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Research Update:

Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Ratings Remain On CreditWatch With Negative Implications

September 30, 2020

Rating Action Overview

- The reinstatement of travel restrictions in the U.K. and recurrence of COVID-19 outbreaks in Europe will further delay air traffic recovery. We now expect approximately 70% fewer passengers at Heathrow Airport in 2020 than in 2019 and approximately 45% fewer in 2021.
- Heathrow Airport (Heathrow) is successfully implementing operating and capital cost savings, and ongoing initiatives to manage leverage and interest costs, however we believe its scope to lower cash burn is limited.
- We expect Heathrow Funding Ltd. (HFL) to post weighted-average funds from operations (FFO) to senior debt of 5.0%-6.0% during 2021-2022 and FFO to total debt of 4.0%-5.0%. While these ratios are below rating guidance, we expect them to improve in 2022, subject to the outcome of the regulatory re-set in 2022.
- We are therefore keeping our ratings on HFL's debt on CreditWatch with negative implications, where they were placed on May 29, 2020. This reflects that we could downgrade the debt by one notch if traffic recovery is weaker than we expect, or regulatory protections do not mitigate the airport's volume risk exposure.

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Rating Action Rationale

The reinstatement of travel-based quarantines in the U.K. and recurrence of COVID-19 outbreaks in Europe will result in passenger numbers to plummet by approximately 70% at Heathrow in 2020 compared with 2019, and by around 45% in 2021. We forecast that the demand for air travel will remain low due to the recurrence of COVID-19 outbreaks in Europe, the unpredictability over which countries may be exempt from quarantines, and the reinstatement of travel restrictions at short notice with no international coordination. In the short term, Heathrow will be harder hit than other European peers because of its high reliance on business traffic (previously 33% of Heathrow's total), which normally replaces holiday traffic in the autumn

months. At the same time, long-haul traffic (previously 52% of Heathrow's total) remains largely limited to flying stranded relatives home. The European Commission's waiver extension of the 80/20 slot allocation rule--which requires that carriers use slots at least 80% of the time to avoid losing them in the next equivalent season--to March 27, 2021, illustrates low industry expectations for traffic recovery during this period. Therefore, other than a temporary spike around Christmas, we do not expect air traffic volumes to increase before 2021. We do not project meaningful recovery until a vaccine becomes widely available, which we anticipate in mid-2021.

The timing, pace, and shape of air traffic recovery remain uncertain. That said, there is pent-up demand for air travel; between July and August Heathrow's traffic recovered in line with our expectations, with airlines' load factors at 65%. This was largely due to people visiting family and friends, and going on holiday.

Absent external support, the scope for additional mitigating actions is limited. In our view, due to the largely fixed cost base, scope for reduction of costs is limited to managing interest costs and leverage.

Heathrow has cut maintenance capex to £445 million, which includes demobilizing expansion works, completing some in-flight programs, and implementing critical safety interventions. The company is also on track to deliver £300 million operating costs savings, about half of which are likely to be carried forward to 2021. These savings arise from temporarily shrinking operations to terminals 2 and 5, freezing recruitment, introducing pay reductions, and cancelling bonuses. While temporary, these actions have helped reduce the monthly cash burn by about a third, to about £159 million on average. We expect EBITDA of about 10% of the 2019 levels in 2020 and about 40% in 2021.

While we understand Heathrow is successfully managing interest costs and leverage, this is unlikely to prevent a significant squeeze on Heathrow's cash flows in 2020 and an increase in debt leverage.

We expect Heathrow to post weighted-average FFO to senior debt of 5.0%-6.0% and FFO to total debt at 4.0%-5.0% over 2021-2022. While these are below our rating guidance, we forecast that the metrics will improve in 2022. In our ratio calculation we look beyond the short-term ratios and place more emphasis on 2021 and 2022, because we think traffic volumes in 2020 do not represent the long-term credit quality of the airport. Free operating cash flows could revert to positive as early as 2021. We expect positive FFO cash interest coverage in 2020, increasing to 1.0x-2.5x for senior debt and 0.5x-2.0x for total debt in 2021.

