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CREDIT OPINION
18 October 2016

Update

Rate this Research

RATINGS

Heathrow Finance plc

Domicile	United Kingdom
Long Term Rating	Ba1
Type	LT Corporate Family Ratings
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Heathrow Finance plc

Update to reflect continued outperformance of regulatory settlement

Summary Rating Rationale

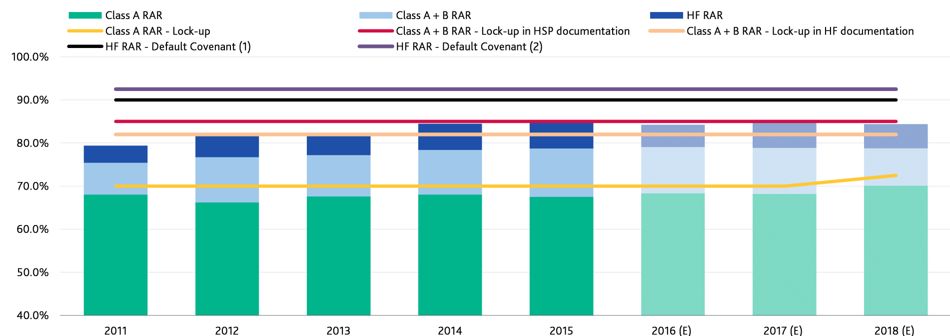
The Ba1 Corporate Family Rating (CFR) of Heathrow Finance plc ("HF") reflects a Probability of Default Rating of Ba2 and a 35% Family-wide loss given default assumption. The CFR is an opinion of the HF group's ability to honour its financial obligations and is assigned to HF as if it had a single class 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 in the HF group structure versus the debt at Heathrow (SP) Limited ("HSP").

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) its long established framework of economic regulation, (3) the resilient traffic characteristics of Heathrow, (4) the capacity constraints the airport faces, (5) the current sustained period of lower capital expenditure levels, (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 secured debt financing structure 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.

Exhibit 1

HF is expected to maintain adequate headroom under its different financial covenants with overall Net Debt to RAB expected to be c. 5 percentage points below the lowest of its default covenants

Class A, class B and HF net debt to RAB (as per covenant calculation)



The 2016, 2017 and 2018 estimates represent Moody's forward view; not the view of the issuer
Source: Moody's Financial Metrics for historical data

Credit Strengths

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

» Long established framework of economic regulation

» Resilient traffic characteristics of Heathrow

» Lower capital expenditure levels until the end of the decade

» 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

Credit Challenges

» Constrained runway capacity could damage LHR's hub status in the long term

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

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.

Factors that Could Lead to an Upgrade

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.

Factors that Could Lead to a Downgrade

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.

Key Indicators

Exhibit 2

Heathrow Finance plc

	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
(FFO + Cash Interest Expense) / (Cash Interest Expense)	2.3x	2.0x	1.7x	1.5x	1.5x
FFO / Debt	6.5%	6.0%	4.8%	3.5%	3.2%
Moody's Debt Service Coverage Ratio	1.8x	1.9x	1.7x	1.5x	1.6x
RCF / Debt	5.0%	2.8%	-0.8%	0.8%	3.2%
Net Debt / RAB [1]	84.9%	84.5%	82.4%	81.6%	79.4%
Adjusted Interest Coverage Ratio	1.3x	1.2x	1.0x	0.9x	0.9x

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations with the exception of [1] which is calculated as per the definition in the financing documentation
Source: Moody's Financial Metrics

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

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Detailed Rating Considerations

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

The HF group owns London Heathrow airport (LHR) in perpetuity, with all key aviation infrastructure controlled by its management. The company owning LHR is a general limited liability company that has no particular legal restrictions in relation to its business activities. 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 75 million passengers, LHR accounts for approximately 48% of the London air travel market for the 12 months ending June 2016 (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 2016, the CAA reports that LHR accounted for 29% of total UK passenger volumes and handled approximately 75% 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 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 the Eurostar's route network and (in the longer term) there is potential for limited competition from domestic high speed rail services.

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 and generates a reasonable return on invested 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 was the first time that the regulatory decision stemmed from the Civil Aviation Act 2012, the parliamentary act that replaced the Airports Act 1986, the regulator, the Civil Aviation Authority (CAA), 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.

