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Research Update:

High Speed Rail Finance (1) Outlook Revised To Positive On Foreseen Operational And Financial Strengths; Rating Affirmed

September 13, 2023

Rating Action Overview

- International traffic volumes continue to improve, and we expect close to full recovery by early 2025 assuming immigration congestions are solved and supported by strong demand that continues to resist macroeconomic pressures. We anticipate domestic traffic to remain stable at the underpin level until 2028, representing 95% of pre-pandemic levels.
- We believe High Speed Rail Finance (1) PLC (HSRF1), special purpose vehicle, will demonstrate a solid operating and financial performances, backed by supportive regulatory and contractual frameworks that allow for timely inflation and operating cost pass-through. This should allow HSRF1 to comfortably sustain a minimum debt service coverage ratio (DSCR) above 1.40x.
- Rating upside is contingent to an improved performance of Eurostar Group, one of HSRF1's main revenue counterparties, which typically contributes 30% of total revenues. Eurostar is undergoing capacity limitations owing to post-Brexit immigration processes and significant financial pressures in the aftermath of the pandemic, and has significant upcoming maturities over the next six-12 months. If downside risks materialize, train path volumes could be affected, and full recovery would be further delayed.
- We revised our outlook on HSRF1's senior secured debt to positive from stable. At the same time, we affirmed our 'BBB+' long-term issue rating on HSRF1's senior secured debt.
- The positive outlook reflects our expectation that HSRF1 will benefit from continued international traffic recovery as well as its protective regulatory regime, while remaining insulated from any financial distress faced by material revenue counterparties.

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Project Description And Key Credit Factors

U.K.-based special-purpose entity HSRF1 is a finance vehicle for HS1 Ltd. (HS1, the project operating company; not rated), the operator of the U.K.'s sole high-speed rail line. HS1 operates under a 30-year concession agreement with the U.K. Secretary of State expiring December 2040 and is regulated by the Office for Rail and Road (ORR), an independent U.K. regulator. HS1 is responsible for the operation, maintenance, and renewal of track and associated infrastructure, along with four railway stations served by the route, which it subcontracts to Network Rail High Speed (NRHS) under a fixed price agreement until 2047. Once HS1's concession ends in 2040, this contract will revert back to the Department for Transport (DfT).

The rail line, which connects St. Pancras International station in London with the Channel Tunnel boundary in south-east Kent, provides track access to domestic and international high-speed traffic, plus a small quantity of freight traffic. HS1 has been in operation since 2007.

Strengths

- Supportive and transparent regulatory framework under which revenue generated from track access charges--typically 90% of project's revenue--is regulated and subject to annual or semiannual increases (depending on the charge component) in line with the retail price index (RPI).
- Domestic train path bookings--80.2% of volumes in financial years 2022 and 2023--are protected by the U.K. Secretary of State's commitment to pay for approximately 53,000 train paths per year, which largely mitigates the project's exposure to domestic volume risk.
- The project's strong competitive position stems from operating the sole high-speed rail connection between London and the Dover-Calais crossing (known as the Eurotunnel) to continental Europe.

Risks

- Eurostar has publicly stated an upcoming risk of breaching its lending covenant as of April 2024 and repayment of £350 million facility maturities, which would threaten liquidity and could disrupt HS1's operations.
- Bottlenecks at border crossings weigh on station capacity and limit the scope for more international services. An upper limit on passenger through-flow has knock-on effects for unregulated revenues including retail.
- One-third of the regulated revenue bears full volume risk from Eurostar's international train path bookings, which remains at 80%-90% of pre-pandemic volumes as Eurostar pursues a yield management strategy.
- The debt repayment profile is relatively back ended because most facilities do not start amortizing until 2027 or 2028. The last private placement issued in December 2016 shortened the concession tail to one year from two, and included a £130 million bullet repayment in December 2039.

