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Research Update:

Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Debt Ratings Placed On CreditWatch With Negative Implications

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Rating Action Overview

- We expect travel restrictions across the globe, weak economic conditions, and social distancing measures related to the COVID-19 pandemic will lead to approximately 55% fewer passengers at Heathrow Airport in 2020 compared to 2019. This is a steeper reduction than we anticipated and the recovery to pre-pandemic levels could take until at least 2023.
- Planned cash preservation and mitigation plans on leverage and interest will partly offset the massive revenue shortfall. Although Heathrow Funding Ltd.'s (HFL) credit metrics in the short term are weaker than in our previous base case, its liquidity remains a rating strength.
- Assuming implementation of these mitigating actions, we expect in 2020 Heathrow's weighted average funds from operations (FFO) to senior debt will be 6.5%-7.5% and FFO to total debt will be 5.0%-6.0%, both calculated as weighted average of respective ratios over 2020-2022.
- We are placing the ratings on HFL's debt on CreditWatch with negative implications.
- The CreditWatch placement reflects the risk of a one-notch downgrade if management does not make progress in executing mitigating actions within the next three months or if traffic volume recovery is weaker than we expect.

Rating Action Rationale

COVID-19-related travel restrictions across the globe, weak economic conditions, and social distancing measures will lead to approximately 55% fewer passengers at Heathrow in 2020 compared to 2019. We expect a significant squeeze on Heathrow's cash flows in 2020 because the airport is likely to service only about 5% of its usual passenger numbers for three months--from about mid-March to mid-June 2020--with flights limited to repatriation and cargo operations. We assume passenger traffic volumes will slowly recover starting in June or July. The loss of cash flows and limited potential to cut costs in the short term given the largely fixed cost base will result in an increase in debt leverage and outweigh controls over operating expenditure

and capital expenditure (capex).

Assuming the 2019 level of traffic returns by 2023 or 2024, and subject to the implementation of mitigating actions, we expect HFL's weighted average over 2020-2022 of annual senior FFO to debt will be 6.5%-7.5% and the weighted average over 2020-2022 of annual FFO to total debt will be 5%-6% over the next two years. Without the mitigating actions, we expect the weighted averages of senior FFO to debt would be 4.5%-5.5% and FFO to total debt would be 3%-4% over the same period.

We think traffic volumes in 2020 are not representative of the long-term credit quality of airports and although the COVID-19 pandemic will likely transform air travel, Heathrow is an essential infrastructure asset with a strong market position and regulated earnings. Therefore, in our ratio calculation, we look beyond the short-term ratios and place more emphasis on 2021 and 2022.

We forecast all revenue streams will suffer over the next two to three years. Compared with 2019, we forecast total revenue to be 50%-55% lower in 2020, 25%-30% lower in 2021, and about 10%-15% lower in 2022. The aeronautical income will depend on traffic volumes and charges per passenger. Heathrow has a regulatory reset as of Jan. 1, 2022. However, although under normal circumstances the regulator could re-baseline revenue by resetting the tariff in the next regulatory period, we think these increases could prove challenging given the economic difficulties airlines will continue facing. While the airlines were willing to pay a premium to land at Heathrow before COVID-19 and the slots were highly valued, following the pandemic, we think airlines–-weakened financially but in stronger negotiating power given lower supply and likely consolidation–-may be unable or unwilling to pay higher aeronautical fees. Non-aeronautical income, which corresponds to about 40% of Heathrow's total, could also drop due to potential deferred lease payments, relief or pauses on tenancies, possible closure of some retail or food and beverage outlets, and lower consumer spend.

EBITDA in 2020 could decline by two thirds from 2019 as high operating leverage limits cost-cutting opportunities. The cost base is largely fixed, with about one third of costs attributable to staff. Heathrow has made 500 senior management members--about 10% of total staff–-redundant, but the scope for further reduction is limited while the airport remains operational because airport staff are needed to ensure safety of operations as long as there is airport traffic. Heathrow put 3,000 of its staff on the U.K. government's salary furlough scheme, which is active until at least October 2020. Heathrow has consolidated operations to T2 and T5 and is operating a single runway, which has reduced maintenance costs. In total, management expects at least a £300 million or 30% operating cost reduction in 2020. Capex in 2020 has been limited to £500 million maintenance costs, which includes demobilizing expansion works, completing some in-flight programs, and implementing critical safety interventions.

As a privately owned airport, Heathrow has more limited financial flexibility and is unlikely to receive state aid. Shareholders, including Ferrovial, which owns a 25% stake, have not commented on providing support. At this stage, there is no danger of triggering an event of default under Heathrow's covenants, at which point creditors could take control over the business, exercise their security, and accelerate debt. The interest cover ratio (ICR) based covenant is tested for an event of default on a past three years rolling average basis. At the testing date of June 30, 2020, the covenant will remain comfortably above 1.05x.

