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Research Update:

Bulgarian Utility Natsionalna Elektricheska Kompania Outlook Revised To Stable On Parent's Refinancing; Affirmed At 'B+'

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Rating Action Overview

- In July 2021, Bulgarian Energy Holding (BEH), the parent of Natsionalna Elektricheska Kompania (NEK), successfully refinanced its short-term debt with a €600 million seven-year bond. We expect BEH's consolidated funds from operations (FFO) to debt to stay firmly between 12% and 20% in 2021-2022, rebounding from last year's low 12.3%, particularly since the large €1.3 billion Balkan Stream project is almost completed and related capital expenditure won't increase the group's debt further.
- NEK's operating performance is improving, and although leverage remains high, almost all debt is to the parent or to the government.
- We revised up our assessment of NEK's stand-alone credit profile to 'b' from 'b-'.
- We therefore revised the outlook on NEK to stable from negative and affirmed the 'B+' rating.
- The stable outlook on NEK reflects our expectation that the rating will continue to be driven by BEH's support and that BEH will maintain adequate liquidity and FFO to debt in the 12%-20% range.

Rating Action Rationale

The outlook revision reflects our view that the credit quality of NEK's parent, BEH, has stabilized. In July 2021, BEH issued a €600 million seven-year Eurobond to refinance its €550 million Eurobond that matured Aug. 2, 2021. In our view, this removed pressure from BEH's liquidity. BEH's largest capital expenditure (capex) project, the expansion of Bulgarian gas transmission gas pipeline between Turkey and Serbia (the Balkan Stream project), is nearly finished. The project costs amount to €1.3 billion, of which €1.1 billion has already been spent. Of the realized expenditure, about €0.5 billion was funded with debt-like long-term liability to the engineering, procurement, and construction company. As a result, we expect BEH's credit metrics to improve, with FFO to debt staying firmly in the 12%-20% band in 2021-2022, compared with the low 12.3% in 2020.

The rating on NEK continues to be driven by BEH's performance. We view NEK as a strategically important subsidiary of BEH, given the former's very important role in Bulgaria's energy system as a hydropower producer and supplier of last resort. Despite improving operating performance, NEK has historically accumulated a lot of debt. It therefore has a significantly higher leverage than BEH. In 2021-2022, we expect NEK's FFO to debt to stay below 12%, versus our estimate of 12%-20% for BEH. Our rating on NEK therefore includes uplift for parent support and is capped one notch below our 'bb-' assessment of the group credit profile.

Nevertheless, NEK's stand-alone credit quality is strengthening. We expect NEK's EBITDA to remain resilient and free operating cash flow (FOCF) to be positive, because the company benefits from ongoing electricity sector liberalization and favorable electricity prices, and its ongoing tariff deficit is covered from Security of Electricity Supply Fund (SESF). Indeed, the company generated EBITDA of BGN249 million in the first half of 2021, compared to BGN237 million BGN191 million for the full years 2020 and 2019, respectively. NEK's 2020 FOCF was also positive, at BGN126 million, thanks to only minimal capex and mostly non-cash interest on related party debt. As a hydropower producer, NEK is well positioned in the energy transition sector and may be eligible for EU grants for green capex, if and when Bulgaria's energy strategy and NEK's specific projects are finalized and obtain all necessary approvals. We understand that Bulgaria is working to resolve NEK's historical tariff deficit (estimated by World Bank at about BGN1.9 billion), and one of the options under consideration is for SESF to issue debt and transfer the proceeds to NEK. We believe this would be very positive for NEK, but we don't include it in our base case at this stage because it depends on political decisions, market uncertainty and execution, and is unlikely to happen before 2023. Before then, NEK's debt, as adjusted by S&P Global Ratings, remains high, with FFO to debt of 6.4% and debt to EBITDA of 15.3x in 2020. Still, we consider that, of the BGN3.6 billion total adjusted debt at end-2020, only BGN12.7 million were to third parties; the rest was to the Ministry of Energy (BGN1 billion) and to BEH, and these are unlikely to trigger a default, in our view. This leads us to assess NEK's stand-alone credit quality at 'b', up from 'b-' previously.

Outlook

The outlook is stable. This reflects our expectation that the rating on NEK will continue to depend on BEH's credit quality due to the one-notch differential between the rating and our assessment of NEK's 'b' SACP. We also consider our expectation that BEH's credit metrics will gradually strengthen. After the low 12% FFO to debt in 2020, the ratio will be firmly between 12% and 20% in 2021-2022. We also expect BEH to have sustainable liquidity after the €600 million bond issue in July 2021.

Furthermore, we factor in our assumption that NEK's stand-alone performance will remain robust thanks to resilient EBITDA, ongoing tariff deficit covered from SESF, and positive FOCF. Moreover, we expect NEK's liquidity to stay manageable, with most debt being to the parent and to the government.