Although LHR retains passenger volume risk within each regulatory period, the passenger volume assumptions used by the CAA to calculate aeronautical charges are rebased at every regulatory period. The assumed traffic growth over Q6 is modest to reflect the view that assumed passenger volumes should have built-in contingencies to accommodate one-off negative shocks. The absence of major shocks in Q6 has therefore supported the 3% outperformance of the forecast included in the regulatory settlement recorded since the beginning of the regulaotry period.

The regulatory settlement also incorporates efficiency targets in the form of expected cost reductions and increased commercial revenues. 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 four fifths 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.

Given that financing costs have remained at historically low levels since the regulatory settlement came into effect, Moody's also expects LHR to outperform the financial targets embedded in the regulated allowed return over the asset base.

In March 2016, the CAA launched a review to evaluate the appropriate regulatory arrangements that should apply in the next regulatory period (H7). Given the delay in the UK government's decision over additional runway capacity, industry stakeholders

suggested that an extension of the current price control period should be considered to give an opportunity to reflect in the new settlement any decision on runway capacity expansion. After a period of consultation, the CAA decided in October 2016 to extend Q6 by a one year to the end of 2019, with an additional one-year extension to be considered by the end of June 2017. The CAA's decision provides for the extension of the regulatory period on the same terms, i.e. a price path of RPI-1.5%.

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, one of Europe's most economically robust areas with GDP per capita well 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 32% 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.

Moody's believes that LHR should be well positioned to withstand the short term impacts of the UK's vote to leave the European Union. In the short term, the impact of the referendum result on demand for air travel will be driven by the negative effect uncertainty is likely to have on economic sentiment. This uncertainty is caused by the lack of clarity over the shape of the UK's future economic and trading arrangements with the EU, as well as with other major economies with which the UK has trade arrangements in place by virtue of its current membership of the EU, and the risk the new arrangements prove to be worse for the UK's economic prospects than the current situation.

The most immediate impact of this uncertainty has been a sharp depreciation of the pound against the dollar (-12% between the date of the referendum and the end of September) and the euro (-11% between the date of the referendum and the end of September). This could affect UK residents' travel decisions, as the depreciation makes the cost of holidaying abroad more expensive. On the other hand, a weaker pound could also attract foreign visitors to Britain. The impact on LHR should be, other things being equal, fairly neutral, given that the airport has a balanced inbound-outbound traffic profile with c. 60% of passengers that use LHR residing abroad and the fact that LHR serves London, a major touristic destination.

Uncertainty could also negatively affect both business investment and consumer confidence and spending, which could in turn cause a deceleration of economic growth. The impact of a UK-specific slowdown would be modest given that a majority of the passengers using the airport reside abroad and the relatively high proportion of business passengers using the airport, which typically represent a more stable demand.

Finally, the regulatory regime should offer another mitigant, as the passenger volume forecasts used by the CAA to calculate aeronautical charges are expected to be reset in the next two or three years, providing an opportunity to take into account any enduring negative impact on passenger demand.

Constrained runway capacity could damage LHR's hub status in the long term

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 operation of bigger aircraft, increases in the number of seats on existing aircraft through seat densification programmes or 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. Although the governmental response to this recommendation has been repeatedly delayed, an announcement is now expected by the end of October 2016.

Over the long term, capacity constraints are likely to have an impact on LHR's future ability to accommodate new destinations without compromising existing frequencies, thereby raising questions over its long-term attractiveness as a hub airport. The absence of new runway capacity should not, however, affect LHR's status as the main airport serving London, minimising the risk of traffic volume losses even if transfer traffic declines.

