STANDARD
&POOR'S

Global Credit Portal®
RatingsDirect®

September 16, 2011

Transaction Update: BAA Funding Ltd.

Up To £50 Billion Multicurrency Program For The Issuance Of Asset-Backed Notes

Primary Credit Analysts:
Olli Rouhiainen, London (44) 20-7176-3769; olli_rouhiainen@standardandpoors.com
Michele Sindico, London (44) 20-7176-3830; michele_sindico@standardandpoors.com

Table Of Contents

Transaction Summary

Surveillance Analysis

Updated Strengths, Concerns, And Mitigating Factors

Updated Business Profile: Excellent, Even After Potential Sale Of Stansted—For Now

Operations: Improved Operational Standards

Profitability—Improving Due To Revenue Growth And Cost-Control

Credit And Cash Flow Evaluation

Corporate And Transaction Structure

Related Criteria And Research

Transaction Update: BAA Funding Ltd.

Up To £50 Billion Multicurrency Program For The Issuance Of Asset-Backed Notes

Ratings Detail

The Issuer

BAA Funding Ltd.

Notes	Current ratings*	Final amount (mil.)§	Interest¶ (%)	Scheduled redemption date§	Maturity date§
A1	A- (sf)/Stable	£299.930	12.45	March 31, 2016	March 31, 2018
A2	A- (sf)/Stable	£249.810	9.200	March 29, 2021	March 29, 2023
A3	A- (sf)/Stable	£199.909	7.075	Aug. 4, 2028	Aug. 4, 2030
A4	A- (sf)/Stable	£899.967	6.450	Dec. 10, 2031	Dec. 10, 2033
A5	A- (sf)/Stable	€999.879	3.975	Feb. 15, 2012	Feb. 15, 2014
A6	A- (sf)/Stable	£396.373	5.850	Nov. 27, 2013	Nov. 27, 2015
A7	A- (sf)/Stable	€749.899	4.600	Sept. 30, 2014	Sept. 30, 2016
A8	A- (sf)/Stable	€749.970	4.600	Feb. 15, 2018	Feb. 15, 2020
A9	A- (sf)/Stable	£749.600	5.225	Feb. 15, 2023	Feb. 15, 2025
A-10	A- (sf)/Stable	£700.000	6.750	Dec. 3, 2026	Dec. 3, 2028
A-11	A- (sf)/Stable	£397.187	Formula that accounts for relevant index-linked UK RPI and 3.334%	Dec. 9, 2039	Dec. 9, 2041
A-12	A- (sf)/Stable	€500.00	4,125	Oct. 12, 2016	Oct. 12, 2018
A-13	A- (sf)/Stable	£750.000	5,875	May 13, 2041	May 13, 2043
A-14	A- (sf)/Stable	$1,000.00	4,875	July 15, 2021	July 15, 2023
B-1	BBB (sf)/Stable	£400.000	6,250	Sept. 10, 2018	Sept. 10, 2018

*Standard & Poor's ratings address timely payment of interest and payment of principal not later than the legal final maturity. ¶The class A notes are subject to a step-up fee from March 2016 (for the class A1 notes), March 2021 (for the class A2 notes), August 2028 (for the class A3 notes), December 2031 (for the class A4 notes), February 2012 (for the class A5 notes), November 2013 (for the class A6 notes), September 2014 (for the class A7 notes), February 2018 (for the class A8 notes), and February 2023 (for the class A9 notes). As part of Standard & Poor's analysis, the step-up fee was modeled fully subordinated to the payments on the class A and B notes and not rated. §Debt totaling no more than 30% of regulatory asset base (RAB) (at issuance) matures during any two-year period, or 50% of RAB (at issuance) within any five-year period.

Transaction Participants

Borrowers	Heathrow Airport Ltd. and Stansted Airport Ltd.
Co-arrangers	The Royal Bank of Scotland PLC and Citigroup Global Markets Ltd.
Borrowers and issuer cash manager	BAA Airports Ltd.
Borrowers' agent	BAA Airports Ltd.
Paying agent and agent bank	Deutsche Bank AG
Facility agent	The Royal Bank of Scotland PLC
Borrowers and issuer security trustee	Deutsche Trustee Co. Ltd.
Borrower liquidity reserve account trustee	Royal Bank of Scotland PLC

Transaction Participants (cont.)	
Principal paying agent and agent bank	Deutsche Bank AG
Issuer's initial hedge counterparty	Banco Bilbao Vizcaya Argentaria S.A.; Banco Santander S.A.; Barclays Bank PLC; BNP Paribas; Bankia S.A.; Crédit Agricole Corporate and Investment Bank; Citibank, N.A. New York, NY, London branch; Deutsche Bank AG; HSBC Bank PLC; Lloyds TSB Bank PLC; Merrill Lynch & Co. Inc.; Morgan Stanley & Co. International PLC; and The Royal Bank of Scotland PLC
Borrowers' initial hedge counterparty	Banco Bilbao Vizcaya Argentaria S.A.; Banco Santander S.A.; BNP Paribas; Bankia S.A.; Crédit Agricole Corporate and Investment Bank; Citibank, N.A. New York, NY, London branch; HSBC Bank PLC; Morgan Stanley & Co. International PLC; and The Royal Bank of Scotland PLC
Issuer and borrowers liquidity facility providers	Lloyds TSB Bank PLC
Issuer's and borrowers' account bank provider	The Royal Bank of Scotland PLC
Shared services provider	BAA Airports Ltd.

