FitchRatings

Fitch Affirms BEH at 'BB-'; Negative Outlook; Rates Upcoming Bond 'BB-(EXP)'

Fitch Ratings-Warsaw/London-06 July 2016: Fitch Ratings has affirmed Bulgarian Energy Holding EAD's (BEH) Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) and its foreign currency senior unsecured rating at 'BB-'. The Outlook is Negative. The agency has also assigned BEH's upcoming Eurobond an expected foreign currency senior unsecured rating of 'BB-(EXP)'. The final rating is contingent on the receipt of final documents conforming materially to the preliminary documentation.

The affirmation reflects BEH group's substantially improved funds from operations (FFO) in 2015 and 2016 from a very low level in 2014 thanks to various legislative and regulatory changes implemented during 2015 and successful renegotiations of power purchase agreements (PPAs) with two thermal power plants.

The Negative Outlook reflects BEH's insufficient liquidity to cover short-term debt maturing mostly in April 2017 and negative free cash flow (FCF) projected by Fitch. After the long-term bond issue planned for 3Q16, liquidity should cover short-term debt and negative FCF, which is likely to lead us to revise the Outlook to Stable from Negative.

The ratings are notched up one level from BEH's standalone rating, reflecting the group's strong links with the Bulgarian state (BBB-/Stable), including guarantees for part of the BEH group's debt. We expect the state to support BEH should the company have insufficient liquidity in a scenario of payment of the full arbitration amount recently ordered by an arbitration court in relation to the terminated Belene nuclear power plant project.

A declining share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed would result in a possible removal of the currently applied one-notch uplift.

KEY RATING DRIVERS

NEK's Improved Financial Position

The affirmation reflects the BEH group's substantially improved cash flow generation in 2015 after very weak results for 2014. This is largely due to a narrowed power tariff deficit at BEH's subsidiary Natsionalna Elektricheska Kompania EAD (NEK), a public supplier of electricity in Bulgaria, following a number of legislative and regulatory changes implemented during 2015. These included the creation of a Security of the Electricity System Fund (SESF), which collects revenues for the co-funding of NEK's deficit from a new 5% charge on sales of electricity producers and proceeds from the sale of CO_2 allowances by the state.

In addition, an obligation-to-society fee paid to NEK by customers on the free market was increased for the regulatory period from August 2015 to June 2016, although the positive impact of this change was partially reduced by a cut of NEK's sale price on the regulated market. At the same time, NEK's obligations to purchase electricity from renewable energy sources and highly efficient cogeneration sources at above-market preferential prices were reduced.

As a result, NEK's EBITDA loss narrowed to BGN124m in 2015 from BGN503m in 2014. Exceptionally high losses in 2014 were driven by NEK's inability to fully recover the costs of purchased electricity from various generation sources, including renewable energy sources, cogeneration plants and thermal power plants with PPAs, given the insufficient level of NEK's regulated sale prices.

We expect NEK's cash flows to improve further in 2016 due to the full-year impact of 2015 legislative and regulatory changes and also due to the renegotiation of NEK's PPAs with two thermal power plants, AES-3C Maritsa East 1 EOOD and Contour Global Maritsa East 3 AD, which came into force following the repayment of NEK's overdue trade payables to these two plants in April 2016. As a result, we expect NEK to generate positive EBITDA of about BGN0.1bn in 2016 for the first time since 2012.

Regulatory Regime's Weakness

Despite recent positive developments addressing NEK's tariff deficit, the BEH group is 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 for the rating.

The regulatory framework in Bulgaria is less developed than in most other EU countries and provides lower and far less predictable remuneration for electricity and gas networks and for electricity and gas supply. Another constraint relates to electricity price-setting for a substantial part of power generation, which is often influenced by political decisions. Planned liberalisation of the electricity generation market in Bulgaria may improve cash flows of the BEH group given that part of electricity generation is currently sold at regulated prices, below market levels.

