

Heathrow Funding Ltd.

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Related Criteria

Related Research

Heathrow Funding Ltd.

Issue Ratings

Class A A-/Negative

Class B BBB/Negative

Credit Highlights

Key Strengths	Key Risks
<ul style="list-style-type: none">• Excellent competitive position as the largest airport in Europe, and the only hub airport in the U.K., with a near monopoly on long-haul flights.• A supportive regulatory environment, ensuring recovery of investment and good predictability of cash flows over five yearly resets.• Resilient traffic and favorable passenger mix, with 52% of long-haul traffic in 2018. However, lifting of current capacity constraints may increase exposure to volume risk.• Above-average profitability among transportation infrastructure companies, with an S&P Global Ratings-adjusted EBITDA margin of 63.5% in fiscal 2018, up from 48.7% in fiscal 2010 (fiscal years ending Sept. 30).• Structural enhancements that reduce the default risk of notes issued by Heathrow Funding Ltd. (HFL) by allowing noteholders to take control of the business ahead of an insolvency of Heathrow (SP) Ltd.	<ul style="list-style-type: none">• Aggressive leverage and relatively weak credit metrics, with S&P Global Ratings-adjusted funds from operations (FFO) of above 8% for the Class A notes and above 6% for consolidated debt (excluding the intercompany loan with Heathrow Finance PLC).• Negative free operating cash flow (FOCF) from fiscal 2019, due to increasing capital investment of about £5 billion in fiscals 2019-2021.• Increasing debt issuance at all levels of the funding platform to finance the expansion costs of a third runway--currently estimated at about £14 billion (in 2014 prices)--and shareholder distributions.

Uncertainty as to the design, funding, and construction cost of the third runway project.

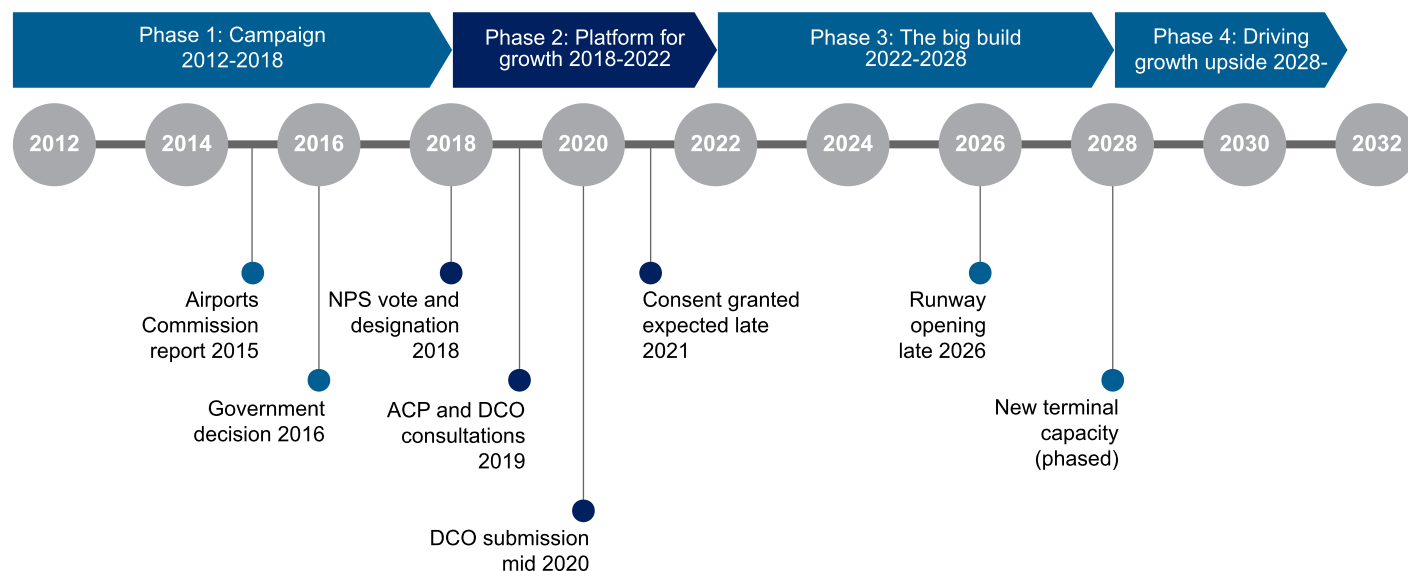
S&P Global Ratings understands that the expansion of Heathrow's third runway, which the management currently estimates will cost about £14 billion (in 2014 prices), is to be entirely privately funded, by a combination of equity and debt. Debt is to be issued from the existing financing platform. The proportion of debt and equity and the form of equity funding have not been confirmed, but we understand the management board aims to deliver expansion while keep aeronautical charges close to their 2016 level in real terms on average, but without specifying the period of time during which average is calculated; and maintain the current credit ratings. At this stage, it is not clear how Heathrow's management will balance the two objectives, but we expect increased clarity as information on the project's design, final cost, and regulatory support becomes available.

To alleviate the effect of the construction cost on regulated charges, which will likely factor in the investment as an addition to Heathrow's regulated asset base (RAB), we also understand that Heathrow will pursue a combination of higher traffic--through bigger and fuller planes--as well as a partial lifting of the Air Traffic Movements (ATM) statutory restriction by 25,000 to 505,000 per year, in advance of the third runway's completion.

Heathrow expects to submit its planning application--a development consent order (DCO)--in mid-2020, and aims to start construction by the end of 2021, with the opening of the runway scheduled for late 2026. In the DCO, Heathrow will propose to deliver capacity accommodating 142 million passengers per year by 2050, subject to demand for this capacity. We expect Heathrow will publish its initial and final business plan submissions for the expansion in December 2019 and December 2020, respectively.

Chart 1

Timetable Of Expansion



ACP--Airspace and future operations consultation. ATM--Air-traffic movements. DCO--Development consent order. NPS--National policy statement. Source: Heathrow.

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Supportive single-till regulation is the hallmark of Heathrow's competitiveness, but parameters for the expansion phase are not yet known.

The Civil Aviation Authority (CAA) is still consulting on the shape of the regulation for the intermediate period before the start of construction (a period known as iH7: January 2020-December 2021), and the subsequent H7 regulatory period (January 2022-December 2026). While the regulator's duty is to ensure Heathrow is able to finance its licensed activities, it will also focus on affordability for airlines and their passengers.

In our view, the CAA will incorporate mechanisms to promote efficient management of: capital expenditure (capex), by deferring the nonessential spending; dividends, by reducing payments; gearing, by limiting increases--for example, raising additional equity; and liquidity, by maintaining a prudent approach.

There are two major areas of uncertainty we see for the iH7 and H7 regulatory periods. First, the CAA has yet to decide whether the costs incurred before granting the DCO (Category C costs) will be added to Heathrow's RAB. Second, there is a risk that the cost of capital might be significantly lower than it is at present (the current pre-tax weighted-average cost of capital is 5.35%). This latter risk becomes apparent when we note trends in the regulated sectors, in the U.K., and overseas, as well as the environment of low interest rates, low expected risk-free rates, and equity returns.

We continue to monitor whether and how the cost of capital for H7 price control will reflect the inherent volume risk in the airport business, the additional execution risks triggered by the expansion, and the attractiveness of the allowed returns to incentivize shareholders to contribute equity.

We expect the CAA to announce the results of its consultations in October 2019, its initial proposal for H7 in the third quarter of 2020, and its final proposal in the first quarter of 2021.

Commercial agreements with airlines supplement regulation and provide more flexibility and volume incentives.

Given its outperformance on traffic levels in the current regulatory period (Q6: April 1, 2014, to Dec. 31, 2019), and an expectation that the CAA may wish to recalibrate the charges in the subsequent regulatory period using regulatory depreciation, Heathrow has proposed entering into commercial arrangements (the so-called "commercial deal") with airlines for the iH7 regulatory period.

Instead of the RAB adjustment, to take account of the outperformance and spread the difference between Heathrow's actual price path and the underlying revenue requirement over the longer term, Heathrow offered fixed and flexible rebates to the airlines. The fixed £260 million rebate (split into £130 million for 2020 and £130 million for 2021) to all airlines will accrue during iH7, but will be paid in full to airlines over four years, starting a year after the rebate has accrued. The fixed rebate will be supplemented by a 10%-20% volume rebate if airlines increase passenger numbers on the flights, thereby increasing the load factor to above the International Air Transport Association average of 82%.

In addition to providing a benefit to the airlines through passenger growth, while also incentivizing load-factor increase, the commercial deal allows Heathrow to keep the advantages of outperformance in Q6, while offering it a degree of protection if passenger volumes decrease in 2020 or 2021.

This is because the rebate has been calculated based on Heathrow's expectation of about 82 million-83 million passengers annually in 2020-2021. If passenger numbers are lower, the rebate would be lower, potentially reducing to zero if actual traffic in 2020-2021 drops to about 75 million passengers (pax) annually--a figure which the CAA predicted in its 2014 forecast. If pax falls below 75 million per year, Heathrow would be subject to the existing regulatory risk based on the iH7 regulatory framework, with the retail price index (RPI) minus 1.5% pricing formula. Higher-than-expected actual pax will result in higher rebates.

Despite Heathrow's preparations, we see downside risks to the macroeconomic environment--and consequently traffic levels--related to Brexit.

In our view, heightened short-term uncertainty around transport policies, and the potential for weaker macroeconomic conditions under differing Brexit scenarios--including Britain leaving the EU with no deal--may weigh on U.K. transportation-infrastructure assets' operating and financial performance.

On March 7, 2019, the U.K. government confirmed that it will match the EU's offer to protect airlines' flying rights within the EU for an initial 12-month period in the event of a no-deal Brexit. As a result, the risk of flights being interrupted as a result of a no-deal Brexit has reduced, but only until March 31, 2020.

In the longer term, uncertainty remains in relation to flying rights within the EU. In the event of a hard or no-deal Brexit, airlines with EU operating licenses are required to be majority owned and controlled by EU nationals (excluding the U.K.). While IAG (owner of British Airways and Iberia) is exposed to this event risk, the EU allows a six-month period to comply with the EU ownership requirement, and the airlines are actively preparing themselves for this. As a contingency plan, airlines can implement share buybacks from non-EU nationals and apply the restriction of voting rights if necessary.

Heathrow's actions to mitigate a potential drop in volumes, due to flight disruption or as the result of an economic downturn following Brexit, include earmarking £114 million of Brexit contingency costs, as well as reducing dividends from £500 million in 2018.

Outlook

The negative outlook on the Class A and the Class B debt issued by HFL reflects a number of uncertainties, including the risk of lower-than-expected future traffic performance, notably in a no-deal Brexit scenario if combined with more-adverse and prolonged economic conditions. Also, in the absence of a firm business plan and regulatory framework for H7 price control, there is a risk of further weakening of the credit metrics to fund the estimated £14 billion (in 2014 prices) cost of the Heathrow expansion. The increasing group indebtedness above the ring fence could put more pressure for a fixed distribution from HFL (even if the debt outside the ring fence does not cause an event of default).