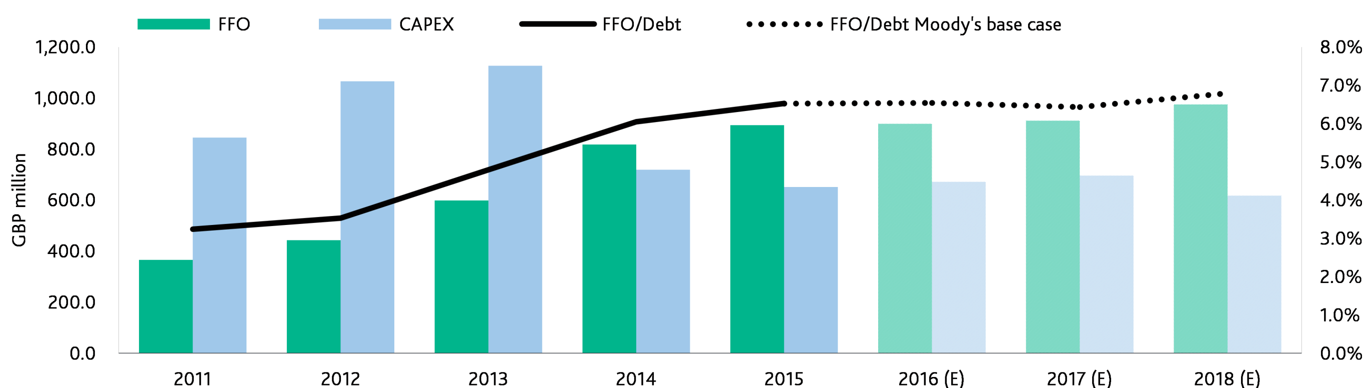
A pause in major capital expenditure until the end of the decade

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 GBP350 million investment on new hold baggage screening equipment across the airport and GBP1 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-flow position.

Exhibit 3

LHR's capital expenditure levels should remain at a lower level until the end of the decade



The 2016, 2017 and 2018 estimates represent Moody's forward view; not the view of the issuer
Source: Moody's Financial Metrics for historical data

Whichever decision is made regarding a new runway, this period of lower capital expenditure should last until the end of the decade. After a government decision to support the construction of a new runway, LHR would need to gain planning consent, a process that is likely to push the bulk of construction operations to the early years of the next decade. On the other hand, if no new runway were to be built, management focus would then likely turn to completing the “toast rack” terminal configuration. The possible extension of the current regulatory period by one year would then also mean that investment levels would not increase until 2020 at the earliest.

High leverage and significant debt maturities

Overall debt levels remain very high relative to the regulated asset base. As of 30 June 2016, HF's reported leverage stood at 85.3% of LHR's RAB. Although the improvement in HF's free cash-flow position could offer a possibility to reduce its leverage, we expect that leverage will remain high. 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.

Recently issued notes 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 plans to harmonise this covenant at the higher level. The maintenance of a five percentage point headroom under the covenant level would then imply an increase in leverage.

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 (GBP4.2 billion), will become due. Although the company has been very successful at managing its liquidity horizon, this high level of maturities 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

HSP is financed via debt provided through a ring-fenced secured debt financing structure (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.

HF is currently financed by (1) GBP276 million 7.125% Senior Secured Notes due Mar 2017, (2) GBP263 million 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 GBP75 million loan facility due Mar 2020, (5) a GBP50 million loan facility due Mar 2022 and (6) a GBP50m loan facility due Jul 2025 (together with the HF Notes the "HF Debt").