Supporting Ratings

Institution/role	Ratings
Bankia S.A. as hedge provider	A-/Stable/A-2
Banco Bilbao Vizcaya Argentaria S.A. as hedge provider	AA/Negative/A-1+
Barclays Bank PLC as hedge provider	AA/Negative/A-1+
Citibank N.A. New York, NY as hedge provider	A+/Negative/A-1
Banco Santander S.A. as hedge provider	AA/Negative/A-1+
BNP Paribas as hedge provider	AA/Negative/A-1+
Crédit Agricole Corporate and Investment Bank as hedge provider	A+/Stable/A-1
HSBC Bank PLC as hedge provider	AA/Stable/A-1+
Deutsche Bank AG as hedge provider	A+/Stable/A-1
Merrill Lynch & Co. Inc. as hedge provider	A/Negative/A-1
The Royal Bank of Scotland PLC as hedge provider and bank account provider	A+/Stable/A-1
Morgan Stanley & Co. International PLC as hedge provider	A+/Negative/A-1
Lloyds TSB Bank PLC as hedge provider and liquidity facility provider	A+/Stable/A-1

Transaction Key Features	
Closing date	Aug. 18, 2008
Collateral	Security in the form of first fixed and floating charges over the securitized assets that include Heathrow and Stansted Airports*, legal mortgages over all real estate, and pledges of shares provided by each entity within the "ringfence"
Country of origination	U.K.
Borrower and issuer combined liquidity facility initial commitment (mil. £)	525

*The sale of Gatwick Airport, previously included in the securitized assets, was completed on Dec. 3, 2009.

Transaction Summary

This transaction update follows Standard & Poor's Rating Services' recent review of BAA Funding Ltd. and the borrowers under the refinancing loan (Heathrow Airport Ltd. and Stansted Airport Ltd.), and a meeting with its management. In June 2011, we affirmed our ratings on all classes of notes in BAA Funding's £50 billion multicurrency program (see "Ratings Affirmed In U.K. Corporate Securitization BAA Funding Following Good Performance To Date," published on June 14, 2011). The first-half results announced July 27, 2011, continue to

show BAA performing in line with our expectations.

The transaction is backed by operating cash flows generated by the borrowers (Heathrow Airport Ltd. and Stansted Airport Ltd.) as the primary source of repayment of an underlying issuer-borrower secured loan. The borrower's main sources of funding are the regulated passenger charges that it levies on airlines in respect of all departing passengers travelling through the airports, as well as charges levied on the airlines in respect of aircraft using the airports. It also collects concession revenues from retailers operating at the airport terminals.

The ratings continue to reflect the underlying business risks of the obligors' assets, as well as the structural enhancements that address the issuer's financial ability to meet full and timely payment of interest and the ultimate repayment of principal for the class A and B notes. As in other corporate securitizations, the future variability of the ratings on the notes depends on factors that include the performance of the underlying operating assets and business risk of the obligors—currently seen as excellent, in our view—which can be influenced by changes in the regulatory framework. These may change over time. Our cash flow assumptions are driven primarily by an assessment of the sustainable long-term performance of this airport business under 'A-' and 'BBB' rating stresses.

Surveillance Analysis

We continue to view the performance of the securitized group including BAA (SP) PLC and its subsidiaries (BAA) to be in line with our expectations and well ahead of our stress analysis. In the first half (H1) of 2011, BAA reported a 7.1% increase in passenger numbers. The improved passenger numbers—combined with high inflation that has allowed BAA to increase passenger charges, and ongoing good performance of its retail operations—helped to boost financial results for BAA. In H1, BAA saw a 12.1% increase in revenues and a 27.1% increase in company-adjusted EBITDA. The company's performance also benefited from the non-recurrence of volcanic ash disturbances and strikes by British Airways' crew. As operating costs grew more slowly than revenues, BAA was able to improve its Standard & Poor's-adjusted EBITDA margins, to 48.9% in H1 2011 from 43.3% in H1 2010. We currently expect BAA to continue to show revenue growth in the remainder of 2011, as we believe passenger numbers will remain robust, and the company is allowed to increase charges to RPI plus 7.5% while maintaining retail revenues. Similarly, we expect BAA to maintain control of costs, and hence the EBITDA margin is likely to remain at least at its current level.

Aside from financial results, BAA has had some challenges. The U.K. Competition Commission reconfirmed its earlier ruling and has required BAA to sell Stansted Airport, with the sale likely to occur in 2012 if request for judicial review is rejected; otherwise, we do not anticipate sale before 2013. BAA also experienced severe winter weather in December 2010, which caused significant traffic issues. We believe that although the disruption caused by snow was severe, it should not have permanently damaged the attraction of the airport for customers. In our opinion, however, further such disruptions could have a negative impact from both customers and the Civil Aviation Authority (CAA), especially if it seemed that the airport had not learned from this experience.

Outlook

The stable outlook for BAA reflects our view that, although the current economic climate is uncertain, we expect key hub airports such as Heathrow to maintain their competitive position during any downturn. Hence, we believe key airports will record lower-than-average volatility in passenger numbers, while the company has a good record in managing operating costs.

There could be negative pressures on our ratings if BAA passenger numbers drop by more than 3%, or if the company's EBITDA drops materially—for example, due to pressure on retail revenues or operating costs.

Currently, we expect BAA Funding to fall short of the EBITDA and cash flow assumptions used for regulatory settlement, mainly because passenger numbers at the airport are significantly below the projections included in the regulatory decisions. This has been mainly caused by the weaker macro economic conditions than anticipated in the regulatory settlement, and somewhat slower-than-anticipated increase in passenger capacity; airlines have been adding more seats for premium services, meaning that larger aircrafts are not carrying as many passengers as anticipated. However, we believe the financial projections remain commensurate with our ratings. We will continue to monitor the ability of the borrower group to maintain strong liquidity and cover future funding needs.

Business risk profile

As a result of our analysis, we still consider the business risk score as "excellent". We now consider this independent from any further asset sale. Our business risk score is mainly driven by the competitive position of Heathrow as one of the biggest hubs in the world, by both traffic and retail revenue. Revenues have proved relatively resilient in the midst of a major period of economic stress. Heathrow also demonstrates a high and increasing EBITDA margin and tested regulatory framework.

This year, the CAA announced a one-year extension of the regulatory period of Heathrow to April 2014. This was in anticipation of the U.K. government passing a law during 2012, which will change the current legislation-driven regulation of the airports to more flexible licensed based regulation giving the CAA more powers. We currently understand that the regulatory change will not negatively affect BAA's credit quality. However, as the bill has not yet been passed, we will monitor the form of the final legislation and the implementation of the regulation by CAA, to see whether the regulation could have implications for BAA.