There is a higher likelihood of a negative rating action on Class A debt, as our base case forecasts adjusted FFO to senior debt falling near 8% in 2020 and 2021. The credit ratios for Class A debt depend on the proportionate share of junior debt in total debt, as the junior debt provides a cushion supporting higher cash-flow certainty for senior debtholders. Potential mitigating actions, such as a more moderate dividend policy or drawing of Class B debt already available in the group, could offset the impact, if sufficient and implemented in good time.

Downside scenario

We could lower the ratings on the Class A and the Class B debt by one notch if weighted-average adjusted FFO to debt were to deteriorate to below 8% for the Class A debt or below 6% for the Class B debt. We could also lower the ratings if group leverage increases from current levels of less than 70% in terms of debt to RAB for the Class A debt, or less than 80% debt to RAB for the Class B debt. This will reduce financial covenant headroom, which sets the maximum leverage triggers at 72.5% debt to RAB for Class A and 82.0% for Class B at HFL.

Upside scenario

We would revise the outlook to stable if the operating environment and the U.K. macro environment become more predictable, and there is clarity on the funding and regulation for the expansion period such that we forecast that weighted-average FFO to debt is likely to stay above 6% for total Class A and Class B debt, and above 8% for the Class A debt.

Our Base-Case Scenario

Assumptions

- In 2018, passenger numbers increased by 2.7% to 80.1 million, thanks mainly to higher load factors. While in the first six months of 2019 (first-half 2019) passenger numbers increased by 1.8%, our assumption of 1.0% growth to 80.9 million in fiscal 2019 reflects Heathrow's capacity constraints, and potential one-off disruptions in 2019 (due to Brexit, BA strikes, or weather events). We expect flat volumes in fiscals 2020-2021.
- An aeronautical tariff of £22.48 per passenger in fiscal 2019, reflecting a favorable passenger mix (53% long-haul passengers in first-half 2019) and the recovery of 2017 yield dilution, somewhat offset by further recoverable 2019 yield dilution as airlines employ cleaner and quieter aircraft, and the introduction of the commercial deal. In fiscals 2020 and 2021, we expect an aeronautical tariff reflecting largely the rebates under the commercial deal.
- Retail revenue growth per passenger of 2%-3% growth in fiscal 2019, thanks to pound-sterling depreciation; retail offer management; and increasing catering income fuelled by a growth in food outlets and a rising number of airlines choosing not to offer free food on board. In fiscals 2020 and 2021, we assume 3%-4% per year growth rates, based on the combined effect of S&P Global Ratings' forecast GDP and the RPI growth.
- Car-parking revenue growth at RPI growth rates. Heathrow Express revenue growth in line with passenger growth, except in 2021 when it drops following the launch of competing Crossrail services from end-2019.
- Operational costs growth per passenger of 2% in fiscal 2019 when excluding £114 million provided for of preparations for Brexit and the impact of implementation of International Financial Reporting Standard (IFRS) 16. The management expects operating costs to decrease by £53 million, as a result of the implementation of IFRS 16. When including these both developments, we expect about 7.5% growth per passenger. In fiscals 2020 and 2021, growth at about 2%-3% per year, as RPI impact will be partially mitigated by cost efficiencies.
- S&P Global Ratings-adjusted EBITDA of £1.8 billion-£1.9 billion EBITDA in fiscals 2019 to 2021.
- S&P Global Ratings-adjusted EBITDA margin down to about 60%, from 63.5% in fiscal 2018, driven mainly by Brexit contingency.
- Capex at about £5 billion over fiscals 2019 to 2021, including capitalized costs linked to the DCO application, some of which will be recovered only in the next regulatory period (Category B costs). We understand certain limited preparatory costs related to construction of the runway (Category C costs) would be incurred subject to the CAA decision on their recovery.

Key Metrics

	2018A	2019E	2020E	2021E
FFO to debt (%)				
Class A and B	8.30	7.0-7.5	6.6-7.1	6.2-6.7
Class A only	9.30	8.4-8.9	7.9-8.4	7.5-8.0
Debt to EBITDA (x)				
Class A and B	6.7	7.0-7.5	7.1-7.6	7.5-8.0
Class A only	N/A	6.2-6.7	6.3-6.8	6.7-7.2
FFO to cash interest coverage (x)				
Class A and B	2.4	1.9-2.4	1.9-2.4	1.8-2.3
Class A only	N/A	2.1-2.6	2.0-2.5	2.0-2.5

*S&P Global Ratings-adjusted ratios. A--Actual. E--Estimate. FFO--Funds from operations. N/A--Not available.

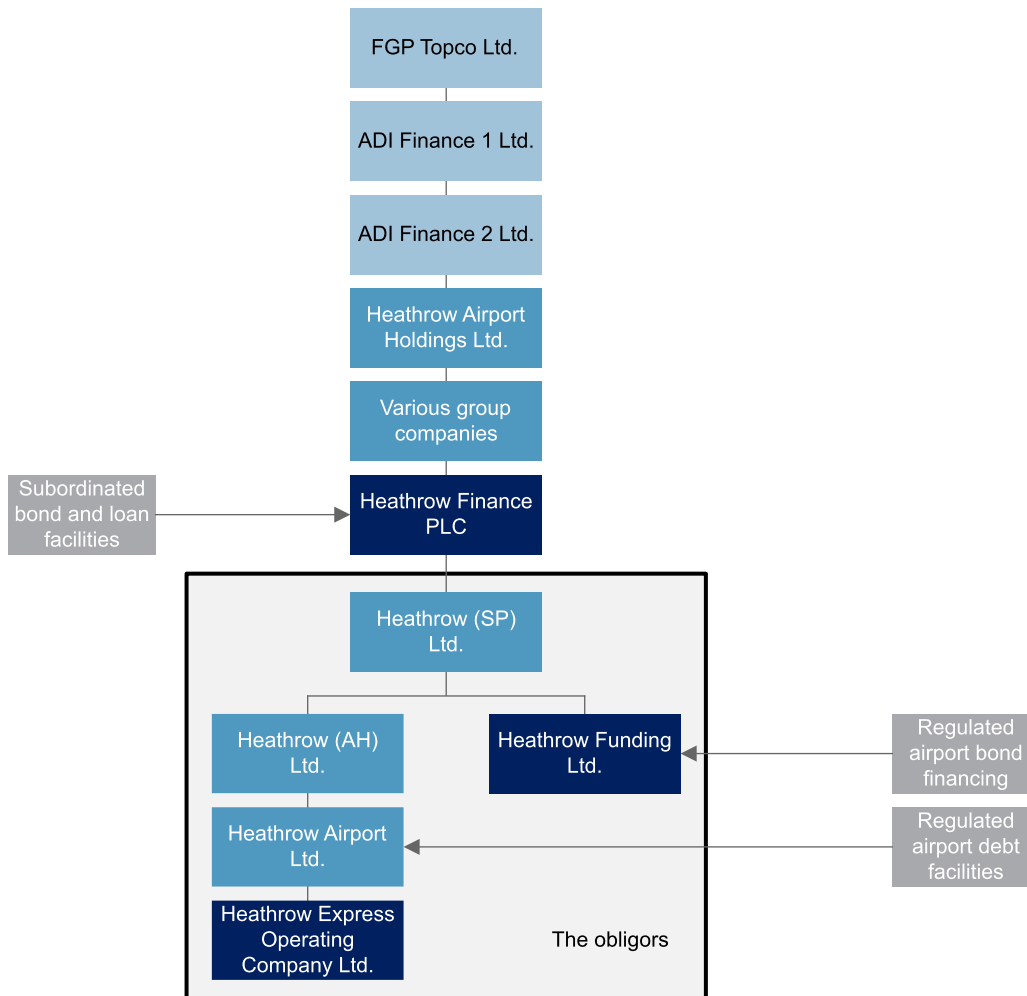
Company Description

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 which owns and operates the group's only asset, Heathrow Airport (Heathrow).

Chart 2

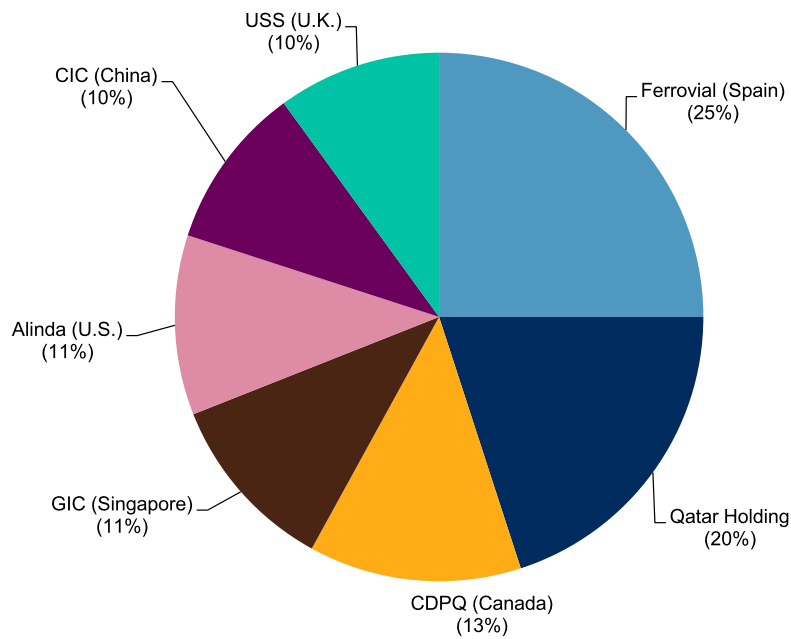
Transaction Structure



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The group companies are indirect subsidiaries of Heathrow Airport Holdings Ltd. (HAH), which is indirectly owned by Ferrovial S.A. (25%), Qatar Holding LLC (20%), and other institutional investors.