Unlike some European peers that have benefited from government support provided directly or indirectly--via the national airlines--as a privately owned airport, Heathrow is less likely to receive state aid. Shareholders--including Ferrovial with a 25% stake--have not commented on providing support, other than backing the reduction in capital expenditure (capex), therefore forgoing part of their future returns.

Given the upcoming reset for the next regulatory period (H7) starting on Jan. 1, 2022, Heathrow's volume risk exposure to air traffic due to COVID-19 and the U.K. government's policies surrounding Brexit, is restricted to the next 15 months. Heathrow is an essential infrastructure asset with regulated earnings and a track record of supportive regulation. The regulation provides for periodic resets, at which point the tariff is reset to the level of traffic expected in the following regulatory period, thus limiting volume risk exposure to the intra-period variations. The regulation also allows the price cap to reopen during the regulatory period if modifications are requested by stakeholders due to extreme circumstances. We understand Heathrow has requested such a modification. Ordinarily, corrections of any intra-period variations

from an average yield per passenger that Heathrow is entitled to generate in the regulatory period, are done via a K-factor adjustment, although the correction is applied two years later.

That said, uncertainty remains as to how the regulator will balance its duty to ensure Heathrow's operations remain financially viable with the evolving needs of customers, and set the charges at an affordable level for the airlines. The recovery of lost revenues could be extended over a prolonged period. We expect the regulator, Civil Aviation Authority, to provide initial H7 proposals in second-quarter (Q2) 2021.

Heathrow benefits from strong liquidity. HFL's parent, Heathrow (SP) Ltd. reported £2.15 billion cash as of June 30, 2020. Excluding proceeds from any further issuance, this should provide for a year of operations with minimal traffic, given a cash burn--the rate at which the company uses up its cash balances to fund operations and capital, and service debt--of £159 million per month with cost containment measures in place. Before the COVID-19 outbreak, Heathrow burned £250 million per month.

Our base case assumes Heathrow will remain in a trigger event and a distribution lockup at the reporting date in December 2020, when testing the interest coverage ratio (ICR) for the following 12 months. Nevertheless, we understand Heathrow is not planning any dividends until it rebounds to profitability, except for £100 million distributed in Q1 2020. At this stage, there is no danger of triggering an event of default under Heathrow's covenants. If it were triggered, creditors could take control over the business, exercise their security, and accelerate debt. The ICR-based covenant is tested for an event of default on a past three years rolling-average basis. At the testing date of Dec. 31, 2020, the covenant will remain comfortably above 1.05x.

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic.

The current consensus among health experts is that COVID-19 will remain a threat until a vaccine or effective treatment becomes widely available, which could be around mid-2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

CreditWatch

The CreditWatch placement reflects that we could lower the ratings on HFL's Class A and Class B debt by one notch if traffic recovery takes longer than we currently expect and the resulting cash burn significantly increases Heathrow's debt levels. Therefore, we could lower the ratings if the trajectory of improvement in the credit metrics diverges from our current expectations.

Upside scenario

We would remove the ratings from CreditWatch and affirm them if:

- Management's mitigating actions package and regulatory protections support FFO to senior debt above 7% and FFO to total debt above 5%;
- Regulatory protections sufficiently compensate for the airport's volume risk exposure in the next regulatory period starting in 2022; and
- COVID-19-related traffic disruption is contained, the risk of a further pandemic peak is reduced, and we observe strong traffic recovery.

We would assign a stable outlook if the economic situation stabilizes and we had more visibility around rules governing air traffic following the U.K's exit from the EU.

