FITCH AFFIRMS HEATHROW FUNDING'S BONDS & HEATHROW FINANCE'S HY BONDS

Fitch Ratings-London-23 June 2014: Fitch Ratings has affirmed Heathrow Funding Limited's (Heathrow Funding) bonds issued under its debt issuance programme and Heathrow Finance Plc's (Heathrow Finance or the holdco) high-yield bonds, as follows:

Heathrow Funding Limited
Class A bonds: affirmed at 'A-', Outlook Stable
Class B bonds: affirmed at 'BBB', Outlook Stable

Heathrow Finance plc
High-yield (HY) bonds: affirmed at 'BB+', Outlook Stable

The affirmations reflect Heathrow's (LHR) solid operational performance to date and relatively more favourable and stable economic conditions expected for the five years to come.

KEY RATING DRIVERS
Fitch's ratings are based on the following factors, among others:

Volume Risk - Stronger
LHR is a large hub/gateway airport serving a very strong origin and destination market. It experienced strong traffic growth of 3.4% in 2013 (up from 0.9% in 2012), and has so far this year shown signs of continued positive trend as traffic rose 2.2% in the first five months of 2014.

From a long-term perspective, LHR benefits from resilient traffic performance with a maximum peak-trough fall in traffic of just 4.5% through the recent economic crisis (which was one of the strongest in the industry). This is due to a combination of factors which Fitch views as stable over time, namely: the attractiveness of London as a world business centre; the role of LHR as a hub offering very strong yield for its resident airlines; the location and connectivity of LHR with the well-off western and central districts of the city; and the capacity constraint at LHR (with only two runways) suggesting there exists unsatisfied demand, which also helps absorbing shocks.

Price Risk - Midrange
LHR is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, and is currently set at RPI-1.5% for the new regulatory period from April 2014 (down from RPI+6.5% in the previous Q5 period). The cap is set for five years by an independent regulator, the CAA, which, among its duties, ensures that airports' operations and investments remain financeable.

The price cap is established to offset LHR'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 every five years. Price cap settlements can prove detrimental to the airport, as CAA's assumptions can appear aggressive. For example, the traffic forecast for Q5 was calculated before the 2007-2008 crisis and proved overly optimistic. This was, however, partly offset by higher-than planned inflation.

Infrastructure Development / Renewal - Stronger

LHR aims to implement a detailed capital investment plan, agreed to by the regulator. The new plan for Q6 with around GBP3.5bn of investment is more modest than Q5 (at over GBP5bn) and Fitch does not expect any particular issues, particularly in light of LHR's overall sound track record in delivering projects on time and on budget. The regulated asset base approach allows for the self-financing of the investments through the tariff. After delivery of a brand new T2 in 2014, LHR will mostly feature state-of-the art terminals. The building of a third runway is currently being reviewed (among other options from other airports) by the Airports Commission with final recommendation due in summer 2015.

Debt Structure - Midrange (Class A) / Weaker (Class B and HY)
The class A debt benefits from its seniority and protective debt structure (ring-fencing of all cash flows from LHR and a set of covenants limiting leverage). It is exposed to some hedging and refinancing risk, which is mitigated by strong market access, due to an established multi-currency debt platform and the use of diverse maturities. Class B and Heathrow Finance's debt have a weaker debt structure due to their subordination.

Credit Metrics
Fitch's rating case resembles CAA's final decisions for Q6, in particular with regard to traffic growth with a five-year CAGR of 0.5%. The notable differences are with regard to inflation with the RPI over the forecast horizon lower by 100bps (at around 2.4% on average in Q6, in line with current RPI), less efficiency savings achieved (over GBP200m higher opex in Q6) and new debt cost higher by 200bps in two and five years (with senior debt all-in-cost at 7.3%), reflecting adverse financing conditions.

Under this scenario, EBITDA is expected to grow at a 5-year CAGR of 3.3% (from GBP1,421m in 2013) and LHR should be able to maintain post-maintenance and tax interest cover ratios (PMICR) for each class of debt at levels above Fitch's rating thresholds of 1.5x-1.6x for an 'A-' rating, 1.2x-1.3x for a 'BBB' rating, and 1.1x-1.15x for a 'BB+' rating. The average PMICR over Q6 for the 'A-'-rated class A bonds is around 1.68x, for the 'BBB'-rated class B bonds 1.36x and the 'BB+'-rated HY bonds 1.26x. The Fitch-calculated net senior leverage ratio remains at around 7x for the next five years, well within criteria guidance of 7x to 10x for strong hub airports.

RATING SENSITIVITIES
The Stable Outlook reflects the expectation that LHR will continue to see stable performance, despite potentially challenging economic prospects. A marked and sustained slowdown of the British economy could derail LHR's record of resilience. Evidence of recessionary prospects over a prolonged horizon (two years) or failure to achieve operational efficiency gains could prompt a revision of the Outlook to Negative. Net debt/EBITDA above 8.5x and PMICR below 1.6x for class A could trigger a downgrade.

On the contrary, a material and sustainable improvement in the economic environment could support higher load factors and use of larger aircrafts by airlines, in turn improving the passenger throughput at LHR with a favourable impact on credit ratios. Net debt/EBITDA consistently below 7x and average PMICR above 1.8x for class A could trigger a rating upgrade.

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Applicable criteria, 'Rating Criteria for Infrastructure and Project Finance' dated 11 July 2012, and 'Rating Criteria for Airports', dated 13 December 2013 are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Rating Criteria for Infrastructure and Project Finance
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=682867
Rating Criteria for Airports
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=725296