Chart 3
Heathrow Group -- Ownership Structure

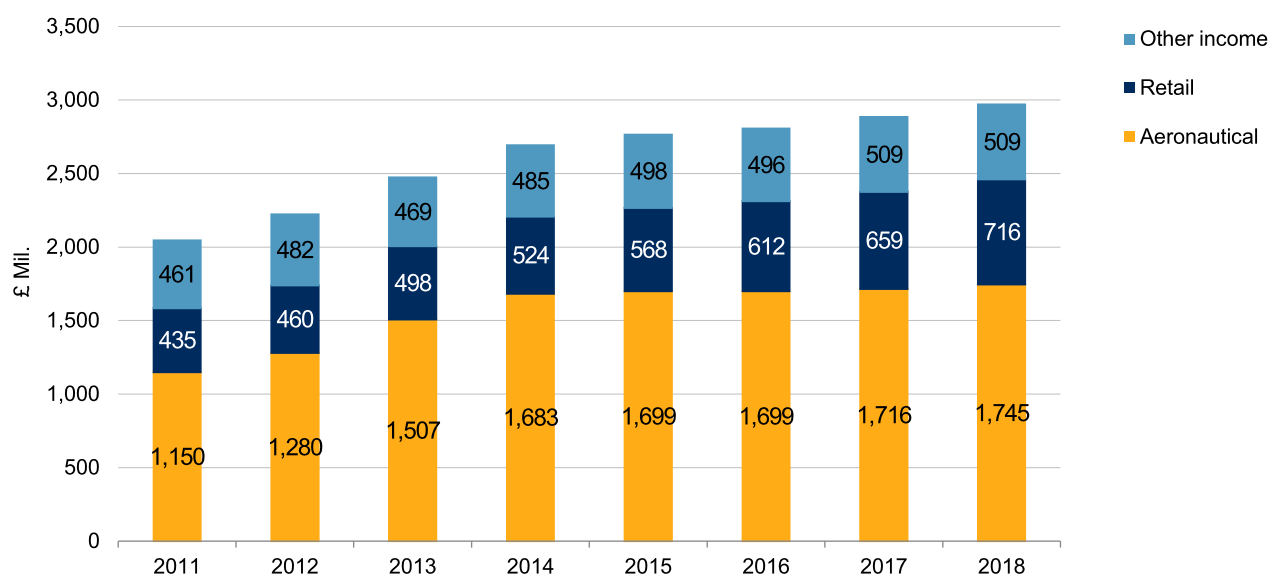


Source: S&P Global Ratings.
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For fiscal 2018, the group's total reported revenues were £2.97 billion, up 3% on fiscal 2017, and S&P Global Ratings-adjusted EBITDA amounted to £1.9 billion, up 4% on fiscal 2017. The revenue base mainly comprises aeronautical revenues (60%), charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, they are subsidised by non-aeronautical income that is generated from retail, car parking, operating Heathrow Express, and property rental.

Chart 4

Heathrow (SP) Ltd. -- Revenue Trend



Source: S&P Global Ratings.

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Business Risk

Heathrow enjoys a dominant market position as Europe's busiest airport, and the world's seventh-largest airport based on number of passengers (behind Atlanta, Beijing, Dubai, Tokyo, Los Angeles, and Chicago).

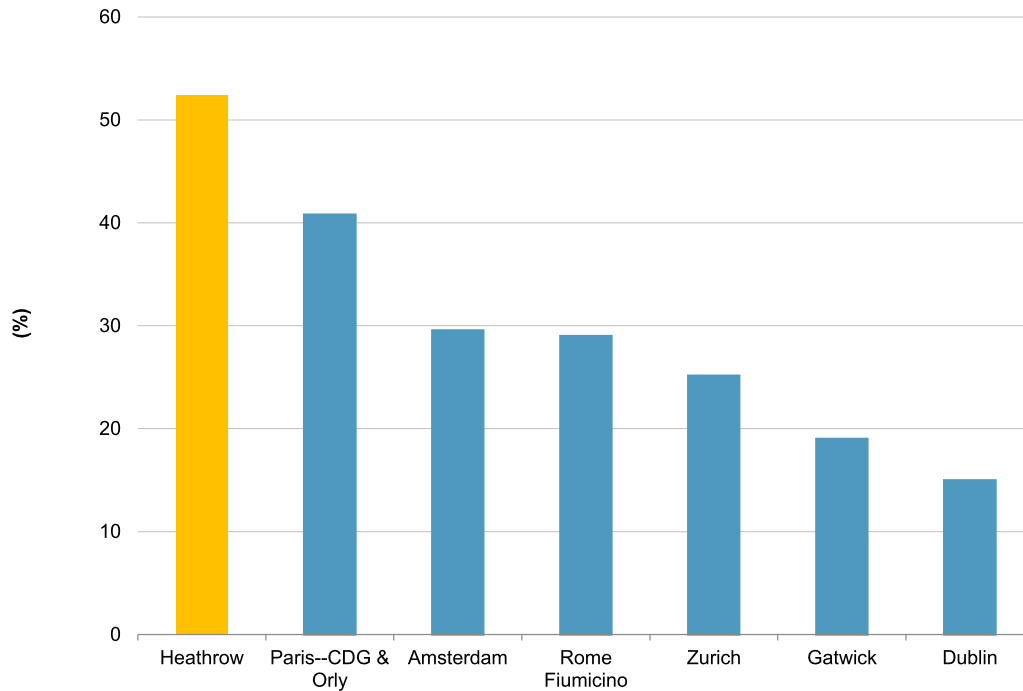
Its competitive position is due largely to its excellent location. It is the largest airport serving the London area--the world's largest aviation market--with a catchment area covering 25 million people (38% of the U.K. population) within a two-hour drive.

Heathrow handles 50% of traffic in the Greater London area. This dictates Heathrow's passenger mix, which, as of fiscal 2018, comprised a majority (70%) of origin and destination (O&D) passengers, a group whose demand is less vulnerable to economic developments. In addition, over a third of passengers (33%) are business travellers, who tend to be less price sensitive compared with those traveling for family or leisure.

As one of Europe's three main hub airports, Heathrow benefits from a high proportion of long-haul traffic (52.4% in 2018), more than any other airport in Europe, and is successful in growing this segment. Long-haul passengers are less price sensitive, and tend to generate more retail revenues given that they spend more time at the airport before boarding. In fiscal 2018, Heathrow's long-haul traffic growth (+3.1%) outpaced short-haul traffic growth (+2.2%). The airport served 87 airlines, operating scheduled flights to 230 destinations in 85 countries, out of which 125 were

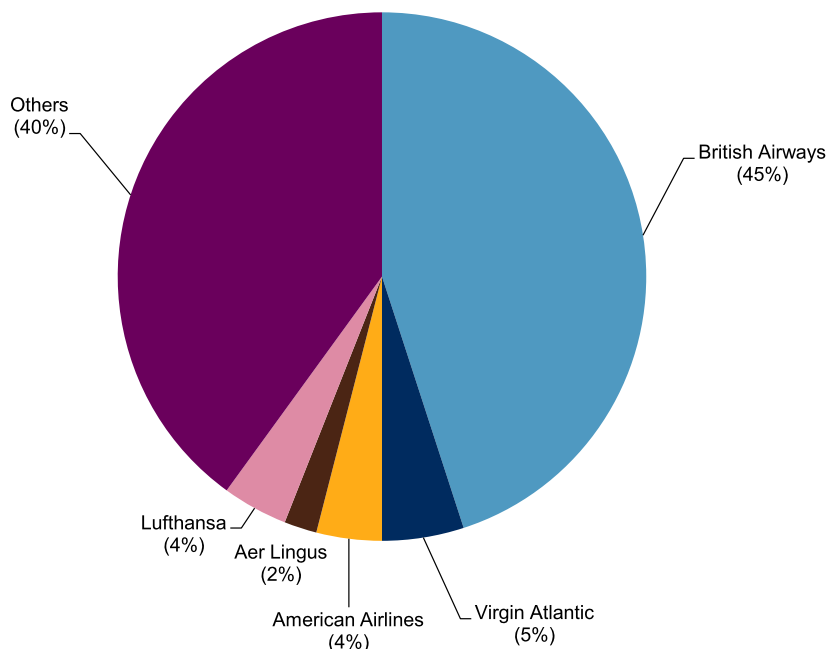
long-haul routes.

Chart 5
Proportion Of Long-Haul Traffic Among Rated EU Airports (2018)



CDG--Charles de Gaulle. Source: S&P Global Ratings.
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These factors combine to make Heathrow more resilient to downturns than its peers, and in our view largely mitigate the exposure of 45% of its traffic to a single airline, BA (BBB/Stable/-).

Chart 6**Heathrow's Airlines Served**

Source: S&P Global Ratings.

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During the last economic downturn, in 2009, traffic at Heathrow dropped by only 1.5% in response to a 5% drop in the U.K.'s GDP; it was the lowest drop among the London airports. However, boosting the current capacity will increase Heathrow's exposure to volume risk. The expansion will raise the airport's capacity to 142 million pax and 740,000 ATMs by 2050, from the current 80.1 million and 480,000 ATMs. Before the opening of the third runway (planned for 2026), another 25,000 ATMs per year could be released by lifting the 480,000-ATM limit once planning permission is obtained (expected around 2021). We anticipate that capacity release will be phased, and that Heathrow will manage this by stimulating demand through pricing.

A growing demand from airlines for new midsize aircraft (NMA), which can fly long distances from smaller airports, also poses a threat to a hub concept, which is the foundation on which Heathrow's expansion is based. However, we think the scale of operations, frequency of services, and convenience of connections that Heathrow can offer will continue to attract demand.

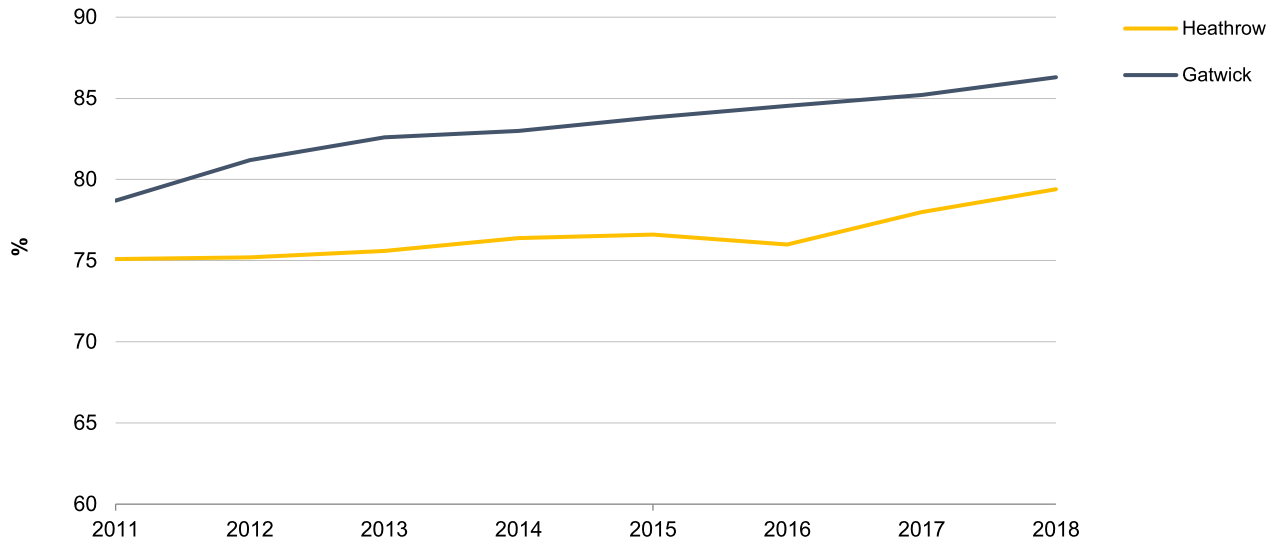
The prices achieved for slots (in early 2016, Oman Air paid \$75 million for a pair of take-off and landing slots; in March 2017, Scandinavian Airlines sold two slot pairs at Heathrow to American Airlines, also for \$75 million. Source: House of Commons, Airport Slots Briefing Paper, June 12, 2017) seem to suggest continuing high demand. However, we believe the management will be challenged as to how best to introduce the new capacity, given that airlines using

Heathrow still have headroom to increase passenger load up to the current industry average of about 82%.