We have also revised our sensitivities analysis to better capture the downturn in passenger traffic, and to enable us to assess the resilience of BAA's financial structure. We now test the structure to stresses that combine the effects of stress on passenger numbers, deflation, and regulatory penalties. BAA continues to pass these stresses if we assume that the company will retain access to financial markets. As a result, the ratings continue to reflect the assets' underlying business risk and the structural enhancements aimed at mitigating financial and other risks.

In particular, these enhancements include:

- Liquidity facilities provided by a suitably rated counterparty (Lloyds TSB Bank PLC; A+/Stable/A-1). The issuer can access amounts equal to 12 months' class A note interest, the senior expenses, and six months' class B note interest; the borrowing group can access amounts equal to the tranche A interest (that includes hedges, the European Investment Bank loan, and the refinancing facility), the senior expenses, and tranche B refinancing facility interest. The liquidity facilities remain undrawn, and the amount available to be drawn is unchanged;
- An adequate hedging structure provided by appropriately rated counterparties, which allows the issuer to cover its interest rate, inflation rate, and currency exposure; the borrowing group may enter into currency swap agreements to hedge non-sterling debt or capital expenditure in the normal course of business; and
- A package of dividend restriction and financial covenants to moderate the cash that can be paid outside the securitized group.

891115 | 300929821

Operating liquidity

Liquidity at June 30, 2011, was, in our view, adequate. We understand that the borrower group had cash and cash equivalents of £50.3 million, and about £1.7 billion of undrawn committed credit facilities. We believe that this should allow the group to cover its negative free operating cash flow forecast of about £0.3 billion to £0.5 billion in 2011, after an estimated £1.1 billion of capital expenditures (capex) by BAA and interest payments.

Other calls on liquidity include upcoming maturities totaling about £0.9 billion, and potential negative working-capital movements. In our view, BAA's liquidity position could tighten in 2012 if the group is unable to access the markets to fund the upcoming maturities. This analysis does not include the borrower and issuer liquidity facilities (totaling approximately £525 million at June 30, 2011), which can only be drawn in certain circumstances to fund interest payments to secured creditors.

Updated Strengths, Concerns, And Mitigating Factors

Strengths

- BAA has a strong competitive position as the dominant U.K. airport operator and as a key hub in Europe.
- We expect to see a continued supportive regulatory environment and government policies.
- The passenger traffic activity has proven to be relatively resilient at Heathrow, especially in a European context.
- Regulatory tariffs are usually reset every five years, which protects profitability against long-term declines in either passenger volumes or retail revenues, while short-term volatility could still occur if passenger numbers fall below expectations or if retail spend declines.
- The borrower group is ring-fenced from the ultimate parent, BAA, and from the ultimate owners.
- Financial forecasts continue to sustain stress-testing.
- The recent Department for Transport (DfT) announcement and its proposed changes primarily remove the possibility of special administration and hence a potential restructuring event for BAA Funding.

Concerns

- In our opinion, the capital structure can be considered aggressive, with class A and B debt-to-RAB (regulatory asset base) under the documentation allowed to increase to 85%. Over the medium term, while there is junior debt outside the securitization structure, BAA management has indicated that it would run with about 5% headroom to the covenants in the securitization to satisfy covenants included in the debt outside the securitization.
- There is negative free cash flow due to a lumpy capital plan for the foreseeable future, and a consequent need to access the debt markets for additional financing.
- There is a significant and recurrent refinancing risk.
- Under the structure, BAA has limited incentive to aim for debt-protection measures that are materially better than covenant levels, and therefore we expect cash to be returned to shareholders to the maximum extent possible.
- The borrower covenants are more flexible than has traditionally been seen in corporate securitization transactions in the U.K.
- The lenders to the security group may include several different lenders in addition to the capital markets debt. The non-capital market debt includes a capex facility, a working capital facility, a European Investment Bank facility. The coexistence of bank debt and capital market issuance presents additional risks compared with other corporate securitizations: For example, an appointment of an administrative receiver over the borrower group might be challenged. It also causes an increase in tax risks above those generally seen in corporate securitization

transactions with a limited-purpose entity and no third-party debt.
- Tax amounts in relation to group relief are provided by BAA's self-certification. We understand that these amounts will be self-certified.
- Under the share service agreement, there is a potential risk on transfer pricing taxes being payable by the borrower group, the amount of which is difficult to quantify.

Mitigating factors

There is a strong covenant package to protect secured debt holders, including limitations on additional debt and business activities. These include a rating confirmation requirement for acquisitions above certain thresholds, a post-enforcement cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on upstream distributions outside the ring-fence.

The overall debt profile has certain maturity limitations.

Payments to service the subordinated debt will continue to be permitted subject to compliance with the restricted payments test of the securitization.

The additional indebtedness levels are 72.5% for the class A debt (including any additional authorized credit facilities of the borrower group ranking pari passu with class A), and 90.0% for the class B debt (including any additional authorized credit facilities of the borrower group ranking pari passu with class B).

Two levels of financial covenants (distribution lock-up/trigger events, and events of default) provide creditors with significant control over the borrower group at the earliest stage of financial and/or operational difficulty, or of material changes in business circumstances. These covenants aim to prevent administration and minimize the borrower's probability of default, which creates an additional credit cushion.

Liquidity facilities cover 12 months of senior interest and six months of junior interest.

Capex facilities and revolving facilities are designed to cover about 40% of the capital plan at the beginning of each regulatory period (currently, the group has £1.7 billion of available facilities and we expect the group to spend about £3.2 billion capex by the end of the current regulatory period).

Secured lenders to the borrower group acceded to a common terms agreement and a security trust intercreditor deed that pool security and seek to regulate enforcement.

There is a tax deed of covenant that seeks to mitigate risks on secondary tax liabilities.

The self-certification for group tax relief by BAA is limited to 0.5% of total RAB. Any amount in excess of this limit will be certified by an independent advisor.

The risk of transfer pricing taxes being payable under the share service agreement has been mitigated by the fact that, firstly, the regulator has historically accepted the mark-up applied to the borrower group by BAA. Secondly, BAA has operated this practice since privatization and HM Revenue & Customs has never challenged the basis—which in our view should mean that HM Revenue & Customs is unlikely to challenge this position now.

