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Research Update:

Heathrow Funding Ltd. Class A And Class B Ratings Remain On CreditWatch Negative After Regulator's Final Proposals

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Rating Action Overview

- On June 28, 2022, the Civil Aviation Authority (CAA or the regulator) published its final proposal for Heathrow's regulatory period (H7) price control period, which runs from 2022 to 2026. The proposed tariff decline for Heathrow Airport Ltd. (HAL) may weigh further on already-tight credit metrics if it is not properly compensated by mitigating actions or traffic recovery.
- The regulator will consider the feedback from market participants during the six-week consultation period before making a final decision on the H7 price control, which is expected later this year. As a result, the extent of the financial impact will depend on several regulatory assumptions that are still subject to change. It will also depend on the traffic recovery's potential sustainability, Heathrow's ability to meet operating efficiencies, and future investments' attractiveness.
- We believe there are still uncertainties regarding Heathrow Funding Ltd.'s (HFL's) ability to recover and sustain its credit metrics to a level commensurate with its credit ratings, notably 2022-2024 weighted-average funds from operations (FFO) to senior debt of at least 7.0% and funds from operations (FFO) to total debt of at least 5.0%.
- We therefore maintained our 'BBB+' issue rating on HFL's senior secured Class A debt and our 'BBB-' issue rating on its junior Class B debt on CreditWatch with negative implications.
- The CreditWatch negative for both the senior and junior debt ratings indicates that the regulatory assumptions for H7 are still subject to discussion, so that a final decision on the charge cap is still subject to change. This fact, combined with uncertainties on the sustainability of the passenger volume recovery path, could test Heathrow's ability to achieve credit metrics commensurate with the ratings. We aim to solve the CreditWatch once the regulator publishes its final decision.

Rating Action Rationale

Our ratings on HFL's debt depend on the CAA's final decision on the H7 regulatory reset. We think that the final proposals published on June 28, 2022, provided more clarity on the rules that will govern the new regulatory period, including the methodology that will be applied for the introduction of a traffic risk-sharing mechanism. However, some of the regulatory assumptions may change between now and the final decision, which we expect will take place later this year. Absent continued strong growth in traffic volumes, increasing commercial revenues, and implementation of cost-efficiency measures, it is still uncertain if Heathrow would be able to achieve and sustain a 2022-2024 weighted-average funds from operations (FFO) to senior debt of at least 7.0% and 2022-2024 weighted-average FFO to total debt of at least 5.0%, which we see as commensurate with the current ratings level. This is because the regulator has proposed a weighted average cost of capital (WACC) of 3.26% for 2022-2026, compared with the 4.65% applied throughout the 2014-2021 regulatory period. The CAA has also assessed that the efficient level of Heathrow's operating expenses would be 5%-10%. The extent of the impact on Heathrow's credit metrics will heavily depend on the parameters of the final decision, Heathrow's ability to achieve the efficiency levels that the CAA expects, its future dividend distributions, and the continued passenger volume recovery path.

The CAA is proposing a charge cap profile for the H7 with a declining trend in real terms. On its final proposals, the regulator announced a charge cap profile, in real values as of 2020:

The CAA's Final Proposal for Heathrow's Charge Cap (2020 Values)