The pace and extent of recovery in air travel remains uncertain with a recovery to pre-COVID levels not before 2023-2024. Although Heathrow has a track record of fast traffic recovery after previous disruptive events such as 9/11, the SARS outbreak, and the global financial crisis of

2008, the scale of the current disruption is unprecedented. Its impact is multidimensional because it comprises a combination of economic (recession), political (border closures and quarantines), and social perception (fear of infection) factors. Difficulties in resolving each of these factors, along with changes in airline capacity, could prolong the recovery from the disruption. Airlines that manage to resume operations after the COVID-19 pandemic has subsided will likely offer reduced capacity both in terms of the number and size of aircraft (focusing on the smaller, newer, more cost-efficient models) and destinations served (focusing on the most profitable routes). Heathrow's traffic volume recovery may be delayed due to very limited participation of domestic traffic, which we expect to start picking up first (see, "Airports Face A Long Haul To Recovery," published May 28, 2020). In the medium term, we think Heathrow is likely to recover faster than smaller or regional airports because airlines will recognize the benefit of the diversity of connections offered by a hub. Some airlines have indicated plans to consolidate their operations at Heathrow.

Heathrow benefits from sound liquidity. HFL's parent, Heathrow (SP) Ltd., reported £2.5 billion cash and £155 million undrawn facilities as at March 31, 2020. This should provide for more than one year of operations with skeleton traffic, given a cash burn--the rate at which the company uses up its cash balances to fund operations, capital, and service debt--of £150 million per month with cost containment measures in place. Before COVID-19, Heathrow burned £250 million per month.

Under our assumptions, we expect Heathrow will trigger a distribution lockup as of the reporting date June 30, 2020 when testing the ICR-based ratio for 12 months to December 2020. Nevertheless, we understand Heathrow is not planning any dividends until it rebounds to profitability, except for £100 million distributed in the first quarter of 2020 on the back of good financial results in 2019 and before the coronavirus outbreak took on a global scale.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Environmental, social and governance (ESG) factors relevant to the rating action:

- Social – Health and safety management factors.

CreditWatch

The CreditWatch placement reflects the likelihood of lowering the ratings for Class A and Class B by one notch if Heathrow does not execute the planned mitigating actions in good time, such that weighted-average S&P Global Ratings-adjusted FFO to debt falls below 7% for the Class A debt and below 5% for the Class B debt. The plan includes a suite of cost-cutting, cash preserving, and mitigating actions on leverage and interest. We could also lower the ratings if passenger volume loss is higher we currently expect.

Upside scenario

We would remove the ratings from CreditWatch and affirm them if:

- Management makes progress in implementing the mitigating actions package by the end of August, supporting FFO to senior debt above 7% and FFO to total debt above 5%; and
- COVID-19-related traffic disruption is contained, risk of a further pandemic peak is reduced, and we observe a strong traffic recovery.

We would assign a stable outlook if the economic situation stabilizes, including visibility regarding rules governing air traffic following the U.K's exit from the EU.

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

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

For 2019, the group's total reported revenue was £3.07 billion, up 3.4% on 2018. Adjusted EBITDA amounted to £1.9 billion, up 2% on 2018. The revenue base mainly comprises aeronautical revenue--approximately 60%--charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, they are subsidized by non-aeronautical income that is generated from retail, car parking, operating the Heathrow Express rail service, and property rental.

Our Base-Case Scenario

Assumptions

- Revenue to decrease by 45%-50% in 2020 as a result of the significant decline in volumes due to lockdown measures in markets served. We anticipate revenue to increase by about 45%-50% year on year in 2021 and by 15%-20% in 2022 as traffic recovers. However, we do not expect revenue to return to 2019 levels until 2024.
- Adjusted EBITDA margins declining toward 43% in 2020 because we do not expect cost-cutting measures and government support initiatives such as furlough schemes to fully offset the decline in revenue, since the cost base is largely fixed, with about one third of costs being staff expenses. The target is to focus on reducing maintenance costs by consolidating operations in T2 and T5 and operate a single runway. Heathrow has stopped non-essential costs and the company is renegotiating all supplier contracts.

- Total capex of about £500 million for 2020 limited to maintenance capex, which reflects demobilizing expansion works and suspending or deferring other projects.
- No distributions planned in 2020 and 2021, except for £100 million already distributed in the first quarter of 2020 before the start of the pandemic.
- Management to implement cash preservation and other mitigation plans on leverage and interest.