Rating Action Rationale

We expect international train path demand to continue recovering, supporting the strengthening of the project's financial profile. As of financial year 2023, international traffic represented 80% of pre-pandemic volumes and we forecast full recovery by 2024-2025. Our base case assumes increased capacity from Eurostar driven primarily by finding immigration control efficiencies, which currently limits capacity deployment. We do not expect Eurostar's business strategy of stopping its secondary routes to affect total train volumes. This is because core routes are the most material paths and the ones that drive growth. The London to Amsterdam route has almost doubled train path volumes since it was launched in 2020. This should allow the project to achieve and sustain financial metrics consistently above 1.40 from close to 1.20x seen from 2020-2022.

The project will remain mostly protected from current macroeconomic volatility thanks to supportive contractual and regulatory frameworks. About 90% of revenues come from highly stable, regulated track and station related charges that are RPI-linked. This protects the project's cash flows from the rise of operational costs in a context of macroeconomic volatility.

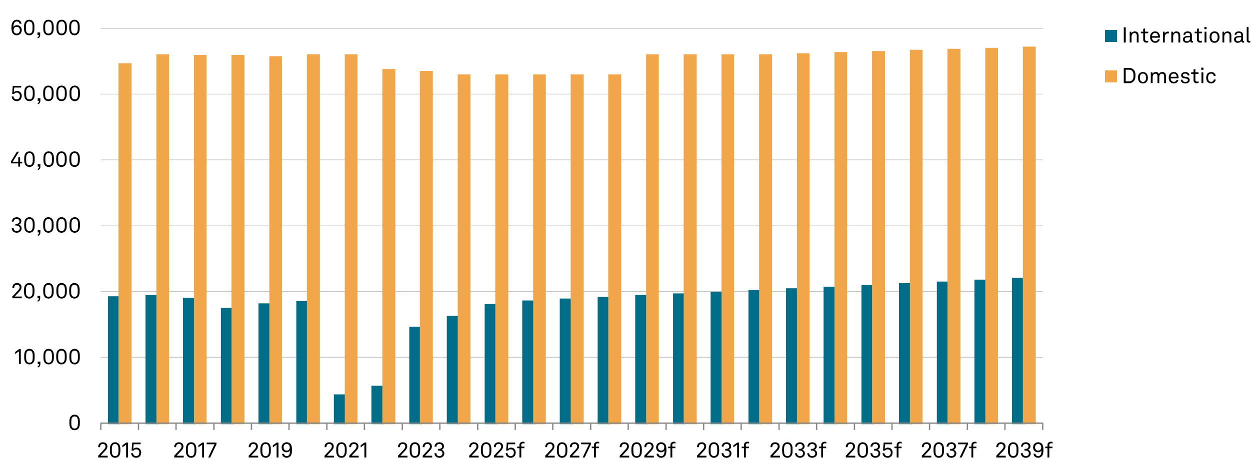
HSRF1's capital expenditure budget is defined by the regulator and subject to a five-year regulatory cycle review. Until the next control period starting April 2025, all variation costs rest on the subcontractor NRHS under the outstanding operator agreement. Similarly, electricity costs are fully passed through to train operators and the project remains insulated.

The project's main source of stability comes from its underpinned mechanism. The mechanism means that about two-thirds of regulated revenue is protected by the U.K. Secretary of State's commitment to pay a minimum level of domestic paths, representing around 95% of pre-covid levels. This largely mitigates the project's exposure to domestic volume risk.

Chart 1

Historic and forecast traffic

Total annual train paths by financial year



f--Forecast. Domestic traffic accounts for number of train paths paid and expected to be paid by underpinned level. It does not represent the actual number of trains. Source: S&P Global Ratings.

We forecast retail revenues will perform better than we previously expected. Sharp drops in passenger numbers on recent strike action days quickly bounced back but fewer international departures and changing commuter habits mean station footfall will remain under pre-pandemic levels in the short term. However, this is compensated by higher-than-expected passenger spend and retail revenues earned from units leased by HS1 at its stations, which we expect will reach pre-pandemic territory by March 2024. This revenue segment represents 8%-10%% of the project's revenue/cash flow.