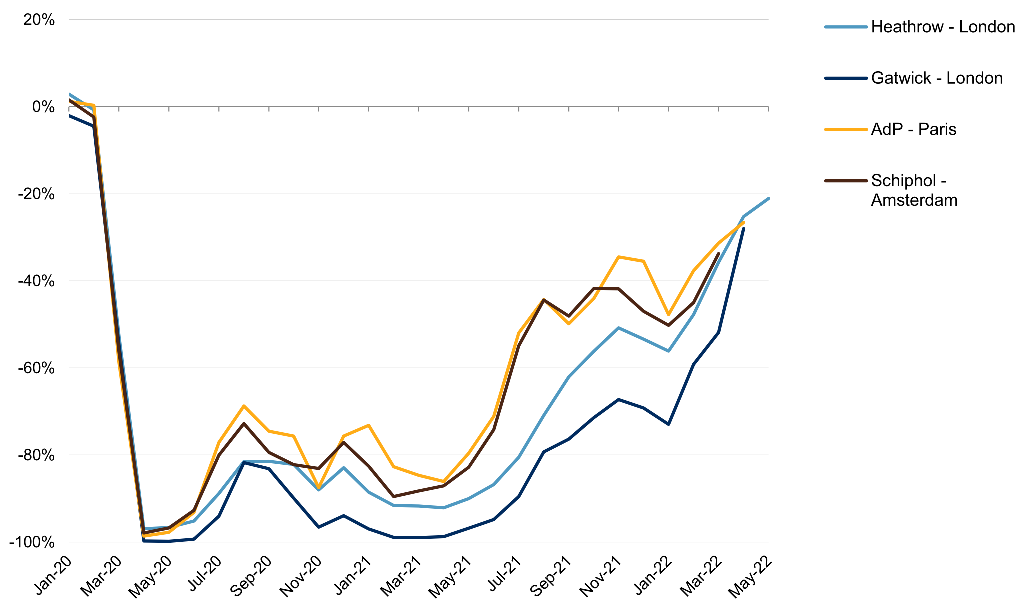
	2022	2023	2024	2025	2026
Charge cap (£ per passenger)	27.39*	25.88	24.42	23.04	21.75

*Equivalent to the current £30.19 charge cap in place.

The final proposal is to keep the 2022 charge cap of £30.19 per passenger unchanged until the end of the year, then from January 2023 apply the profile shown in the table above, annually adjusted by the consumer price index (CPI). The declining profile aims to capture the upward trend of the passenger volume recovery path in the coming years. Although Heathrow's traffic has recovered significantly over the past few months and could partially mitigate the effects of the lower charges, the tariff cut could imply higher volatility of earnings and profitability than we currently assess. We could revise our assessment of Heathrow's competitive position if we came to believe that the WACC was not attractive enough to incentivize investments during H7. Delivery of investment while maintaining sufficient liquidity could also be compromised if charge caps are lower than announced and profitability remains volatile.

Heathrow's passenger recovery path in 2022 is in line with other rated European airports. With the easing of travel restrictions in the U.K. and other countries from February 2022, Heathrow has seen the number of passengers in the airport increase every month. It ended 2021 with 19.4 million passengers, equivalent to 24% of 2019 levels. In 2022, more than 20 million passengers have already used the airport so far; 5.3 million of whom were in May, representing 79% of the total for May 2019.

European Passenger Recovery
(% of 2019 levels)



Source: S&P Global Ratings.

However, it is uncertain whether this momentum can continue after Europe's summer months. The pace of passenger traffic recovery could decelerate later in the year as inflation starts to bite, disposable incomes diminish, and business and Asia-Pacific travel lags. We will monitor the passenger volume recovery path, and whether it will result in the CAA's revision under the final decision.

The CAA has defined the rules for the traffic risk-sharing mechanism. The mechanism aims to recover lost revenue resulting from lower-then-expected passenger volumes (measured against the CAA's benchmark curve), and its presence is a positive for Heathrow's regulatory framework. That said, in our view, the cash conversion period is not sufficient to sustain credit metrics if an event like the COVID-19 pandemic should occur in the future. The recovery will start two years after the mismatch, and full recoverability will take 10 years.

CreditWatch

We kept our issue ratings on HFL's Class A and Class B debt on CreditWatch with negative implications, indicating that the charge caps--absent continued traffic recovery and mitigating actions from Heathrow--may be lower than expected, resulting in financial metrics that are not commensurate with the ratings. Additionally, it reflects that because of the undefined parameters, Heathrow's competitive position remains uncertain. We aim to solve the CreditWatch once the regulator publishes its final decision, which we expect later this year.

We would likely lower the issue ratings on HFL's Class A and Class B debt if Heathrow were unable to sustain 2022-2024 weighted-average FFO to senior debt of at least 7% and 2022-2024 weighted-average FFO to total debt of about 5%. This could occur if:

- The charge caps to be announced in the final decision are more than 5% lower than ones recently proposed, assuming they are still presenting a declining trend in real values;
- The passenger volume recovery on Heathrow does not materialize, so that Heathrow's passenger volumes in 2023 are less than 56 million, which is equivalent to 70% of 2019 levels; or
- We believe that Heathrow will be unable to present a cost and investment structure that fits lower charge caps, resulting in a lower profitability throughout H7.

