24 MAR 2023

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

Fitch Ratings - Warsaw - 24 Mar 2023: Fitch Ratings has upgraded Bulgarian Energy Holding EAD's (BEH) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) to 'BB+' from 'BB'. The Outlook on the IDRs is Stable.

The upgrade reflects BEH's revised Standalone Credit Profile (SCP) to 'bb' from 'b+', driven by strong financial results and substantially reduced leverage, and also improvements in the regulatory framework. BEH's SCP is notched up once for strong links with its sole owner, the Bulgarian state (BBB/ Positive), to arrive at the 'BB+' IDR.

Fitch has also upgraded BEH's foreign-currency senior unsecured rating, including the rating of BEH's EUR600 million bonds due 2025 and EUR600 million bonds due 2028, to 'BB+' from 'BB'.

Key Rating Drivers

Improved SCP: Fitch has revised up BEH's SCP to 'bb' from 'b+' based on higher earnings, lower net debt and, as a result, substantially reduced financial leverage. This was driven by progressive liberalisation of the energy market and its full integration with neighbouring countries', allowing the group to benefit from a high power-price environment. We expect net leverage to remain solid for the rating in 2023-2025.

Better Regulatory Framework: The higher SCP also reflects an improved regulatory framework, which is relevant to a substantial part of BEH's business mix as on average 19% of EBITDA comes from regulated gas and electricity transmission. In our view, its SCP may further strengthen in the medium term, given the planned full liberalisation of the energy market, albeit also subject to BEH's financial policy and capex plan.

High Electricity Prices: An increase in the average energy sale price due to a growing share of free-market transactions (around 80% of generated volumes sold on unregulated market in 2022, compared with 75% in 2021, 65% in 2020) is the primary driver of our record EBITDA expectations for 2022. Our rating case assumes EBITDA to peak in 2022 at around BGN4.4 billion before it trends lower to about BGN2.5 billion in 2025, which is still well above the long-term average, as markets normalise. In our view, BEH's merchant position allows for short-term profit maximisation, but is a rating constraint as it exposes the group to price risk and introduces volatility and unpredictability to cash flow.

Liberalisation on Track: After the completion of the planned liberalisation of the energy market in

Bulgaria, we expect BEH will be able to sell its entire generated volumes in the competitive market, which should be beneficial for profitability given the favourable position of most of its generation assets, particularly nuclear and hydro power plants, in the country's merit order. Bulgaria's wholesale electricity market is fully liberalised since June 2021, and the remaining retail part of the market should transition to market terms by 2025. We view the ongoing liberalisation as beneficial for BEH's future financial profile, especially given recent day-ahead market coupling, which enables Bulgarian energy prices to follow EU electricity market price dynamics.

Eliminating Public Supplier Burden: We expect the planned abolition of BEH's subsidiary NEK's public supplier function to improve the visibility of the group's financial results and enhance the transparency of regulations. The regulatory framework has already improved through establishing the Security of the Electricity System Fund (SESF), which successfully covered deficits arising from purchasing energy at regulated prices from producers and selling it to consumers at times of lower tariffs. After withdrawing the public supplier function, NEK will become a purely hydro energy generator, which we deem positive for BEH's credit profile.

Windfall Tax Limits Profits: The Bulgarian government introduced a generation price cap that differs for each energy source to limit the increase in electricity prices for customers. If the selling price exceeds the limit, the generator will pass the additional revenue to a special fund created to finance capped tariffs for end-customers. We expect around BGN1.1 billion of contribution from BEH to SESF in 2023 compared with BGN3.2 billion in 2022, assuming the price cap remains in place until June 2023 and wholesale prices decline thereafter. The measure aims to limit extraordinary profits of generation companies that benefit from high market prices.

Large Capex Plans: We expect BEH's capex (already high in 2021 at BGN1.7 billion) to remain large over 2023 and 2024 at BGN1.2 billion and BGN1.6 billion, respectively. This will be driven by spending on the construction of a gas interconnector between Bulgaria and Serbia, the expansion of underground gas storage in Chiren and the construction of a liquefied natural gas (LNG) terminal in Alexandroupolis. We expect it to normalise at around BGN0.8 billion-BGN0.9 billion per year from 2025.