Company Description

HFL is a wholly owned subsidiary of Heathrow (SP) Ltd., a debt-issuing vehicle in the ring-fenced financing group, which includes as obligors:

- Heathrow (SP) Ltd. as a holding company of the financing group;
- Heathrow (AH) Ltd. as an intermediate holding company; and
- Heathrow Airport Ltd. (HAL) as a borrower, an operating company that owns and operates the group's only asset, Heathrow Airport (Heathrow).

The group's companies are indirect subsidiaries of Heathrow Airport Holdings Ltd., which is indirectly owned by Ferrovial S.A. (25%), Qatar Holding LLC (20%), and other institutional investors.

In 2019, the group's total reported revenue was £3.07 billion, up 3.4% on 2018. Adjusted EBITDA amounted to £1.9 billion, up 2% on 2018. The revenue base mainly comprises aeronautical revenue--approximately 60%--charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, they are subsidized by non-aeronautical income that is generated from retail, car parking, operating the Heathrow Express rail service, and property rental.

Our Base-Case Scenario

Assumptions

- Revenues 65%-70% lower in 2020 and 45%-50% lower in 2021 compared with 2019, as a result of the significant decline in traffic volumes. We do not expect revenue to return to 2019 levels until 2024.
- Adjusted EBITDA margins at about 17% in 2020 and about 40%-45% in 2021 because we do not expect cost-cutting measures to fully offset the decline in revenue, since the cost base is largely fixed.
- Total capex of about £445 million in 2020, limited to maintenance capex, which reflects demobilizing expansion works and suspending or deferring other projects. Capex in 2021 of about £360 million.
- No distributions planned in 2020 and 2021, except for £100 million already distributed in Q1 2020 before the start of the pandemic.
- Management to implement cash preservation and other mitigation plans on leverage and interest.

Key metrics

Table 1

Heathrow Funding Ltd. -- Key Metrics

	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020e	2021f	2022f
FFO to debt (%)					
Class A and B	8.3	9.0	N.M.	1.5-2.5	6.0-7.5
Class A only	9.3	10.0	N.M.	2.0-3.5	7.0-9.5
Debt to EBITDA (x)					
Class A and B	6.7	6.8	70-80	15-20	8.0-10.0
Class A only	N/A	N/A	60.0-70.0	15-20	7.0-9.0
FoCF to Debt (%)					
Class A and B	2.9	3.2	N.M.	N.M.	2.5-4.5
Class A only	N/A	N/A	N.M.	0.0-1.0	3.5-5.5
FFO to cash interest coverage (x)					
Class A and B	2.4	2.8	0.0-1.0	0.5-2.0	2.0-4.0
Class A only	N/A	N/A	0.0-1.0	1.0-2.5	2.0-4.0

a--Actual. e--Expected. f--Forecast. N.M.--Not meanignful. N/A--Not applicable.

Liquidity

We expect Heathrow (SP) Ltd. to maintain strong liquidity, supported by our expectation that its liquidity sources will exceed uses by more than 1.5x in the 12 months to June 30, 2021 and more than 1x in the subsequent 12 months to June 30, 2022.

In our view, HFL has a high standing in credit markets, demonstrated by its well-established debt issuance program active in eight currencies and at the senior, junior, and holding company levels. It also has solid and well-established relationships with banks; its banking group includes over 30 banks providing either liquidity or hedging capacity. We think this would allow HFL to easily access funding if necessary, although possibly at a higher cost.

We expect principal liquidity sources over the 12 months to June 30, 2021 will include:

- Unrestricted cash and short-term investments of about £2.15 billion;
- Access to about £80 million of undrawn credit facilities at Heathrow (SP) level; and
- Positive working capital of about £50 million.

We expect principal liquidity uses over the same period will include:

- Negative FFO of about £150 million;
- Capex of approximately £400 million;
- Debt maturities of approximately £500 million;
- No dividends; and
- Cash preservation and mitigation initiatives on leverage and interest

Covenants

Trigger event ratios are tested twice a year. When tested in either June or December, the testing period is always the 12 months ended December that year.