Additionally, we could lower the ratings by more than one notch if we assessed that the company's regulatory parameters would increase Heathrow's volatility of profitability and would not incentivize its investment plan, which could challenge Heathrow's business risk profile.

We could remove the ratings from CreditWatch depending on the outcome of CAA's decision for the tariffs, and passenger volume prospects for the regulatory period. Following the CAA's final decision, we would remove the Class A rating from CreditWatch if Heathrow were able to sustain a 2022-2024 weighted-average FFO to senior debt at 7.0% or above. We would remove the Class B rating from CreditWatch if Heathrow's 2022-2024 weighted average FFO to total debt was at least 5.0%.

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.

The group's companies are indirect subsidiaries of Heathrow Airport Holdings Ltd.

In the first quarter of 2022, the group's total reported revenue was £516 million, more than the triple that of the same period 2021. Its reported EBITDA amounted to £273 million. The revenue base mainly comprises aeronautical revenue--approximately 55%--charged to airlines primarily for passenger facilities, take-off and landing, and aircraft parking. Under a single-till regulatory mechanism, the revenues are subsidized by non-aeronautical income that is generated from retail, car parking, the Heathrow Express rail service, and property rental.

Our Base-Case Scenario

Assumptions

We have updated our assumptions to incorporate the CAA's final proposals and Heathrow's passenger-level recovery path, in addition to our updated macroeconomic forecasts.

Our main assumptions for 2022-2024 are:

- Passenger traffic recovery will reach about 65% of 2019 levels in 2022, about 80% in 2023, and 90% in 2024.
- The charge cap in 2022 will remain at £30.19 per passenger. Afterwards, we have incorporated the CAA's declining curve as of 2020 values: £25.88 in 2023 and £24.42 in 2024. The values will be adjusted to their nominal values by our consumer price index (CPI) assumptions of 8.7% in 2022, 4.8% in 2023, and 1.6% in 2024.
- As passenger volumes recover, we expect Heathrow's personnel-related expenses will increase to face the recovered demand. Since the airport has a high fixed cost structure, we still think margins will improve, reaching 45%-50% in 2022 and about 50%-55% in 2023 and 2024.
- Total investments, mostly focused on maintenance, of about £470 million in 2022, and £600 million-£650 million annually in 2023 and 2024. We do not forecast material expansion investments in the airport, because this has not been considered in the CAA's final proposals when setting the proposed charge caps.
- Net debt levels will remain about £12 billion for the senior debt and about £14 billion for total debt.
- Dividend distributions from 2023.

Based on these assumptions, we expect the following credit metrics:

Heathrow Funding Ltd.--Key Metrics

	2022e	2023e	2024e
Passengers (% of 2019 levels)	65	80	90
Charge cap (£ per passenger)	30.19	29.50-30.50	28.50-29.50
EBITDA (bil. £)	1.2-1.3	1.6-1.7	1.7-1.8
EBITDA margin (%)	45-50	50-55	50-55
Senior FFO to senior debt (%)	5.0-6.0	6.5-7.5	8.5-9.5
FFO to total debt (%)	4.0-5.0	4.5-5.5	6.5-7.5

e--Estimate. FFO--Funds from operations.

Despite the declining charge cap during the 2022-2026 regulatory period, which the CAA announced in its final proposals, the recovery path of passenger volumes could help Heathrow to improve its cash flow generation. We still expect the 2022-2024 weighted average FFO to senior debt and FFO to total debt will be commensurate with Heathrow's triggers of 7.0% and 5.0%, respectively, with 2022 ratios still below our thresholds for the ratings, while 2023 is now also at risk of not being commensurate with the triggers.

Liquidity

We consider that Heathrow's liquidity position remains strong, with its liquidity sources surpassing uses by about 2.0x in the next 12 months and by more than 1.2x in the next 24 months. This is a result of Heathrow's efforts to contain the cash burns while the airport has not yet recovered its passenger volume. Additionally, since Heathrow will focus its investments on maintenance in the coming years, we expect positive free operating cash flow (FOCF) generation, which further improves its financial flexibility.