In 2018, the load factor increased to almost 79.4%, from 76.4% in 2014. Still, aircraft served by Heathrow on average carry more empty seats than those served by Gatwick (load factor 86.7% in 2018).

Chart 7

Load Factor Comparison
Heathrow versus Gatwick

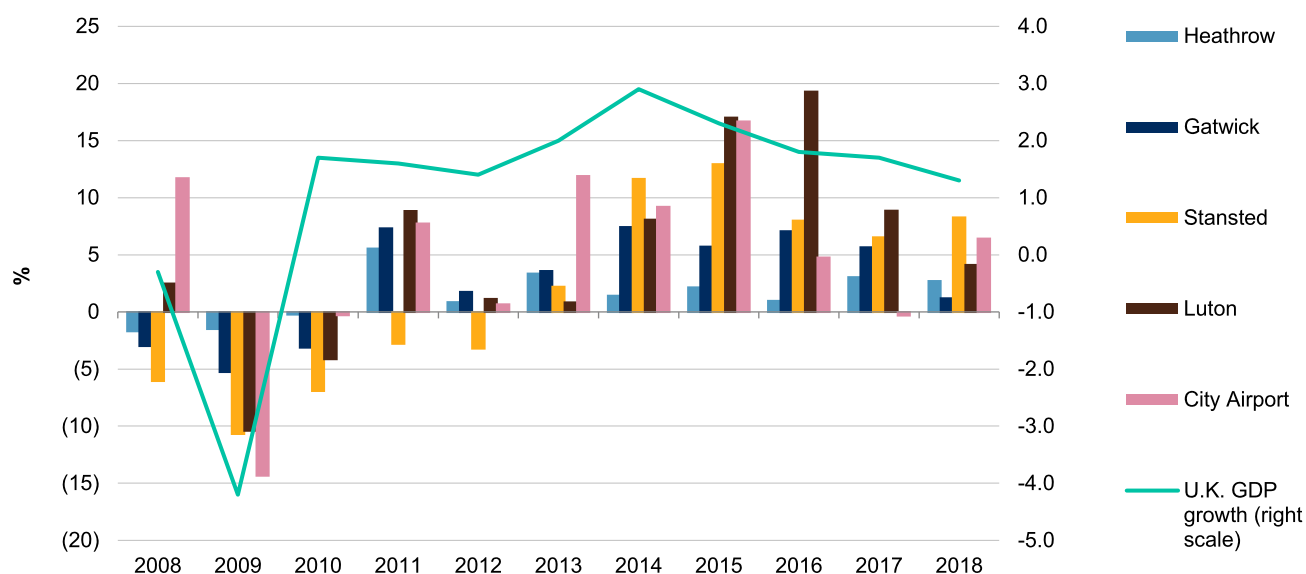


Source: S&P Global Ratings.

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Chart 8

U.K. GDP And London Airports' Traffic Growth



Source: S&P Global Ratings.

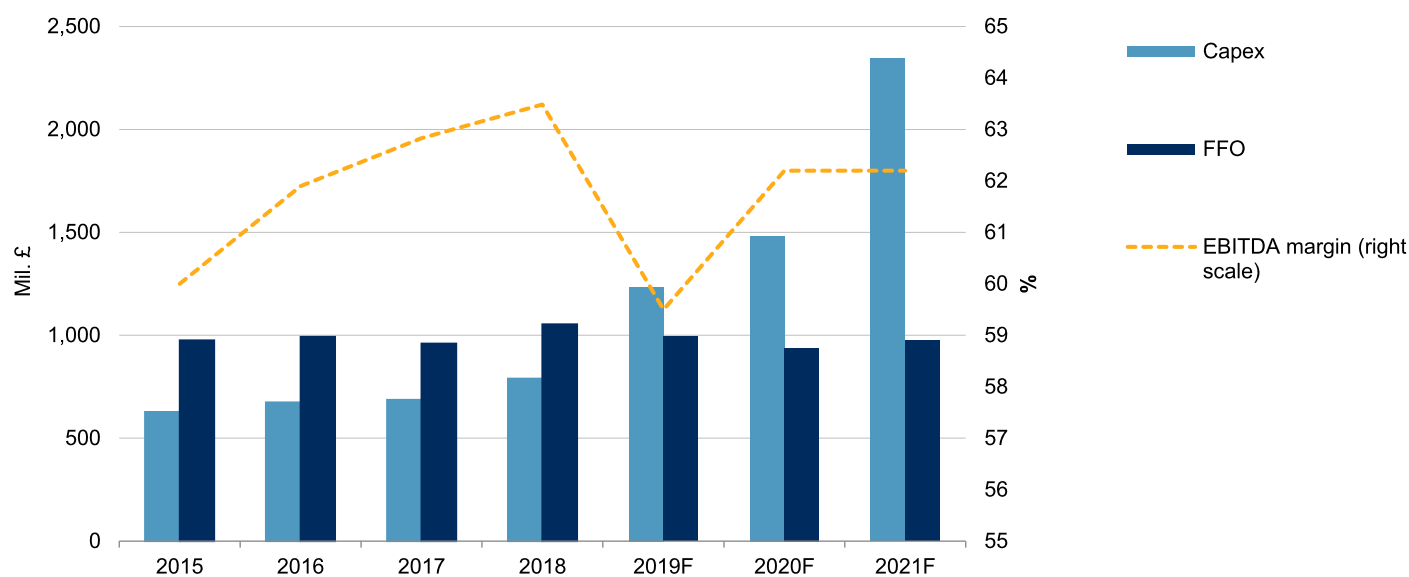
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We expect certain mitigation could come from the regulatory framework for H8 (a regulatory period which will start when the third runway is operational). The five-yearly regulatory resets allow for an adjustment of the aeronautical charges to reflect changes in costs and revenues, and in assumed traffic volumes in case of any underperformance against the settlement terms. In the past, the CAA has also permitted allowances in the traffic forecast for aviation-related demand shocks, such as the 2010 volcanic ash. In our view, the regulatory framework under which Heathrow operates is predictable and supportive. It is based on the RAB concept, which encourages investment by allowing recovery of capex costs via tariffs. A fair return over the RAB ensures the business' profitability and shareholder returns, which grow in line with capex. The delivery of Terminal 5, redevelopment of Terminals 2 and 3, and baggage-infrastructure investment have all increased the level of RAB and influenced the level of revenues Heathrow is able to claim under the aeronautical charges.

Heathrow's profitability, at 63.5% S&P Global Ratings-adjusted EBITDA margin in fiscal 2018, is not only above average for the transportation infrastructure industry, but also the highest among rated European airports. This is the result of the high level of recent investments in the airport's infrastructure, and Heathrow's ability to recover investment costs. Since 2004, the company has invested £12 billion, including for the construction of Terminal 5 (£4.3 billion), the upgrade of Terminal 2 (£2.5 billion), the construction of piers for A380 aircraft in Terminals 3 and 4, and implementation of the integrated baggage system.

Chart 9

Heathrow (SP) Ltd. -- Capex, FFO, And EBITDA Margin



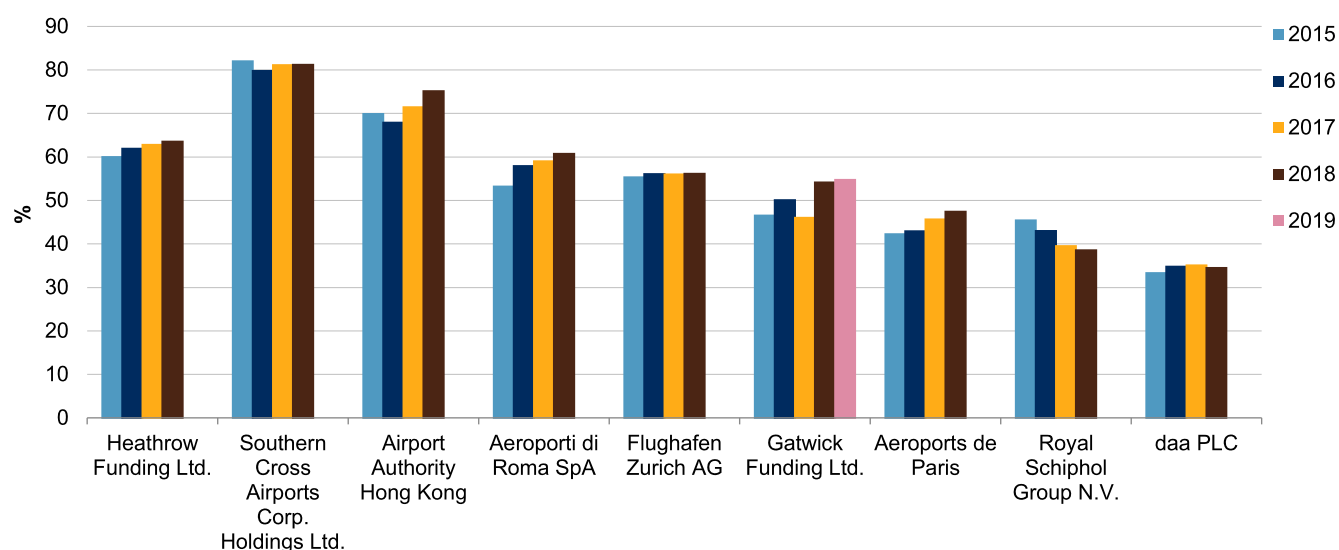
F--Forecast. Capex--Capital expenditure. FFO--Funds from operations. Source: S&P Global Ratings. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Heathrow's success in increasing its commercial revenues per passenger, in particular from retail and car parking, and its focus on delivering operating efficiencies, have both supported profitability. Another boost has been capacity optimization on long-haul and short-haul routes through larger aircraft and higher seat-densification, especially by BA.

We expect profitability to decline in 2019 because of cost increases linked to contingent plans for Brexit, which are partially mitigated by continued implementation of cost efficiencies and recovery of 2017 yield dilution (understated charges).

