FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Heathrow Funding and Heathrow Finance Notes, Outlook Negative

Tue 30 Mar, 2021 - 14:55 ET

Fitch Ratings - London - 30 Mar 2021: Fitch Ratings has affirmed Heathrow Funding Limited's class A bonds at 'A-' and class B bonds at 'BBB'. Fitch has also affirmed Heathrow Finance plc's outstanding high yield (HY) notes at 'BB+'. The Outlooks are Negative.

RATING RATIONALE

The affirmation reflects our expectation that Heathrow's supportive regulation and significant market power as a primary hub airport, will allow it to significantly increase 2022 aero tariffs, by around 40% to 50% in nominal terms under Fitch's cases to offset reduced traffic during recovery from the coronavirus pandemic. Heathrow also has financial flexibility in the form of largely deferrable shareholder distributions and its ability to reduce its cost base to some extent.

Overall, we expect that this will enable Heathrow to deleverage below our rating sensitivities of 8x for the class A and 9x for the class B notes by 2022, and 10x for the HY notes by 2023. This will be driven by a gradual recovery from 2021 following the severe coronavirus-related volume shock in 2020.

The Negative Outlooks reflect the ongoing uncertainty relating to the timing and duration of the traffic shock triggered by the coronavirus pandemic, together with the embedded execution risk in delivering tariff increases in the next regulatory period, H7, starting in January 2022. For the HY notes, it also reflects the uncertainty related to the timing of resumption of dividend payments to Heathrow Finance plc from Heathrow SP, although significant cash reserves at Heathrow Finance plc mitigate any short-term liquidity risk.

Heathrow's liquidity position is strong, partly due to significant debt issuance in 2019 ahead of anticipated capex related to the third runway project, which we now expect to be significantly delayed, in addition to further debt issuances during 2020.

KEY RATING DRIVERS

Large Hub with Resilient Traffic: Volume Risk - Stronger

Heathrow is a large hub/gateway airport serving a strong origin and destination market. Heathrow has historically demonstrated traffic resilience, with a maximum peak-to-trough fall of just 4.4% through the 2008 economic crisis, reflecting the attractiveness of London as a world business centre; the role of Heathrow as a primary hub offering strong yield for its resident airlines; the location and connectivity of Heathrow with the well-off western and central districts of the city; and unsatisfied demand as underlined by the capacity constraint, which also helps absorb shocks.

The coronavirus pandemic led to an unprecedented impact on travellers' mobility with a contraction of 72.7% of Heathrow's passenger numbers in 2020. We currently expect traffic to reach around 90% of 2019 levels by 2025 under the updated Fitch rating case (FRC), but if the severity and duration of the pandemic are longer than expected, we will revise the rating case accordingly.

Regulated and Inflation-Linked: Price Risk - Midrange

Heathrow is subject to economic regulation, with a price cap calculated under a single till methodology based on RPI+X, and is currently set at RPI-1.5% for the Q6 regulatory period, which started in April 2014 and has been extended through i (interim) H7 to 2021. The price cap, set by the UK Civil Aviation Authority (CAA), is established to offset Heathrow's significant market power and is highly sensitive to several assumptions made by the regulator, such as cost of capital, traffic forecast and operational efficiency. The regulatory process is transparent but creates material uncertainty each time it is reset.

Capacity Constrained: Infrastructure Development/Renewal - Midrange

As a result of the coronavirus pandemic, Heathrow's next regulatory period (from 2022 to end-2026) excludes the approval, planning, funding and execution of the third runway project, reducing regulatory uncertainty. The coronavirus-driven 2020 traffic contraction alleviates capacity constraints in the short term, but in Fitch's view this issue remains in the longer term.

Heathrow has a record of successfully accessing capital markets to secure funding and delivering capex projects. We also note the regulator's mandate to ensure capex can be financed in addition to affordability to end-users as supportive.

Refinance Risk Substantially Mitigated: Debt Structure - Midrange (Class A); Midrange (Class B); Weaker (HY)

The class A debt benefits from its seniority, security, and protective debt structure (ring-fencing of all cash flows and a set of covenants limiting leverage). The debt portfolio is exposed to some floating rate risk, with at least 75% being fixed, in addition to some refinance risk, which is mitigated by the issuer's strong capital market access, due to an established multi-currency debt platform and the use of diverse maturities. The class B notes benefit from many of the strong structural features of the class A notes. The HY notes have a weaker debt structure due to their deep structural subordination.