The transaction legal opinions confirmed that the transaction benefits from a capital markets exemption and, notwithstanding the inclusion of bank debt in the transaction, an administrative receiver could be validly appointed in the event of the enforcement of loan security for the companies included in the borrower group.

Updated Business Profile: Excellent, Even After Potential Sale Of Stansted—For Now

We consider that BAA's business profile remains "excellent".

This reflects our view that Heathrow benefits from an unrivalled competitive position as the largest hub airport in Europe. It will continue to attract high traffic levels, has demonstrated traffic and retail revenue resilience in the midst of a major period of economic stress, and benefits from supportive single-till regulation. Heathrow also benefits from a strong catchment area with good public transportation links. We also believe that although Stansted airport is more volatile than Heathrow in terms of passenger volumes, it provides some diversification benefits.

In our view, the potential sale of Stansted is likely to increase predictability of revenues in the short term, since Heathrow is operating at capacity and is unlikely to see any material decrease in demand—while Stansted could see more volatility due to its function as a low-cost airport. We will, however, keep monitoring the potential sale of Stansted, and whether having three competing airports in London will change the way the regulator (CAA) will treat BAA. Specifically, we will monitor the setting of the regulatory rate of return and capex for the next regulatory period starting April 1, 2014.

Elements supporting the business risk profile include:

- London being a major business and tourist destination;
- Heathrow being the key U.K. hub operations for the three global airline alliances;
- A solid, tested, regulation;
- A solid management team with a track record of operational improvement after a difficult start and a cost-cutting plan; and
- A high and increasing EBITDA margin.

Heathrow Airport remains the busiest airport in Europe, handling 68.7 million passengers in the 12 months to Aug. 31, 2011.

As an operating business, the BAA group will continue to face challenges, including the execution of a large capex program. In our opinion, this is likely to result in negative free cash flow generation for at least the current regulatory period, and therefore a rising absolute level of debt. Other challenges include continuing to maintain Heathrow as the most attractive airport in London. We therefore need to rely on the management of the BAA group to take the right strategic decision to maintain its excellent business risk profile. The successful execution of the capex program at Heathrow is a key challenge, as will be maintaining a competitive position as the aviation market evolves. Other medium- to long-term competitive threats stem from other airports pursuing an expansion and hub strategy in Europe or in the Middle East—although this would only impact transfer traffic at Heathrow, which accounts for about one-third of overall traffic.

Competitive position: Maintained through the economic downturn, but there are potential clouds in the future

During the economic downturn in late 2008 and 2009, Heathrow showed that its hub status makes it more flexible during downturns—when O&D (origin and destination) traffic is weak—to offer more attractive transfer services. We also note that in times of stress, airlines retrench from the regional and second-tier operators and preserve their operations in key hubs. This is due to the value of slots and to retain a critical mass, which is the rationale of hubs'

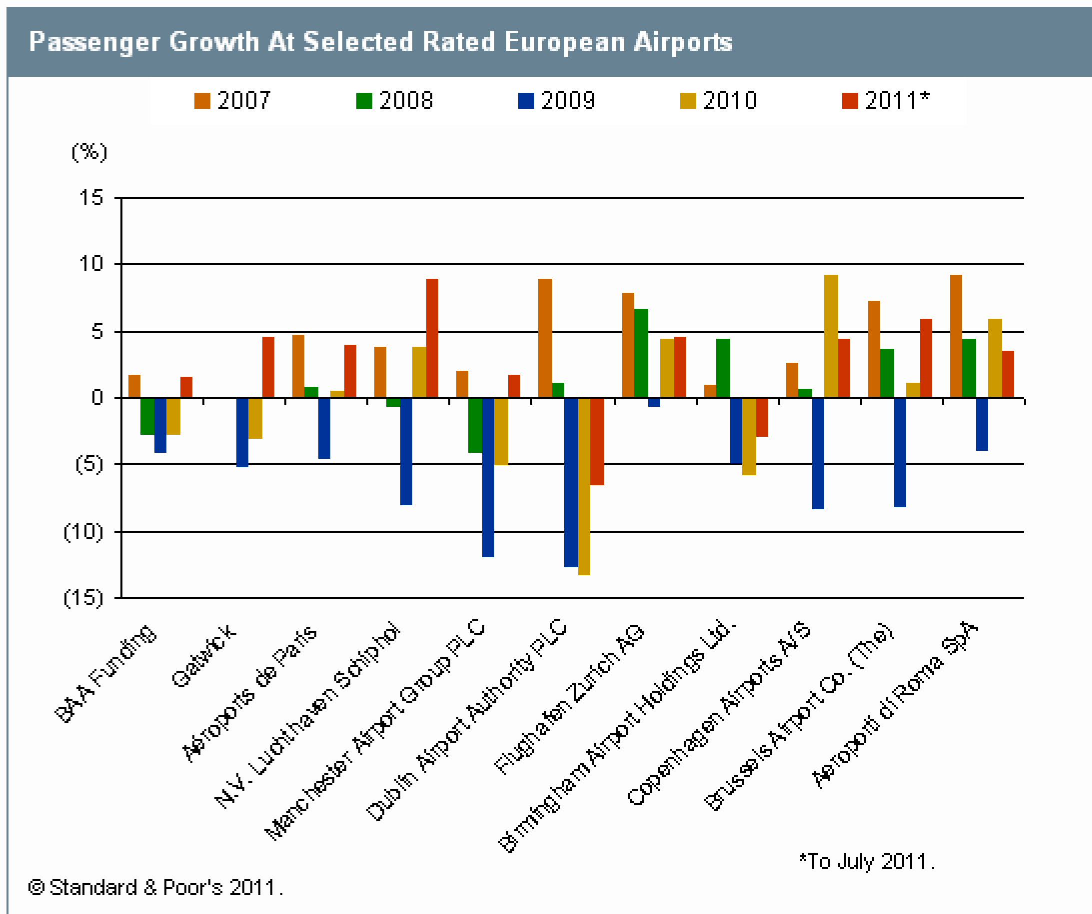
operations. Hubs offer a high number of routes, optimize aircraft turnaround and occupancy, and typically maximize airlines' yields.