Key metrics

Table 1

Heathrow Funding Ltd. -- Key Metrics

	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020e	2021f	2022f
FFO to debt (%)					
Class A and B	8.3	9.0	0.5-1.0	5.5-6.5	5.5-6.5
Class A only	9.3	10.0	1.0-1.5	6.5-7.5	6.5-7.5
Debt to EBITDA (x)					
Class A and B	6.7	6.8	21.0-22.0	9.5-11.5	9.5-11.5
Class A only	N/A	N/A	18.0-20.0	8.5-10.5	8.5-10.5
FFO to cash interest coverage (x)					
Class A and B	2.4	2.8	1.0-2.0	2.0-4.0	2.0-4.0
Class A only	N/A	N/A	1.0-2.0	2.5-4.5	2.5-4.5

All figures adjusted by S&P Global Ratings. 2019 year-end debt comprises net financial debt of £13 billion with key adjustments being £2.5 billion in intercompany loan considered as equity, £345 million in index-linked derivative accretion, and £384 million in leases. a--Actual. e--Estimate. f--Forecast. N/A--Not applicable.

Liquidity

We expect Heathrow (SP) Ltd.'s liquidity to remain adequate, supported by our expectation that its liquidity sources will exceed uses by more than 1.2x in the 12 months to March 31, 2021.

In our view, HFL has a high standing in credit markets, demonstrated by its well-established debt issuance program active in eight currencies and at the senior, junior, and holding company levels. It also has solid and well-established relationships with banks, its banking group includes over 30 banks providing either liquidity and/or hedging capacity. We think this would allow HFL to easily access funding if necessary, even if it was at a higher cost.

We expect principal liquidity sources over the 12 months to March 31, 2021 will include:

- Unrestricted cash and short-term investments of about £2.5 billion;
- Access to about £155 million of undrawn credit facilities at Heathrow (SP) level; and
- FFO of about £200 million, net of lease commitments.

We expect principal liquidity uses over the same period will include:

- Capex of approximately £500 million;
- Debt maturities of approximately £255 million;
- No dividends other than £100 million distributed in Q1 2020; and
- Cash preservation and mitigation plans on leverage and interest.

Covenants

Trigger event ratios are tested twice a year. When tested in either June or December the tested period is always the 12 months ended December that year.

Under our assumptions, we expect Heathrow to breach a trigger event under ICR when tested on June 30, 2020, for the 12 months ended Dec. 31, 2020. The restricted payments will stop immediately after the breach.

This will result in blocking dividends and any payments to subordinated creditors--including on debenture--so no cash can flow to Heathrow Finance. Since debt service costs at Heathrow Finance are £100 million per year, Heathrow Finance would be able to withstand four years without distributions from Heathrow (SP) taking into account that it had £244 million of cash and £273 million of undrawn facilities as of March 31, 2020. The first principal repayment at Heathrow Finance level is in 2024.

The event of default covenants are tested in June only, and on a past three years – ended December that year - rolling average basis. As of the testing date on June 30, 2020, we expect the ICR-based event of default covenant will remain comfortably above 1.05x.

Structural Features

The ring fence includes approximately 10% of junior debt (Class B) that protects senior debtholders. HFL would continue to service Class B debt for as long as there is cash. Given the Class B debt's subordinated status, HFL can defer the principal and interest on Class B indefinitely if there is cash shortfall. Furthermore, the Class A debt benefits from stronger senior-only credit metrics.

This supports our assessment that the 'bbb' senior stand-alone credit profile (SACP) is one notch higher than the 'bbb-' subordinated SACP.

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 "Criteria | Corporates |

Utilities: 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 criteria, due primarily to higher volume risk and the absence of a credit remedy period after triggering an event of default on the intercompany loan, during which creditors take control of the business and stabilize its credit quality or sell the company's shares. However, HFL benefits from the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value prior to default on HFL's debt.

Ratings Score Snapshot

Senior Secured (Class A)

Issue Rating: BBB+/Watch Neg/--

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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Subordinated (Class B)

Issue Rating: BBB-/Watch Neg/--

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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Junior stand-alone credit profile: bbb-

Structural features: None

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Airports Face A Long Haul To Recovery, May 28, 2020
- Heathrow Funding Ltd. Class A Debt Downgraded To 'BBB+'; Class B Debt Downgraded To

'BBB-'; Outlooks Negative, April 1, 2020

- Negative Rating Actions Taken On European Airports Due To COVID-19 Restrictions, March 26, 2020
- U.K. Court's Runway Decision To Have A Limited Impact On Heathrow, March 12, 2020
- Heathrow Funding Ltd. Aug. 9, 2019

Ratings List

Ratings Placed On CreditWatch

	To	From
Heathrow Funding Ltd.		
Senior Secured Class A	BBB+/Watch Neg	BBB+/Negative
Senior Secured Class B	BBB-/Watch Neg	BBB-/Negative

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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