FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Heathrow Funding and Heathrow Finance Notes; Outlook Negative

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Fitch Ratings - London - 03 Aug 2022: Fitch Ratings has affirmed Heathrow Funding Limited's class A bonds at 'A-' and class B bonds at 'BBB'. Fitch has also affirmed Heathrow Finance plc's outstanding high yield (HY) notes at 'BB+'. The Outlooks are Negative.

RATING RATIONALE

The Negative Outlooks reflect the ongoing uncertainty relating to the final decision on tariff regime in 2022-2026. The final proposals presented by the regulator (Civil Aviation Authority, CAA) in June 2022 are worse than we initially expected and, to some extent, below the CAA's initial proposal, namely in terms of weighted average cost of capital (WACC). This is translated into strained financial metrics under the updated Fitch Rating Case (FRC), which has exhausted the financial cushion under the prevailing rating threshold for the class A, B and HY bonds. A final decision on the level of charges for 2022-2026 will be made in 2H22, although even at that point management can appeal the decision to the Competition and Markets Authority (CMA).

The Negative Outlooks also reflect uncertainties on the post-pandemic trajectory in traffic recovery with challenges from the macroeconomic backdrop, rising interest rates and surging inflation denting consumers' disposable income and willingness to travel.

For the HY notes, the Negative Outlook further reflects the uncertainty related to the dividend payments to Heathrow Finance plc from Heathrow Funding, which was magnified by the sizeable cash flow volatility from Heathrow Funding during the pandemic.

The affirmation of the class A, class B and HY notes reflects our expectation that Heathrow will deleverage below our rating sensitivities of 8x, 9x and 10x, respectively, by 2024 due to a gradual traffic recovery and a largely deferrable shareholder distribution.

Heathrow's liquidity position is strong, in part due to significant debt issuance in 2019 ahead of anticipated capex related to the third runway project, which has been significantly delayed, in addition to the further debt issuances during 2020. Heathrow Finance has significant cash reserves covering debt service until 2025.We currently expect traffic to recover to 2019 levels by 2026 in the FRC.

KEY RATING DRIVERS

Large Hub with Resilient Traffic: Volume Risk - Stronger

Fitch has confirmed 'Stronger' assessment of Revenue Risk (Volume), following the publication of its new Transportation Infrastructure Rating Criteria, which assesses volume risk on a five-point scale.

Heathrow is a large hub airport serving a strong origin and destination market within a wealthy catchment area. Its traffic demonstrated strong resilience to economic downturns, namely during the global financial crisis. Heathrow's traffic peak-to-trough of only 4.4% through the 2008 economic crisis reflects a combination of factors: the attractiveness of London as a world business centre; the role of Heathrow as a primary hub offering strong yield for its resident airlines; the location and connectivity of Heathrow with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint, which also helps absorb shocks.

During the pandemic, LHR's traffic performance was similar to other UK airports, mostly driven by policy on travel restrictions.

Regulated and Inflation-Linked: Price Risk - Midrange

Heathrow is subject to economic regulation, with a price cap calculated under a single till methodology. The price cap, set by the CAA, is established to offset Heathrow's significant market power and is highly sensitive to the assumptions made by the regulator on several building blocks, such as cost of capital, traffic forecast and operational efficiency. The regulatory process that leads to the cap determination is transparent but creates material uncertainty each time it is reset.

Unconstrained Capacity in Medium Term: Infrastructure Development/Renewal - Stronger

We have re-assessed Heathrow's infrastructure Renewal risk at 'Stronger' from 'Midrange' as a result of the postponement of the third runway expansion project beyond 2026. As a result of the coronavirus pandemic, Heathrow's current regulatory period comes with less uncertainty relating to the approval, planning, funding and execution of the third runway project, given that this is now not expected to form part of the H7 regulatory period (2022-2026).

Heathrow has a proven record of maintaining and developing its infrastructure to a high level. There are no medium-term constraints in terms of terminal and runway capacity as the airport's traffic recovers after the pandemic. There is a temporary cap of 100,000 departing passengers per month put in place by the airport, aimed at curbing travel disruptions and flight cancellations due to staff shortages. In our opinion, this is short term and it does not affect the overall assessment of infrastructure risk.

