Ratings On All Notes In Heathrow Funding Deal Affirmed; Outlook Stable

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OVERVIEW

- Today's rating actions follow our review of Heathrow Funding Ltd.'s (Heathrow's) operating and financial performance.
- Following our review, we have affirmed our 'A- (sf)' rating on the class A notes and our 'BBB (sf)' rating on the class B notes issued by Heathrow under its £50 billion program.
- Heathrow is a corporate securitization, which grants bondholders first-ranking security over Heathrow airport and the Heathrow Express rail link.

LONDON (Standard & Poor's) Oct. 25, 2013--Standard & Poor's Ratings Services today affirmed its 'A- (sf)' rating on the class A notes and its 'BBB (sf)' rating on the class B notes issued by Heathrow Funding Ltd. (Heathrow). The outlook is stable (see list below).

These rating actions follow our review of Heathrow's performance, which continues to align with our expectations. Heathrow ended financial year 2012 with 70 million passengers, an increase of 0.9% year-on-year, which we consider to be a stable growth figure. The traffic data as of the first nine months of 2013 showed a 3.6% increase when compared to the first nine months of 2012 and represents a step closer to the 71.4 million passenger mark that was forecast by management for the full year. The traffic growth in 2013 was largely driven by increased aircraft size as larger aircrafts started to be deployed, particularly on Middle Eastern routes. It can also be attributed to the increased traffic in Europe that followed British Airways' acquisition of

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Bmi and the return in passenger demand this year, in the months corresponding to last year's Olympic Games. Heathrow's operational performance translates into revenue growth of 10.7% to £1.8 billion and EBITDA growth of 22% to £1 billion in the first nine months of 2013.

We continue to view Heathrow's business risk profile as "excellent," reflecting its strong competitive position and supportive regulatory regime. These positive features have made performance less vulnerable to economic conditions and operational disturbances. We maintain this view, despite the Civil Aviation Authority (CAA)'s latest proposal for regulation, which suggests capping charges at retail price inflation (RPI). This level is higher than the cap level suggested in April 2013 (RPI -1.3%) but significantly below both the cap level applicable during the current regulatory period and the level proposed by Heathrow for the next one.

Under our base-case scenario, this RPI formula, combined with the lower capital expenditure (capex) levels forecast by the CAA in its latest proposal, and our assumptions of modest passenger growth at around 1% per year and RPI between 2%-3%, would lead to positive free operating cash flows for the second half of the new regulatory period. This would support the "excellent" business risk profile. We have not fully captured into our near-term forecast the costs savings included in the business plans.

Under the terms of the financing, Heathrow can issue:

- Senior debt (class A notes plus any senior debt issued by the borrower group, ranking pari passu with the class A notes), up to a debt-to-regulatory asset base (RAB) of 70.0% before April 1, 2018, and 72.5% thereafter; and
- Total debt (senior debt and class B notes plus any junior debt issued by the borrower group, ranking pari passu with the class B notes), up to an aggregate debt-to-RAB of 85%.

Currently, the senior and junior leverage ratios stand at 67.8% and 77.9%, respectively. These compare with ratios of 66.2% and 76.7% as of December 2012. The disposal of Stansted Airport by the securitization group, and the application of the proceeds, led to a 4.3% decrease in the securitization group's debt during the six months ended June 30, 2013. Since then, however, the net gearing has increased primarily due to the effect of restricted payments, interest payments, and capex.

Under our base-case scenario, we expect the company to continue complying with these covenants. However, 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, in our base-case scenario we expect a decline in interest cover ratios, but we believe these should maintain some headroom under trigger levels.

In our opinion though, the capital structure remains aggressive in nature. Therefore, when submitted to a mix of stresses deemed commensurate with the rating of the notes, it shows signs of weakness--in particular during periods of deflation, and under stressed cost of debt and stressed RPI-hedging assumptions. In none of these cases, however, would the notes be exposed to a default in payment or a breach of the financial default ratios at the current rating levels and under the current regulatory architecture.

Our analysis assumes continued access to the markets to refinance debt coming due, restricted payments and operational losses. Refinancing risk is therefore the main risk factor in our analysis, which we currently deem to be somewhat mitigated, primarily by the fact that debt must remain at a constant proportion of RAB. This makes for a relatively stable and predictable asset valuation proxy.

The stable outlook reflects our view that Heathrow will perform robustly over the next two years in terms of passenger numbers, regulatory performance, and profitability.

We could take a negative action should, over time, the regulatory framework substantially vary and become less supportive of Heathrow's ability to finance its operations in the banking and capital markets. That said, in such a scenario, we believe that the weaker debt structure of class B notes makes them more exposed to rating pressure. We could also take a negative rating action if the company is faced with an operational shock that leads to a significant reduction in passenger volumes, or if it is met with material regulatory penalties due to its failure to meet regulatory targets.

At this stage, we believe there is limited scope for higher ratings on Heathrow's notes, as the financial covenants set in the bond program allow Heathrow to operate at high leverage.

Heathrow is a corporate securitization that grants bondholders first-ranking security over Heathrow airport and the Heathrow Express rail link. The transaction closed in 2008. Since then, Heathrow has been periodically issuing further debt in accordance with its previously stated intention to refinance part of its bank debt with capital markets issuance. This serves to lengthen the group's debt maturity profile. Principal and interest for the financing group's obligations is serviced through various revenue sources but primarily through passenger charges.

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