Research Update:

Bulgaria-Based Power Producer NEK Outlook Revised To Positive On Long-Term Prospects; 'BB' Rating Affirmed

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Rating Action Overview

- Since Nov. 23, 2023, our 'BBB' long-term rating on Bulgaria has carried a positive outlook based on a one-in-three chance that the country would join the Eurozone by 2026; due to an oversight, we did not revise our outlook on NEK at that time.
- We believe state-owned Bulgarian Energy Holding (BEH), the owner of Natsionalna Elektricheska Kompania (NEK), will likely receive extraordinary government support in the event of financial distress and ongoing support for future nuclear projects, despite political uncertainties in the country.
- We also expect NEK would remain a highly strategic subsidiary of BEH during the next two years, despite its volatile and weak performance, and that the group would benefit from the liberalization of Bulgaria's retail power market, expected to be completed by year-end 2025.
- Accordingly, we have now revised our outlook on NEK to positive from stable and affirmed our 'BB' long-term issuer credit rating on the company.
- The positive outlook indicates that we could raise our ratings on NEK if we upgrade Bulgaria, which would imply that the state has a stronger ability to support NEK's parent, BEH, and NEK's performance improves following the retail energy market's liberalization from 2026.

Rating Action Rationale

We consider Bulgaria to have at least a one-in-three likelihood of joining the eurozone by 2026. Bulgaria does not yet meet all convergence criteria (formal conditions that all countries must meet before joining) for Eurozone accession, including price stability. However, given moderating domestic inflation, the gap to the threshold is narrowing. We believe the unstable political situation in the country could lead to some limited delays to the country's eurozone accession, unless the political deadlock worsens. Even if Bulgaria were not to accede to the eurozone in 2025, we think this would likely be delayed only to Jan. 1, 2026. Bulgaria has been running a currency board for over 25 years and the lev has been included in the Exchange Rate Mechanism (ERM II) since July 2020. We monitor closely the current political uncertainties in Bulgaria and the country's advancement in joining the Eurozone (see "Bulgaria 'BBB/A-2' Ratings Affirmed; Outlook Remains Positive," published May 24, 2024, on RatingsDirect).

We continue to perceive a moderately high likelihood that BEH, NEK's 100% owner, would receive support from the Bulgarian government. This has been demonstrated by a track record of state support, despite the unstable domestic political situation. We observe extraordinary support being provided to BEH's subsidiaries in the form of state guarantees, state loans, and cash capital injections. And, in 2016, NEK received interest-free financial aid directly from the Bulgarian government, which it repaid in April 2022 using its own funds and the proceeds of an intercompany loan from BEH. We expect the government's willingness to provide support would continue in the future, since BEH maintains its strategic importance for the country's security of energy supply and strategic energy plan. BEH is Bulgaria's leading electricity producer, generating 60% of the nation's electricity, and the owner of the electricity and gas transmission systems. We will, however, closely monitor the political uncertainties and the evolution of the rule of law and institutional framework in Bulgaria, since these could impair the government's willingness to support BEH and the timeliness of such support. In addition, decisions regarding required investments and funding of new nuclear reactors in Bulgaria, expected within the next six months, will be critical to our view of the group's credit quality and the likelihood of government support.

The rating on NEK continues to depend on BEH's credit quality, since we regard NEK as a highly strategic subsidiary involved in low-carbon hydro-electricity generation and supply. We view NEK as a highly strategic subsidiary of BEH (its sole owner) given NEK's very important role in Bulgaria's energy system as a hydropower producer, supplier of last resort, and public supplier of electricity at regulated prices, as well as NEK's transformation from a loss-making operation historically to a contributor of close to 10% of BEH's EBITDA in 2024-2026. NEK's leverage is significantly higher than BEH's, whose leverage is minimal, but should gradually reduce once the retail energy market is liberalized. All NEK's debt is to its parent BEH, illustrating what we consider to be ongoing funding support from the parent. In 2024-2026, we expect NEK's funds from operations (FFO) to debt to be 6% on average, compared with more than 100% for BEH, constraining NEK's stand-alone credit profile (SACP) in the 'b' category. Our rating on NEK therefore includes two notches of uplift for parental support above our 'b+' assessment of NEK's SACP, and is capped at one notch below our 'bb+' assessment of BEH's group credit profile (GCP).