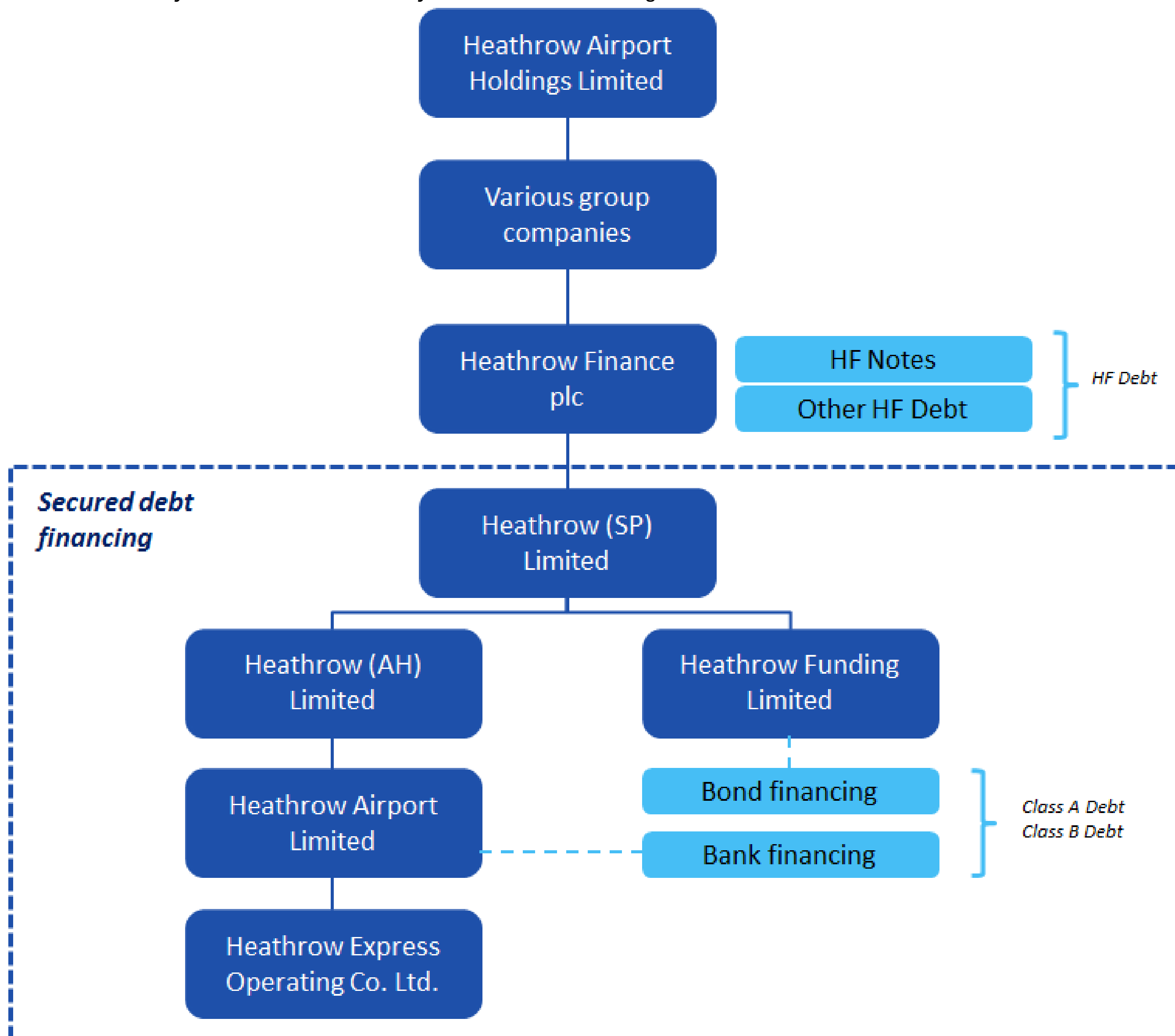
The HF Debt is structurally subordinated to the Class A and Class B Debt and HSP can only provide cash to service debt at HF if it complies with the financial terms of the HSP SDF.

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 Heathrow Airport Holdings Limited (“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 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.

Exhibit 4
Heathrow Finance plc group structure
HF Debt is structurally subordinated to debt issued by HSP's secured debt financing



Source: Moody's

Liquidity Analysis

HF's first debt maturity will be a GBP276 million note due in March 2017 (the next maturity beyond that is GBP263 million due in September 2019). In the meantime, interest payments will need to be met from cash received from HSP, as 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.