Support from State: The IDR of BEH reflects a one-notch uplift from its SCP for strong links with the Bulgarian state (BBB/Positive). Based on Fitch's Government-Related Entities Rating Criteria, we view the status, ownership and control links between BEH and the Bulgarian state as 'Strong', and the support track record and socio-political and financial implications of a BEH default as 'Moderate'. These all lead to a support score of 17.5, which allows a one-notch uplift to BEH's SCP as it is not constrained by a cap defined as the sovereign rating minus one notch given the current rating differential between the state and BEH.

Corporate-Governance Limitations: BEH's corporate-governance limitations include a qualified audit opinion for the group's 2009-2021 consolidated financial statements, a fairly complex group structure, and lower financial transparency than EU peers'. These limitations are reflected in an ESG Relevance Score of '4' for group structure and financial transparency.

Derivation Summary

BEH has a leading 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 the group comparable to some of its central European peers such as MVM Zrt. (MVM, BBB/Negative) and PGE Polska Grupa Energetyczna S.A. (PGE, BBB+/Stable). However, BEH is a negative outlier in the peer group in corporate governance and cash-flow predictability resulting from the high merchant exposure of its generation assets, which is not mitigated through quasi-regulated capacity payments, as is the case for PGE, or through a substantial regulated business. The progressive liberalisation of the Bulgarian energy market, combined with its coupling with neighbouring countries' energy markets, substantially increases BEH's profitability in the current price environment, and in our view improves regulation transparency.

BEH's rating includes a one-notch uplift from its SCP to reflect links with the sovereign, whereas this is not the case for MVM or PGE.

Key Assumptions

Fitch's key assumptions within our rating case for the issuer:

- Group EBITDA averaging BGN3 billion a year over 2022-2026

- Total capex at BGN6.1 billion over 2022-2026

- Dividends at 100% of net income during 2023-2026

- State-provided financing to subsidiary Bulgargaz (BGN800 million) in 2022

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Stronger SCP due to funds from operations (FFO) net leverage falling below 3.5x on a sustained basis, and supported by an internal corresponding leverage target, lower regulatory and political risk, higher earnings predictability, and better corporate governance

- Further tangible government support to BEH, 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 Bulgaria by two notches

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Weaker SCP, for example due to FFO net leverage exceeding 4.5x on a sustained basis, escalation of regulatory and political risk, or insufficient liquidity

- Weaker links with the Bulgarian state

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Healthy Liquidity: At end-June 2022 BEH had BGN3.2 billion of unrestricted cash and equivalents and BGN0.4 billion of Fitch-projected negative free cash flow (FCF) after acquisitions in the next 12 months starting from July 2022. This compares with short-term debt maturities of BGN0.4 billion. The next large debt maturity is in June 2025, when a EUR600 million (BGN1.2 billion) bond matures.

Issuer Profile

BEH is a 100% state-owned, integrated utility operating in Bulgaria. It is involved in electricity generation, electricity transmission, public supply of electricity, gas transmission and transit, public supply of gas, lignite mining and telecommunications.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

BEH has an ESG Relevance Score of '4' for Group Structure and Financial Transparency due to a qualified audit opinion, a fairly complex group structure, and lower financial transparency than EU peers'. These factors have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Bulgarian Energy Holding EAD	LT IDR	BB+	Upgrade		BB
	LC LT IDR	BB+	Upgrade		BB
• senior unsecured	LT	BB+	Upgrade	RR4	BB

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		

RATINGS KEY	OUTLOOK	WATCH
EVOLVING	⭘	◆
STABLE	⭘	

Applicable Criteria

Corporate Rating Criteria (pub.28 Oct 2022) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09 Apr 2021) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub.30 Sep 2020)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Bulgarian Energy Holding EAD	EU Issued, UK Endorsed

DISCLAIMER & DISCLOSURES

Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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