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Credit Opinion: Heathrow Finance plc

Global Credit Research - 20 Oct 2015

London, United Kingdom

Ratings

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

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Key Indicators

Heathrow Finance plc[1]

	12/31/2014	12/31/2013	12/31/2012	12/31/2011
(FFO + Cash Interest Expense) / (Cash Interest Expense)	2.0x	1.7x	1.5x	1.5x
FFO / Debt	6.0%	4.8%	3.6%	3.3%
Moody's Debt Service Coverage Ratio	1.9x	1.7x	1.5x	1.6x
RCF / Debt	2.8%	-0.8%	0.8%	3.3%
Net Debt / RAB	86.1%	82.9%	82.1%	79.7%
Adjusted Interest Coverage Ratio	1.2x	1.0x	0.9x	0.9x

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Ownership of Heathrow, one of the world's most important hub airports and the largest European airport

- Resilient traffic characteristics of Heathrow

- Long established framework of economic regulation

- Declining capital expenditure programme

- Constrained runway capacity

- High leverage, currently Net Debt to RAB in the mid 80s percent but potentially trending up to the high 80s percent

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

Corporate Profile

The only asset of Heathrow Finance plc ("HF") is its shares in Heathrow (SP) Limited ("HSP"). HSP is a holding company which owns the company that owns London Heathrow Airport ("LHR"). LHR is subject to economic regulation on the UK regulated price-cap utility model, with charges set by the UK Civil Aviation Authority (the "CAA"). HF reported 2014 pre-exceptional EBITDA of GBP1,567m and 31 Dec 2014 RAB of GBP14,860m for LHR. HF is indirectly owned by Heathrow Airport Holdings Limited ("HAH"). HAH is ultimately owned 25% by Ferrovial S.A. (a Spanish infrastructure & construction company), 20.00% by Qatar Holding LLC (a sovereign wealth fund), 12.62% by Caisse de depot et placement du Quebec, 11.20% by the Government of Singapore Investment Corporation (a sovereign wealth fund), 11.18% by Alinda Capital Partners (an infrastructure fund), 10.00% by China Investment Corporation (a sovereign wealth fund) and 10% by the University Superannuation Scheme (a pension scheme).

The HSP group is financed via debt provided through a ring-fenced secured debt financing structure (the "HSP SDF"). HSP can only provide cash to service debt at HF if it complies with the financial terms of the HSP SDF. HF debt holders benefit from a security interest in HF's shares in HSP. HF is currently financed by (1) GBP293m 7.125% Senior Secured Notes due Mar 2017, (2) GBP263m 5.375% Senior Secured Notes due Sep 2019 and (3) GBP250 million 5.75% Senior Secured notes due Mar 2025 (together the "HF Notes"), as well as (4) a GBP77.5m loan facility due Dec 2019, (5) a GBP75m loan facility due Mar 2020 (of which GBP50m remain undrawn), (6) a GBP50m loan facility due Mar 2022 and (7) a GBP50m loan facility due Jul 2025 (together with the HF Notes the "HF Debt"), which together rank pari passu among themselves.

SUMMARY RATING RATIONALE

The Ba1 Corporate Family Rating (CFR) of HF reflects a Probability of Default Rating of Ba2 and a 35% Family-wide loss given default assumption. The CFR is an opinion of the HF group's ability to honour its financial obligations and is assigned to HF as if it had a single class of debt and a single consolidated legal structure. The Ba3 / LGD-5(83%) rating of the HF Notes reflects the structural subordination of the HF Notes and the other HF Debt in the HF group structure versus the HSP SDF.

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

DETAILED RATING CONSIDERATIONS

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

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

As reported by the Civil Aviation Authority, with more than 74 million passengers, LHR accounts for approximately 50% of the London air travel market for the 12 months ending June 2015 (counting Luton Airport as serving London). It should be noted that this somewhat understates LHR's position because of its role as the UK (and Europe's) largest hub airport. Indeed, LHR is also the UK's major gateway airport and the largest European airport by number of passengers. For the 12 months ending June 2015, the CAA reports that LHR accounted for 30% of total UK passenger volumes and handled approximately 80% of all of the UK's scheduled long haul traffic. Its large route network underpins this position, with over 80 airlines operating at LHR, 185 destinations served in 84 countries and five of the top 10 intercontinental routes by number of seats offered touching LHR. LHR therefore serves a geographical area much wider than London.