Almost all retail units are leased, minimum guarantee rents are at 80% of pre-pandemic levels with a higher proportion of income made up of turnover income. HS1 also plans to expand its retail space by 2%, by moving delivery bays to a more efficient location. That said, we expect a much slower revenue growth rate for station car parks as changing commuter habits take hold. By March 2024, we expect car parks to be at 90%-95% pre-pandemic levels versus 88% in March 2023. This business line provides limited support to cash flows, historically representing about 3%-4% of total revenues.

Any deterioration to our view of Eurostar's creditworthiness could limit HSRF1 from potential rating upside. Eurostar published its financial statements for financial year 2022 in June 2023. In the statements, management highlighted the risk of breaching its April 2024 financial covenant and the need to refinance its £350 million loan facilities maturing in June 2024.

Our base case assumes Eurostar will take a proactive approach to tackle these matters ahead of the respective deadlines, as demonstrated in its track record. However, we acknowledge the risks around the current unsustainable capital structure and its potential effects to Eurostar's creditworthiness if it fails to manage those risks. Under this scenario, we would review our opinion on Eurostar's creditworthiness, which in turn would limit the potential rating upside for HS1 in the future. That said, we do not expect any negative effects on HS1's credit quality because we have seen a positive track record of Eurostar's payment compliance even when at the brink of bankruptcy during the height of the pandemic.

We acknowledge other risks outside of HSRF1's control that could delay rating upside. Our expectation for train path volumes also reflects strong passenger demand. This is due to retained pent-up demand following years of challenging travel conditions due to the pandemic and even despite higher ticket prices. In our view, passenger demand could be threatened if disposable income falls further in 2024 and 2025 and unemployment rises, which could affect train frequency and delay recovery. Similarly, high ticket prices have been the strategy across rail and aviation sectors as an attempt to recover margins. We think that if demand becomes sensitive to prices, there would be increasing competition with air traffic that might lead to limiting additional capacity deployment and therefore delaying HS1's train path volume recovery.

In respect to operational constraints, we are also monitoring the developments and actions taken to solve waiting times for passport control checks. It is critical to have a long-term solution for this issue to increase train capacity, given that there is no physical availability to find alternatives. This creates constraints at European stations as well that could lead to unavailability for some routes, but this is not yet reflected in our base-case scenario. We think operational challenges could affect the frequency of trains and lead to inefficiencies.

Outlook

The positive outlook indicates we could raise the rating on HSRF1 by one notch in the medium to long term if our expectations of consistent solid operating and financial performances are sustained, on the back of improvements of its revenue counterparty Eurostar's financial health, and more specifically Eurostar's ability to find a long-term solution for its capital structure, reducing its short-term refinancing risk.

Downside scenario

We could revise the outlook to stable if international traffic stalled or we see an increasing risk of operating disruption from international train operators that could affect traffic recovery or lead to a deterioration in our view of Eurostar's creditworthiness, which in turn would limit rating upside. We would be likely to revise the outlook to stable if the regulatory revision results are detrimental for the project.

Upside scenario

We could raise the rating if, contingent to our view of Eurostar's enhanced creditworthiness, HSFR1's projected minimum annual DSCR is comfortably above 1.40x while maintaining a strengthened performance in our resiliency analysis. This could happen if our base case materializes with international traffic fully recovering to pre-pandemic levels by 2025, on the back of an improved operating and financial position from critical counterparty Eurostar. We would also need to gain some visibility on the regulatory review that determines track charges for the next regulatory period starting in March 2025.

Performance Update

We expect the project to receive underpinned payments from DfT until at least March 2028. Track bookings by domestic train operating companies (TOCs) were 20% below the underpin level and 80.2% of total volumes for the latest financial year. TOCs are running below the underpin level with many operational issues caused by strikes and workforce pay demands. Although this does not directly affect HS1--as it receives the underpin level anyways--it delays recovery and potential growth of domestic volumes. More importantly, the rail reform legislation continues to be delayed and will potentially hinder the sector's growth. Positively, passenger volumes continue to grow reaching 83% of pre-pandemic levels, fostering nonregulated revenues that are already above these levels. It seems people commute less but spend more each time they travel.

