FitchRatings

Fitch Downgrades Bulgarian Energy Holding to 'BB'; Places on RWN

Ratings Endorsement Policy
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Fitch Ratings-Warsaw/London-18 March 2015: Fitch Ratings has downgraded Bulgarian Energy Holding EAD's (BEH) Long-term foreign and local currency Issuer Default Ratings (IDR) and its foreign currency senior unsecured rating to 'BB' from 'BB+', and placed the ratings on Rating Watch Negative (RWN).

The rating downgrade reflects a substantial deterioration of BEH group's credit metrics driven by a wider tariff deficit at its subsidiary Natsionalna Elektricheska Kompania EAD (NEK) amid an unfavourable regulatory and market environment.

The RWN reflects the risk of a further rating downgrade if NEK's and BEH group's financial results fail to materially improve in 2015-2016 from weak 2014 preliminary levels. The speed and scale of results improvement depends on the implementation of planned regulatory and legislative changes as well as on NEK's long-term power purchase agreements renegotiation. We expect a deterioration of the BEH group's liquidity in 2015 due to working capital outflow projected by Fitch, which together with capex will result in negative free cash flow (FCF). Based on preliminary numbers for 2014, BEH expects to meet a debt incurrence covenant, as defined in the EUR500m eurobond documentation, albeit with limited headroom. In our view, failure to meet the eurobond covenant resulting in limitation to raise debt would substantially worsen BEH group's liquidity position.

We expect to resolve the RWN in the next few months once the 2014 audited consolidated financial statements are available and depending on the progress on various efforts aimed at narrowing NEK's deficit. The efforts include planned regulatory and legislative changes, for instance, related to a reduction of NEK's obligation to purchase electricity from renewable energy sources and cogeneration plants and also renegotiation of long-term contracts with two thermal power plants, AES-3C Maritsa East 1 EOOD and Contour Global Maritsa East 3 AD.

BEH's ratings are notched up one level from its standalone rating of 'BB-'/RWN, reflecting the BEH group's strong links with the Bulgarian state (BBB-/Stable). We expect that the state will support BEH to avoid potential liquidity issues in case of a covenant breach.

KEY RATING DRIVERS

Deteriorated Financial Position of NEK
NEK, which acts as a public supplier of electricity in Bulgaria, reported heavy losses on its core activity in 2014 due to an unfavourable regulatory and market environment. Inability to fully recover the costs of purchased electricity from various generation sources, including renewable energy sources, cogeneration plants and thermal power plants with long-term power purchase agreements, given the insufficient level of NEK's regulated sale prices resulted in a preliminary EBITDA loss of BGN0.5bn at NEK in 2014 compared with close to break-even EBITDA in 2013. This in turn had a material negative impact on BEH's consolidated profitability and credit metrics. The widened tariff deficit of NEK has created liquidity issues for the company and an increase of overdue trade payables to its suppliers. BEH continues to support NEK through inter-company loans of BGN1.2bn.

Fitch views the Bulgarian regulatory environment as less developed and far less predictable than in western Europe. Several legislative and regulatory changes aimed at narrowing NEK's deficit are planned by the government, parliament and the regulatory office for 2015, but may be subject to delays or may yield lower-than-expected positive impact as happened in 2014 with some planned changes.

BEH's Weak Credit Ratios
Based on selected preliminary numbers for 2014 we estimate BEH group's EBITDA to have dropped to BGN0.3bn in 2014 from BGN0.6bn in 2013 primarily due to the losses at NEK. We expect that BEH group's funds from operations (FFO) to have followed a similar trend, though cash flow from operations (CFO) was temporarily boosted by working capital inflows (partly due to increased overdue trade payables of NEK). This resulted in a substantial worsening of BEH group's credit metrics. We expect FFO adjusted net leverage to have increased to about 8x in 2014 from 2.8x in 2013.

Recovery Dependent on Regulatory Changes
We project a modest recovery of credit metrics in 2015-2016 depending on the implementation of the planned regulatory/legislative changes aimed at narrowing NEK's tariff deficit. We project net leverage of about 6x in 2016, which is still a very high level given BEH's business profile and the limited predictability of the Bulgarian regulatory environment.

