

FITCH AFFIRMS HEATHROW FUNDING BONDS & HEATHROW FINANCE HY

Fitch Ratings-London-14 October 2015: Fitch Ratings has affirmed Heathrow Funding Limited's (Heathrow Funding) bonds issued under its debt issuance programme and Heathrow Finance Plc's (Heathrow Finance or the holdco) high-yield bonds, as follows:

Heathrow Funding Limited

Class A bonds: affirmed at 'A-', Outlook Stable

Class B bonds: affirmed at 'BBB', Outlook Stable

Heathrow Finance plc

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

The affirmations reflect Heathrow's (LHR) strong operational and financial performance to date, mainly due to better-than-expected traffic growth, and to a lesser extent to the efficiencies achieved in operating costs and the lower cost of debt. In 2015, Fitch expects EBITDA to reach GBP1.6bn, growing year-on-year by 2.1% (and by over 5% if excluding the one-off 'K' factor mechanism recoveries of 2014).

KEY RATING DRIVERS

Volume Risk - Stronger

LHR is a large hub/gateway airport serving a strong origin and destination market. Traffic has improved this year, rising 2.3% year-on-year in the first nine months of 2015. This compares to growth of only 1.1% in 2014 (down from 3.4% in 2013).

From a long-term perspective, LHR benefits from resilient traffic performance with a maximum peak-trough fall in traffic of just 4.4% through the recent economic crisis (one of the lowest declines in the industry). This is due to a combination of factors that Fitch views as stable: the attractiveness of London as a world business centre; the role of LHR as a hub offering strong yield for its resident airlines; the location and connectivity of LHR with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint at LHR (with only two runways), which also helps absorb shocks.

Price Risk - Midrange

LHR is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, and is currently set at RPI-1.5% for the new five-year (four years and 9 months) regulatory period, which started in April 2014 (down from RPI+7.5% in the previous Q5 period). The cap is set for five years by an independent regulator, the CAA, which, among its duties, ensures that airports' operations and investments remain financeable.

The price cap is established to offset LHR's significant market power and is highly sensitive to the assumptions made by the regulator on several building blocks such as cost of capital, traffic forecast and operational efficiency. The regulatory process that leads to the cap determination is transparent but creates material uncertainty every five years. Price cap settlements can prove detrimental to the airport, as CAA's assumptions can be aggressive. For example, the traffic forecast for Q5 was calculated before the 2007-2008 crisis and proved overly optimistic. However, this was partly offset by higher than planned inflation.

Infrastructure Development/Renewal - Stronger

LHR aims to implement a detailed capital investment plan, agreed by the regulator. The plan for Q6 with around GBP3.5bn of investment is more modest than Q5 (at over GBP5bn) and Fitch does not expect any major issues, particularly in light of LHR's overall sound track record of delivering projects on time and on budget. The regulated asset base approach allows for the self-financing of the investments through tariffs. With the successful delivery of the brand new terminal T2 in 2014, LHR features mostly state-of-the art terminals.

As announced in July 2015, the Airports Commission has recommended LHR as the site of a new runway for London. The government is expected to make a decision by the end of 2015, but there is no certainty that it will decide in LHR's favour due to local opposition and lobbying by rival Gatwick. If a favourable outcome is decided for LHR, Fitch understands that the planning process would take another five years before any works can begin. In the short to medium term, Fitch does not expect any impacts on the notes' ratings but any developments will be closely monitored.

Debt Structure - Midrange (Class A)/Weaker (Class B and HY)

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

Credit Metrics

Despite better traffic than expected, Fitch's rating case conservatively reflects CAA's final decisions for Q6 for traffic (which assumes potential traffic shocks). Fewer efficiency savings are also assumed in addition to higher cost of new debt (by 200bp) in year 2016 and 2018 (with senior debt all-in-cost at 7.1%), reflecting adverse financing conditions.

Under Fitch's rating case, EBITDA is conservatively expected to remain broadly flat. Fitch's calculated five-year average PMICR for the 'A-' rated class A bonds is 1.8x (up from 1.7x), for the 'BBB' rated class B bonds 1.5x (marginally up) and the 'BB+' rated HY bonds 1.3x with dividend cover at holdco level over 3.0x. The Fitch-calculated net senior leverage ratio drops to below 7x for the next five years (compared to about 7x previously), well within criteria guidance for strong hub airports.

Heathrow is currently benefiting from many favourable economic factors (notably in terms of traffic and cost of debt). If these positive trends continue (and are viewed as sustainable), a change in outlook (or ratings) may be warranted at the next review, particularly for the class A and B notes.

RATING SENSITIVITIES

Downgrade Triggers

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.

Upgrade Triggers

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 LHR's management of its capital structure and subsequent targeting of HY investors.

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Applicable Criteria

Rating Criteria for Airports (pub. 13 Dec 2013)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=725296

Rating Criteria for Infrastructure and Project Finance (pub. 28 Sep 2015)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=870967

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