We do not see the change in ownership of Stansted a key issue for Heathrow in the medium term, as illustrated by the limited impact of the sale of Gatwick so far on Heathrow's performance. We believe that Heathrow's hub nature and its wealthy catchment area set it aside from Gatwick. In our view, Heathrow also serves a less cost-conscious customer than the other two major London airports. This, combined with the hub nature of the airport, allows airlines to gain higher yields at Heathrow than any other London airport. However, we see some threats to Heathrow in the future:

- More passengers could move to other airports if Heathrow's charges continue to rise significantly faster than other airports, leading to a further increase in price differential on flying out of Heathrow.
- Similarly, if Heathrow's management does not maintain suitable operating standards, and hence customer satisfaction, this could lead to Stansted and Gatwick chipping away at Heathrow's customer base.

On transfer traffic, BAA's Heathrow competes mainly with Europe's other major international hub airports, most notably Frankfurt, Amsterdam Airport Schiphol, and Paris Charles de Gaulle (CDG) (see chart 1). Capacity constraints at Heathrow have somewhat affected its competitive position. In addition, the number of destinations served by Heathrow lags behind those of CDG, Frankfurt, and Schiphol. BAA, however, has a higher-frequency service to major destinations, which is an important factor for both travelers and airlines because it gives a choice of connections. In addition, Heathrow is less exposed than its peers to competition from transfer passengers.

Chart 1



Heathrow's performance has continued to be robust in 2011, after a predictable performance in 2010. Heathrow Airport has seen 6.8% growth in passenger numbers in the eight months to August 2011 and recorded its busiest August on record. Over the past 12 months to August, Heathrow handled 68.7 million passengers. Stansted's fortunes have contrasted with Heathrow's, and the airport has continued to be under pressure as low-cost airlines and passengers have moved aircrafts away from the airport to serve other routes. Stansted has seen passenger volumes down by 1.8% so far in 2011—although this drop is more significant when we consider the boost to passenger numbers in April 2011 relative to April 2010, when they were hit by the Icelandic ash cloud. In the month of August, Stansted saw passenger volumes drop by 5.1%, which is a tough start for the important summer season.

Regulation continues to support the ratings

We continue to view regulation as one of the key supporting factors for BAA's "excellent" business risk profile, with the single-till model moderating the impact of its passenger traffic and spending over the medium term. In our view, the potential introduction of a license-based regime should be neutral to BAA's business risk profile, unless it leads to lower regulatory returns, materially increases the potential for penalty payments, or increases cash flow volatility.

We expect the U.K. regulatory framework to change in the short term, with the current primary legislation-driven regulation changed into more flexible, license-based regulation. The changes will be made into legislation via the Airports Economic Regulation Bill, which is expected to go through parliament in 2012. We expect that the

891115 | 300929821

regulatory change will materially increase the CAA's powers as the regulator. In our view, the license-based regime initially will not materially affect BAA's business risk profile, as we believe that key factors to our analysis—including single-till regulation, a regulatory rate of return, and the five-yearly reset—will remain, and other factors that could cause materially higher earnings volatility will not be introduced initially. In our view, however, changes are possible in the future as the competitive environment among London airports evolves. For example, we have seen moves in other European countries toward dual-till type regulation. If this continues, we would need to assess the impact of any material changes to regulation at that time.

In June 2011, the CAA announced that it will be extending the current regulatory period by one year to March 2014 to allow it more time to consider the new, licensed-based regulation. We view the extension of the current regulatory period as neutral for Heathrow, as the airport maintains its price formula of RPI plus 7.5% and is committed to spending capex of £735 million, in line with our expectations for the year.

During July 2011, the U.K. Competition Commission upheld its decision after a review that BAA should sell Stansted Airport and one of Glasgow or Edinburgh airports (outside the securitization). Although BAA could ask for a judicial review, which could delay the process, our base case conservatively assumes that BAA will sell Stansted Airport following the completion of the process.

Operations: Improved Operational Standards

Operational performance improved significantly in 2010, excluding the severe snow closure during the Christmas holidays. During the regulatory year to March 2011, BAA paid only £0.7 million as quality rebates as per the regulatory accounts for Heathrow, and £0.3 million for Stansted.

At Heathrow, the proportion of aircraft departing within 15 minutes of schedule decreased to about 71% in the year to December 2010 (2009: 77%), and at Stansted it remained at 78% (2009: 82%). The decline at Heathrow was due to weak performance in July 2010, and the snow disruption in December 2010 that left the airport closed or partially closed for five days.

Other key operational and service standards have remained at 2009 levels, having seen some improvement offset by weaker performance over the winter months. At Heathrow, the baggage misconnection rate dropped to about 17 bags per 1,000 passengers in 2010 from 19 bags in 2009, while about 97% of customers waited less than five minutes to clear security. These improvements in service standards are reflected in recent results in the independent Airport Service Quality surveys produced by Airports Council International, where Heathrow maintained its position compared with peers.

Capital investment plan

In our view, BAA has a lumpy capex plan ahead of it, almost exclusively at Heathrow Airport.

In 2010, the main focus of the group's investment program continued to be at Heathrow. The group invested £841.1 million in capex (2009: £1,002.8 million—including £127.1 million at Gatwick), with £818.7 million at Heathrow and £22.4 million at Stansted. The major projects at Heathrow included the construction of Terminal 5C and Terminal 2,and the baggage tunnel connecting Terminals 3 and 5. Terminal 5C has successfully opened and is now in use by BA. There were various other projects across the rest of the Heathrow campus, such as the Terminal 4 refurbishment and the improvement of check-in capacity associated with airline relocations. Capex at Stansted was mainly used for maintenance and modernization of the airport.

We estimate that BAA will spend about £1.0 billion–£1.2 billion in capex each year over the next two-and-a-half years, with capex moderating to £735 million in the extension year as agreed with airlines and the CAA. The majority of this spend will be at Heathrow due to the construction of a new Terminal 2, which will provide similar facilities to Terminal 5 and will mainly be used by Star Alliance carriers.

