, CAA would determine its base-case passenger forecast for the regulatory period. Should reported traffic levels differ from CAA's threshold, there would be an upward adjustment to the regulatory asset base (RAB) if Heathrow underperforms and, conversely, a downward adjustment in case of overperformance. However, we think this RAB mechanism, although assuring the recoverability in the long term, does not result in immediate cash compensation. This could put the already tight credit metrics for the rating under further pressure if no other short-term compensating measures are applied during a stressful period. Given that the risk-sharing mechanism's implementation is not defined yet, we have not considered it as part of our base-case scenario. However, once it is defined, we could reassess how it affects our view of the regulations' supportiveness to Heathrow and the further effect on the company's credit metrics.

Heathrow's recovery path will be slower than previously anticipated, in the face of pandemic-related uncertainties and varying cross-border restrictions. Although many countries, such as the U.K., are lifting the travel restrictions and suspending test requirements for fully vaccinated passengers, we think recovery in air passenger numbers will remain volatile. As such, we anticipate a more modest recovery trajectory for Heathrow. Although mobility restrictions have not been as severe as in 2020, we view the uncertainty regarding further variants and the efficacy of current vaccines against them will weaken consumer confidence to travel. Combining this with a lack of a domestic market and a reliance on long-distance routes, we think Heathrow will be unable to fully recover its 2019 traffic levels before 2025. For further information on our view on our rated European airports, see "A Volatile Recovery Ahead For European Airports," published Jan. 24, 2022, on RatingsDirect.

The airport's passenger volumes in 2021 were 19.4 million passengers, at about 24% of 2019 levels and 12.3% lower than in 2020. Despite the efficient vaccine rollout in the U.K., travel restrictions in the country to prevent the spread of COVID-19 variants were stricter than in other European countries, delaying the start of traffic recovery. Several countries, such as the U.K. and the U.S., reopened their borders for fully vaccinated tourists in the final few months of 2021, after the summer season, contributing to the delay in recovery. Additionally, by the end of the year, several countries reimposed travel restrictions because of the omicron variant, delaying Heathrow's passenger recovery.

Chart 1

Heathrow's Monthly Traffic Statistics



Source: S&P Global Ratings.

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We forecast that Heathrow's passenger volumes, as a proportion of 2019 levels, will be about 55% in 2022, 70% in 2023, and about 80% in 2024. We view positively that countries are lifting border restrictions, and that some countries now view COVID-19 as endemic rather than pandemic. However, the likelihood of new variants emerging means the recovery path is uncertain and it will depend on whether governments reimplement mobility restrictions, as well as on the efficacy of the vaccines against new variants. Therefore, further COVID-19 variants and waves could harm our current view of the recovery path. If that were to happen, we would reassess our base case.

The recent rapid spread of the omicron variant highlights the inherent uncertainties of the pandemic as well as the importance and benefits of vaccines. Although we cannot rule out the risk of new, more severe variants displacing omicron and evading existing immunity, our current base case assumes that existing vaccines will continue to provide significant protection against

severe illness. Furthermore, many governments, businesses, and households around the world are tailoring policies to limit the adverse economic impact of recurring COVID-19 waves. Consequently, we do not expect a repeat of the sharp global economic contraction of second-quarter 2020. Meanwhile, we continue to assess how well each issuer adapts to new waves in its geography or industry.

CreditWatch

We placed our issue ratings on HFL's Class A and Class B debt on CreditWatch with negative implications because of the lack of definition of the H7 regulatory package, which we could deem to be less supportive in mitigating Heathrow's traffic risk exposure, along with the possibility that tariffs may be insufficient to keep the company's credit metrics commensurate with the current rating.

We would likely lower the issue ratings on HFL's Class A and Class B debt if the implemented rules for the regulatory period mean Heathrow would be unable to sustain 2022-2024 weighted-average FFO to senior debt of at least 7% and 2022-2024 weighted-average FFO to total debt of about 5%. This could occur if:

- The new tariff approved by the CAA for Heathrow's H7 regulatory period is lower than the existing one of £30.19 per passenger, assuming our traffic forecast; or
- Regulatory protections do not sufficiently compensate for the airport's volume risk exposure in the next regulatory period (H7), leading us to reassess our view of Heathrow's regulatory framework and how this could affect the company's earnings profile and, hence, its business fundamentals.

We could remove both the ratings from CreditWatch depending on the outcome of CAA's decision for the tariffs, the risk-sharing mechanism, and passenger volume prospects for the regulatory period. Following the CAA's decision, we would remove the Class A rating from CreditWatch if Heathrow's 2022-2024 weighted-average FFO to senior debt was at 7.0% or above. We would remove the Class B rating from CreditWatch if Heathrow's 2022-2024 weighted average FFO to total debt was at least 5.0%.

Company Description

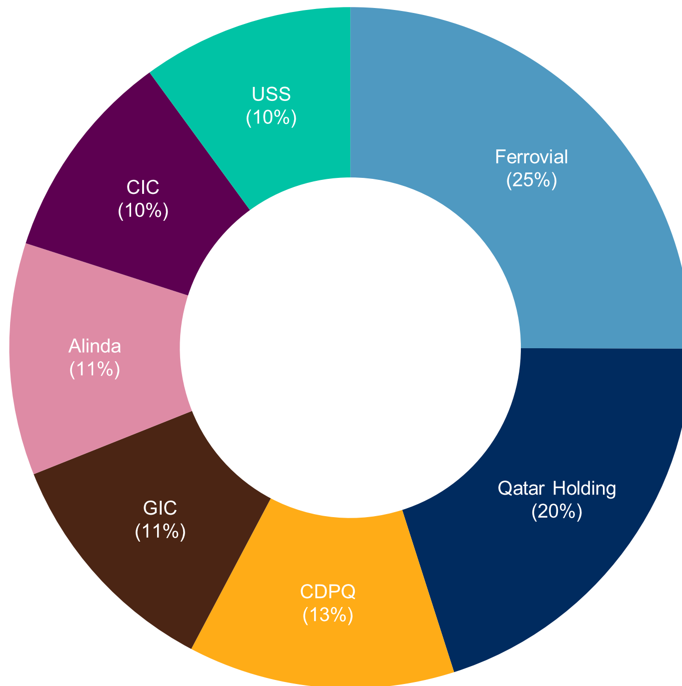
HFL is a wholly owned subsidiary of Heathrow (SP) Ltd., a debt-issuing vehicle in the ring-fenced financing group, which includes as obligors:

- 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.