Repayment of Overdue Payables

NEK's widened tariff deficit in 2014 created liquidity issues for the company and an increase of overdue trade payables to its suppliers. In April 2016, after several months of attempts to raise new funding, BEH managed to raise a bridge loan of EUR535m (BGN1bn) which allowed NEK to repay overdue trade payables of BGN1.1bn to two thermal power plants. The bridge facility is part of the plan to raise long-term debt initiated in September 2015. The bridge facility is planned to be repaid from the proceeds of an upcoming bond issue.

After the repayment of overdue trade payables to two thermal power plants, renegotiation of NEK's long-term contracts with these two plants agreed in April 2015 came into force. As a result, the capacity tariffs NEK pays to both power plants decreased by about 15%, which has a positive impact on NEK's EBITDA of about BGN100m per year.

Decision on Belene Arbitration

An arbitration court has recently ordered NEK to pay EUR550m (BGN1.1bn) to Russia's Atomstroyexport for the nuclear power plant equipment following a long arbitration process related to the terminated Belene nuclear power plant project. We assume in our rating case projections that NEK will pay the ordered amount to the Russian party by end-2017. This would increase BEH's FFO adjusted net leverage in 2017 to 3.7x (compared with 2.3x in a scenario of no payment for the Belene arbitration) still well below the negative rating guideline of 5x.

It is possible that NEK will not have to pay the full arbitration amount of EUR550m (BGN1.1bn), which is the value of the produced equipment but only a net amount as the equipment could be sold back to the Russian party. The Bulgarian government has recently started discussions with the Russian counterparty regarding a net payment. If the negotiations with the Russians are not successful, an alternative measure could be for the Bulgarian state to inject cash to BEH group by purchasing non-operational assets related to the construction of the Tsankov Kamak dam from NEK. These assets are worth about BGN900m and are mainly related to road infrastructure and a dam wall which by law should not be held on NEK's balance sheet, but should be exclusive state property. Effectively, the arbitration payment could be financed from the cash injection by the state.

We treat these scenarios as an upside to the rating. The company does not expect to pay the full amount without the government's tangible support or expects to pay only a net amount to the Russian party. Therefore, no new external funding is planned for the Belene arbitration payment.

Bond Issue to Improve Liquidity

BEH group's available liquidity, mostly comprising BGN1.2bn of unrestricted cash, at end-April 2016 was not sufficient to fully cover short-term debt of BGN1.2bn and negative FCF of BGN0.3bn (projected by us for 2016, which is a proxy for FCF for 12 months starting from end-April 2016). This negative FCF excludes BGN0.9bn of working capital changes which mostly comprise an outflow in April 2016 to repay overdue trade payables funded by a bridge loan.

After the long-term bond issue planned for 3Q16 liquidity should be sufficient to cover short-term debt and the Fitch-projected negative FCF. We expect the state to support BEH should the company have insufficient liquidity in a scenario of payment of the full arbitration amount recently ordered by an arbitration court in relation to the terminated Belene nuclear power plant project.

Following the planned bond issue and bridge loan repayment, the next large debt maturity is in November 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
The senior unsecured rating is at the same level as the IDR. However, if the ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH) to consolidated EBITDA is above 2x on a sustained basis then we would consider rating unsecured debt one notch lower than the IDR. This ratio was temporarily above 2x in 2014 due to depressed EBITDA but improved to below 1x in 2015 thanks to EBITDA recovery. We expect that prior-ranking debt to EBITDA will remain well below 2x in the next few years.

Strong Links with the State
The IDR is notched up one level from BEH's standalone rating, reflecting the group's strong links with the Bulgarian state. This is mainly evidenced by state guarantees for 23% of the group's debt provided to some BEH subsidiaries (as of end-2015), down from 50% in 2012, 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.

We expect that the level of state guarantees will decline further in 2016-2017 as the state-guaranteed debt is amortised and most new debt is unlikely to be guaranteed in our view. The only planned new state-guaranteed loan is for a gas interconnector with Greece (BGN215m) to be taken in 2016. The declining share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed would be negative for the rating.

