

Credit Opinion: Heathrow Finance plc

Global Credit Research - 10 Jun 2014

London, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1
Senior Secured -Dom Curr	Ba3/LGD5

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Key Indicators

Heathrow Finance plc

	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Cash Interest Coverage [1]	1.7x	1.5x	1.5x	1.3x
FFO / Debt	4.6%	3.4%	3.1%	1.9%
Moody's Debt Service Coverage Ratio	1.7x	1.5x	1.5x	1.4x
Moody's Implied Concession Life Coverage Ratio	58.7%	65.5%	64.7%	74.1%
Net Debt / RAB	82.9%	82.1%	79.7%	81.9%
Adjusted Interest Coverage	1.1x	0.9x	0.9x	0.8x

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3". In addition, Moody's adjusts for one time items.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

- Ownership of Heathrow, one of the world's most important hub airports and the largest European airport
- Relatively resilient traffic characteristics of Heathrow
- Long established framework of economic regulation
- Declining capital expenditure programme at Heathrow
- Constrained runway capacity
- An expectation that the Heathrow Finance group will maintain Net debt / RAB in the 80s per cent, whilst facing significant debt maturities

- The features of the secured debt financing structure at operating company level which puts certain constraints around management activity together with the protective features of the Heathrow Finance debt

Corporate Profile

The only asset of Heathrow Finance plc ("HF") is its shares in Heathrow (SP) Limited ("HSP"). HSP is a holding company which owns the company that owns London Heathrow Airport ("LHR"). LHR is subject to economic regulation on the UK regulated price-cap utility model, with charges set by the UK Civil Aviation Authority (the "CAA"). HF reported 2013 pre-exceptional EBITDA of GBP1,410m and 31 Dec 2013 RAB of GBP14,585m for LHR. HF is indirectly owned by Heathrow Airport Holdings Limited ("HAH"). HAH is ultimately owned 25% by Ferrovial S.A. (a Spanish infrastructure & construction company), 20.00% by Qatar Holding LLC (a sovereign wealth fund), 13.29% by Caisse de depot et placement du Quebec, 11.88% by the Government of Singapore Investment Corporation (a sovereign wealth fund), 11.18% by Alinda Capital Partners (an infrastructure fund), 10.00% by China Investment Corporation (a sovereign wealth fund) and 8.65% by the University Superannuation Scheme (a pension scheme).

The HSP group is financed via debt provided through a ring-fenced secured debt financing structure (the "HSP SDF"). HSP can only provide cash to service debt at HF if it complies with the financial terms of the HSP SDF. HF debt holders benefit from a security interest in HF's shares in HSP. HF is currently financed by (1) GBP325m 7.125% Senior Secured Notes due Mar 2017 and (2) GBP275m 5.375% Senior Secured Notes due Sep 2019, (together the "HF Notes"), as well as (3) a GBP85m loan facility due May 2016, and (4) a GBP77.5m loan facility due Dec 2019 (together with the HF Notes the "HF Debt"), which together rank pari passu among themselves.

SUMMARY RATING RATIONALE

The Ba1 Corporate Family Rating (CFR) of HF reflects a Probability of Default Rating of Ba2 and a 35% Family-wide loss given default assumption. The CFR is an opinion of the HF group's ability to honour its financial obligations and is assigned to HF as if it had a single class of debt and a single consolidated legal structure. The Ba3 / LGD-5(85%) rating of the HF Notes reflects the structural subordination of the HF Notes and the other HF Debt in the HF group structure versus the HSP SDF.

HF's Ba1 CFR reflects (1) its ownership of Heathrow, which is one of the world's most important hub airports and the largest European airport, (2) the relatively resilient traffic characteristics of Heathrow, (3) the long established framework of economic regulation that pertains to Heathrow and which currently applies for the period to 31 December 2018, (4) the declining capital expenditure programme at Heathrow, (5) the capacity constraints it faces, (6) an expectation that the HF group will maintain Net debt / RAB in the 80s per cent, and (7) the features of the HSP SDF which puts certain constraints around management activity together with the protective features of the HF Debt which effectively limits HF's activities to its investment in HSP.

DETAILED RATING CONSIDERATIONS

OWNERSHIP OF HEATHROW, ONE OF THE WORLD'S MOST IMPORTANT HUB AIRPORTS AND THE LARGEST EUROPEAN AIRPORT

LHR is owned in perpetuity and all key aviation infrastructure is controlled by management. The company owning LHR is a general limited liability company that has no particular legal restrictions in relation to its business activities. It is also not subject to any particular provision that would imply bankruptcy remoteness. However, LHR is subject to regulatory oversight, which places some constraints on operations and capital expenditure.

