FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms High Speed Rail Finance (1) Notes at 'A-'/Stable

Thu 27 Aug, 2020 - 15:19 ET

Fitch Ratings - London - 27 Aug 2020: Fitch Ratings has affirmed High Speed Rail Finance (1) PLC's senior secured notes and programme ratings at 'A-' with Stable Outlook. The issuer is funding vehicle for HS-1 Limited, which is the operator of the only high-speed railway operating in the UK. A full list of ratings is below.

RATING RATIONALE

HS-1 benefits from a robust operating profile and the critical nature of the railway connection between the UK and continental Europe. Domestic volumes are substantially underpinned by the UK government. We view demand for international traffic as robust in the long term, despite being significantly impacted by the COVID-19 pandemic at present. We currently assume demand to progressively recover by 2023 from the shock in 2020.

Tariffs are based on RPI-linked investment recovery charges and a pass-through of operating costs. HS-1 outsources most operations and maintenance (O&M) to an experienced operator. Debt is fully amortising and secured, with minimal exposure to interest-rate risk. Fitch's rating-case debt service coverage ratio (DSCR) profile is robust, averaging 1.6x from financial year to March 2021 until concession maturity.

The outbreak of coronavirus and related government containment measures worldwide create an uncertain global environment for the rail sector. While HS1's most recent performance data indicated in our view a short-term impairment, material changes in revenue and cost profile are occurring across the rail sector and will continue to evolve as economic activity and government restrictions respond to the ongoing pandemic. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector as a result of the virus outbreak for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on expectations for future performance and assessment of key risks.

KEY RATING DRIVERS

Highly Stable Volumes; Volume Risk: 'Stronger'

The UK government guarantees around 95% of domestic train paths as part of the underpinned volume scheme, making domestic revenue effectively availability-based. International volumes are based on dominant Eurostar train services from London to the continent, predominantly Paris and Brussels.

RPI Link, Costs Pass-Through; Price Risk: 'Stronger'

The concession framework allows the sponsors to recover their invested capital including debt through the RPI-linked investment recovery charge, which represented over 70% of EBITDA in FY20. Unlike most regulated assets in the UK, this is not subject to periodic regulatory review. The RPI revenue swap mitigates the risk of low inflation, as HS-1 will receive cash flows growing at a fixed rate while the payable portion will accrete as per realised RPI.

The operations-and-maintenance recovery charge (OMRC) component of revenues is designed to meet the majority of HS-1's operating, maintenance and renewal costs, and is subject to benchmarking and review every five years. The OMRC charges can also be reopened under certain circumstances, such as where there is a material shortfall in charges. The OMRC charges can also be reallocated between operators where traffic is 4% above or below the forecasts presented at the beginning of the control period.

Full Outsourcing to an Experienced Operator; Operation Risk: 'Stronger'

The majority of O&M is outsourced to a wholly owned subsidiary of Network Rail, which is a public body of the UK government (AA-/Negative) and the leading rail infrastructure operator in the UK. Network Rail guarantees the subsidiary's obligations. The concession and operating agreements are not strictly 100% back-to-back, and in contrast to standard Private Finance Initiative (PFI) concessions there is a limited universe of replacement operators. However, we believe HS-1's ability to periodically renegotiate the terms of the operating agreement mitigates these risks. HS-1 also benefits from a substantial pass-through of all liabilities to train-operating companies.

High Visibility on Capex; Infrastructure Development & Renewal Risk: 'Stronger'

Major maintenance is largely the infrastructure operator's responsibility, with HS-1's responsibility limited and predictable. Forward-looking escrow arrangements in respect of track and station capex provide high visibility of O&M and renewal costs. The five-year concessionaire's review of asset conditions is expected to prevent HS-1 incurring unexpected handover liabilities at concession maturity.

Solid Debt Structure; Debt Structure: 'Stronger'

The rated debt ranks senior, is secured and considered fully amortising, with more than 95% of the current outstanding debt either at fixed or swapped interest rates. A dedicated 12-month liquidity facility within the ring-fenced group, together with covenanted lock-up and default ratios, provide strong creditor protection. The amortisation of legacy swaps' crystallised mark-to-market value is fixed and reflected in the DSCR metric, and additional debt service is small at GBP17 million a year until 2026.

Financial Profile

Under Fitch's rating case (FRC), HS-1's DSCR profile is robust, averaging 1.6x from FY21 until concession maturity, with a minimum DSCR of 1.2x in FY21, which is approaching but not breaching the lock-up covenant. Despite the short-term deterioration, its credit metrics maintain buffer against our negative sensitivity trigger. We run a severe stress case where international train paths are down to zero, domestic train paths revert to government-underpinned volumes only, and unregulated revenue is down by half until the concession ends in 2040. Even under this stress case the average DSCR remains at about 1.0x.