NEK's stand-alone credit quality will remain constrained until the retail power market is fully liberalized, which we anticipate by year-end 2025. We forecast NEK will face highly volatile and deteriorated EBITDA margins of 5%-10% until the retail power market's full liberalization by the end of 2025, and the termination of its public supplier mandate is expected on July 1, 2025, at the earliest. This results in very weak credit metrics for NEK over 2024-2025, with S&P Global Ratings-adjusted FFO to debt expected to decline toward 6% on average from 9% in 2023 and the exceptionally high 56.3% reported in 2022 on the back of a spike in power prices. Adjusted debt to EBITDA will increase toward 12.0x on average in 2024-2025 from 10.4x in 2023 and 1.6x reported in 2022. We expect a gradual improvement in NEK's EBITDA margin only from 2026 once the company's mandate as a public power supplier is terminated and assuming normal hydrology conditions. Until then, NEK is obliged to sell electricity to end suppliers at regulated prices of Bulgarian lev (BGN) 120 per megawatt hour (/MWh) to BGN130/MWh, for which purchased volumes are only partly covered by fixed-price contracts with thermal power producers ContourGlobal and AES that mature in February 2024 and 2026, respectively. NEK will likely experience squeezed margins in 2024-2025 because its costs are only partly compensated by the Security of Electricity Supply Fund (SESF) with a time lag. From 2026, if the retail power market's liberalization is implemented as planned, the company sole activity will be the sale of its low-variable-cost hydropower at market prices as the dominant hydro producer generating about 5% to 6% of Bulgaria's electricity. We therefore expect cash flow from operations to turn positive from 2026 but NEK to remain highly exposed to volatile hydropower volumes and power market prices.

We expect BEH's leverage to stay low in 2024-2026, supported by a more diverse activity mix, including 30% of regulated EBITDA. BEH's adjusted credit metrics for 2023 remained solid, with FFO to debt at 112% and debt to EBITDA at 0.8x. In 2023, BEH reported EBITDA of BGN2.2 billion (about €1.1 billion), and increased capital expenditure (capex) and dividends of BGN990 million and BGN1.4 billion, respectively. This resulted in about BGN700 million lower cash on balance sheet, at BGN3.9 billion, slightly eroding the BGN4.6 billion of accumulated cash following rapid deleveraging in 2022. BEH's strong results in 2022 were mainly due to a rise in average power prices on the Bulgarian electricity exchange market (IBEX) beyond BGN500/MWh, equivalent to about €250/MWH, from which BEH's fixed-cost nuclear and hydro power producer subsidiaries benefitted greatly. In 2024-2025, we expect power prices to normalize at about BGN180/MWh on average, still relatively high compared with pre-pandemic levels. This, alongside the retail power market's postponed liberalization to year-end 2025, will likely materially reduce BEH's EBITDA to BGN1.5 billion-BGN2.0 billion on average from BGN2.3 billion in 2023. Nevertheless, we expect BEH's debt to EBITDA to stay below 1.0x during that period due to positive discretionary cash flow, despite exceptional dividend distributions to the state in 2023 of about BGN1.4 billion and annual average capex rising to BGN1.1 billion in 2024-2026, notably to fund the digital transformation of the power transmission grid and expansion of Bulgartransgaz's underground gas storage facility in Chiren.

Outlook

The positive outlook factors in a one-in-third chance of Bulgaria entering the Eurozone by year-end 2026. We would monitor closely the current political uncertainties that might delay this integration. It also reflects our view of NEK as a highly strategic subsidiary of BEH and our view of the group's moderately high likelihood of receiving support from the state. We anticipate BEH will maintain minimal leverage, prudent capex and financial policy, with no new large debt-financed projects, as well as adequate liquidity.