As reported by the Civil Aviation Authority, with more than 72 million passengers, LHR accounts for approximately 52% of the London air travel market for the 12 months ending March 2014 (counting Luton Airport as serving London). It should be noted that this somewhat understates LHR's position because of its role as the UK (and Europe's) largest hub airport. Indeed, LHR is also the UK's major gateway airport and the largest European airport by number of passengers. For the 12 months ending March 2014, the CAA reports that LHR accounted for 32% of total UK passenger volumes. Its large route network underpins this position. Over 80 airlines operate at LHR and six of the top 10 intercontinental routes by number of seats offered touch LHR. LHR therefore serves a geographical area much wider than London.

LHR is also exposed to some trans-modal competition, in particular from rail. Domestic air services compete with rail, and the Eurostar rail service competes very effectively with airlines on the London-Paris and London-Brussels routes. Rail competition with airlines may increase in future as other high speed rail destinations are added to serve London in addition to Eurostar's route network and (in the longer term) there is potential for limited

competition from domestic high speed rail services.

RELATIVELY RESILIENT TRAFFIC CHARACTERISTICS

LHR traffic has grown at reasonably constant growth rates over the past 10 years. The standard deviation of the long term average annual passenger growth rate for LHR is 2.7% which evidences low volatility compared to most rated airports in Europe.

Much of that resilience is underpinned by the capacity constraints LHR operates under. The pent-up demand it faces means that traffic at the airport tends to suffer lower declines than other comparable airports when economic activity weakens. Under strong economic conditions, however, the airport's ability to accommodate additional traffic is restricted.

In addition, the airport's traffic performance is partly explained by its catchment area's strength. LHR serves London and the South east of England directly, an area that represents one of Europe's most economically robust with GDP per capita above the European average. The economic base has a good level of diversity which is underpinned by London's status as one of the leading world cities from an economic, political and cultural perspective.

LHR estimates that 37% of LHR's traffic is transfer traffic, with the majority of this traffic captured by British Airways. The resilience of this traffic depends on British Airways's strategy and financial health and on LHR's ability to offer an attractive and competitive environment to transfer passengers. LHR's management has focused on improving passenger experience, with passenger satisfaction improving notably since the opening of Terminal 5. However, capacity constraints might have an impact on LHR's future ability to accommodate new destinations without compromising existing frequencies thereby raising questions over LHR's long-term attractiveness as a hub airport.

LONG ESTABLISHED FRAMEWORK OF ECONOMIC REGULATION

LHR is subject to a framework of economic regulation that is considered appropriate and transparent. It is a form of price cap regulation that has proven to permit fair recovery of costs, is considered an appropriate mechanism for remunerating capital expenditure, and generates a reasonable return on capital.

On 1 April 2014, a new regulatory settlement came into effect covering the period to 31 December 2018, the sixth quinquennium (or Q6) since economic regulation was first applied at LHR. Although this is the first time that the regulatory decision will stem from the Civil Aviation Act 2012, the parliamentary act that replaced the Airports Act 1986, the regulator, the CAA, has largely opted for a continuity of approach.

Under the Act, LHR has been subject to a Market Assessment Test that determined that it is a Dominant Airport, i.e. an airport with an element of monopoly power in its service area. As a consequence LHR has been issued a Licence and is subject to economic regulation. LHR's regulated revenues are defined as yearly passenger price caps derived from dividing by annual passenger forecasts the sum of (1) the remuneration of an agreed regulatory asset base (RAB) at a predetermined weighted average cost of capital (WACC); (2) allowances for the recovery of asset depreciation and operating costs, with some efficiency targets incorporated; and (3) the netting-off of non-aeronautical revenues.

The main highlights from the current regulatory settlement are:

1. The passenger volume numbers used by the CAA to calculate aeronautical charges are rebased to a level somewhat in line with current passenger volumes and only assume modest growth rates over Q6. This reflects the view that assumed passenger volumes should have built-in contingencies, and represents a change from past regulatory assumptions. This is considered a de-risking for LHR in terms of future traffic volumes (but not an elimination of passenger volume risk) and is considered a credit positive.

2. LHR's business plan assumes a step up in costs in the first year of Q6 as the new Terminal 2 becomes operational. The assumed airline moves to the new Terminal 2 will be phased over a number of months so there will be a period of relatively inefficient double running of Terminal 1 and Terminal 2. The CAA has assumed that the old Terminal 1 space will be closed down in December 2016 and that this closure and other efficiencies will reduce the cost base progressively over the remainder of Q6. LHR management are planning to close Terminal 1 in October 2015, thereby achieving additional savings. The overall efficiencies required by the CAA are, however, challenging and assume that by the end of Q6 LHR will operate on a materially lower cost base. This represents an area of risk for LHR.