Profitability—Improving Due To Revenue Growth And Cost-Control

BAA is currently underperforming with respect to the CAA's operating expenses forecasts. In the regulatory year to March 31, 2011, BAA's operating costs were £38 million above CAA's 2008 decision (equal to 4% of total operating costs). Revenues were lower than the 2008 decision mainly due to lower-than-anticipated passenger growth, which could not be offset by strong retail performance.

BAA's adjusted EBITDA margins increased to 48.0% in the financial year to Dec. 31, 2010, from 45.3% in 2009. This was mainly driven by revenues growing significantly above inflation while costs were growing more slowly. We would anticipate that BAA will continue to manage its cost base and either maintain or improve its EBITDA margins going forward.

BAA's margins are toward the top end of its peer group, including rated European airports. For example, the key peers with "excellent" business risk profiles—Aeroports de Paris and N.V. Luchthaven Schiphol—reported EBITDA margins of 34.5% and 40.4%, respectively.

Credit And Cash Flow Evaluation

As of Dec. 31, 2010, the group's reported securitized total debt amounted to £9.9 billion (up about 16% year on year. This was primarily driven by the upstreaming of cash from the securitized structure to BAA (SP) Ltd., to reduce debt at this level (accounting for about 10% of the overall increase), and the negative free cash flow due to high capital expenditures.

At Dec. 31, 2010, the group's senior and junior gearing ratios (nominal net debt to RAB) were 68.8% and 77.7%, compared with trigger levels of 70% and 85%. The company experienced some weakening in these ratios due to the same factors, which drove up overall debt levels. The group has the flexibility to manage the senior gearing ratio, using the currently undrawn junior debt tranche of the capex facility up to the lower of £400 million and the level of senior debt drawings.

In the year ended Dec. 31, 2010, the group's senior and junior interest cover ratios (the ratio of cash flow from operations, minus tax paid and 2% of RAB to interest paid) were 2.080x and 1.85x, compared with trigger levels of 1.40x and 1.20x.

Under our base case assumption, we expect the company to continue to maintain compliance with all the covenants, but on a debt-to-RAB basis we expect it to increase leverage within the securitization to nearly 70% on a senior debt basis, and to nearly 80% on a junior debt basis. Due to the increased debt, we expect a moderate decline in interest cover ratios, but we believe these should maintain at least 10% headroom to trigger levels.

Adjusted funds from operations (FFO) fell to £451.3 million in 2010 from £483.8 million a year earlier, on the back of higher indexation on index-linked debt. Capex reduced to £841.1 million in 2010 from about £1 billion in 2009,