Upside scenario

We could raise the rating on NEK if BEH's GCP improves to 'bbb-', which could stem from a one-notch upgrade of Bulgaria to 'BBB+'. We could also upgrade NEK if we revise our assessment of BEH's SACP to 'bbb-' from 'bb+', all other factors remaining equal. This would depend on:

- Greater stability of the group's profitability; and
- Clarity over the national energy transition plan and its implementation by BEH, notably regarding the phaseout of highly carbon-intensive lignite power generation and mining, as well as the development of new nuclear power plants as old units mature.

We could also upgrade NEK should we start to regard it as core to BEH, possibly due to improving profitability and leverage in line with BEH's and a materially higher contribution to BEH's EBITDA.

These factors notwithstanding, we wouldn't upgrade NEK solely because its SACP improved to 'bb-' or 'bb', unless this prompted a revision of BEH's GCP to 'bbb-' at the same time.

Downside scenario

We would likely revise the outlook to stable should we take a corresponding rating action on Bulgaria, or if:

- We no longer saw NEK as highly strategic to BEH, for example because of operational weaknesses at its hydropower plants, or a demonstrated lack of support from its parent.
- We see a lower likelihood of BEH receiving government support. We will monitor the Bulgarian government's stability, its capacity and willingness to support BEH in a timely manner if needed, and any negative intervention from the state beyond exceptional measures taken during the energy crisis.
- BEH's GCP deteriorates to 'bb', which could follow weaker operating performance, higher leverage, or lower liquidity, for example as a result of electricity prices dropping below our forecast, postponement of full market liberalization beyond 2025, or a steep increase in capex or dividends compared to our forecast.

Company Description

NEK is a Bulgarian electricity producer with 2.7 gigawatts (GW) of installed capacity at 31 hydropower stations and pump storage plants. In 2023, it generated 5.0% of Bulgaria's total electricity production. NEK also has an important role as a public supplier to protected customers in Bulgaria. The company's S&P Global Ratings-adjusted EBITDA totaled about BGN201 million as of 2023.

NEK is 100% owned by BEH, Bulgaria's vertically integrated energy holding company, which itself is fully owned by the Bulgarian government through the Ministry of Energy. BEH controls electricity generation assets with 6.3GW of total installed capacity (in addition to NEK's hydropower, this includes nuclear and thermal power plants), as well as coal mining, and power and gas transmission assets in the country. In 2023, BEH's adjusted EBITDA was BGN2.3 billion.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Bulgaria of 2.1% in 2024, 3.3% in 2025, and 3.1% in 2026, compared with 1.8% in 2023.
- Domestic consumer price inflation of 2.5% in 2024, 2.8% in 2025, and 2.2% in 2026, compared with 8.6% in 2023.
- Unregulated power prices of BGN180/MWh-BGN190/MWh and average regulated power prices of BGN100/MWh-BGN110/MWh in 2024-2026.
- NEK to achieve normalized generation volumes of 2.4 terawatt hours (TWh) to 2.5 TWh annually in 2024-2026, after poor hydrological conditions in 2023.

- A share of unregulated electricity sales of about 40% in 2024 and gradually increasing toward 100% with the electricity market's full liberalization by the end of 2025, with NEK's role as public supplier to be abolished from July 1, 2025.
- The difference between regulated electricity prices and NEK's cost of electricity purchases from regulated producers and under legacy power purchase agreements to be fully covered by the SESF with a lag (as long as NEK acts as a public supplier).
- Capex of BGN80 million–BGN100 million in 2024 and BGN170 million-BGN180 million in 2025 and 2026, reflecting required modernization and rehabilitation of assets and construction of two new hydro power plants with 800MW of capacity to be operational by 2032.
- No dividends in 2024, to compensate for exceptionally high dividend distribution in 2023, and a 50% dividend payout ratio in 2025-2026, although we understand the dividend policy is flexible.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of loans from the parent.
- No acquisitions.