FINANCIAL PROFILE

For the class A and class B debt, we forecast net debt to EBITDA returning to below the respective negative rating action triggers of 8x and 9x by 2022, and remaining below them under the FRC, indicating a temporary impairment of Heathrow's credit profile. After turning negative in 2021, post maintenance interest cover ratios (PMICRs) remain consistently above the respective negative rating action trigger levels of 1.6x and 1.3x for the class A and class B notes throughout the remainder of the forecast period.

For the HY debt, we forecast net debt to EBITDA returning to below the negative rating action trigger of 10x by 2023 under the FRC, and remaining below it for the remainder of the forecast period. After turning negative in 2021, PMICRs also remain fairly consistently above the negative rating action trigger level of 1.15x. However, the dividend cover is materially affected by the reduced cash up-streaming from Heathrow SP to Heathrow Finance plc, resulting in no dividends in 2021, and low cover in 2022. This is mitigated by strong liquidity at Holdco level, with around GBP377 million of cash available as at end February 2021. Fitch estimates this will cover over three years of debt service.

We are closely monitoring developments in the sector as airports' operating environment has substantially worsened and we will revise the FRC should the severity and duration of the pandemic be worse than expected or the issuer fails to enforce tariff increase as expected.

PEER GROUP

Heathrow is one of the most robust assets in the sector. Historically, it has higher leverage than its European peers (Aeroports de Paris (ADP); A-/Negative), albeit with a better debt structure for senior debt. However, ADP's Issuer Default Rating (IDR) is now aligned with that of Heathrow Funding Limited's class A debt. This reflects that the coronavirus pandemic and acquisition-related debt has led to a sustained impairment of ADP's leverage metrics under the FRC. Compared with Gatwick (BBB+/Negative), Heathrow's bonds benefit from a stronger revenue risk profile.

Fitch compared the structural subordination of Heathrow Finance plc's HY notes with that of Gatwick Airport Finance plc (BB-(EXP)/Negative), Atlantia SpA (BB/Rating Watch Evolving; RWE)/ Autostrade per l'Italia SpA (ASPI; BB+/RWE) and Getlink S.E. (BB+/Stable). The rating of Gatwick Airport Finance's notes reflects their structural subordination to the Gatwick ring-fenced group, in addition to the current lock-up that prevents cash up-streaming to Gatwick Airport Finance plc, and is expected to continue until mid-2024. This is materially longer than for Heathrow, which we assume will resume cash up-streaming in 2022.

Atlantia is rated one notch below ASPI, its opco, as compared with Heathrow Funding Limited it has fewer structural protections. Similar to Heathrow, for Getlink, lock-ups at the opco, together with limited ability to push down debt to the opco due to restrictions on additional indebtedness, lead to a two-notch difference for the 'BB+' rated debt, versus the 'BBB'-rated debt issued by Channel Link Enterprises Finance plc (CLEF).

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

All classes: Revenue recovery combined with deleveraging ahead of Fitch's current expectations could lead to a revision of the Outlook to Stable.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Class A notes: Failure to improve net debt to EBITDA to below 8x by 2023, or average PMICR below 1.6x.

Class B notes: Failure to improve net debt to EBITDA to below 9x by 2023, or average PMICR below 1.3x.

HY notes: Failure to improve net debt to EBITDA to below 10x by 2023, or average PMICR below 1.15x.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

TRANSACTION SUMMARY

Heathrow is a major global hub airport with significant origin and destination traffic and resilience due to its status as the preferred London airport.

Revenues are regulated and subject to an inflation-linked price cap on a single till basis. We view the structured, secured and covenanted senior debt as offsetting some of the higher expected five-year average leverage under the Fitch rating case for the class A and B bonds compared with peers. The HY bonds are structurally subordinated.

CREDIT UPDATE

Traffic fell by 72.7% in 2020 vs 2019 from 80.9 million to 22.1 million. Revenue in 2020 was GBP1.175 billion, vs 2019 revenue of GBP3.070 billion, primarily reflecting material reductions in both aeronautical and retail revenues (around 60%). Other revenue performed slightly better, falling by around 40% year on year. Prior to coronavirus, management had been projecting 2020 revenues of GBP3.061 billion.

As part of the April 2020 review, Fitch projected Heathrow revenue of GBP1.504 billion, meaning actual revenues have under-performed Fitch's previous expectations. Aeronautical income fell, predominantly due to reduced passenger numbers as a result of the pandemic. Fewer aircraft movements also drove revenue down following the European Commission's temporary suspension of the slot usage rule. Retail income declined as a result of reduced passenger numbers. The decrease in other revenue demonstrated relative resilience in other regulated charges collections and property and others.