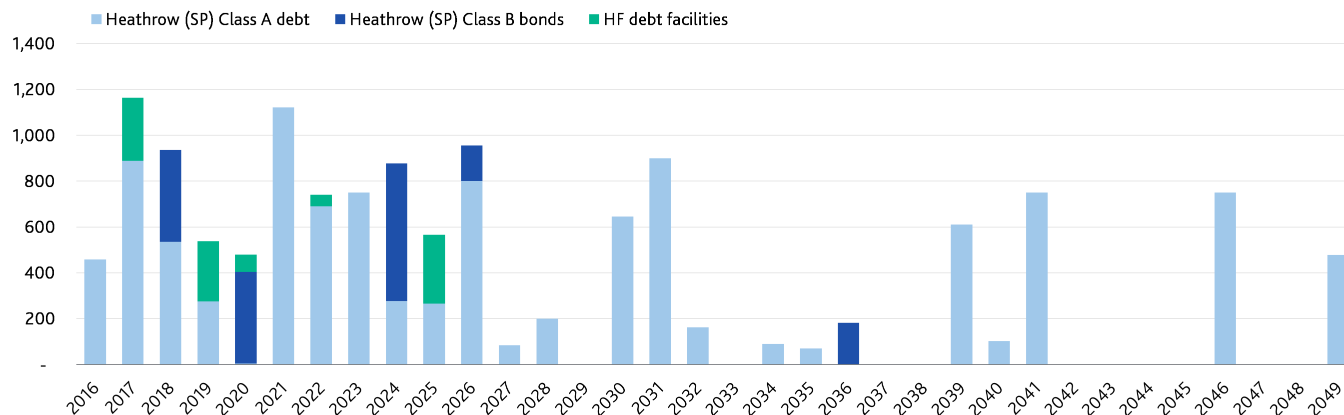
The liquidity of the HF group as a whole is considered good for at least the 18 months. Operating cash flow after tax is significant and positive in each quarter, with a peak over the summer months of each year. As at 30 June 2016, HF group had GBP1,400 million of undrawn revolving credit facilities at HSP maturing in 2020 (mostly Class A Debt availability but c. 30% of this amount is available as Class B Debt) and GBP750 million in standby liquidity facilities, also at HSP. In addition, HSP had GBP587 million in cash and GBP531 million in other committed but undrawn facilities. HF had GBP17 million in cash, as well as GBP150 million and GBP200 million in

committed bank facilities to be drawn in 2016 and 2017 respectively, provinding enough funds to repay the GBP276 million 7.125% Senior Secured Notes due in March 2017.

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 EUR700 million and CHF400 million in 2017, though these maturities are largely covered by the group's cash position.

Exhibit 5

HF Group debt maturity profile (GBP million) as of 30 June 2016



Note: The EUR500 million Class A bond maturing in 2016 was repaid on 12 October

Source: Heathrow Finance plc

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. HF is indirectly owned by Heathrow Airport Holdings Limited ("HAH"). HAH is ultimately owned 25.00% 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 10.00% by the University Superannuation Scheme (a pension scheme).

Rating Methodology and Scorecard Factors

HF's Corporate Family Rating reflects our assessment of the company's business profile and financial performance in line with our Privately Managed Airports and Related Issuers Rating Methodology, published in December 2014.

Exhibit 6

Heathrow Finance plc - Rating Factors Grid

Privately Managed Airports and Related Issuers Industry Grid [1][2]	Current FY 12/31/2015		Moody's 12-18 Month Forward View As of 10/18/2016 [3]	
Factor 1: Concession and Regulatory Frameworks (15%)	**Measure**	**Score**	**Measure**	**Score**
a) Ability to Increase Tariffs	A	A	A	A
b) Nature of Ownership / Control	Aaa	Aaa	Aaa	Aaa
Factor 2: Market Position (15%)				
a) Size of Service Area	Aa	Aa	Aa	Aa
b) Economic Strength & Diversity of Service Area	Aaa	Aaa	Aaa	Aaa
c) Competition for Travel	Baa	Baa	Baa	Baa
Factor 3: Service Offering (15%)				
a) Passenger Mix	Baa	Baa	Baa	Baa
b) Stability of traffic performance	Aa	Aa	Aa	Aa
c) Carrier Base	Aa	Aa	Aa	Aa
Factor 4: Capacity and Capital (5%)				
a) Ability to accommodate expected traffic growth	Baa	Baa	Baa	Baa
Factor 5: Financial Policy (10%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Factor 6: Leverage and Coverage (40%)				
a) (FFO + Cash Interest Expense) / (Cash Interest Expense)	2.3x	Ba	2x - 2.3x	Ba
b) FFO / Debt	6.5%	Ba	6% - 6.6%	Ba
c) Moody's Debt Service Coverage Ratio	1.8x	B	1.7x - 1.8x	B
d) RCF / Debt	5.0%	Ba	2% - 5%	B
Rating:				
Indicated Rating from Grid Factors 1-6		N/A		Ba1
Rating Lift			0	0.0
a) Indicated Rating from Grid		N/A		Ba1
b) Actual Rating Assigned				Ba1

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2015; Source: Moody's Financial Metrics™. [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.
Source: Moody's Financial Metrics

Ratings

Exhibit 7

Category	Moody's Rating
HEATHROW FINANCE PLC	
Outlook	Stable
Corporate Family Rating	Ba1
Senior Secured -Dom Curr	Ba3

Source: Moody's Investors Service

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