Key metrics

Natsionalna Elektricheska Kompania EAD--Forecast summary

	--Fiscal year ended Dec 31--				
(Mil. BGN)	2022a	2023a	2024e	2025f	2026f
EBITDA	1,313	201	100-300	100-300	100-300
Capital expenditure	16	21	50-100	150-200	150-200
Dividends	0	225	0	0-100	50-150
Debt	2,125	2,101	2,050-2,150	2,100-2,200	2,150-2,250
Funds from operations to debt (%)	56.3	9.0	2.0-7.0	4.0-9.0	5.0-10.0
Free operating cash flow to debt (%)	54.1	21.2	0	0	0-5.0
Debt/EBITDA (x)	1.6	10.4	14-15	10-11	9-10

All figures include S&P Global Ratings adjustments. BGN--Bulgarian lev. a--Actual. e--Estimate. f--Forecast.

Liquidity

We continue to view NEK's liquidity as adequate because we factor in continued loans from its parent, whereas on a stand-alone basis NEK's liquidity is weaker. Our assessment of NEK's liquidity therefore reflects our view of the parent's liquidity. This assessment recognizes NEK's status as a highly strategic part of BEH group and the ongoing support it receives through intragroup debt-payment rescheduling. Since 2022, after NEK repaid its BGN1.2 billion government loan due in 2023, all of NEK's debt has been to its parent, BEH. Factoring in all financings, NEK's committed liquidity sources covered its liquidity needs by only about 1.0x as of June 30, 2024.

We calculate principal liquidity sources for the 12 months from June 30, 2024, as:

- No committed credit lines;
- Cash and cash equivalents of BGN210 million; and

- Cash FFO of about BGN70 million.

We expect principal liquidity uses for the same period will include:

- Debt maturities of about BGN195 million comprising loans payable to BEH;
- Maintenance capex of about BGN110 million; and
- No dividends.

Environmental, Social, And Governance

Governance factors are a negative consideration in our credit rating analysis of NEK, reflecting our view of a lack of prudent risk management, historical litigations, and unfinished projects at the group level. Still, the company is fully owned by the government through BEH, and its activities are closely aligned with government policy and shaped by applicable regulations.

Environmental and social factors are a relatively negative consideration, since NEK's parent BEH produces about 18% of its electricity through coal power plants and operates coal mines in Bulgaria. Although the total phaseout of coal is not planned before 2038 in Bulgaria's energy plan, we perceive energy transition risk as high and exposure to carbon prices as material. The rest of BEH's generation fleet produces low-carbon electricity, with the Kozloduy nuclear power plant contributing about 74% of BEH's total production in 2023 and NEK's hydropower plants about 8%.

NEK also has an important social role in maintaining reliable, safe, and sustainable electricity supply. However, social factors are the key reasons for historically unsupportive regulation and NEK's accumulation of its historical tariff deficit. However, the retail market's liberalization deadline of year-end 2025 mitigates this factor.

Ratings Score Snapshot

Issuer credit rating	**BB/Positive/--**
Business risk:	Weak
Country risk	Moderately high
Industry risk	Moderately high
Competitive position	Weak
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	b+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Moderately negative (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	b+

Issuer credit rating	BB/Positive/--
Group credit profile	bb+
Entity status within group	Highly strategic
Related government rating	BBB/Positive/A-2

Related Criteria

- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Industry Credit Outlook Update Europe: Utilities, Jul. 18, 2024
- Research Update: Bulgaria 'BBB/A-2' Ratings Affirmed; Outlook Remains Positive, May 24, 2024
- Bulletin: Bulgaria’s Eurozone Entry's Still Likely Despite Government Collapse, Apr. 3, 2024
- Industry Credit Outlook 2024: EMEA Utilities, Jan. 9, 2024
- Research Update: Bulgaria Outlook Revised To Positive From Stable On Prospects Of Eurozone Accession; 'BBB/A-2' Ratings Affirmed, Nov. 24, 2023
- Research Update: Bulgarian Power Company NEK Upgraded To 'BB' On Parent’s Lower Leverage And Higher Likelihood Of Support; Outlook Stable, Aug. 17, 2023
- Credit FAQ: Bulgaria Reaffirms Eurozone Commitment With Parallel Currency Discussion, Jul. 6, 2023

Ratings List

Outlook Action

	To	From
Natsionalna Elektricheska Kompania EAD		
Issuer Credit Rating	BB/Positive/--	BB/Stable/--