As at December 2020, Heathrow reduced its net operating costs by over GBP300 million compared with the December 2019 forecast. To deliver this, Heathrow implemented a comprehensive business protection plan, which included company-wide organisational redesign, temporary pay cuts, bonus cancellations, recruitment freeze, use of the government furlough scheme, consolidation of operations into two terminals and one runway and renegotiations of suppliers' contracts. Many of these initiatives are expected to generate some further cost savings in 2021, either as permanent or volume-driven reductions to the largely fixed cost base. Terminal 4 is also expected to remain non-operational until end-2021.

2020 EBITDA fell by 86% to GBP270 million vs 2019 EBITDA of GBP1.921 billion. Prior to the pandemic, management had projected EBITDA of GBP3.061 billion in 2020. As part of the April 2020 review, Fitch projected EBITDA of GBP535 million under the FRC. In terms of capex, Heathrow significantly reduced spending during 2020 to preserve cash, with investment focused on the safety and resilience of the airport.

The CAA published a consultation on Heathrow's proposed regulated asset base adjustment on 5 February 2021, with a view to making a decision during March. The CAA has ruled out a no-intervention option, although the timing, extent and form is not yet clear. Heathrow also submitted its revised business plan in December 2020. The plan will inform the CAA's initial proposals in relation to the H7 regulatory period due to be published in summer 2021.

In terms of covenants and waivers, Heathrow secured a waiver from Heathrow Finance plc's creditors in July 2020. As a result, Heathrow Finance plc's interest coverage ratio covenant is waived for 2020. In addition, Heathrow Finance plc's regulatory asset ratio covenant was revised from 92.5% to 95.0% in 2020 and 93.5% in 2021. Despite the deteriorated traffic outlook, as at December 2020, Heathrow did not forecast any covenant breach in 2021 as a result of mitigations in place.

Heathrow has maintained strong levels of liquidity throughout the pandemic with 2021 maturities already fully pre-funded. Heathrow has also retained strong market access thus far during the pandemic, which we expect to support continued strong liquidity. Heathrow plans to raise further debt during 2021 to ensure the liquidity horizon extends to 24 months by the end of 2021.

Risks related to Brexit are now significantly reduced. The UK left the EU on 31 December 2020 with no meaningful interruption to flights between the UK and the EU.

FINANCIAL ANALYSIS

Under the Fitch base case, we assume traffic to remain 60% below 2019 levels following the 72.7% contraction in 2020, with recovery to 2019 levels by 2024. We forecast EBITDA to grow to around GBP2.5 billion by 2025, from GBP1.9 billion in 2019 driven by the traffic recovery. Under the FRC, we assume traffic to remain 60% below 2019 levels in 2021, with recovery to around 90% of 2019 levels by 2025, meaning recovery to 2019 levels extends beyond the 2025 forecast horizon. We forecast EBITDA to grow to around GBP2.3 billion by 2025, from GBP1.9 billion in 2019, driven by the traffic recovery.

All potential investment related to the third runway expansion has been deferred to beyond the H7 regulatory period, meaning capex assumed under Fitch cases more focused on maintenance. We assume dividend payments will resume and generally increase from 2023. Fitch net debt to EBITDA will recover to levels in line with our downgrade sensitivities by 2022 for the class A and B notes, and by 2023 for the HY debt.

Fitch also ran additional sensitivities, testing a downside case with a longer traffic recovery, the effect of lower inflation. The sensitivities demonstrate that the issuer's credit profile would be impaired under the downside case, but is not significantly affected by moderately lower inflation.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Heathrow Finance plc				
• Heathrow Finance plc/Debt/3 LT	LT	BB+ Rating Outlook Negative	Affirmed	BB+ Rating Outlook Negative
• Heathrow Finance plc/Debt/5 LT	LT	A- Rating Outlook Negative	Affirmed	A- Rating Outlook Negative
Heathrow Funding Limited				

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Infrastructure and Project Finance Rating Criteria (pub. 24 Mar 2020) (including rating assumption sensitivity)

Airports Rating Criteria (pub. 22 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Third-party Model (24 March 2020)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Heathrow Finance plc	UK Issued, EU Endorsed
Heathrow Funding Limited	UK Issued, EU Endorsed

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