PEER GROUP

Channel Link Enterprises Finance Plc (CLEF; rail/transportation, BBB/Stable) has the same catchment area as HS-1's international traffic. CLEF benefits from materially lower leverage than HS-1 but has weaker DSCR and a 'Midrange' debt structure. We deem HS-1 stronger than CLEF in terms of lower expected volatility in revenue, operating and infrastructure renewal costs, which explains the two-notch difference in their ratings.

Given the stable revenue profile and metrics, HS-1 compares well with Meridian Hospital Company PLC (hospital PFI concession), whose bond is currently rated 'BBB+'/Positive with an average DSCR of 1.6x.

RATING SENSITIVITIES

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

- An upgrade is unlikely as we believe that HS-1 could raise additional debt.

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

-Material underperformance of FRC, resulting in an average DSCR of below 1.45x from FY21 until debt maturity.

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

The high-speed rail line connects London's St Pancras International station to high-speed commuter services throughout Kent, and international passenger destinations in Europe, mainly Paris and Brussels, via the Channel Tunnel.

CREDIT UPDATE

Solid Pre-Pandemic Performance

Despite the impact of coronavirus being felt in the last quarter of FY20, HS-1's financial and operational performance remained solid for FY20. Revenue increased 5% to GBP237 million with a stable EBITDA margin of 40%. This was primarily driven by mild growth of around 1% in total train paths and a slight increase in net unregulated income (retail and parking). In terms of train paths, domestic paths were stagnant while international path growth was mainly driven by higher demand.

Coronavirus Affecting Mainly International Volumes

The COVID-19-related travel restrictions and social distancing measures have severely impacted train paths, mainly in the international segment. During the lockdown period, Eurostar was operating under 20% of its usual traffic. However, Eurostar has made all contractual payments based on the forward- working timetable and agreed volumes until December 2020. Therefore, cash flows have seen little impact so far.

However, while London & South Eastern Railway (LSER) continues to pre-book its train paths, Eurostar has submitted zero forward-working timetable in July 2020 and will book train paths ad-hoc (spot bids) after December 2020 to maintain operational flexibility. This change will have negative working capital effect on HS-1 in the short term as track access charges are billed quarterly in advance whereas spot bids are billed monthly in arrears. We believe that the negative effect on HS-1's working capital will be absorbed in the medium term.

Domestic volumes are effectively unaffected by the pandemic. On top of the government-underpin scheme, under which the government guarantees around 95% of domestic train paths, the emergency measure agreement (EMA) announced in March 2020 directly took over the revenue and cost risks from domestic train operating companies including LSER, ensuring a full timetable. We understand from HS-1 that EMA for LSER applies up to October 2021, with an option to extend to March 2022. This provides further visibility of domestic volumes, which we expect to be above the guaranteed domestic train paths.

OMRC Reopener

Under HS-1's passenger access terms, certain OMRC charges must be reallocated between operators when passenger train paths are above or below certain thresholds. Given the significant decline of international volumes and that Eurostar submitted a zero forward-working timetable, the reopener is likely to be triggered in December 2020. HS-1 has the contractual ability to recover the costs of operating the railway and we expect the OMRC reopener to be broadly neutral to HS-1.

Fitch Cases

Fitch's 2020 rating case reflects our conservative assumptions relative to the management case for the coronavirus impact on both international and domestic train path growth, increasing at an aggregate CAGR of 0.8% until 2040. Under our rating case, for international traffic, we expect traffic to be 60% below 2019 levels at the expiry of the current forward-working timetable in December 2020. We assume that traffic will gradually recover to 2019 levels by December 2023. For domestic traffic, our assumptions reflect the EMA in place. Thereafter, we assume marginal growth.

We forecast the average DSCR profile between 2021 and 2040 at 1.6x with a minimum DSCR of 1.2x, approaching but not breaching the lock-up covenant in FY21. This is deemed robust under our rating assumptions.

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

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

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
High Speed Rail Finance (1) PLC				
• HS1 Limited/Debt/1 LT	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
• • GBP610 million fixed-rate bonds due November 2038 XS0888566519	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Infrastructure and Project Finance Rating Criteria (pub. 24 Mar 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

High Speed Rail Finance (1) PLC	EU Issued

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Infrastructure and Project Finance   Europe   United Kingdom