Chart 2

Heathrow Airport Holdings Ltd. Ownership Structure



Source: S&P Global Ratings.

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In 2021, the group's total reported revenue was £1.2 billion, 3.3% higher than in 2020. Its reported EBITDA amounted to £384 million, 42.2% above 2020 levels. 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

Our main assumptions for 2022-2024 on Heathrow are:

- Passenger traffic recovery will reach about 55% of 2019 levels in 2022, about 70% in 2023, and 80% in 2024.
- Charges in 2022 will remain at the same level as the interim ones for the year at £30.19 per passenger, and then adjusted by our retail price index assumptions of 4.9% in 2022, 2.7% in 2023, and 3.0% in 2024.

- As passenger volumes recover, we expect Heathrow's personnel-related expenses will increase to face the recovered demand. Since the airport has a high fixed cost structure, we still think margins will improve, reaching 40%-45% in 2022 and about 50%-55% in 2023 and 2024.
- Total investments, mostly focused on maintenance, of about £470 million in 2022, and £600 million-£650 million annually in 2023 and 2024. We do not currently forecast material expansion investments in the airport in the short to medium term due to lower passenger volumes in the terminals.
- Net debt levels will remain about £12 billion for the senior debt and about £14 billion for total debt.
- No dividend distributions.

Key metrics

Table 1

Heathrow Funding Ltd. Key Metrics

	2022e	2023e	2024e
Passengers (% of 2019 levels)	55	70	80
Charge (£ per passenger)	30.19	31.50-32.00	32.50-33.00
EBITDA (bil. £)	0.9-1.1	1.3-1.5	1.6-1.8
EBITDA margin (%)	40-45	50-55	50-55
Senior FFO to senior debt (%)	4.0-5.0	7.0-8.0	9.0-10.0
Junior FFO to total debt (%)	2.0-3.0	5.0-6.0	7.0-8.0

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

Liquidity

We consider that Heathrow's liquidity position remains strong, with its liquidity sources surpassing its uses by about 2.0x in the next 12 months and by more than 1.5x in the next 24 months. This is a result of new debt issued to maintain a higher cash position under adverse circumstances, reduced operating expenses and investments, and the interest rate swap transactions. These measures have minimized cash burn during a period in which passenger volumes have not yet recovered to close to pre-pandemic levels. Additionally, since Heathrow will focus its investments on maintenance in the coming years, we expect positive free operating cash flow generation, which further improves its financial flexibility.

We think HFL has a high standing in credit markets, as demonstrated by its well-established program for debt issuance, having already issued in several countries, multiple currencies (including British pound sterling, euro, Canadian dollar, and Swiss franc), and various structural levels (senior, junior, and at the holding company level). The company also has solid and well-established relationship with banks. Its banking group includes more than 30 institutions providing either liquidity or hedging capacity. We think this would allow HFL to easily access funding if necessary, albeit possibly at a higher cost.

We expect principal liquidity sources over the 12 months from Dec. 31, 2021 will include:

- Unrestricted cash and short-term investments of about £2.6 billion;
- £1.2 billion undrawn credit facilities available until November 2023; and
- Cash FFO of about £450 million.

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

- Debt maturities of about £730 million;
- Maintenance investments of about £450 million; and
- No dividend distributions.

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:

- Senior interest coverage ratio of at least 1.05x; and
- Senior regulatory asset ratio below 92.5%.

In our base-case scenario, we expect these financial covenants will be in compliance, albeit with a small cushion to the ratios, in the next 24 months, since passenger volumes are still recovering and therefore Heathrow's cash flow generation is still lower than before the pandemic.

Additionally, both Class A and Class B debt have to 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: E-2 S-4 G-2

Social factors are a negative consideration in our credit rating analysis of Heathrow Funding due to the impact of the COVID-19 pandemic on Heathrow airport's operations. Although governments are adopting more flexible travel policies and lifting restrictions, we do not rule out the possibility that new variants could cause governments to reintroduce restrictions, even for a short period of time. This could pose a risk to the recovery path of passenger volumes, which ended 2021 at 24% of 2019 levels, as well as to the airport's cash flow generation. Given Heathrow's high exposure to long-haul and business traffic (53% and 33%, respectively, in 2019), we expect slower and more protracted recovery to pre-pandemic levels. Environmental and governance factors have an overall neutral influence on our credit rating analysis.

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 (HAL); 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 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 debt (Class A)

Issue Rating: BBB+/Watch Neg/--

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: Positive (+1 notch)

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Junior debt (Class B)

Issue Rating: BBB-/Watch Neg/--

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

- A Volatile Recovery Ahead For European Airports, Jan. 24, 2022
- Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Taken Off CreditWatch Negative And Affirmed; Outlook Negative, March 4, 2021

Ratings List

CreditWatch Action

	To	From
Heathrow Funding Ltd.		
Senior Secured (Class A)	BBB+/Watch Neg	BBB+/Negative
Subordinated (Class B)	BBB-/Watch Neg	BBB-/Negative

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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