MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Heathrow Finance's ratings, maintains negative outlook

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London, July 20, 2022 -- Moody's Investors Service (Moody's) has today affirmed the Ba2 long-term Corporate Family Rating (CFR) of Heathrow Finance plc (HF). Concurrently, Moody's has affirmed the company's Ba3-PD probability of default rating and the B1 senior secured debt ratings. The outlook remains negative.

HF owns London Heathrow Airport (LHR) through its shares in Heathrow (SP) Limited (HSP).

RATINGS RATIONALE

Today's rating action follows the publication of the Final Proposals by the UK Civil Aviation Authority (the CAA) on the level of charges applicable over the 2022-26 (H7) period to Heathrow Airport Limited (HAL), the airport company owned by the HF group.

Moody's decision to maintain a negative outlook on HF reflects the continued risks to the group's credit profile linked to the H7 final regulatory determination against the backdrop of an uncertain economic environment, current operational challenges, and the potential for the Final Proposals to result in a one notch lower rating. However, the rating affirmation factors in potential for some changes in the final regulatory determination and management measures to strengthen the balance sheet or improve cash flows, as well as HF's strong liquidity, such that the existing ratings could be maintained.

On 28 June, the CAA published the Final Proposals, which assume a reduction in the level of HAL's airport charges over the H7 period, with an average profiled price cap of GBP24.5 (2020 prices) per passenger. This is about GBP2 higher than during the regulatory period from 2014 to 2021, and at the low end of the range included in the Initial Proposals published in October 2021. According to the CAA, the reduction in the level of charges compared to the mid-point of the Initial Proposals reflects a number of factors, including the increase in passenger volumes forecast and the reduction in the (real) vanilla weighted average cost of capital (WACC) to 3.26% from 4.65% in Q6, and compared with the range of 3.6%-5.6% included in the Initial Proposals.

The CAA has introduced price profiling, which means that HAL's charges will be higher in the early years of H7 and decrease towards the end of the regulatory period. The profiled yield per passenger will decrease from GBP27.39 (2020 prices) in 2022 to GBP21.75 (2020 prices) in 2026. While the price profiling will support cash flows in the near term and when traffic is most likely to remain below the pre-pandemic levels, the reduction in airport charges will put pressure on HAL's cash flow towards the end of the regulatory period, limiting the company's ability to deleverage, in particular as the airport is capacity constrained by a flight cap and hence once it reaches its annual capacity its ability to outperform regulatory assumptions will be limited.

The Final Proposals introduce a traffic risk sharing (TRS) mechanism. Under the TRS mechanism, if passenger volumes in each individual year are lower than those assumed by the regulator, then HAL will have protection against lower revenues. If volumes exceed those assumed by the CAA, then any benefits will be shared with customers through lower airport charges. The proposed TRS mechanism assumes that the amount of risk to be shared for that year will be calculated as 50% of any difference up to 10% of forecast allowed revenues and 105% of any difference above 10% of forecast allowed revenue. Moody's notes positively that the TRS mechanism offers some protection in the event of slower traffic recovery or any future traffic shocks, such as those seen during the pandemic. However, the adjustment will be subject to a two-year delay and will be spread over ten years, which materially limits any cash flow benefits in the near term. At the same time, traffic outperformance in the early years will result in a reduction in airport charges towards the end of H7, when the profiled yield per passenger will already be lower. This could result in a weakening of cash flows in the latter years of H7.

As part of the Final Proposals, the CAA has revised its assumptions of operating costs, capital expenditure and commercial revenue. However, there continues to be material differences between the regulatory assumptions and those made by HAL in its business plan. In particular, the CAA assumed operating costs of GBP5.9 billion (2020 prices), which is GBP300 million less than HAL's proposals, and capital expenditure of GBP3.6 billion (2020 prices) against HAL's proposal of GBP4.5 billion. In the case of investments, the regulator has, however, developed new incentives.

The Final Proposals are subject to consultation until 9 August and the CAA will publish its Final Decision in the autumn. In this regard, some of the regulatory assumptions may still change before the regulatory decision is published. HAL will then have six weeks to decide whether to appeal the final determination. If they, or the airlines, appeal to the Competition and Markets Authority (CMA), the regulatory outcome would only be known well into the first half of 2023. This is because the CMA will have a maximum of 32 weeks to determine the appeal from the date the CAA publishes its Final Decision. The CMA appeal would, in the normal course, not suspend the implementation of the Final Decision.