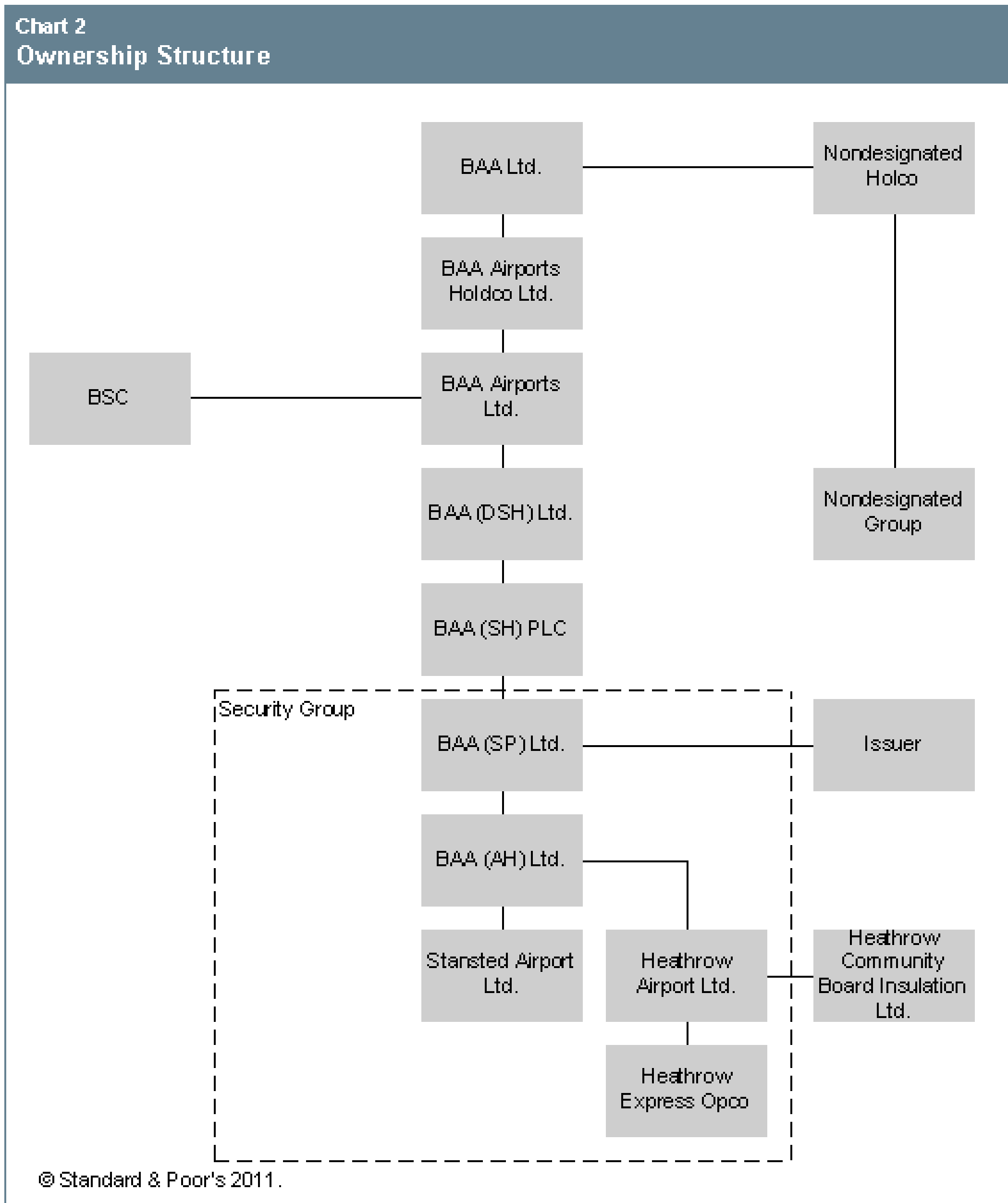
891115 | 300929821

as anticipated due to the sale of Gatwick, and continues to track the regulator settlement. This helped to narrow the negative free cash flow in 2010 compared with 2009, to negative £260.6 million. However, we expect capex to increase again in 2011 due to investment in Terminal 2. Net interest paid in the year ended Dec. 31, 2010, was £393.8 million (2008: £512.9 million). This consisted of £326.2 million paid primarily in relation to external debt, and £67.6 million under the debenture between BAA (SP) and BAA (SH) PLC. We treat this latter interest as dividend, as it is subject to compliance with the restricted payment condition: In case of underperformance and breach of this condition, the interest on the debenture will no longer be paid without leading to the default of BAA Funding.

BAA's progress in refinancing the initial acquisition debt has been good during 2010 and in the first half of 2011. The company accessed the market for the first time with class B issuance in September 2010, followed by successful issuance of class A debt. In June 2011, BAA successfully issued its first dollar-denominated bond to the U.S. market, widening the pool of funds accessible to the company. The refinancing facility was fully repaid in September 2011.

Corporate And Transaction Structure

BAA Funding Ltd. is a wholly-owned subsidiary of BAA Ltd., which is itself controlled by a Ferrovial-led consortium that acquired BAA in 2006. The principal activity of BAA, its holding companies, and its subsidiaries (the BAA group) is the provision and management of various airport facilities in the U.K., including London's Heathrow and Stansted airports. The BAA group also owns and operates the Heathrow Express, a rail link connecting Heathrow and central London. The designated airports and the rail link are collectively referred to as the "securitized assets" (see chart 2).



This transaction was made under a secured-loan structure, comprising a borrower group and an issuer, which is bankruptcy-remote to our rating standard. The issuer (BAA Funding) issues the rated debt and grants a loan to the borrower group. The issuer satisfies our special-purpose entity and bankruptcy-remoteness criteria (see "European Legal Criteria For Structured Finance Transactions," published on Aug. 28, 2008).

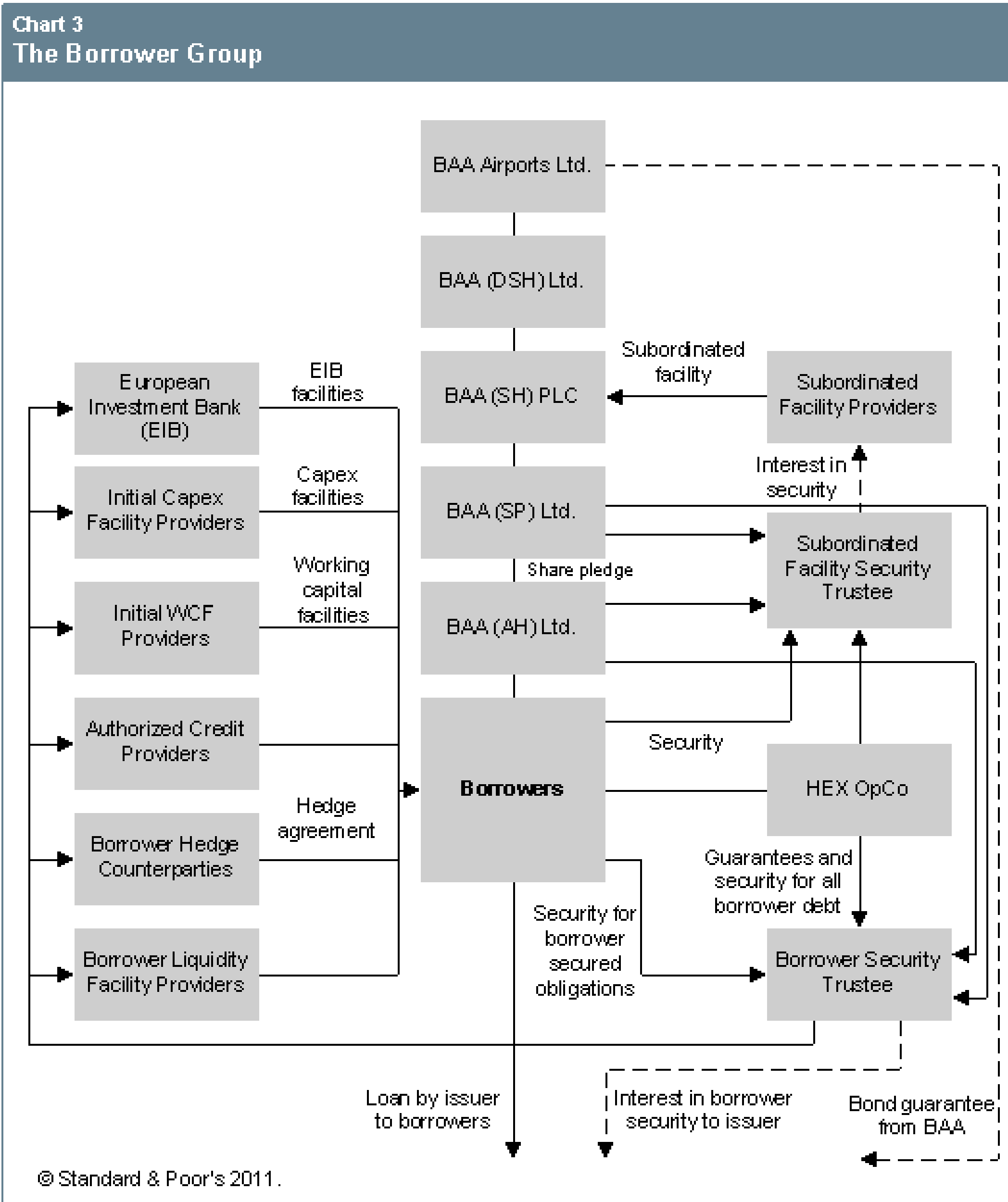
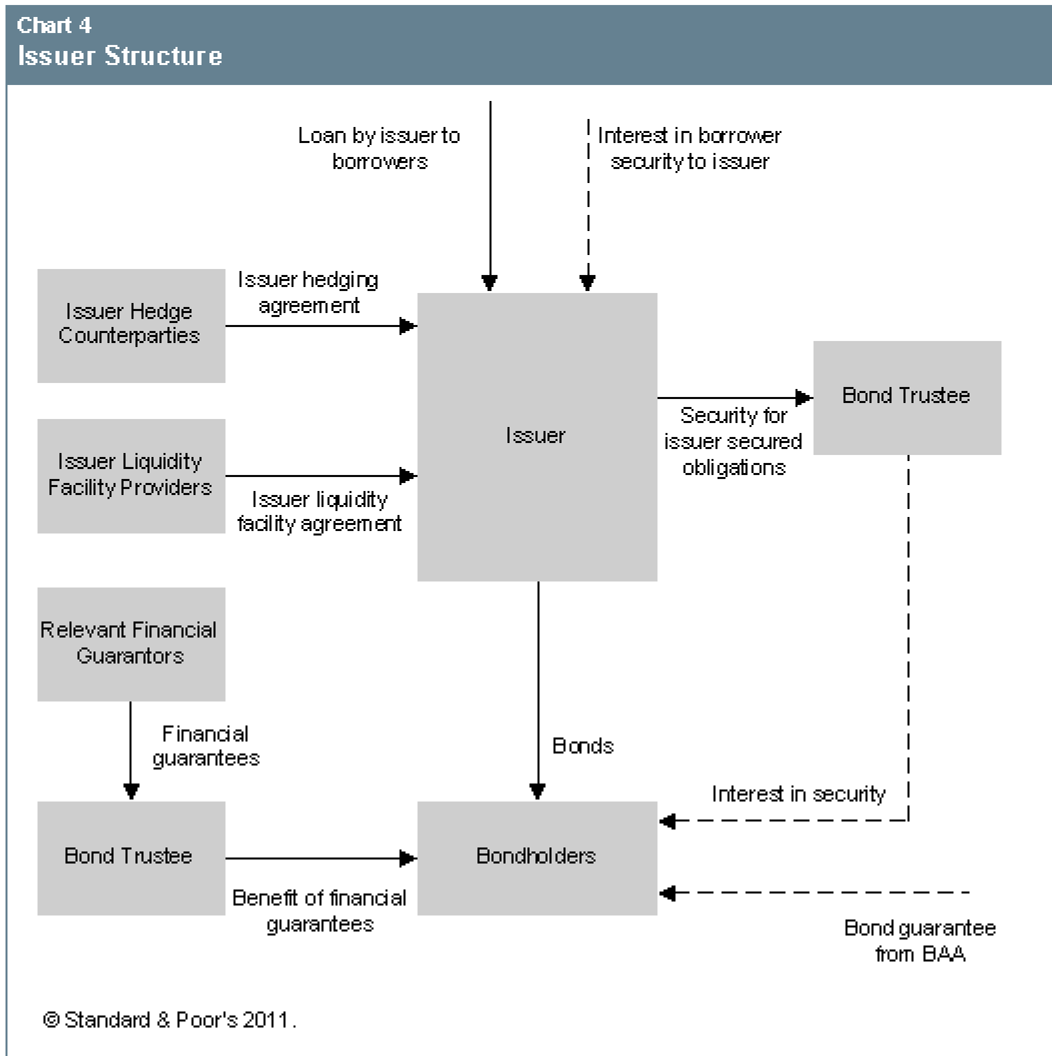