3. The CAA has reduced LHR's cost of capital to reflect an actual and expected lower interest rate environment. The pre-tax, real WACC of 5.35% (4.66% vanilla WACC) is lower than Q5's 6.2% (5.06% vanilla WACC). Much of the difference between these headline figures can be explained by a reduction in corporation tax and a different methodology of determining the WACC. Normalising for these factors, the relevant like-for-like comparator for Q5 is around 5.6%. The remainder of the difference corresponds to lower costs of debt and equity. The lower cost of capital assumption is a credit negative for LHR but not an unexpected one in Moody's view.

DECLINING CAPITAL EXPENDITURE PROGRAMME AT HEATHROW

The opening of the new Terminal 2 on 4 June marks the start of a pause in LHR's master plan. After seeing investments of more than GBP1 billion per year for the past decade, the regulatory settlement for the period covering April 2014 - 31 December 2018 incorporates a 33% reduction in the average allowed annual capital expenditure at LHR.

Although LHR management will undertake investment programmes such as a GBP 340 million investment on a new hold baggage screening system at Terminal 3 and GBP 1 billion in several asset replacement projects, the scale and complexity of the capital expenditure will be noticeably lower than in the recent past, leading to an improvement in HF's free cash position.

This sustained period of lower capital expenditure should last until the next regulatory period, when investment is expected to increase again as the next phase of significant terminal construction gathers pace.

CONSTRAINED RUNWAY CAPACITY

LHR is operating at 98% of its runway capacity, given the limit imposed on the number of air traffic movements per annum and the existence of a night time curfew. In addition, a restriction on the use of runways so that they can only be used in 'segregated alternate mode' is also in place to provide some noise respite to those living under the fly-paths of the airport. While passenger growth at the airport can continue in the short to medium term thanks to the introduction of bigger aircraft, these restrictions will impact growth levels in the future.

The Airports Commission, an independent commission established in September 2012 to consider how the UK can "maintain its status as an international hub for aviation and immediate actions to improve the use of existing runway capacity in the next 5 years", has shortlisted two options for the construction of additional runway capacity at LHR in its interim report; a final report is expected in the summer of 2015.

HIGH LEVERAGE AND SIGNIFICANT DEBT MATURITIES

Overall debt levels remain very high relative to the regulated asset base. As of 31 March 2014, HF's reported leverage stood at 82.7% of LHR's RAB. Although the improvement in HF's free cash position could offer a possibility to reduce its leverage, we expect that leverage will remain high, with the potential to increase to 85% in accordance with the company's financial policy guidance. We believe that HF's management will seize this pause in its investment plans to use proceeds from any bond issuances at HSP and HF to boost dividend distributions to HF's shareholders and service debt higher in the ownership structure.

Since the implementation of the HSP SDP, the company has established a bond issuance platform that has been used repeatedly to diversify its sources of financing, issuing bonds in five different currencies and extending the average maturity of its debt. However, over the course of the next 5 years, up to 40% of HF's consolidated debt (GBP4.5 billion), will become due. This, and the company's high leverage limit its ability to withstand unexpected external shocks. The ability to continue to secure funding well in advance of upcoming debt maturities will be a key factor in HF's credit profile.

STRUCTURAL CONSIDERATIONS

The HF Notes and the other HF Debt rank pari passu and are subject to the terms of an Intercreditor Agreement which regulates their rights with regard to each other and any future holder of HF Debt, and provides for the sharing of the security granted to the HF Debt holders. HF Debt holders benefit from a pledge of all of the shares in HSP (HF's only material asset) and a pledge of shares in HF. Moody's considers that the HSP SDF isolates the credit profile of LHR from that of the wider HAH group. While there is a certain reliance on HAH for operational support, this is considered acceptable within the context of the rating levels. This together with the security granted to the HF Debt holders should isolate HF from the risks of failure of the wider HAH group, and enables Moody's to ignore any debt in the wider HAH group when assessing the rating of HF. There are certain restrictions on the raising of further debt by HF.

The HSP group is financed via the HSP SDF. HSP can only provide cash to allow debt at HF to be serviced if it complies with the financial terms of the HSP SDF. The HSP SDF provides for the issuance of two tranches of debt, called ("Class A Debt") and ("Class B Debt"). Class B Debt is subordinated to Class A Debt. The terms of the HSP SDF limit the amount of Class A Debt and Class B Debt that can be issued by HSP through a requirement to maintain certain Net Debt to RAB ratios and interest cover ratios.