We think HFL has a high standing in credit markets, as demonstrated by its well-established program for debt issuance, having already issued in several countries, multiple currencies (including British pound sterling, euro, Canadian dollar, and Swiss franc), and various structural levels (senior, junior, and at the holding company level). The company also has solid and well-established relationships with banks. Its banking group includes more than 30 institutions providing either liquidity or hedging capacity. We think this would allow HFL to easily access funding if necessary, albeit possibly at a higher cost.

We expect principal liquidity sources over the 12 months from March 31, 2022, will include:

- Unrestricted cash and short-term investments of about £2.7 billion;
- £1.2 billion undrawn credit facilities; and
- Cash FFO of about £700 million.

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

- Debt maturities of about £1.5 billion;
- Maintenance investments of about £500 million; and
- No dividend distributions.

Covenants

The Class A debt has financial covenants measured at Heathrow (SP) Ltd.'s level that could lead to an event of default if not in compliance, as follows:

- Senior interest coverage ratio of at least 1.05x; and
- Senior regulatory asset ratio below 92.5%.

In our base-case scenario, we expect these financial covenants will be in compliance, albeit with a small cushion to the ratios, in the next 24 months, since passenger volumes are still recovering and therefore Heathrow's cash flow generation is still lower than before the pandemic.

Additionally, both Class A and Class B debt must comply with the following ratios, otherwise there would be a lock-up for distributions at Heathrow (SP) Ltd.:

- Senior interest coverage ratio higher than 1.40x;
- Junior interest coverage ratio higher than 1.20x;
- Senior regulatory asset ratio below 72.5%; and
- Junior regulatory asset ratio below 85.0%.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-4, G-2

Social factors are a negative consideration in our credit rating analysis of HFL because of the pandemic's impact on Heathrow Airport's operations. Although governments are adopting more flexible travel policies and lifting restrictions, we do not rule out the possibility that new variants could cause restrictions to be reintroduced, even for a short period of time. This could pose a risk to the recovery path of passenger volumes, which ended May 2022 at 79% of 2019 levels, as well as to the airport's cash flow generation. Given Heathrow's high exposure to long-haul and business traffic (53% and 33%, respectively, in 2019), it could result in a slower and more protracted recovery to pre-pandemic levels. Environmental and governance factors have an overall neutral influence on our credit rating analysis.

Structural Features

The ringfence includes approximately 10% of junior debt (Class B) that protects senior debtholders. HFL will 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 'BBB+' rating on HFL's Class A debt also incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s 'bbb' senior SACP, reflecting structural features designed to increase cash-flow certainty for debtholders. The 'BBB-' rating on the subordinated Class B debt reflects its 'bbb-' 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 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 ratings-to-principles approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published Feb. 24, 2016. HFL does not meet all the requirements 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 debt (Class A)

Issue rating: BBB+/Watch Neg/--

Business risk: Excellent

- Country risk: Low

- Industry risk: Low
- Competitive position: Excellent

Financial risk

- Cash flow/Leverage: Highly leveraged

Anchor: bbb-

Modifiers

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

Senior stand-alone credit profile: bbb

Structural features: +1 notch

Junior debt (Class B)

Issue rating: BBB-/Watch Neg/--

Business risk: Excellent

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

Financial risk

- Cash flow/Leverage: Highly leveraged

Anchor: bbb-

Modifiers

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

Senior stand-alone credit profile: bbb-

Structural features: None

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- European Aviation Is Set For A Strong Summer Before Brewing Macro Headwinds Blow In, June 8, 2022
- Heathrow Funding Ltd. Class A 'BBB+' And Class B 'BBB-' Debt Ratings On CreditWatch Negative, Feb. 24, 2022

Ratings List

Ratings Affirmed	
Heathrow Funding Ltd.	
Senior Secured	BBB+/Watch Neg
Subordinated	BBB-/Watch Neg

69-33-999-225; or Stockholm (46) 8-440-5914