Chart 10

EBITDA Margin -- Peer Comparison



Source: S&P Global Ratings. Note: Year-end is December, except for Gatwick Funding Ltd. and Airport Authority Hong Kong (March).
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Peer comparison

Table 1

Heathrow Funding Ltd. -- Peer Comparison

	Heathrow Funding Ltd.	Aeroports de Paris	Royal Schiphol Group N.V.	Gatwick Funding Ltd.	Southern Cross Airports Corp. Holdings Ltd.	Airport Authority Hong Kong
Rating composition						
Business risk profile	Excellent	Excellent	Excellent	Strong	Excellent	Excellent
Country risk	Low	Intermediate	Very low	Low	Very low	Very low
Industry risk	Low	Low	Low	Low	Low	Low
Competitive position	Excellent	Excellent	Excellent	Strong	Excellent	Excellent
Financial risk profile	Aggressive	Intermediate	Intermediate	Significant	Significant	Modest
Anchor	bbb	a	a	bbb	a-	aa
Modifiers	Senior: Positive CRA (+1 notch); Junior: No impact	Positive CRA (+1 notch)	No impact	No impact	Negative CRA (-1 notch)	Negative CRA (-1 notch)
SACP	Senior: bbb+; Junior: bbb	a+	a	bbb	bbb+	aa-
Likelihood of government support	N/A	Moderately high (no impact)	Moderate (+1 notch)	N/A	N/A	Almost certain (+2 notches)

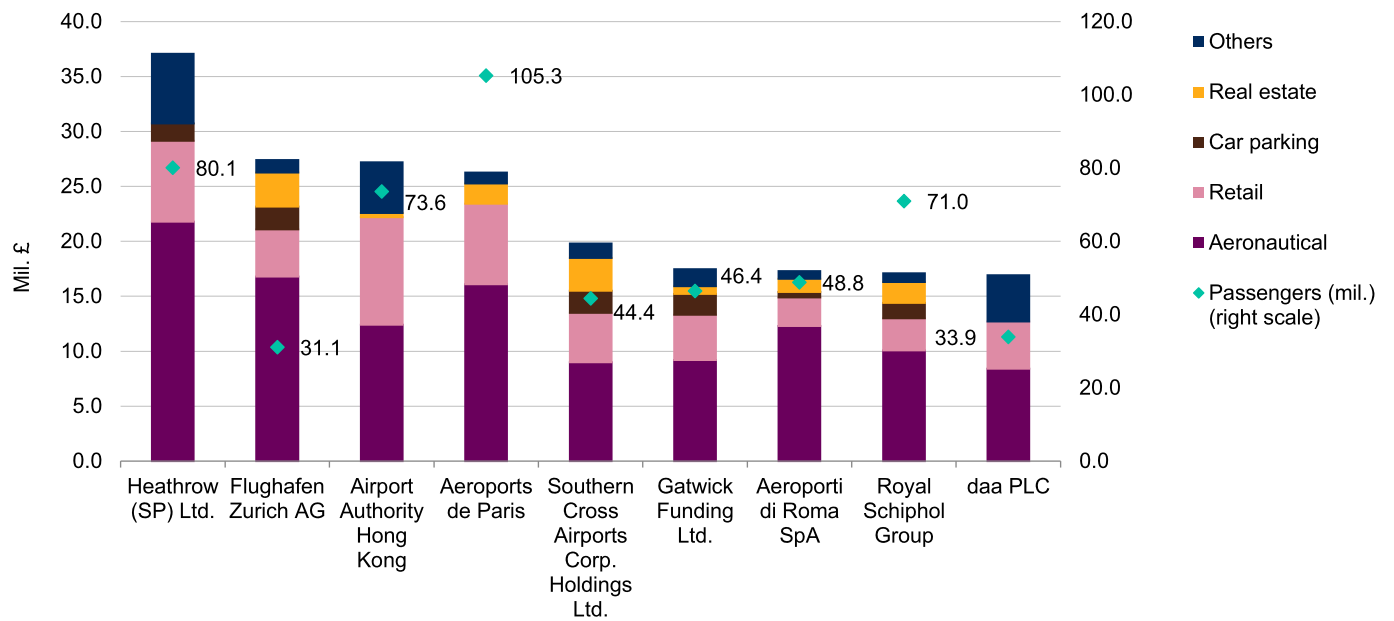
Table 1

Heathrow Funding Ltd. -- Peer Comparison (cont.)						
	Heathrow Funding Ltd.	Aeroports de Paris	Royal Schiphol Group N.V.	Gatwick Funding Ltd.	Southern Cross Airports Corp. Holdings Ltd.	Airport Authority Hong Kong
Issuer credit rating	N/A	A+/Stable/--	A+/Stable/A-1	N/A	BBB+/Stable/--	AA+/Stable/--
Structural features	Class A: +1 notch; Class B: N/A	N/A	N/A	Class A: +1 notch	N/A	N/A
Issue credit rating	Class A: A-/Negative; Class B: BBB/Negative	N/A	N/A	Class A: BBB+/Negative	N/A	N/A
S&P Global Ratings-adjusted metrics (mil. £)						
Revenues	2,970.0	4,022.6	1,355.5	810.8	876.4	2,131.9
EBITDA	1,885.5	1,908.0	521.5	443.9	711.4	1,600.7
Funds from operations (FFO)	1,052.8	1,462.2	408.2	322.1	488.2	1,367.9
Interest expense	800.7	202.4	79.3	111.9	245.3	5.3
Cash interest paid	762.7	193.4	71.6	109.5	223.2	6.8
Cash flow from operations	1,155.8	1,371.5	471.8	293.8	458.1	1,132.6
Capital expenditures	789.0	955.8	499.9	256.5	216.9	1,236.6
Free operating cash flow	366.8	415.6	(28.2)	37.3	241.2	(104.0)
Discretionary cash flow	244.8	50.0	(163.3)	(112.7)	(226.3)	(104.0)
Cash and short-term investments	711.0	1,846.9	347.2	2.6	115.6	1,696.8
Debt	12,650.8	5,937.6	2,138.9	2,667.3	4,723.2	0.0
Equity	(2,636.0)	5,211.1	3,698.7	238.3	(1,025.5)	6,587.0
S&P Global Ratings-adjusted ratios						
EBITDA margin (%)	63.5	47.4	38.5	54.7	81.2	75.1
Return on capital (%)	11.2	11.1	5.9	9.7	13.6	25.7
EBITDA interest coverage (x)	2.4	9.4	6.6	4.0	2.9	304.1
FFO cash interest coverage (x)	2.4	8.6	6.7	3.9	3.2	201.9
Debt/EBITDA (x)	6.7	3.1	4.1	6.0	6.6	0.0
FFO/debt (%)	8.3	24.6	19.1	12.1	10.3	N.M.
Cash flow from operations/debt (%)	9.1	23.1	22.1	11.0	9.7	N.M.
Free operating cash flow/debt (%)	2.9	7.0	(1.3)	1.4	5.1	N.M.
Discretionary cash flow/debt (%)	1.9	0.8	(7.6)	(4.2)	(4.8)	N.M.

Source: S&P Global Ratings. CRA--Comparable ratings analysis. N/A--Not applicable. N.M.--Not meaningful. SACP--Stand-alone credit profile. Year-end is Dec. 31, 2018, except for Gatwick Funding Ltd. (March 2019) and Airport Authority Hong Kong (March 2018).

Chart 11

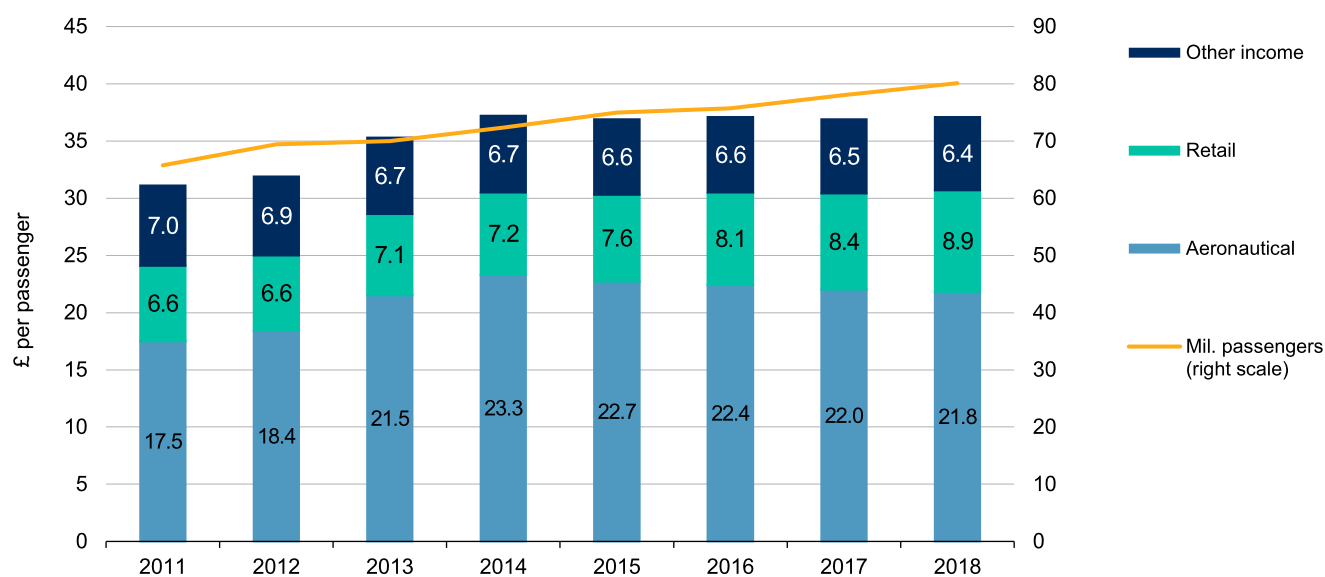
Peer Comparison -- Revenue Per Pax (Fiscal 2018)



Source: S&P Global Ratings. Note: Data as of Dec. 31, except for Gatwick Funding and Airport Authority Hong Kong (March). Data excludes international business operations for Aeroports de Paris, daa and Flughafen Zurich. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 12

Heathrow (SP) Ltd. -- Revenue Per Passenger



Source: S&P Global Ratings.

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Despite operating only one airport with just two runways (by comparison, Aeroports de Paris' [AdP's] Charles de Gaulle has four runways; Paris Orly has three; Amsterdam Schiphol has six), and serving fewer passengers than AdP (in fiscal 2018, Charles de Gaulle and Orly had 105.3 million pax, combined), Heathrow is the biggest out of these four European hubs in terms of revenue and earnings generation. Benefiting from an excellent competitive position, Heathrow has been able to charge the highest aeronautical fees in Europe (£21.80 per passenger in fiscal 2018), which, in addition to returns allowed on the capex, granted it the highest profitability among its peers. Although passenger growth at Heathrow lags behind peers (year on year to Dec. 31, 2018: Heathrow +2.7%; Charles de Gaulle +4%; Schiphol +3.7%) demand is high due to its capacity constraints, as illustrated by the prices airlines are prepared to pay on the secondary market for slots at Heathrow.

Worldwide, one of Heathrow's closest peers is, in our view, Sydney Airport (rated entity name Southern Cross Airports Corp. Holdings Ltd.). Although less than half the size of Heathrow (44.4 million passengers in 2018, about £711 million EBITDA), Sydney Airport is the largest in Australia, located in the country's biggest population area. Given the lack of a viable alternative means of public transport, Sydney Airport has resilient passenger traffic and a light-handed, supportive regulatory regime (based on a dual-till model), providing for capex recovery in the tariff and allowing tariff opening in case of additional investment. Both scenarios support the airport's profitability, which exceeds that of Heathrow. Sydney Airport is also facing potential capacity constraints in 20-30 years' time, although it has decided not to participate in development of the Western Sydney Airport. Financially, Sydney Airport has similarly aggressive

leverage to Heathrow, with significant distributions and refinancing risk.

Airport Authority Hong Kong (AAHK) is ranked the eighth-largest airport globally, based on the number of passengers (74.5 million in 2018), just behind Heathrow. The airport serves Hong Kong, as well as the Pearl River Delta in China--one of the world's largest urban areas in term of population and size. Much like Heathrow, significant O&D traffic and large non-aeronautical revenues (AAHK retail revenues per pax are higher than Heathrow) support profitability and stable cash flows. Hong Kong International Airport is developing the three-runaway system (3RS) to relieve capacity constraint, which is expected to result in an increase in financial leverage over the next two to three years. Government ownership in AAHK is a key differentiator of our ratings on the company, as we equalize our rating with that on the Hong Kong government, providing a two-notch uplift to the stand-alone credit profile (SACP) (aa-).