The terms of the HSP SDF also contain other constraints such as a requirement to comply with a hedging policy, liquidity dedicated to meeting interest payments on HSP SDF debt, and additional reporting requirements. While such protections only benefit HSP debt holders directly, and they could in theory be waived by HSP financiers, they do provide some element of protection to HF creditors by helping to protect the financial profile of HSP.

Liquidity Profile

HF's first debt maturity will be a GBP85m loan in May 2016 (the next maturity beyond that is GBP325m due in March 2017). In the meantime, interest payments will need to be met from cash received from HSP, there are no other sources of cash available and no specific liquidity is kept at HF. HSP will not be permitted to upstream cash to HF if it fails to meet certain tests, generally performance related, but also related to the maintenance of adequate liquidity at HSP.

The liquidity of the HF group as a whole is considered good for at least the next 12 to 18 months. Operating cash flow after tax is significant and positive in each quarter, with a peak over the summer months of each year. As at 31 Mar 2014, HF group had GBP2 billion of undrawn revolving credit facilities in HSP with several maturity dates between December 2015 and April 2018 (mostly Class A Debt availability but some Class B Debt) with good covenant headroom and over GBP300 million cash. HSP has very successfully improved its debt maturity profile over the past couple of years, extending the liquidity horizon and increasing the average maturity of its debt. HSP faces maturities of EUR 750 million in 2014 and GBP 300 million and USD 500 million in 2015, though some of these maturities have been prefunded by issuances of GBP 785 million since April and a further GBP 100 million already committed and to be cash-settled in September.

Rating Outlook

The rating outlook is stable. This reflects Moody's expectation that LHR will see low single digit growth overall in passenger volumes and maintain a credit profile commensurate with the current rating category.

The outlook further assumes that HSP will continue to manage its debt raising programme in a way that minimises refinancing risk and allows it to comfortably meet new funding requirements.

What Could Change the Rating - Up

The Corporate Family Rating and rating of the HF Notes could move up if the HF group were to exhibit a financial profile that evidenced materially lower leverage than currently expected. This could be suggested by a Net Debt to RAB ratio likely to be permanently below 80% and an Adjusted Interest Cover Ratio of permanently more than 1.2 times.

What Could Change the Rating - Down

The Corporate Family Rating and rating of the HF Notes could move down if the HF group were to exhibit a financial profile that evidenced materially higher leverage than currently expected. This could be suggested by a Net Debt to RAB ratio consistently in the high 80s and an Adjusted Interest Cover Ratio of less than 1.0 times.

Other Considerations

HF's rating reflects our assessment of the company's business profile and financial performance in line with our Global Rating Methodology for Operational Airport outside of the United States, published in May 2008.

Rating Factors

Heathrow Finance plc

Airports Industry [1][2]	Current 12/31/2013		[3] Moody's 12-18 months forward view As of 6/11/2014	
Factor 1: Governance and Rate Setting (15%)	Measure	Score	Measure	Score
a) Legal Status / Corporate Objectives		A		A
b) Rate Setting Methodology		A		A
c) Nature of Ownership / Control		Aaa		Aaa
Factor 2: Market Position (15%)				
a) Size of Service Area		Aa		Aa
b) Robustness & Diversity of Service Area		Aaa		Aaa
c) Competition for Medium to Long Distance Travel		Baa		Baa
Factor 3: Passenger & Airline Base (10%)				
a) Passenger Mix (O&D / Transfer)		Baa		Baa
b) Standard Dev of Long Term Average Annual Passenger Growth Rate		Aa		Aa
c) Carrier Base (Transfer Traffic)		Ba		Ba
Factor 4: Operating Environment & Capital Programme (10%)				
a) Operational Restrictions		Baa		Baa
b) Complexity of Airport Capital Expenditure Programme		Baa		Baa
Factor 5: Stability of Business Model & Financial Structure (10%)				
a) Ability and Willingness to Pursue Opportunistic Corp Activity		Aa		Aa
b) Ability and Willingness to Increase Leverage		Baa		Baa
c) Targeted Proportion of Rev outside of Owned Airport Services		Aa		Aa
Factor 6: Key Credit Metrics (40%)				
a) Cash Interest Coverage	1.7x	B	1.7-2.0x	B
b) FFO / Debt	4.6%	B	4-6%	B
c) Moody's Debt Service Coverage Ratio	1.7x	B	1.7-2.0x	B
d) Moody's Implied Concession Life Coverage Ratio	58.7%	Ba	55-61%	Ba
Rating:				
Indicated Rating from Grid Factors 1-6		Ba2		Ba2
Rating Lift		0		0
Indicated Rating from Grid		Ba2		Ba2
Uplift under GRI Methodology		0		0
Actual Senior Unsecured Rating Assigned		Ba1		Ba1

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2013. [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures



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