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Liquidity May Substantially Weaken
At end-December 2014, BEH group had sufficient unrestricted cash of BGN383m against short-term debt of BGN146m. However, planned repayment of overdue trade payables of NEK in 2015 is likely to lead to a working capital outflow. We expect this, together with capex, to lead to negative FCF and a deterioration of the BEH group's liquidity in 2015. Based on preliminary numbers for 2014, BEH expects to meet a debt incurrence covenant (EBITDA coverage ratio of no less than 4x), as defined in the EUR500m eurobond documentation, albeit with limited headroom. In our view, failure to meet the eurobond covenant resulting in limitation to raise debt would substantially worsen BEH group's liquidity position and could result in a liquidity crunch in 2015.

We expect that the state will support BEH to avoid potential liquidity issues. Lack of support from the state in case of liquidity issues may result in a removal of the one-notch uplift for state support and a potential downgrade of the standalone rating if the liquidity shortfall has not been remedied.

Most of BEH's debt is due in 2018 when the EUR500m bond (BGN1bn) issued in 2013 matures. We expect BEH to start the bond refinancing process well ahead of maturity.

Senior Unsecured Debt Rating
Failure to substantially improve BEH group's EBITDA in 2015-2016 so that the ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH) to consolidated EBITDA returns to below 2x-2.5x may lead us to notch down the rating for senior unsecured debt of the holding company (including for the EUR500m bonds) from the IDR. This would be due to the structural subordination of the holding company's creditors to the external creditors lending directly to its operating companies. Currently, the senior unsecured rating is at the same level as the IDR but if the ratio of prior-ranking debt to consolidated EBITDA remains well above 2x on a sustained basis then we would consider rating unsecured debt one notch lower than the IDR.

Strong Links with the State
BEH is notched up one level from its standalone rating of 'BB-'/RWN, reflecting the group's strong links with the Bulgarian state, and in accordance with the agency's Parent and Subsidiary Rating Linkage criteria. The strong linkage is mainly evidenced by state guarantees for about 30% of the group's debt (as of end-2013), its strong operational ties with the state and its strategic importance due to its dominant market position in the country's electricity and gas market. The state plans to guarantee BEH's new EUR80m loan related to a gas interconnection project between Bulgaria and Greece.

Corporate Governance Limitations
The ratings reflect BEH's corporate governance limitations, including a qualified audit opinion for BEH group's 2009-2013 financial statements and frequent management changes.

RATING SENSITIVITIES

Negative: Future developments that could lead to negative rating action include:
- Failure to materially improve the group's EBITDA and FFO from the weak 2014 levels and to demonstrate de-leveraging
- Failure to maintain sufficient liquidity
- Weakening links between BEH and Bulgaria through, for instance, a reduction of the share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed

Positive: The ratings are on Rating Watch Negative. As a result, Fitch's sensitivities do not currently anticipate developments with a material likelihood, individually or collectively, of leading to an upgrade. Future developments that could, nonetheless, lead to a positive rating action include:
- FFO adjusted net leverage below 3x on a sustained basis, for instance, due to a reduced capex plan and improved financial performance, including liquidity management and debt maturity profile
- A substantial narrowing of NEK's deficit and increased predictability of cash flows at BEH group, for instance, due to regulatory/legislative decisions
- Progress in the liberalisation of the electricity market through a rising share of market-based pricing in the generation sector

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- Gradual improvement in NEK's EBITDA from a preliminary BGN0.5bn loss in 2014 to break-even within the next two to three years on the back of regulatory changes and renegotiation of power purchase agreements
- Capex of around BGN3.5bn in 2015-2019 co-funded with EU grants and CO_2 reimbursement. Capex to result in negative FCF in the medium term

- Forthcoming tangible state support in case of potential liquidity issues
- No dividend pay-outs in the next three years

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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.

Applicable criteria, 'Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage', dated 28 May 2014, are available at www.fitchratings.com.

Additional Disclosure
Solicitation Status