Upside scenario

Rating upside will be largely driven by a strengthening of the group credit quality beyond our current 'bb-' assessment. This would mainly depend on the combination of:

- The group's debt to EBITDA dropping below 4.0x and FFO to debt rising, and staying, above 20%;
- Manageable capex plans, with no large new projects to be funded with debt nor or long-term payables (i.e. not covered by equity funding from the government or from EU grants);
- Sustainable adequate liquidity at the group level; and
- Strengthening management and governance practices, including prudent financial policy and strategy at the group's level.

Additionally, successful implementation of market liberalization in Bulgaria, a resolution of historic tariff deficit and of the loan to the Bulgarian government related to the Belene project would all support an upgrade.

Ratings upside would also hinge on NEK's SACP improving by at least two notches to 'bb-'. We believe such a significant movement would likely take time and could be driven by strengthening business and a reduction in debt, such as through resolution of historical tariff deficit or of the loans from the parent and the government.

Downside scenario

We believe that, after BEH has completed its refinancing and most part of its sizable Balkan Stream project, the possibility of a negative rating action on NEK, or a downward revision of the group credit profile, is limited. It could materialize if BEH's FFO to debt declines sustainably below 12%, which could happen due to a very material deterioration in operating performance, large and unexpected debt-funded capex projects, or weakening liquidity. None of these scenarios are part of our base case.

Rating pressure could also stem from a sovereign downgrade by at least two notches. Furthermore, we could downgrade NEK if we saw a pronounced deterioration in its liquidity and ability to generate sufficient cash flow to repay its relatively modest external debt, or if parental support significantly diminishes. However, these developments are also far from our base-case scenario.

Company Description

NEK is a Bulgarian electricity producer with 2.7GW installed capacity at 30 hydropower stations and pump storage plants. In 2020, it generated 5.8% of Bulgaria's total electricity production. Also, NEK has an important role as a supplier of last resort to protected customers in Bulgaria. The company's S&P Global Ratings-adjusted EBITDA was BGN236.7 million.

NEK is 100% owned by BEH, Bulgaria's vertically integrated energy holding, which itself is fully owned by the Bulgarian state through the Ministry of Energy. BEH controls electricity generation assets with 6.3GW total installed capacity (in addition to NEK's hydropower, this includes nuclear and thermal power plants), as well as coal mining, electricity system operator, gas transmission and distribution assets in the country. In 2020, BEH's EBITDA, as adjusted by S&P Global Ratings, was BGN907.6 million.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Bulgaria of 2.9% in 2021 and of 4.3% in 2022. Consumer price index of 1.5% in 2021 and of 1.7% in 2022.
- Capex at about BGN90 million in 2021 and then to stabilize at BGN60 million-BGN70 million through 2023. We do not assume any large debt-funded capex projects.
- EBITDA sustained above the BGN220 million-BGN240 million achieved in 2020. In fact, the BGN249 million achieved in the first half of 2021 suggests a potential outperformance.
- We continue to treat BGN1 billion loan obtained from the government in December 2016 and maturing in December 2023 as debt rather than equity, in line with criteria.
- We understand that the government plans to restructure NEK's historical tariff deficit (estimated by World Bank at about BGN1.9 billion) through issuing bonds at SESF in 2023-2024, but because it is long term and will depend on execution, obtaining necessary approvals and market situation at the time, we don't include it in the base case at this stage.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of the loans from the parent if and when needed.

Key metrics for NEK

- FFO to debt of 6%-12% in 2021-2022.
- Slightly positive FOCF.

Liquidity

We now view NEK's liquidity as less than adequate. Although the ratio of liquidity sources to liquidity needs is below 1x, most short-term debt is to the parent BEH. Furthermore, NEK's debt to third parties is minimal and can be easily serviced from its cash flow. We believe that the parent has been willing and able to provide sufficient liquidity support to NEK in a timely manner, and that NEK has some flexibility regarding interest payments in loans from BEH. We also understand that €536 million loan from BEH is in process of being renegotiated for potential extension.

Principal liquidity sources in the 12 months from July 1, 2021, include:

- BGN376 million of cash and cash equivalents; and
- Our estimate of cash FFO at BGN95 million-BGN100 million.

Principle liquidity uses over the same period include:

- BGN1.2 billion of debt amortization (mainly consists of €536 million loan from BEH, which is due in 2021); and
- Maintenance capex of BGN10 million.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Very low

Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

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

Stand-alone credit profile: b

- Group credit profile: bb-
- Entity status within group: Strategically important (+1 notch from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 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

- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Natsionalna Elektricheska Kompania EAD		
Issuer Credit Rating	B+/Stable/--	B+/Negative/--