Chart 3
The Borrower Group
BAA Airports Ltd.
BAA (DSH) Ltd.
BAA (SH) PLC
BAA (SP) Ltd.
BAA (AH) Ltd.
Borrowers
European Investment Bank (EIB)
EIB facilities
Initial Capex Facility Providers
Capex facilities
Initial WCF Providers
Working capital facilities
Authorized Credit Providers
Borrower Hedge Counterparties
Hedge agreement
Borrower Liquidity Facility Providers
Subordinated facility
Subordinated Facility Providers
Interest in security
Subordinated Facility Security Trustee
Share pledge
Security
HEX OpCo
Guarantees and security for all borrower debt
Borrower Security Trustee
Security for borrower secured obligations
Loan by issuer to borrowers
Interest in borrower security to issuer
Bond guarantee from BAA
© Standard & Poor's 2011.



Full details of the BAA Funding transaction, including a definition of the covenants and details on past performance, are available in the new issue report and previous transaction updates (see "Related Criteria And Research").

Related Criteria And Research

- Ratings Affirmed In U.K. Corporate Securitization BAA Funding Following Good Performance To Date, June 14, 2011
- Transaction Update: BAA Funding Ltd., March 10, 2010
- Industry Report Card: A Protracted Return To Growth For European Airports, Feb. 25, 2010
- Industry Report Card: Somber Outlook Persists For Some European Corporate Securitizations To October 2009, Oct. 14, 2009
- BAA Funding Ltd. Debt Issues Assigned Negative Outlook On Dept. for Transport Consultation Paper; All Ratings Affirmed, March 12, 2009
- European Legal Criteria For Structured Finance Transactions, Aug. 28, 2008

- New Issue: BAA Funding Ltd., Aug. 26, 2008
- Methodology For Rating And Surveilling European Corporate Securitizations, Jan. 23, 2008
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Overview Of Legal And Analytical Challenges In Rating U.K. Corporate Securitizations, Jan. 18, 2007
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Related articles are available on RatingsDirect. Criteria, presales, servicer evaluations, and ratings information can also be found on Standard & Poor's Web site at www.standardandpoors.com. Alternatively, call one of the following Standard & Poor's 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) 495-783-4011.

Additional Contacts:
Structured Finance Europe; StructuredFinanceEurope@standardandpoors.com
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Additional Contacts:
Structured Finance Europe; StructuredFinanceEurope@standardandpoors.com
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Copyright © 2011 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

The McGraw·Hill Companies