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

RESILIENT TRAFFIC CHARACTERISTICS

LHR traffic has grown at reasonably constant growth rates over the past 10 years. The standard deviation of the long term average annual passenger growth rate for LHR is 2.2% which evidences low volatility compared to most rated airports in Europe.

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

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

LHR estimates that 36% of LHR's traffic is transfer traffic, with the majority of this traffic captured by British Airways. The resilience of this traffic depends on British Airways's strategy and financial health and on LHR's ability to offer an attractive and competitive environment to transfer passengers. LHR's management has focused on improving passenger experience, with passenger satisfaction improving notably since the opening of Terminal 5. However, capacity constraints might have an impact on LHR's future ability to accommodate new destinations without compromising existing frequencies thereby raising questions over LHR's long-term attractiveness as a hub airport.

LONG ESTABLISHED FRAMEWORK OF ECONOMIC REGULATION

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

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

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

The main highlights from the current regulatory settlement are:

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

2. At the time of the regulatory settlement, LHR's business plan assumed a step up in costs in the first year of Q6 as airline moves to the new Terminal 2 were assumed to be phased over a number of months resulting in a period of relatively inefficient double running of Terminal 1 and Terminal 2. The CAA assumed that the old Terminal 1 space would be closed down in December 2016 and that this closure and other efficiencies would reduce the cost

base progressively over the remainder of Q6. Terminal 1 was in fact closed some 18 months earlier (on 30 June 2015), thereby allowing LHR management to achieve additional savings. Although the overall efficiencies required by the CAA are challenging and assume that by the end of Q6 LHR will operate on a materially lower cost base, about two thirds of the operating efficiencies required during Q6 have already been secured or can be considered as easily achievable. In Moody's view there is a reasonable chance that LHR management will outperform the regulatory settlement in terms of operating efficiencies and non-aeronautical revenues. .

3. The CAA has reduced LHR's cost of capital to reflect an actual and expected lower interest rate environment. The pre-tax, real WACC of 5.35% (4.66% vanilla WACC) is lower than Q5's 6.2% (5.06% vanilla WACC). Much of the difference between these headline figures can be explained by a reduction in corporation tax and a different methodology of determining the WACC. Normalising for these factors, the relevant like-for-like comparator for Q5 is around 5.6%. The remainder of the difference corresponds to lower costs of debt and equity. The risks relating to the lower cost of capital assumption have now substantially been mitigated, as financing costs have remained at historically low levels since the regulatory settlement came into effect, thus allowing LHR to extend its maturity profile and reduce its long-term cost of debt.

DECLINING CAPITAL EXPENDITURE PROGRAMME

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

Although LHR management will undertake investment programmes such as a GBP 350 million investment on new hold baggage screening equipment across the airport and GBP 1 billion in several asset replacement projects, the scale and complexity of the capital expenditure will be noticeably lower than in the recent past, leading to an improvement in HF's free cash position.

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

CONSTRAINED RUNWAY CAPACITY

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

The Airports Commission, an independent commission established in September 2012 to consider how the UK can "maintain its status as an international hub for aviation and immediate actions to improve the use of existing runway capacity in the next 5 years", made a clear and unanimous recommendation to the UK government in July 2015 in favour of expansion at LHR. A governmental response to this recommendation is expected before the end of 2015. .

HIGH LEVERAGE AND SIGNIFICANT DEBT MATURITIES

Overall debt levels remain very high relative to the regulated asset base. As of 30 June 2015, HF's reported leverage stood at 85.1% of LHR's RAB. Although the improvement in HF's free cash position could offer a possibility to reduce its leverage, we expect that leverage will remain high, with the potential to increase. We believe that HF's management will boost dividend distributions to HF's shareholders and service debt higher in the ownership structure, to the extent consistent with its policy to maintain a five percentage point headroom under its leverage covenant level.