Our base case assumes Heathrow will continue breaching a trigger event under ICR when tested on Dec. 31, 2020 for the 12 months ended Dec. 31, 2020. Under trigger events all distributions and any payments to subordinated creditors--including on debenture--are blocked, so no cash can flow to HFL. Since debt service costs at HFL are £100 million per year, Heathrow Finance would be able to withstand four years without distributions from Heathrow (SP), taking into account that as of June 30, 2020 it had about £400 million cash. The first principal repayment at the HFL level is in 2024.

The event of default covenants are tested in June only, and on a past three years rolling-average basis. At the testing date on June 30, 2020, the ICR-based event of default was comfortably above 1.05x.

Structural Features

The ring-fence includes approximately 10% of junior debt (Class B) that protects senior debtholders. HFL would continue to service Class B debt as long as there is cash. Given the Class B debt's subordinated status, HFL can defer the principal and interest on Class B indefinitely if there is cash shortfall. Furthermore, the Class A debt benefits from stronger senior-only credit metrics. This supports our assessment that the 'bbb' senior stand-alone credit profile (SACP) is one notch higher than the 'bbb-' subordinated SACP.

Our rating on HFL's Class A debt also incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s senior SACP to reflect structural features designed to increase cash-flow certainty for debtholders. The rating on the subordinated Class B debt reflects its subordinated SACP.

HFL's structural features include:

- Restrictions on business activities, mergers, acquisitions, and business transformation;
- Covenants restricting dividends and other subordinated payments from the financing group, and a restriction on raising further additional senior debt;
- A dedicated liquidity facility sized to cover 12 months of senior interest and six months of junior interest--available to the issuer, HFL, and the borrower, HAL; and
- A prudent hedging policy and provisions, mitigating refinancing risk.

We apply our rating-to-principles approach to HFL, using our criteria "Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published Feb. 24, 2016. HFL does not meet all requirements in order to be rated under our structurally enhanced debt criteria, due primarily to higher volume risk and the absence of a credit remedy period after triggering an event of default on the intercompany loan, during which creditors take control of the business and stabilize its credit quality or sell the company's shares. However, HFL benefits from the right for creditors to step in and appoint an administrative receiver while the business may still retain significant value prior to default on HFL's debt.

Ratings Score Snapshot

Senior Secured (Class A)

Issue Rating: BBB+/Watch Neg/--

Business risk: Excellent

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

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: bbb-

Modifiers

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

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Subordinated (Class B)

Issue Rating: BBB-/Watch Neg/--

Business risk: Excellent

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

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Liquidity: Strong(no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Junior stand-alone credit profile: bbb-

Structural features: None

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
- , Sept. 14, 2009

Related Research

- Airline Group IAG Affirmed At 'BB' Due To Capital Increase Offsetting Drop In Passenger Volumes; Outlook Negative, Sept. 21, 2020
- British Airways Affirmed At 'BB' As IAG's Capital Increase Offsets Fall In Passenger Numbers; Outlook Negative, Sept. 21, 2020
- From Bad To Worse: Global Air Traffic To Drop 60%-70% In 2020, Aug. 12, 2020
- WEBCAST/SLIDES published: COVID-19 Recovery: European Airports Face More Woes Ahead, July 27, 2020
- Research Update: Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Debt Ratings Placed On CreditWatch With Negative Implications, May 29, 2020

- Airports Face A Long Haul To Recovery, May 28, 2020
- Research Update: Heathrow Funding Ltd. Class A Debt Downgraded To 'BBB+'; Class B Debt Downgraded To 'BBB-'; Outlooks Negative, April 1, 2020
- 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

Ratings List

Ratings Affirmed	
Heathrow Funding Ltd.	
Senior Secured (Class A)	BBB+/Watch Neg
Senior Secured (Class B)	BBB-/Watch Neg

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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) 783-4009.

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