



## Fitch Affirms Heathrow Funding's Class A Notes at 'A-', Outlook Stable

Fitch Ratings-London-31 May 2019: Fitch Ratings has affirmed Heathrow Funding Limited's class A and B bonds at 'A-' and 'BBB', respectively, with Stable Outlooks. Fitch has also affirmed Heathrow Finance PLC's outstanding notes at 'BB+' with a Stable Outlook.

### KEY RATING DRIVERS

The affirmations reflect Heathrow's continued strong operational and financial performance, with traffic growth ahead of Fitch's base case in 2018. Heathrow is a large hub gateway airport serving a strong origin and destination market that experienced a small peak to trough decline of 4.4% in 2008-09. The airport is well maintained but capacity constrained. Its debt structure is protective, secured and ring-fenced. Proven access to capital markets mitigates refinance risk.

The bulk of capex, related to the construction of a third runway, will be concentrated in the next regulatory period H7 (expected to be from 2022-2026) but there is still substantial uncertainty around the final regulatory decisions, including the allowable return on capital (WACC) for H7. Heathrow's cash flow generation and forecast leverage evolution is highly sensitive to WACC changes. However, its ability to reduce or defer shareholder distributions, together with the shareholders' stated commitment to maintaining the existing investment grade rating could mitigate the impact of a reduction on the allowable H7 WACC. We expect greater clarity on the H7 regulatory outcome by the end of 2019.

### Large Hub with Resilient Traffic: Volume Risk - Stronger

Traffic has remained resilient, growing by 2.7% in 2018. Heathrow's maximum peak-trough fall in traffic of just 4.4% through the 2008 economic crisis was due to a combination of factors: the attractiveness of London as a world business centre; the role of Heathrow as a primary hub offering strong yield for its resident airlines; the location and connectivity of Heathrow with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint, which also helps absorb shocks.

### Regulated and Inflation-Linked: Price Risk - Midrange

Heathrow is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, and is currently set at RPI-1.5% for the Q6 regulatory period, which started in April 2014 and will be extended to 2021. The cap is set by an independent regulator, the UK Civil Aviation Authority (CAA), whose duties include ensuring that airports' operations and investments remain financeable and affordable.

The price cap is established to offset Heathrow's significant market power and is highly sensitive to the assumptions made by the regulator on several building blocks, such as cost of capital, traffic forecast and operational efficiency. The regulatory process that leads to the cap determination is transparent but creates material uncertainty each time it is reset.

### Capacity Constrained, Funding Uncertainty: Infrastructure Development/Renewal - Midrange

Heathrow's next regulatory period brings more uncertainty relating to the approval, planning, funding and

execution of the third runway project. We believe that Heathrow's track record of successfully accessing capital markets to secure funding and of delivering capex projects mitigates some of these risks. We also note the regulator's mandate to ensure financeability of capex in addition to affordability to end users as supportive, despite some uncertainty regarding timing and price-recovery of the investment.

#### Refinancing Risk Substantially Mitigated: Debt Structure - Midrange (Class A); Midrange (Class B); Weaker (HY)

The class A debt benefits from its seniority, security, and protective debt structure (ring-fencing of all cash flows and a set of covenants limiting leverage). It is exposed to some hedging and refinancing risk, which is mitigated by the issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities. The class B notes benefit from many of the strong structural features of the class A notes. The HY notes have a weaker debt structure due to their deep structural subordination.

#### Financial Profile

Fitch's rating case five-year average post maintenance interest coverage ratio (PMICR) is 2.0x for the 'A-' rated class A bonds, 1.7x for the 'BBB' rated class B bonds and 1.3x for the 'BB+' rated HY bonds. In the rating case, net senior debt to EBITDA averages about 7.4x but increases substantially from 2018 to 2023, largely driven by the debt-funded capex. However, Heathrow's balance sheet flexibility and/or partial equity funding of expansionary capex could reduce the impact on projected leverage.

#### PEER GROUP

Heathrow is one of the most robust assets in the global sector. It has higher leverage than its European peers (Aéroports de Paris; A+/Stable), albeit with a better debt structure for senior debt. Compared with Gatwick (BBB+/Stable), Heathrow's bonds benefit from a stronger revenue risk profile.

#### RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action:

- Class A notes: net debt to EBITDA consistently above 8x and average PMICR below 1.6x.
- Class B notes: net debt to EBITDA consistently above 9x and average PMICR below 1.3x.
- HY notes: net debt to EBITDA above 10x, PMICR below 1.15x and dividend cover below 3.0x.

Exposure to aviation downturn: A marked and durable degradation of the British economy as a result of uncertainties regarding the Brexit outcome, among other factors, could derail Heathrow's resilience. Evidence of recessionary prospects over two years could prompt negative rating action.

Financing of the third runway: a significant reduction of WACC compared with the current level, with a knock-on impact on projected leverage would be credit negative.

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action:

- Class A notes: net debt to EBITDA below 7x and average PMICR above 1.8x.
- Class B notes: net debt to EBITDA below 8x and average PMICR above 1.5x.
- HY notes: An upgrade is unlikely given Heathrow Finance PLC's management of its capital structure and subsequent targeting of HY investors.

#### CREDIT UPDATE

Revenue grew by 3% in 2018 vs 2017 and opex grew by 0.8%, resulting in EBITDA growth of 4.4% to GBP 1.84 billion from GBP 1.76 billion. Heathrow's regulatory asset base also increased to GBP16.2 billion from GBP15.8 billion. Several recent refinancings have also pushed out debt maturities at attractive rates.

Overall, Heathrow is on track to significantly outperform the original Q6 forecast by about 5.4% in terms of revenue, 4.5% in terms of EBITDA, 5.3% in terms of passengers, underperform by 2.4% in terms of opex, and

delivered additional operational efficiency of 2.8% compared to the Q6 target.

Heathrow has proposed an agreement with airlines for 2020 and 2021, built around rebates overlaid on an extension of the existing RPI-1.5% price path and regulatory framework. The CAA supports this approach in principle and is currently consulting with stakeholders. This deal may allow all parties to focus on H7 and provide Heathrow with some downside protection. In the short term, there will be lower prices for airlines and no negative adjustment of the RAB in 2022.

Planning of the third runway is ongoing and Heathrow is proceeding with stakeholder consultations ahead of submission of its final plan to the CAA in 2020. The CAA plans to provide additional clarity on the regulatory framework in mid-2019. The latest report by independent consultant PWC in February 2019 suggests a significantly lower WACC compared with previous periods, which could strain leverage during the expansion.

#### Fitch Cases

Fitch's rating case from 2019-23 assumes relatively flat traffic consistent with slightly higher airline load factors and the airport's capacity constraint, regulatory price reductions to 2021 overlaid with the proposed airline deal and higher cost of new debt (by 200bp) in 2020 and 2022. We assume a lower WACC for 2022-23, consistent with the CAA's public consultation materials.

Consequently, the largely debt-funded capex which ramps up by 2021 and then again in 2022-23, together with the reset of the Q6 outperformance and the reduction of WACC strains forecast leverage. There is substantial uncertainty around the final regulatory decision and some uncertainty around timing and price recovery of the investment. However, we note positively that Heathrow has additional flexibility not factored into our forecast, including dividend deferral leading up to capex ramp-up and partial funding of the expansion through shareholder contributions.

#### Asset Description

Heathrow is a major global hub airport with significant origin and destination traffic and resilience due to its status as the preferred London airport and capacity constraints. Peers include Aeroports de Paris in terms of size and Gatwick in terms of location and debt structure.

Revenues are regulated and subject to an inflation price cap on a single till basis. We view the structured, secured and covenanted senior debt as offsetting some of the higher expected five-year average leverage under the Fitch rating case for the class A and B bonds compared with peers. The HY bonds are, by nature, structurally subordinated.

#### Contact:

Primary Analyst  
Shyamali Rajivan  
Director  
+44 20 3530 1733  
Fitch Ratings Limited  
30 North Colonnade  
London E14 5GN

Secondary Analyst  
Danilo Quattromani  
Senior Director  
+39 02 879087 275

Committee Chairperson

Ian Dixon  
Managing Director  
+44 20 3530 1815

Media Relations: Athos Larkou, London, Tel: +44 20 3530 1549, Email: [athos.larkou@thefitchgroup.com](mailto:athos.larkou@thefitchgroup.com)

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Applicable Criteria

Airports Rating Criteria (pub. 23 Feb 2018)

Rating Criteria for Infrastructure and Project Finance (pub. 27 Jul 2018)

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