The company has issued new notes that incorporate a Net Debt to RAB covenant, which, at 92.5%, is higher than the 90% covenant included in earlier financing arrangements. Over the medium term, the company will have the option to harmonise this covenant at the higher level whilst maintaining a five percentage point headroom under the covenant level, as per its financial policy.

Since the implementation of the HSP SDF, the company has established a bond issuance platform that has been used repeatedly to diversify its sources of financing, issuing bonds in six different currencies and extending the average maturity of its debt. However, over the course of the next 5 years, c. 30% of HF's consolidated debt

(GBP3.8 billion), will become due. This, and the company's high leverage, limit its ability to withstand unexpected external shocks. The ability to continue to secure funding well in advance of upcoming debt maturities will be a key factor in HF's credit profile.

STRUCTURAL CONSIDERATIONS

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

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

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

Liquidity Profile

HF's first debt maturity will be a GBP293m note due in March 2017 (the next maturity beyond that is GBP263m due in September 2019). In the meantime, interest payments will need to be met from cash received from HSP, there are no other sources of cash available and no specific liquidity is kept at HF. HSP will not be permitted to upstream cash to HF if it fails to meet certain tests, generally performance related, but also related to the maintenance of adequate liquidity at HSP.

The liquidity of the HF group as a whole is considered good for at least the next 12 to 18 months. Operating cash flow after tax is significant and positive in each quarter, with a peak over the summer months of each year. As at 30 June 2015, HF group had GBP1,520 million of undrawn revolving credit facilities at HSP with maturities primarily in November 2019 (mostly Class A Debt availability but c. 30% of this amount is available as Class B Debt) with good covenant headroom and GBP869 million in cash and other committed facilities. HSP has very successfully improved its debt maturity profile over the past couple of years, extending the liquidity horizon and increasing the average maturity of its debt. HSP faces maturities of GBP 300 million and EUR 500 million in 2016, though these maturities are largely covered by the group's cash position.

Rating Outlook

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

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

What Could Change the Rating - Up

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

What Could Change the Rating - Down

The Corporate Family Rating and rating of the HF Notes could move down if the HF group were to exhibit a financial profile that evidenced materially higher leverage than currently expected. This could be suggested by a

materially reduced headroom under its Net Debt to RAB covenant or an Adjusted Interest Cover Ratio that is consistently less than 1.0 times.

Rating Factors

Heathrow Finance plc

Privately Managed Airports Industry Grid [1][2]	**Current12/31/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 10/20/2015**	
Factor 1: Concession and Regulatory Frameworks (15%)	**Measure**	**Score**	**Measure**	**Score**
a) Ability to Increase Tariffs		A		A
b) Nature of Ownership / Control		Aaa		Aaa
Factor 2: Market Position (15%)				
a) Size of Service Area		Aa		Aa
b) Economic Strength & Diversity of Service Area		Aaa		Aaa
c) Competition for Travel		Baa		Baa
Factor 3: Service Offering (15%)				
a) Passenger Mix		Baa		Baa
b) Stability of traffic performance		Aa		Aa
c) Carrier Base		Aa		Aa
Factor 4: Capacity and Capital (5%)				
a) Ability to accommodate expected traffic growth		Baa		Baa
Factor 5: Financial Policy (10%)				
a) Financial Policy		Ba		Ba
Factor 6: Leverage and Coverage (40%)				
a) (FFO + Cash Interest Expense) / (Cash Interest Expense)	2.0x	Ba	1.9-2.4x	Ba
b) FFO / Debt	6.0%	Ba	5-7%	Ba
c) Moody's Debt Service Coverage Ratio	1.9x	B	1.7-2.0x	B
d) RCF / Debt	2.8%	B	1-4%	B
Rating:				
Indicated Rating from Grid Factors 1-6		Ba1		Ba1
Rating Lift		0		0
a) Indicated Rating from Grid		Ba1		Ba1
b) Actual Rating Assigned		Ba1		Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] Based on financial data as of 12/31/2014 [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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