The government did not provide a guarantee for the bridge facility, which was initially expected by potential lenders, saying that NEK's deficit issue has to be resolved first. However, the government was instrumental in the implementation of legal and regulatory changes to improve NEK's financial situation supporting our view of current strong links with BEH.

The government plans to issue a comfort letter before the Eurobond issue stating that the Bulgarian State will undertake necessary measures to financially support BEH so that BEH meets its obligations to the bondholders. The letter will say that notification to the EU will be made before support is granted in line with the EU's state aid rules. We treat comfort letters as a weaker form of support than guarantees.

Corporate Governance Limitations
The ratings reflect BEH's corporate governance limitations, including a qualified audit opinion for BEH group's 2009-2015 financial statements and frequent management changes. We view the group's financial transparency, including on business segments as weak compared with its European peers.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for BEH include:
- Improvement in NEK's EBITDA from a BGN0.5bn loss in 2014 to a BGN0.1bn profit in 2016 on the back of regulatory and legislative changes and renegotiation of PPAs. This is the key driver of improved profitability of the BEH group.
- Proceeds from the upcoming bond issue used to repay EUR535m (BGN1bn) bridge loan raised in April 2016.

- Capex of BGN3bn in 2016-2019, co-funded with EU grants and CO2 reimbursement; capex to add to negative FCF in the medium term
- NEK to pay EUR550m (BGN1.1bn) to the Russian party by end-2017.
- Forthcoming tangible state support in case of prolonged tight liquidity position

RATING SENSITIVITIES
Negative: Future developments that could lead to negative rating action include:
- Prolonged tight liquidity position.
- FFO adjusted net leverage exceeding 5x on a sustained basis.
- Weakening links between BEH and Bulgaria through, for instance, a reduction in the share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed.
- Sustained increase in prior-ranking debt above 2x EBITDA, which would be negative for the senior unsecured rating.

Positive: The Outlook is Negative and Fitch currently thus does not anticipate an upgrade. Nonetheless, future developments that could lead to positive rating action include:
- Improved liquidity position and projected FFO adjusted net leverage below 5x on a sustained basis would lead to a revision of the Outlook to Stable.
- Tangible government support, including additional state guarantees materially increasing the share of state-guaranteed debt or cash injections for NEK's payment of the arbitration amount related to the terminated Belene nuclear project would support the one-notch uplift over the standalone rating for strong links with the state in the longer term.
- Substantially lower payment for the Belene nuclear power plant equipment agreed with the Russian party compared with the amount ordered by the arbitration court.
- Longer track record of a shrinking accumulated tariff deficit at NEK.
- Progress in the liberalisation of the electricity market through a rising share of market-based pricing in the generation sector.
- Stronger corporate governance.

Contact:
Principal Analyst
Artur Galbarczyk
Associate Director
+48 22 338 6291

Supervisory Analyst
Arkadiusz Wicik, CFA
Senior Director
+48 22 338 6286
Fitch Polska S.A.
Krolewska 16
00-103 Warsaw

Committee Chairperson
Josef Pospisil, CFA
Managing Director
+44 20 3530 1287

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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Applicable Criteria

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0Njc4NTQzNzcsInNlc3Npb25LZXkiOiJIT1RCVklBVjZZMlhNTFFWMlRITFpYNFNTQkRIVE9KTzdSRkRaUkZEIn0.FzLWJPH-YjsRjpOnnT7DYE57YdiMGzvDuFfaVlnjBqY)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1008488&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0Njc4NTQzNzcsInNlc3Npb25LZXkiOiJIT1RCVklBVjZZMlhNTFFWMlRITFpYNFNTQkRIVE9KTzdSRkRaUkZEIn0.FzLWJPH-YjsRjpOnnT7DYE57YdiMGzvDuFfaVlnjBqY)
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