Gatwick's competitive position and profitability are weaker than Heathrow's, due to Gatwick's less favorable passenger mix, with its primary focus on short-haul travel (81%) and primary exposure to family and leisure passengers (83%), rather than business passengers. Gatwick serves about half the passenger numbers of Heathrow, and generates earnings that are about a quarter of Heathrow's.

Table 2

Heathrow Funding Ltd. And Peers -- Key Performance Indicators						
	Heathrow Funding Ltd.	Aeroports de Paris	Royal Schiphol Group N.V.	Gatwick Funding Ltd.	Southern Cross Airports Corp. Holdings Ltd.	Airport Authority Hong Kong
Operations						
Country of location	U.K.	France	Netherlands	U.K.	Australia	Hong Kong
Ownership or concession maturity	Ownership	Ownership	Ownership	Ownership	Consession (99 year lease till 2097)	Ownership
Asset type	Hub	Hub, origin and destination	Hub, origin and destination	Origin and destination	Origin and destination	Hub, mostly origin and destination
Runways	2	10	6	1	3	2, with third runway under construction
Regulatory model						
Charge setting flexibility	Price cap, single till	Price cap, adjusted/dual till	Dual till	Contracts and commitments	Dual till (Commercially negotiated charges)	N.A.
Price agreement period	2014-2019	2016-2020	Annual (every April)	2014-2019	Various	Various
Regulator	CAA	French gov't/ISA	Aviation Act and Operation Decree	CAA	Not regulated currently	Hong Kong government under the Airport Authority Ordinance
	Heathrow	Charles de Gaulle	Amsterdam	Gatwick	Sydney	Hong Kong
Traffic						
Group passengers (mil.)	80.1	281.4	79.2	46.4	44.4	75.1
Passengers (mil.)	80.1	72.2	71.0	46.4	44.4	75.1
% origin and destination	70	89	63	N.A.	N.A.	About two-thirds

Table 2

Heathrow Funding Ltd. And Peers -- Key Performance Indicators (cont.)						
% long-haul passengers	52	41	30	19	37	N.A.
% business passengers	33	N.A.	30	17	16	N.A.
Top-three airlines	British Airways (45%), Virgin (5%), AA (4%)	Air France, N.A., N.A.	KLM (49%), easyJet (8%), Transavia (7%)	easyJet (43%), British Airways (18%), Norwegian (11%)	Quantas, Singapore Airlines, Virgin Australia	Cathay Pacific, Cathay Dragon, Hong Kong Airlines
No. of airlines	87	149	89	51	61	More than 120 airlines
Destinations	230	292	327	228	103	Over 220
No. ATMs	476	481	499	286	348	429
Seat load factor (%)	79.4	85.6	85.7	86.3	N.A.	Above 80
Revenues overview						
Total (mil. £)	2,970.0	4,020.3	1,354.8	810.8	877.6	1,950.7
Per pax	37	35	17	17	20	26
% aeronautical revenues	59	42	59	53	1	36
Per pax	22	16	10	9	10	9
% of non-aeronautical revenues	41	27	41	47	0	64
Per pax	15	10	7	8	10	17
Retail	48	72	42	50	0	N.A.
Car parking	10	0	20	23	0	N.A.
Property rental	0	18	27	8	0	N.A.
Other	42	10	11	19	0	N.A.
% international revenues	0	31	0	0	0	Minimal

Source: S&P Global Ratings. Pax--Per passenger. N.A.--Not available. Year-end is Dec. 31, 2018, except for Gatwick Funding (March 2019) and Airport Authority of Hong Kong (March 2018). All figures are in GBP, converted from local currencies at the year-end exchange rate.

Financial Risk

Our assessment is constrained by Heathrow (SP) Ltd.'s aggressively leveraged balance sheet with relatively weak credit metrics. We expect negative FOCFs from fiscal 2019 onwards, and further gearing up to support the expansion capex and distributions.

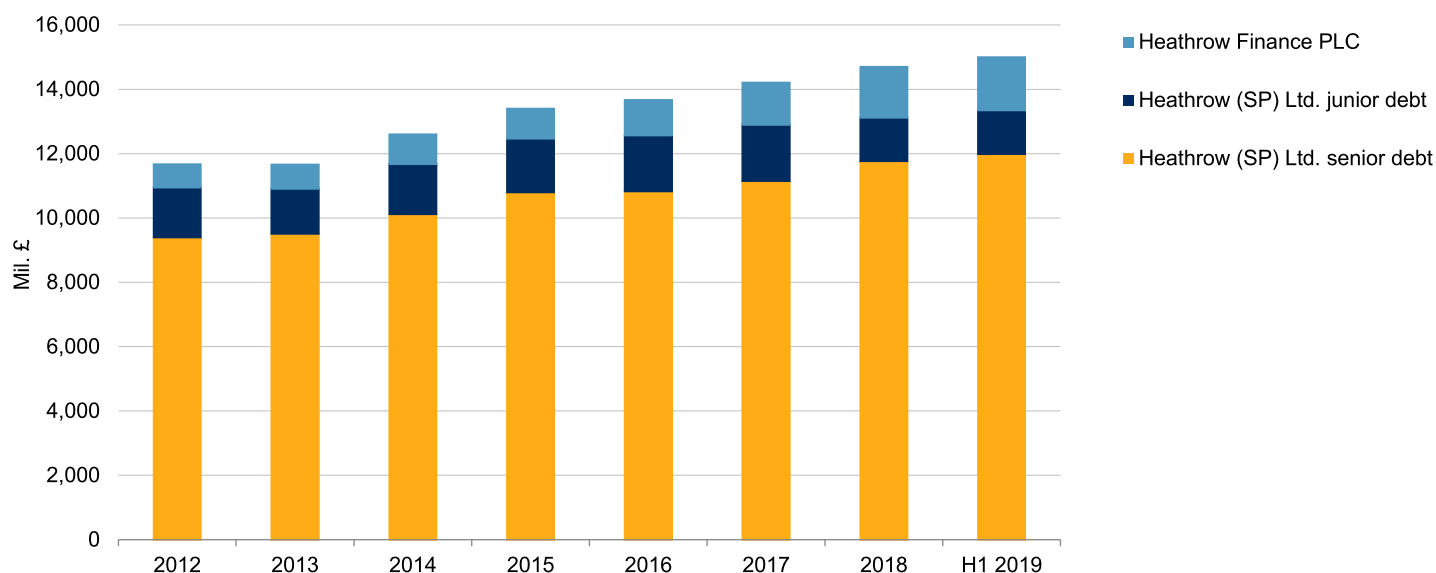
While we anticipate the ratio of S&P Global Ratings-adjusted FFO to debt over 2019-2021 to remain above 8% for the Class A debt and above 6% for the consolidated debt (excluding the debenture of £2.2 billion, as at Dec. 31, 2018), we expect the group to be increasing its already aggressively leveraged structure. From fiscal 2019 onward, the FOCFs will no longer be able to cover expansion-related costs of about £5 billion in fiscals 2019 and 2021. When construction of the third runway commences, capex is likely to increase from £1 billion-£2 billion annually in iH7, to about £3.3 billion annually in H7. While at present, it is unknown to what extent the shareholders will participate in the expansion cost--currently estimated at about £14 billion (in 2014 prices)--we anticipate significant issuances to cover financing

needs related to the construction.

We expect the group to be issuing at the three levels of its existing financial platform; that is, senior and junior debt by HFL, and by Heathrow Finance PLC. In an effort to protect the financial metrics of the ring-fenced group, Heathrow is likely to take advantage of a relatively higher headroom offered by the covenants at the Heathrow (SP) Ltd. junior and the Heathrow Finance PLC levels, and increase indebtedness at these levels. As of Dec. 31, 2018, the junior RAR (Regulatory Asset Ratio, net senior debt to the RAB) had a 6.6% headroom to its covenants, while its Group RAR at the Heathrow Finance PLC level had a 6.2% headroom to its covenants, compared with a 4.3% headroom to the senior RAR.

Chart 13

Heathrow Group -- Gross Debt



Source: S&P Global Ratings.

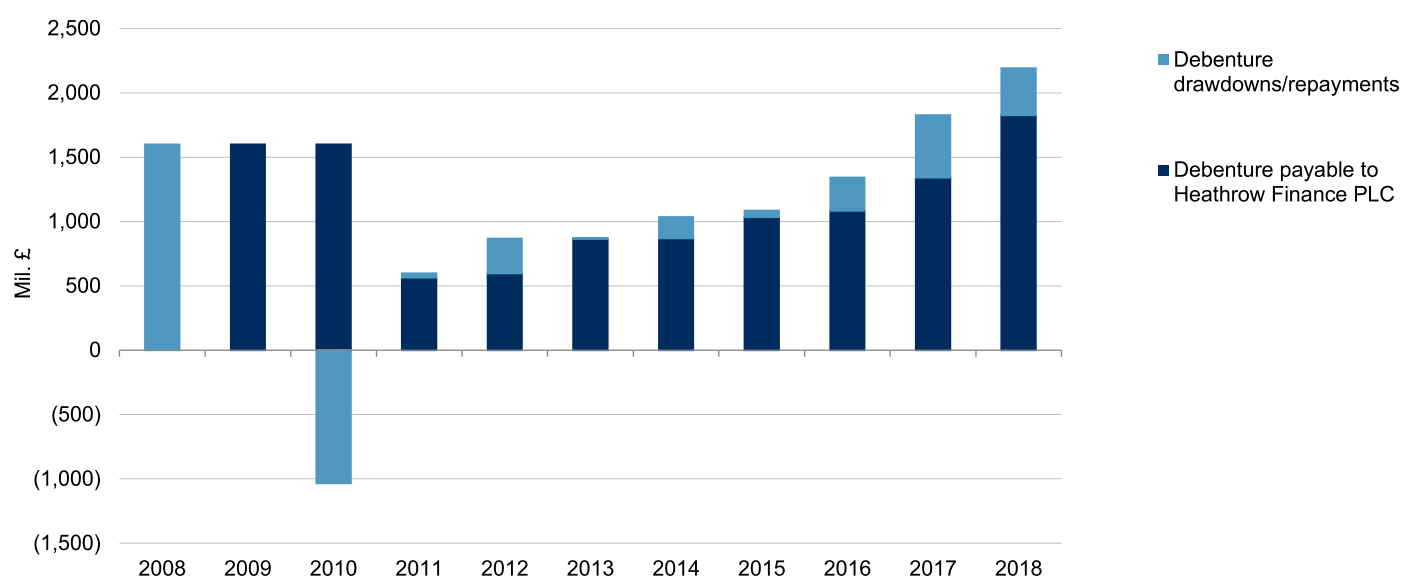
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Debt raised by Heathrow Finance PLC is pushed down via the unsecured loan note between Heathrow Finance PLC and Heathrow (SP) Ltd. (the debenture), dated Jan. 31, 2008. While the loan currently matures in December 2030, we understand that the management intends to extend it as needed, until it is repaid. The original maturity date of the originally £1.6 billion loan was May 5, 2011. Debenture ranks junior and subordinate to all other unsecured obligations of Heathrow (SP) Ltd., and does not have any scheduled amortization. Its interest is set at a rate equal to the sum of Heathrow Finance PLC's debt service and a rate of return on the loan note. Cash pushed to Heathrow (SP) Ltd. consists of net debt raised at Heathrow Finance PLC net of any temporary loan repayments. The debenture is not subject to any covenants, and does not have any triggers that would result in a default or acceleration. As such, we treat it as akin to equity. We expect Heathrow SP Ltd.'s liabilities under the debenture will continue growing, as

Heathrow Finance PLC will be raising more debt.