ORR, the independent regulator, has kicked off the tariff review process for HS1's next periodic review. It intends to review operations, maintenance, and renewals charges for using the network for the five-year period from April 2025-March 2030. In February 2024, HS1 will present its charges proposal while draft determination from ORR will be presented by September 2024. We expect the final determination by January 2025 and will monitor the developments of this process to assess and incorporate the impact into our rating.

Base Case

Assumptions

- International train paths: A combination of forward and spot bookings until March 2025, but a higher share of forward bookings. Total train paths in 2023 (12 months to March 2024): 16,135; 2024: 17,970; 2025: 18,461; 2026: 18,793; thereafter we assume growth will be driven by the combination of France and U.K. GDP growth expectations, which is around 1.3% combined.
- We do not include the potential entrance of any service challenger.
- Domestic train paths: Until March 2028 an underpin amount of 52,806 paths per year. March

2029: 55,575 train paths per year, which was the number run before the pandemic; thereafter we assume growth will be driven by U.K. GDP growth expectations.

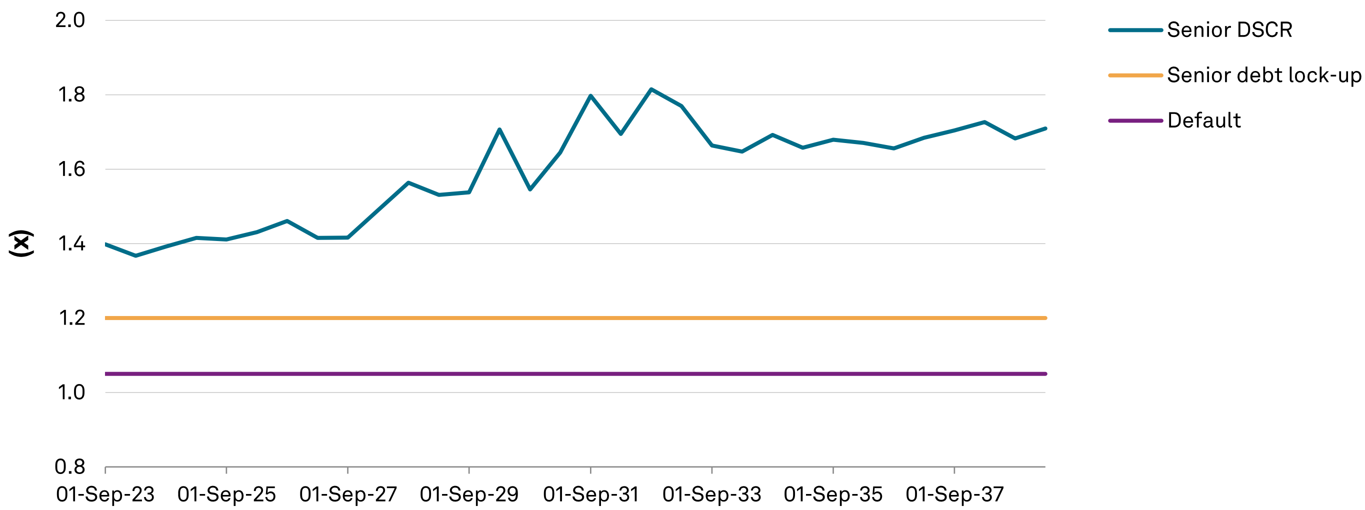
- Freight train paths: 450-500 train paths per year.
- Unregulated revenue: We assume retail will reach pre-pandemic levels of around £30 million by March 2024, while car park revenue will likely be delayed to at least March 2026 but will add £8 million-£9 million. Thereafter we assume revenues will grow with footfall, led by traffic volumes.
- Operating costs: In line with management's forecast, with cost pass-through of the operations and maintenance recovery charge, power, and station costs.
- A recessionary period between 2035 and 2038, in line with our assumptions in the peer project, Channel Link Enterprise Finance PLC, which is designed to replicate the stress on the underlying volumes in 2008-2009.
- Cost of letter of credit (LoC): To ensure comparability in our cash flow analysis, we assume that the liquidity facility is drawn on an amount equal to the next six months of debt service. We also consider £51 million of the working capital facility as drawn, in line with the project's actual balance.
- Tax rate: 25%
- RPI: 7.64% for 2023; 2.27% for 2024; 2.04% for 2025-2026; 2.47% for 2027; 2.51% for 2028-2031; and 2.54% for 2031-2036; 2% growth thereafter, in line with our macroeconomic forecasts.
- U.K. GDP growth: 1.22% for 2027-2031; 1.17% for 2032-2036; and 1.21% thereafter.
- France GDP growth: 1.4% over 2027-2038.