Heathrow has stable and predictable maintenance capex requirements while growth capex is mostly uncommitted, which allows for flexibility in response to market conditions and trends. Obsolescence risk is minimised through LHR's competitive position in the area and its role as a global hub. Heathrow has a record of successfully accessing capital markets to secure funding and of delivering capex projects. We also note the regulator's mandate to ensure financeability of capex in addition to affordability to end-users as supportive, despite some uncertainty regarding timing and price-recovery of the investment.

Refinancing Risk Mitigated: Debt Structure - Midrange (Class A); Midrange (Class B); Midrange (HY notes)

The class A debt benefits from its seniority, security, and protective debt structure (ring-fencing of all cash flows and a set of covenants limiting leverage). It is exposed to some floating rate risk, with at least 75% being fixed, in addition to some refinance risk, which is mitigated by the issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities. The class B notes benefit from many of the strong structural features of the class A notes.

The HY notes have a midrange debt structure, but a lower rating due to their deep structural subordination to the class A and B notes.

Financial Profile

For the class A and B debt, we forecast net debt to EBITDA returning to below the respective negative rating action triggers of 8x and 9x by 2023, and remaining just below them under the FRC.

For the HY debt, we forecast net debt to EBITDA returning to below the negative rating action trigger of 10x by 2024 under the FRC, and remaining just below it under the FRC. However, the dividend cover is materially affected by the reduced cash up-streaming from Heathrow Funding to Heathrow Finance plc. This is mitigated by strong liquidity at the Holdco level, with around GBP1.3 billion of cash available as of June 2022. Fitch estimates this will cover over four years of debt service.

PEER GROUP

Heathrow is one of the most robust assets in the sector. Historically, it has higher leverage than its European peers, albeit with a much better debt structure for senior debt. Heathrow's closest peers are Aeroports de Paris (ADP; BBB+/Negative) in terms of hub status in EMEA and Gatwick (BBB+/Negative) and Manchester Airport Group (MAG, BBB/Negative) in terms of London catchment area.

Compared with ADP's senior unsecured debt, Heathrow's class A and B notes have stronger and more protective features, which explain Heathrow's higher debt capacity for any given rating level. Compared with Gatwick and MAG, Heathrow's bonds benefit from a stronger revenue risk profile, justifying the rating differentials.

Heathrow's class B is a notch below Gatwick as Heathrow's stronger operations are offset by higher leverage. The HY notes at Heathrow Finance plc has a lower rating due to deep structural subordination and high leverage among peers.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Class A notes: failure to improve net debt to EBITDA below 8x on a sustained basis.

Class B notes: failure to improve net debt to EBITDA below 9x on a sustained basis.

HY notes: failure to improve net debt to EBITDA below 10x on a sustained basis.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

All classes: An upgrade is currently unlikely given our recovery expectations. Revenue recovery combined with deleveraging ahead of Fitch's current expectations could lead to a revision of the Outlook to Stable.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

TRANSACTION SUMMARY

Heathrow is a major global hub airport with significant origin and destination traffic and resilience due to its status as the preferred London airport. Revenues are regulated and subject to an inflation-linked price cap on a single till basis.

The transaction is the ring-fenced financing of Heathrow. The class A and B bonds are structured, secured and covenanted senior debt. The HY bonds are structurally subordinated.

CREDIT UPDATE

Operational Performance

Heathrow's traffic recovery improved from 44% of the 2019 level in January 2022 and to 83% in June 2022 (compared with 24% for full-year 2021 and an average 85% in June 2022 for European peers). This was supported by the relaxation of international travelling rules since January 2022, including the removal of all UK travel restrictions on 18 March 2022 and release of pent-up demand. Traffic recovery was driven by European traffic and other international traffic, while domestic was slightly lagging behind.