Chart 14

Heathrow (SP) Ltd. -- Debenture



Source: S&P Global Ratings.

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The payments under the debenture are factored into the restricted payments made by Heathrow (SP) Ltd., which fund the distributions to external shareholders, payments of debenture interest and debenture repayments, net of debt raised by Heathrow Finance PLC and any temporary loan repayments.

Table 3

Heathrow Group -- Distributions

	--Fiscal year ended Dec. 31--						
	2012	2013	2014	2015	2016	2017	2018
Distributions to ultimate shareholders	(240.0)	(555.0)	(405.0)	(300.0)	(325.0)	(525.0)	(500.0)
Interest on debenture, debenture repayments, other	(245.0)	(161.0)	(95.0)	(223.0)	(341.0)	(957.0)	(286.0)
Gross restricted payments by Heathrow (SP) Ltd. to Heathrow Finance PLC	(485.0)	(716.0)	(500.0)	(523.0)	(666.0)	(1,463.0)	(786.0)
Debt drawdown, other	275.0	4.0	165.0	125.0	260.0	750.0	564.0
Net restricted payments by Heathrow (SP) Ltd. to Heathrow Finance PLC	(210.0)	(712.0)	(335.0)	(398.0)	(406.0)	(713.0)	(222.0)

In our view, increasing indebtedness at Heathrow Finance PLC could increase the pressure for fixed distributions from Heathrow (SP) Ltd., even if the debt outside the ring fence does not cause an event of default.

Financial summary

Table 4

Heathrow (SP) Ltd. -- Financial Summary					
Industry Sector: Infrastructure					
	--Fiscal year ended Dec. 31--				
	2018	2017	2016	2015	2014
(Mil. £)					
Revenues	2,970.0	2,884.0	2,807.0	2,765.0	2,692.0
EBITDA	1,885.5	1,812.0	1,736.5	1,660.0	1,594.0
Funds from operations (FFO)	1,052.8	960.3	991.6	975.4	984.8
Interest expense	800.7	855.7	757.9	697.6	931.2
Cash interest paid	762.7	798.7	699.9	660.6	609.2
Cash flow from operations	1,155.8	1,126.3	1,017.6	992.4	952.8
Capital expenditures	789.0	686.0	674.0	627.0	853.0
Free operating cash flow	366.8	440.3	343.6	365.4	99.8
Discretionary cash flow	244.8	(178.7)	7.6	33.4	(345.2)
Cash and short-term investments	711.0	525.0	660.0	172.0	268.0
Gross available cash	711.0	525.0	660.0	722.0	438.0
Debt	12,650.8	12,723.1	12,148.3	12,100.4	13,312.8
Equity	(2,636.0)	(2,635.0)	(1,979.0)	(1,075.0)	(1,390.0)
Adjusted ratios					
EBITDA margin (%)	63.5	62.8	61.9	60.0	59.2
Return on capital (%)	11.2	10.9	10.0	8.4	8.3
EBITDA interest coverage (x)	2.4	2.1	2.3	2.4	1.7
FFO cash interest coverage (x)	2.4	2.2	2.4	2.5	2.6
Debt/EBITDA (x)	6.7	7.0	7.0	7.3	8.4
FFO/debt (%)	8.3	7.5	8.2	8.1	7.4
Cash flow from operations/debt (%)	9.1	8.9	8.4	8.2	7.2
Free operating cash flow/debt (%)	2.9	3.5	2.8	3.0	0.8
Discretionary cash flow/debt (%)	1.9	(1.4)	0.1	0.3	(2.6)

Liquidity

We expect Heathrow (SP) Ltd.'s liquidity to remain adequate, supported by our expectation that its liquidity resources will exceed its funding needs by more than 1.2x in the 12 months to June 30, 2020.

Our opinion is supported by a generally high standing in credit markets, as demonstrated by a well-established program for debt issuance at various structural levels (senior, junior, holding company) in several countries and in seven currencies (including British pound, euro, U.S. dollar, Canadian dollar, Australian dollar, Norwegian krona, and Swiss franc), and by solid and well-established relationships with a number of banks providing various facilities (including Morgan Stanley, The Royal Bank of Scotland plc, HSBC Bank plc, Lloyds Bank plc, BNP Paribas, National Australia Bank Ltd., Canadian Imperial Bank of Commerce, JPMorgan Chase, and others). In our view, the excellent

competitive market position of the airport and supportive regulatory framework should enable Heathrow to absorb a high-impact event without refinancing.

However, the currently strong liquidity position is, in our view, temporary. In anticipation of potentially more difficult access to financing markets due to Brexit, the management is prefunding capex related to the expansion, and resizing liquidity to align with future large capital requirements. We expect increasing debt issuance up to about 3% headroom to senior RAR covenants and 5% headroom to junior RAR covenants at the Heathrow (SP) Ltd. level, and at a 5% headroom at Heathrow Finance Ltd. level.

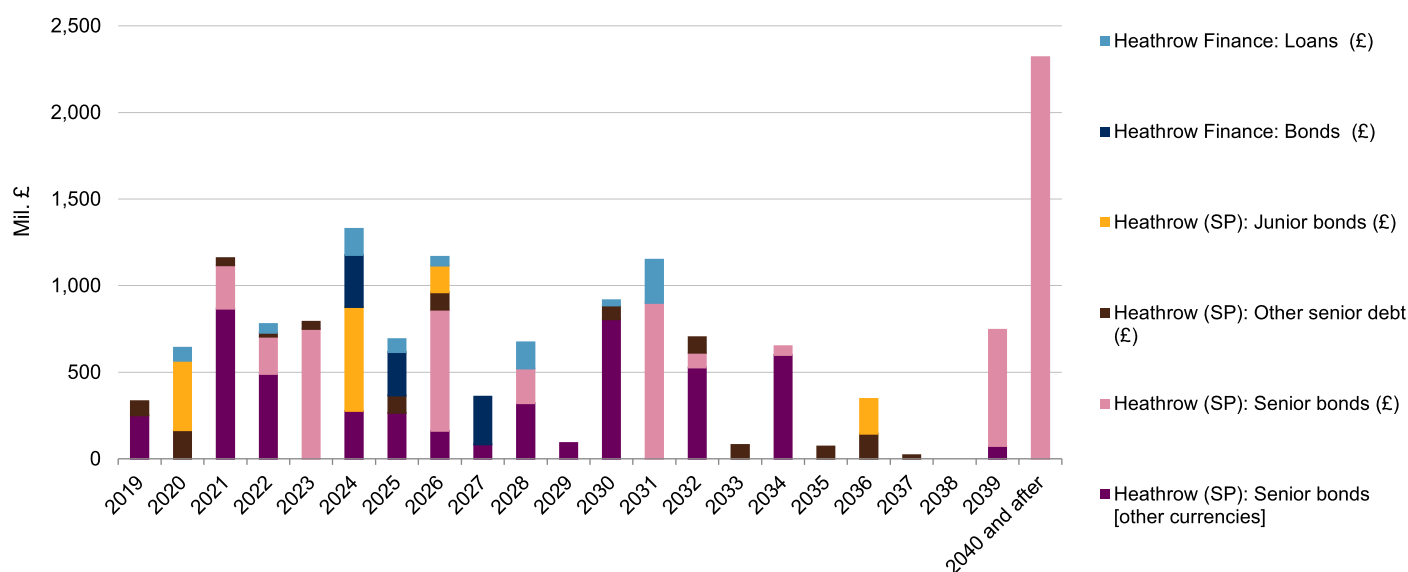
Principal Liquidity Sources	Principal Liquidity Uses
<p>We anticipate the following liquidity sources and uses over the period:</p> <ul style="list-style-type: none"> • Unrestricted cash and short-term investments of about £820 million; • Access to about £2.3 billion of undrawn credit facilities, including £1.6 billion expiring in November 2021; • FFO of about £0.86 billion; and • Positive working capital of £97 million. 	<p>We estimate the following liquidity needs over the same period:</p> <ul style="list-style-type: none"> • Expected capex of approximately £1.4 billion; • Debt maturities of approximately £0.8 billion; and • Leases of about £45 million-£50 million.

Debt maturities

The weighted average life of HFL's debt is 11.8 years, and more than 60% of the debt will mature after the opening of the third runway.

Chart 15

Heathrow Group -- Debt Maturity Profile (As Of June 30, 2019)



Source: S&P Global Ratings. Data as of June 30, 2019.
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In the context of Brexit and GBP depreciation, we expect that Heathrow will be further diversifying its funding base in order to reduce exposure to pound-sterling denominated debt, in favour of U.S. dollars, euros, and Canadian dollars.

Other considerations

The approximately 10% layer of junior debt in the ring fence offers a cushion of protection to senior debtholders, demonstrated by stronger senior-only credit metrics, and justifies that the senior SACP, at 'bbb+', is one notch higher than our assessment of its subordinated SACP ('bbb').

Structural Features

HFL's Class A debt rating incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s senior SACP to reflect structural features designed to increase cash-flow certainty for debtholders. The rating on the subordinated Class B debt reflects its 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 restriction on raising further 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 rating-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 (SED) criteria, due primarily to higher risk of competition and the absence of a credit remedy period, during which creditors take control of the business and stabilize its credit quality or sell the company's shares. However, HFL benefits from the majority of the structural enhancements listed in the SED criteria, and has additional risk-mitigating factors such as the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value.

The combination of these factors leads, in our view, to a marginal reduction in the default risk of HFL, similar to the marginal default risk reduction from which SED senior bondholders can benefit.

Table 5

Heathrow Funding Ltd. -- Structural Features	
Closing date	Aug. 18, 2008
Collateral	First ranking fixed and floating charges over all material assets of the obligors and first-ranking and enforceable pledge over the shares in Heathrow (SP) Ltd.
Country of origination	U.K.
Financial covenants	
Additional indebtedness test	
Senior RAR	72.5%
Junior RAR	90%
Trigger events/restricted payment conditions	
Senior RAR	70% (72.5% from April 2018)
Junior RAR	85%
Senior ICR	1.40x
Junior ICR	1.20x
Event of default	
Senior RAR	92.5%
Senior ICR	1.05x
Liquidity facility	Covering 12 months of interest on senior debt and six months of debt service on junior debt.