Key metrics

- Minimum ADSCR is 1.37x (March 2024) and median ADSCR is 1.64x.
- The minimum ADSCR is consistent with a minimum stand-alone credit profile (SACP) of 'bbb+' given the project's operations phase business assessment of '4'.
- We removed the temporary median ADSCR adjustment because our SACP reflects the expected metrics recovery. In our view, the robustness of the median is not enough to indicate complementary resilience throughout the life of the transaction.

Chart 2

S&P Global Ratings' base-case DSCR



DSCR--Debt service coverage ratio.

Downside Case

Assumptions

- International train paths: Slower recovery for the next two years at -30% of our base-case traffic assumptions. From March 2026 onward, we forecast flat recovery at 18,000 train paths, plus a two-year shock starting in 2034. The shocks reflect the effect of an incident, such as a tunnel fire, resulting in partial temporary tunnel closures with 20% capacity constraint.
- Domestic train paths: Train paths at the underpin level of 52,806 per year through the life of the project.
- Freight train paths: Stress follows international traffic volumes.
- Unregulated revenue: 20% below our base case.
- Regulated costs: As per the base case.
- RPI: One percentage point above our base case for 2023-2027. Thereafter, in line with the base case (including the recessionary period 2035-2039).
- Cost of LoC: We assume SONIA at 6% throughout the life of the project.

Key metrics

- The project performs strongly under our downside-case scenario, with a minimum base-case

ADSCR that remains above 1.10x supporting a resiliency assessment of 'high'.

Rating Score Snapshot

Senior debt issue rating	**BBB**
Preliminary operations phase SACP	bbb+
Downside resiliency assessment and impact:	High (+1 notch)
Median DSCR impact:	Neutral
Debt structure impact:	-1 notch
Liquidity impact:	Neutral
Refinancing impact:	N/A
Future value modifier impact:	N/A
Holistic analysis impact:	N/A
Structural protection impact:	N/A
Counterparty assessment impact:	Neutral
Operations phase SACP	**bbb+**
Parent linkage and external influences (senior debt)	
Parent linkage:	Delinked
Project SACP:	**bbb+**
Extraordinary government support:	N/A
Sovereign rating limits:	N/A
Full credit guarantees:	N/A

DSCR--Debt service coverage ratio. N/A--Not applicable.

Related Criteria

- Criteria | Infrastructure | General: General Project Finance Rating Methodology, Dec. 14, 2022
- Criteria | Infrastructure | General: Sector-Specific Project Finance Rating Methodology, Dec. 14, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology Applied To Bank Branch-Supported Transactions, Oct. 14, 2013
- Criteria | Structured Finance | General: Global Derivative Agreement Criteria, June 24, 2013
- General Criteria: Global Investment Criteria For Temporary Investments In Transaction Accounts, May 31, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Industry Top Trends Update Europe: Transportation Infrastructure, July 18, 2023
- Issuer Ranking: Global Project Finance Issuers, Strongest To Weakest, June 12, 2023
- High Speed Rail Finance (1) 'BBB+' Rating Affirmed And Removed From Under Criteria Observation; Outlook Stable, Jan. 31, 2023

Ratings List

Ratings Affirmed; Outlook Action	
High Speed Rail Finance (1) PLC	
Senior Secured	BBB+/Positive