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Research Update:

# Heathrow Funding Ltd. Class A Debt Downgraded To 'BBB+'; Class B Debt Downgraded To 'BBB-'; Outlooks Negative

**April 1, 2020**

## Rating Action Overview

- The airport sector in Europe is facing an unprecedented decline in air traffic amid the COVID-19 pandemic, which has led governments to introduce travel restrictions and quarantine orders, with our current base case a 25% decrease in passenger traffic for 2020.
- We also anticipate a eurozone and U.K. recession in 2020, which would hamper passenger traffic recovery, leading to materially weaker cash flows and credit ratios for European airports than we previously expected.
- We now expect lower credit metrics at Heathrow (SP) Ltd. (Heathrow)--the operating company servicing the debt issued by Heathrow Funding Ltd. (HFL) and, as we announced on March 26, 2020, have lowered our issue ratings on HFL's Class A debt to 'BBB+' from 'A-' and its Class B debt to 'BBB-' from 'BBB'.
- The negative outlooks indicate we could lower the ratings by one notch if weighted-average adjusted funds from operations (FFO) to debt were to deteriorate to below 7% for the Class A debt or below 5% for the Class B debt.

PRIMARY CREDIT ANALYST

**Beata Sperling-Tyler**
London
(44) 20-7176-3687
beata.sperling-tyler
@spglobal.com

SECONDARY CONTACT

**Tania Tsoneva, CFA**
Dublin
+353 1 568 0611
tania.tsoneva
@spglobal.com

ADDITIONAL CONTACT

**Industrial Ratings Europe**
Corporate_Admin_London
@spglobal.com

## Rating Action Rationale

**On March 26, 2020, we lowered our issue ratings on HFL's Class A debt by one notch to 'BBB+' from 'A-' and on its Class B debt by one notch to 'BBB-' from 'BBB'.** The downgrade (see "Negative Rating Actions Taken On European Airports Due To COVID-19 Restrictions," published on RatingsDirect) reflected that we expect Heathrow to post lower credit metrics than we previously forecast in fiscals 2020-2022, as well as our view of the weak global operating and macroeconomic environment, which could impair a recovery in air traffic.

**Heathrow's weaker credit metrics will result from air traffic disruption, which is unprecedented in scale and beyond management's control.** In our base case for 2020, we assume a 25% drop in passenger volumes compared with 2019 and about a 30% drop in EBITDA compared with our forecast before the COVID-19 pandemic. We expect the rebates under a commercial deal with the airlines that were based on passenger numbers of over 74.5 million in the year will no longer accrue in 2020–2021. Instead, the aeronautical tariff in 2020-2021 will be calculated based on a formula of the retail price index minus 1.5%. We expect Heathrow's management to implement operational cost savings. These include:

- Consolidation of spaces within and across terminals, which in extreme could include a temporary closure of some of the airport's terminals;
- A reduction of capital expenditure (capex) in 2020 and 2021 to levels that support only capex necessary for safe and secure operation of the airfield.

We also expect Heathrow to reduce its debt issuance due to a delay to the expansion pending its appeal to the Supreme Court against the judgement of the U.K. Court of Appeal in a case brought by environmental activists. In addition, shareholders may lower their restricted distribution requirements in 2020 and 2021.

**However, in our view, these measures will be insufficient to prevent Heathrow's credit metrics from weakening.** This is because it has about £13 billion of S&P Global Ratings-adjusted debt, excluding £1.6 billion at the HFL level. We now expect Heathrow's FFO to senior debt to decline to 5%-6% in 2020, and a weighted average in 2020-2022 of 7%-8%. Similarly, we expect FFO to total debt to decline to 4%-5% in 2020, and a weighted average in 2020-2022 of 5%-6%.

**Heathrow has adequate liquidity.** Heathrow was pre-funding its expansion capex, which is now delayed. Therefore, even assuming a lack of air traffic for three months in 2020, the company has sufficient liquidity to adequately cover capex, distributions, and debt maturities in the 24 months to Dec. 31, 2021. This includes £1.6 billion in cash and £2.2 billion in undrawn committed lines as of Dec. 31, 2019. Moreover, in our view, HFL has a high standing in credit markets, shown by its well-established debt issuance program at the senior, junior, and holding company levels in several countries and seven currencies. It also has solid and well-established relationships with eight banks, providing various facilities. We believe this would allow HFL to easily access funding if necessary, even if it was at a higher cost.

## Outlook

### Downside scenario

The negative outlook on the issue ratings reflects that we could lower them should the pandemic prove more severe and long lasting than we currently expect, leading adjusted weighted-average FFO to senior debt over 2020-2022 to fall below 7% and adjusted average FFO to total debt to fall below 5%.

This could also happen if the recessionary macroeconomic backdrop is harsher or more prolonged than expected, thereby affecting overall mobility. Passenger volumes might not reach expected levels due to operating or economic conditions being more severe than we anticipate. Financial metrics could be negatively affected if shareholders and management do not adequately mitigate the effects, for example, by lowering their distributions and re-leveraging plans, reducing operating costs, and delaying uncommitted capex.

### Upside scenario

We would revise the outlook to stable if COVID-19-related traffic disruption is contained, the risk of a further pandemic is reduced, we observe a strong traffic recovery, and the economic situation stabilizes, including visibility over rules governing air traffic post the U.K's exit from the EU.

## Ratings Score Snapshot

### Senior Secured (Class A) Issue Rating: BBB+/Negative/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Senior SACP: bbb

Structural features: +1 notch

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### Subordinated (Class B) Issue Rating: BBB-/Negative/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Junior SACP: bbb-

Structural features: N/A

## Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Negative Rating Actions Taken On European Airports Due To COVID-19 Restrictions, March 26, 2020
- U.K. Court's Runway Decision To Have A Limited Impact On Heathrow, March 12, 2020
- Heathrow Funding Ltd.; Aug 9, 2019