Senior RAR--Ratio of senior debt plus any debt that is not subordinated less amounts held in authorized investments or cash to RAB. Junior RAR--Ratio of total debt less amounts held in authorized investments or cash to regulatory asset base (RAB). Senior ICR--The ratio of (1) cash flow from operations of the obligors less corporation tax paid to HM Revenue & Customs, less 2%; multiplied by the RAB to (2) interest and equivalent recurring finance charges paid or forecast to be paid on senior debt and any permitted financial indebtedness that is not subordinated to such senior debt.

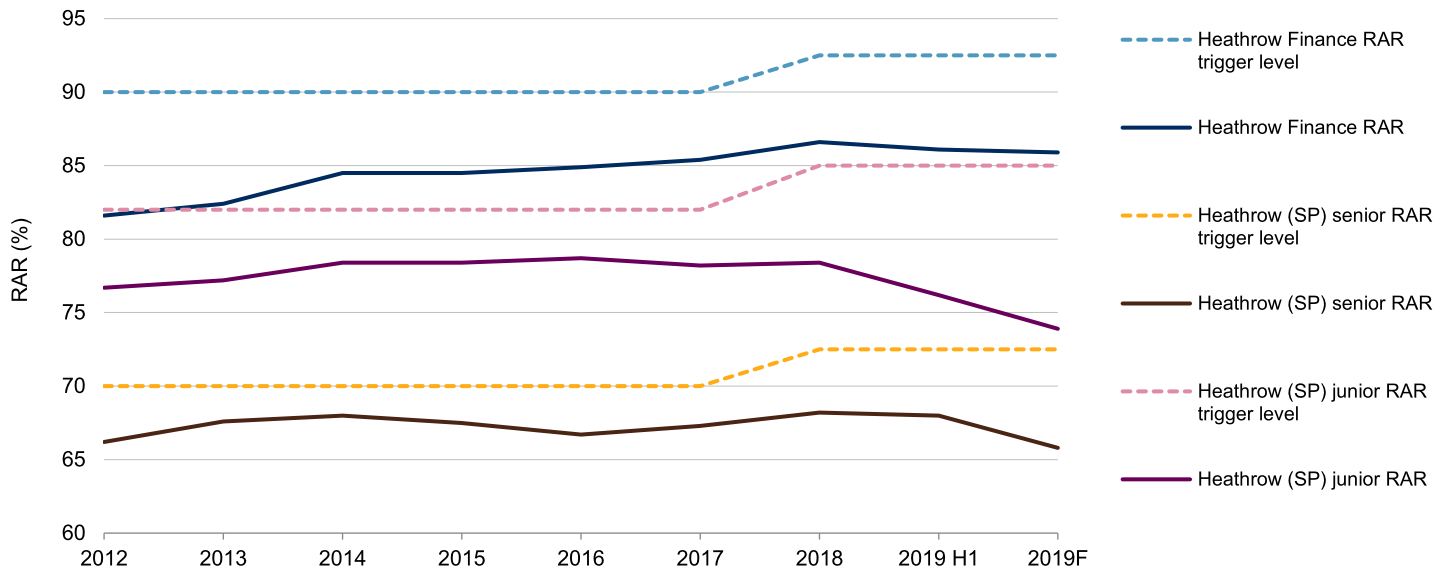
In February 2019, the management implemented modifications to the definition of net debt to RAB covenants, to accommodate the effect of International Financial Reporting Standards (IFRS) 16, which from Jan. 1, 2019 has required companies to capitalize their operating leases. The debt amount for the calculation of the leverage covenant will subsequently include future operating leases, but exclude existing operating leases.

Under the management forecast, the covenant ratios will be met with an adequate headroom. We understand the

management intends to maintain at least 3% headroom to senior RAR and 5% headroom to junior RAR at Heathrow (SP) Ltd., and a 5% headroom to Heathrow Finance Ltd.'s RAR.

Chart 16

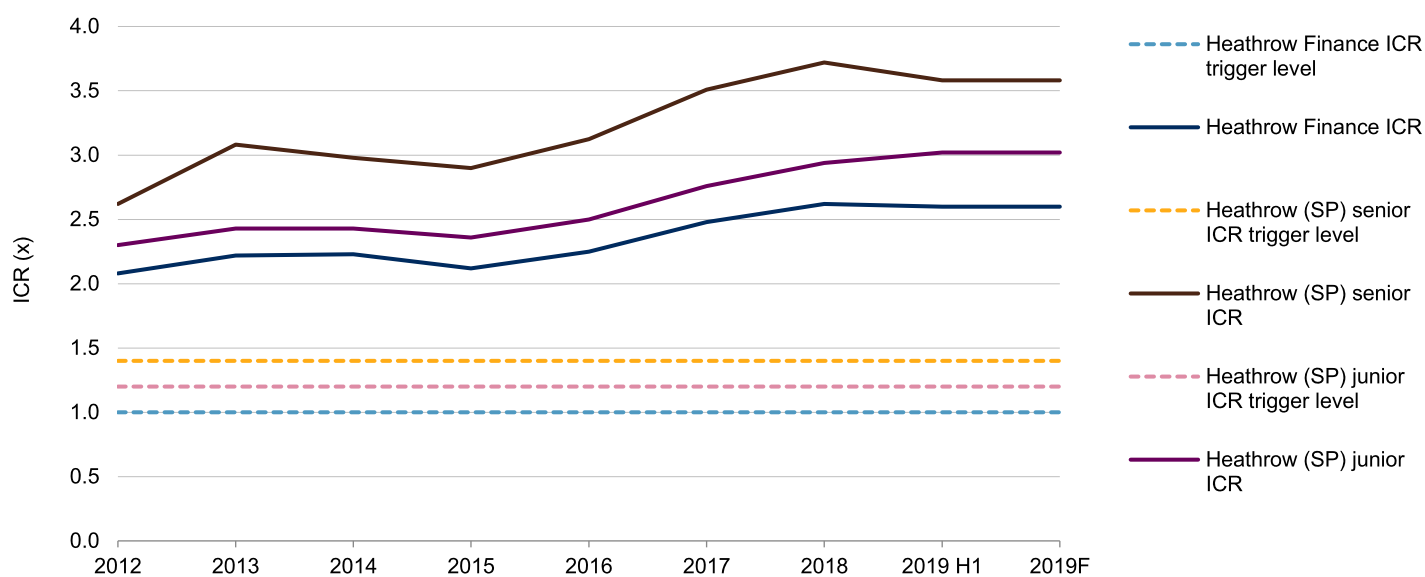
Heathrow Group -- Financial Covenant Performance (RAR)



F--Management's forecast. H2--Second half. RAB--Regulated asset base. RAR--Regulatory asset ratios.
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Chart 17

Heathrow Group -- Financial Covenant Performance (ICR)



F--Management's forecast. H2--Second half. ICR--Interest cover ratio.
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Environmental, Social, And Governance

Heathrow's position as the U.K.'s biggest airport makes it more exposed than its U.K. peers to safety and security risks, such as potential terror-attacks and flying objects, such as drones, entering restricted airspace around the aerodromes. However, measures are in place to mitigate these risks.

Further risk stems from environmental requirements. Heathrow's expansion must not result in an increase in carbon emissions so significant that it would jeopardize the U.K.'s ability to meet its carbon-reduction targets. Given its global scale, Heathrow is already focusing on helping to reduce aviation's carbon footprint. It aims to become carbon neutral by 2020, with a goal of no carbon emissions by 2050; and it also seeks to reduce the number of people affected by aircraft noise. To achieve these targets, Heathrow is encouraging airlines to use quieter, more fuel-efficient modern planes, by adjusting the composition of the aeronautical charges. It is also replacing the routine stacking, designing an optimum combination of arrivals and sequencing, as well as working toward increasing the share of passengers using public transport. Finally, Heathrow is developing the next generation of high-quality, cost-effective carbon offsetting.

We believe the favorable regulatory framework, in combination with strong management and potential support from shareholders, will enable the company to accommodate any financial effect of the above challenges within the current financial metrics.

Reconciliation

Our main analytical adjustments to the consolidated financial statements of Heathrow (SP) Ltd. (the ultimate holding company within the ring-fenced financing group) are described below.

We treat the £2.2 billion intercompany loan between Heathrow (SP) Ltd. and Heathrow Finance PLC-- a holding company outside--the ring-fenced financing group--as equity following the extension of its maturity to December 2030 (the original maturity of the loan was May 2011). The equity treatment reflects that this loan is subordinated and cannot cause a default on the group's secured debt, and that payments are restricted to distribution and the event of covenants defaults in favor of the secured creditors.

Table 6

Reconciliation Of Heathrow (SP) Ltd. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. £)

--Fiscal year ended Dec. 31, 2018--

**Heathrow Funding Ltd.
reported amounts**

	Debt	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Dividends
	15,060.0	1,954.0	1,211.0	825.0	1,885.5	1,711.0	485.0
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	(70.0)	--	--
Cash taxes paid - Other	--	--	--	--	--	--	--
Cash interest paid reported	--	--	--	--	(576.0)	--	--
Accretion on IL bonds, accretion on IL swaps, less interest on debenture	--	--	--	--	(155.0)	--	--
Operating leases commitments (£471.6 is an NPV at 7%)	471.6	50.5	31.7	31.7	(31.7)	18.8	--
Postretirement benefit obligations/ deferred compensation	3.2	(2.0)	(2.0)	3.0	--	--	--
Accessible cash & liquid investments	(711.0)	--	--	--	--	--	--
Capitalized interest	--	--	--	50.0	--	--	--
Nonoperating income - Pension service cost	--	--	2.0	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	(574.0)	--
Index-linked derivative accretion	488.0	--	--	--	--	--	--
Foreign currency swaps	(477.0)	--	--	--	--	--	--
Intercompany loan between Heathrow (SP) Ltd. and Heathrow Finance PLC	(2,191.0)	--	--	--	--	--	--
Home loss provision	7.0	--	--	--	--	--	--
Revaluation gain on investment property	--	(117.0)	(117.0)	--	--	--	--

Table 6

Reconciliation Of Heathrow (SP) Ltd. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. £) (cont.)							
Interest on debenture payable to Heathrow Finance	--	--	--	(109.0)	--	--	--
Increase in the amount owned to Heathrow Finance PLC	--	--	--	--	--	--	(363.0)
Total adjustments	(2,409.2)	(68.5)	(85.3)	(24.3)	(832.7)	(555.2)	(363.0)
S&P Global Ratings' adjusted amounts							
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends paid
	12,650.8	1,885.5	1,125.7	800.7	1,052.8	1,155.8	122.0

NPV--Net present value.

Ratings Score Snapshot

Class A Issue Rating: A-/Negative

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Senior SACP: bbb+

Structural features: +1 notch

Class B Issue Rating: BBB/Negative

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Junior SACP: bbb

Structural features: N/A

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- Bulletin: Brexit Still Weighs On Heathrow Rating, Despite Strong Earnings In 2018, Feb. 25, 2019
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- Bulletin: Heathrow Funding Ltd. Class A And Class B Bond Ratings Unchanged By New Liquidity Facility, May 25, 2018

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