Bulgarian Energy Holding EAD (/gws/en/esp/issr/92151696)

FitchRatings

Fitch Upgrades Bulgarian Energy Holding to 'BB'; Outlook Stable

Fitch Ratings-Warsaw/London-15 February 2018: Fitch Ratings has upgraded Bulgarian Energy Holding EAD's (BEH) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) and foreign currency senior unsecured rating to 'BB' from 'BB-' and removed these ratings from Rating Watch Positive (RWP). The Outlook on the IDRs is Stable.

The upgrade follows improvement in BEH's standalone credit profile after both recovery and greater visibility in earnings as well as the publication of Fitch's new "Government-Related Entities Rating Criteria" (GRE criteria), which we have applied in our assessment of BEH's ratings. The ratings were put on RWP in December 2017 after the release of the exposure draft of the GRE criteria.

KEY RATING DRIVERS

Improved Results: BEH's results have stabilised in 2016 with Fitch-calculated EBITDA at about BGN0.7 billion and we expect that it will remain at this level over 2017-2021. This is largely due to legislative and regulatory changes, implemented in 2015 and remaining in force, which have narrowed power tariff deficits at BEH's subsidiary, Natsionalna Elektricheska Kompania EAD (NEK), a public supplier of electricity in Bulgaria. Consequently, we expect the group's funds from operations (FFO) adjusted net leverage to stabilise at about 3.7x, which led us to revise the group's standalone credit profile to 'BB-' from 'B+'.

Regulatory Regime's Weakness: Despite positive developments addressing NEK's tariff deficit, BEH and its subsidiaries are yet to establish a track record of improved cash flows while the Bulgarian operating environment remains subject to high regulatory and political risk. This is a constraint on the ratings despite BEH's strong projected credit metrics for the ratings and BEH's strong position as the leading integrated utility in Bulgaria. The energy market in Bulgaria is being liberalised, which can provide some upside to the group's EBITDA in the future.

Belene Payment Removes Event Risk: In December 2016, NEK paid BGN1,177 million, including accrued interest, to Russia's Atomstroyexport for the nuclear power plant equipment following a long arbitration process related to the terminated Belene nuclear power plant project. Funds for the payment were provided by the state in the form of an interest-free loan maturing in 2023. We deem the payment as positive for BEH as it has eliminated a large event risk for the company. That the payment was made from state-loan funds underlines BEH's strengthened links with the 100% owner Bulgarian State (BBB/Stable).

Parent Support Assessment: The share of state-guaranteed debt at BEH has fallen in our projections to about 5% at end-2017 (from 50% in 2012), but with the expected receipt of state guarantees to BEH's gas interconnector project between Greece and Bulgaria (IGB project) as well as counting in the interest free state-loan given to NEK, the share of state-guaranteed and state-provided debt was at about 40% at end-2017 and should remain at this level over our five-year rating horizon. Moreover, the Ministry of Energy provided BEH with a letter of support (not a formal guarantee) before its 2016 Eurobond bond issue, stating that the Bulgarian State will undertake necessary measures to financially support BEH so that it meets its obligations to bondholders.

We therefore view the status, ownership and control links between BEH and the State as strong, although support track record and expectations are only moderate. We deem the socio-political and financial implications of BEH's potential default for the Bulgarian State as moderate. Consequently, BEH's IDRs include a single-notch uplift from the group's standalone profile.

Corporate Governance Limitations: The ratings continue to reflect BEH's corporate governance limitations, including a qualified audit opinion for BEH's 2009-2016 consolidated financial statements. We view the group's financial transparency, including on business segments, as weak compared with its European peers.

DERIVATION SUMMARY

BEH has a dominant position in the Bulgarian gas and electricity market through its ownership of most of Bulgaria's power generation assets (including a nuclear power plant, lignite-fired and hydro power plants), the country's largest mining company, the country's electricity transmission network, gas transmission and transit networks and through its position as the public supplier of both electricity and gas in Bulgaria.

BEH's integrated business structure and strategic position in the domestic market makes it comparable to some of central European peers such as CEZ, a.s. (A-/Negative) and PGE Polska Grupa Energetyczna SA (PGE, BBB+/Stable). However, BEH operates in a more volatile and less transparent regulatory environment than CEZ or PGE and its results are less predictable with some corporate governance issues. BEH's rating includes a single-notch uplift to reflect its links with the sovereign, whereas this is not the case for CEZ or PGE.

KEY ASSUMPTIONS

Fitch's Key Assumptions within Our Rating Case for the Issuer
- Marginally positive EBITDA at NEK with impact of the remedy actions maintained
-Capex for 2017-2021 at BGN2.8 billion
- Dividend at 50% of group net income
- Forthcoming tangible state support in case of tight liquidity

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Further tangible government support, such as additional state guarantees materially increasing the share of state-guaranteed debt or cash injections, which would more tightly link BEH's credit profile with Bulgaria's stronger credit profile
- Upgrade of the sovereign rating
- Stronger standalone credit profile due to lower regulatory and political risk, higher earnings predictability, better corporate governance or FFO adjusted net leverage falling below 3x on a sustained basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Weaker links with the Bulgarian State
- Weaker standalone credit profile, eg. due to escalation of regulatory and political risk, FFO adjusted net leverage exceeding 4x on a sustained basis or insufficient liquidity
- Sustained increase in prior-ranking debt to above 2x EBITDA (2016: 2.0x; 2017-2021: averaging just below 2.0x), which would be negative for the senior unsecured rating of BEH

LIQUIDITY

Liquidity Gap: At end-September 2017 BEH had BGN1,186 million of unrestricted cash against short-term financial liabilities of only BGN147 million. However, the group's EUR500 million (BGN980 million) Eurobond is due in November 2018. We expect BEH to refinance the Eurobond during 2018.

Should BEH not refinance the Eurobond, the amount of cash on balance should be sufficient to cover redemption needs. However, Fitch expects BEH to incur new debt to cover negative free cash flow forecasted for 2018-2019, totalling about BGN0.2 billion, or reduce capex.

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Summary of Financial Statement Adjustments - Financial debt at end-2016 is increased by BGN1,177 million of the face value of the state-loan received by NEK. The same amount, representing NEK's payment to Atomstroyexport with respect to the Belene nuclear project, is taken out from cash flow from operations and added to non-operating/non-recurring cash flow, as per Fitch definitions, for 2016.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

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Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017) (https://www.fitchratings.com/site/re/901296)
Exposure Draft: Corporate Rating Criteria (pub. 14 Dec 2017) (https://www.fitchratings.com/site/re/907387)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018) (https://www.fitchratings.com/site/re/10019302)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/10020620)
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