The regulatory uncertainty comes in the context of improving traffic trends as reflected in a pick up in Heathrow airport's passenger volumes to around 83% of pre-pandemic levels in June alone, when the airport handled close to 6 million passengers. However, the increase in traffic has brought operational challenges given staff shortages across the aviation industry as a whole, including at the airport but also airlines and ground handlers. This prompted HAL to introduce a cap of 100,000 departing passengers a day until 11 September. Since July and August are typically the busiest months for the airport, the cap will limit recovery in Heathrow airport's traffic this year. Post summer season, there is still uncertainty around traffic levels given worsening macroeconomic conditions, cost of living pressures, uncertainty around geopolitical tensions and the threat of increasing number of COVID cases.

Against this backdrop, HF's financial profile will depend not only on the final determination, but also traffic evolution, the company's ability to deliver cost efficiencies and grow commercial revenue, as well as future financial policies, including for the HSP group, on whose cash flows HF is reliant for its debt service.

More generally, HF's Ba2 CFR continues to reflect (1) its ownership of LHR, which is one of the world's most important hub airports and the largest UK airport; (2) its long established framework of economic regulation, although with uncertainty around the future level of charges pending final regulatory determination; (3) LHR's resilient traffic characteristics before the pandemic; (4) its highly-leveraged financial profile; (5) the features of the HSP secured debt financing structure which puts certain constraints around management activity, together with the protective features of the HF debt which effectively limit HF's activities to its investment in HSP; and (6) the group's strong liquidity.

HF's B1 senior secured rating reflects the structural subordination of the HF's debt in the HF group structure versus the debt at HSP. The rating positively reflects the company's strong liquidity position and Moody's expectation that the HSP group will continue to be able to upstream cash flows under the terms of its debt structure.

LIQUIDITY AND DEBT COVENANTS

As of end-May 2022, the HF group held GBP2.3 billion of cash on balance sheet, of which GBP309 million at the HF level. HSP also had GBP1.15 billion availability under credit facilities due in November 2023. Following the upstream of GBP1 billion of distributions from HSP, HF's cash balance increased to GBP1.3 billion as of end-June 2022, which provides for an excellent liquidity in the context of its debt service requirements that amount to around GBP110 million per year. HF's next debt maturity of GBP300 million is in March 2024.

HF's debt documentation includes two covenants - Group Interest Cover Ratio (ICR) of 1.0x and Group RAR, calculated as net debt/regulated asset base (RAB), of 92.5% as events of default. In addition, the group's debt documentation includes covenants at the level of HSP. Since the start of the pandemic, HF has received a covenant waiver with respect to its Group ICR ratio twice. In addition, the company's gearing covenant was temporarily relaxed. Management expects to be able to comply with its covenants at HF at the next testing date as of end-December 2022 as well as at the HSP group.

RATIONALE FOR NEGATIVE OUTLOOK

The negative outlook reflects the continued risks to HF's credit profile linked to the H7 final regulatory determination against a backdrop of uncertain economic environment and traffic recovery prospects.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Given the negative outlook, upward rating pressure on HF's ratings is unlikely in the near term. The outlook could be changed to stable if there was greater clarity around the evolution of the group's credit metrics, with good headroom against the covenants, and the group's liquidity remained strong.

Positive rating pressure would only develop if the group's financial profile and key credit metrics were to sustainably strengthen, leading to the restoration of an appropriate headroom under its covenants and an adjusted interest cover ratio (AICR) consistently higher than 1.0x, while continuing to maintain a good liquidity profile.

Downward pressure on HF's ratings could develop if (1) the group's headroom under event of default financial covenants were to reduce or the group faced a risk of extended covenant breaches; (2) the HSP group's ability to upstream cash were significantly reduced; or (3) there were concerns about the group's or the company's liquidity.

The principal methodology used in these ratings was Privately Managed Airports and Related Issuers published in September 2017 and available at https://ratings.moodys.com/api/rmc-documents/63380. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The only asset of HF is its shares in HSP, a holding company which in turns owns the company that owns LHR, Europe's busiest airport in terms of total passengers before the pandemic. HF is indirectly owned by Heathrow Airport Holdings Limited (HAH). HAH is ultimately owned 25% by Ferrovial S.A. (a Spanish infrastructure & construction company), 20% by Qatar Holding LLC (a sovereign wealth fund), 12.62% by Caisse de depot et placement du Quebec (a pension fund), 11.2% by the Government of Singapore Investment Corporation (a sovereign wealth fund), 11.18% by Alinda Capital Partners (an infrastructure fund), 10% by China Investment Corporation (a sovereign wealth fund) and 10% by the University Superannuation Scheme (a pension scheme).

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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