Increase in traffic was faster than expected, which resulted in labour shortage and travel disruptions. The key problem is insufficient staff for baggage ground handling. We expect the airport to become more involved in route scheduling to minimise further disruptions as opposed to accepting the airlines' proposed increases in routes.

Regulatory Update

Pending the final decision, 2022 charges had materially increased from GBP19.36/pax to GBP30.19/pax. However, as per the final proposal for 2022-2026, nominal charges per passenger will decline to GBP26.31 in 2026, equivalent to an average yield of GBP28.39 in 2022-2026, which is in the lower quartile of the CAA's initial proposal. Key drivers for a lower price cap compared with management's assumptions are higher projected traffic and most significantly a decrease in WACC (to 3.26% from 3.60%-5.60% initial range). Lower WACC projection is driven by lower real cost of debt and lower asset beta, given the introduction of a traffic risk sharing (TRS) mechanism, which in the CAA's view decreases assets systematic risk.

TRS's purpose is to mitigate effect of the pandemic-like events or significant overperformance. TRS is set to compensate lost revenue, resulting from lower-than-expected passenger volumes. The provision is credit positive in the long term, given it sets a floor to the downside. However, we see the overall effect on recoverability timing (up to 12 years) and lower WACC (due to lower asset beta) as insufficient to sustain a quick recovery in financial metrics following a pandemic-like shock. The new asset beta positions Heathrow closer to regulated network utilities, which have lower volume risk even after accounting for the new TRS mechanism.

Liquidity

Heathrow has maintained strong liquidity throughout the coronavirus pandemic. Heathrow has also retained strong market access thus far during the pandemic, which we expect to support continued strong liquidity.

As of June 2022, available cash was GBP1.3 billion at Heathrow Funding, which adds to undrawn liquidity facilities of GBP900 million and GBP250 million for class A and B notes. This would be sufficient to cover debt maturities until 2024 under FRC.

GBP1.3 billion cash available at Heathrow Finance would by itself be enough to service debt until 2025, even assuming no cash is unstreamed from Heathrow Funding.

FINANCIAL ANALYSIS

Under the FRC, we assume traffic in 2022 to recover to 70% of 2019 level and full gradual recovery by 2026. Aero-yield is assumed as per the CAA's final proposal price cap: decrease from GBP30.2 (nominal) in 2022 to GBP26.3 in 2026. Non-aero yield significantly decreases due to the dilution effect of higher numbers of passengers, lower capex in commercial offerings and macroeconomic pressure on demand. As a result, we forecast EBITDA to be at around GBP1.8 billion by 2026, compared with GBP1.9 billion in 2019.

Potential investment related to the third runway expansion has been deferred to beyond the H7 regulatory period, meaning capex assumed under the Fitch cases is more focused on maintenance. We assume no dividend to ultimate shareholders within the forecast period.

Fitch also ran additional sensitivities, testing a downside case with a longer traffic recovery and higher inflation pressure on costs. The sensitivities demonstrate that the issuer's credit profile would be impaired under the downside case with metrics remaining sustainably above the rating thresholds.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Heathrow Finance plc			
Heathrow Finance plc/Debt/3 LT	LT	BB+ Rating Outlook Negative Affirmed	BB+ Rating Outlook Negative
Heathrow Funding Limited			

Heathrow Finance plc/Debt/1 LT	LT	A- Rating Outlook Negative Affirmed	A- Rating Outlook Negative
Heathrow Finance plc/Debt/2 LT	LT	BBB Rating Outlook Negative Affirmed	BBB Rating Outlook Negative
Heathrow Finance plc/Debt/1	LT	A- Rating Outlook Negative Affirmed	A- Rating Outlook Negative
Heathrow Finance plc/Debt/5 LT	LT	A- Rating Outlook Negative Affirmed	A- Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Transportation Infrastructure Rating Criteria (pub. 16 May 2022) (including rating assumption sensitivity)

Infrastructure & Project Finance Rating Criteria (pub. 20 Jul 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Third-party Model (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Heathrow Finance plc	UK Issued, EU Endorsed
Heathrow Funding Limited	UK Issued, EU Endorsed

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