Research Update:

Bulgaria-Based Natsionalna Elektricheska Kompania Upgraded To 'BB-' On Performance Track Record; Outlook Stable

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Rating Action Overview

- The parent of Natsionalna Elektricheska Kompania (NEK), Bulgarian Energy Holding (BEH) has accumulated a track record of improving operating performance and risk management, and we estimate consolidated EBITDA will exceed Bulgarian lev (BGN) 2 billion (about €1.1 billion) in 2021 and BGN1.4 billion-BGN1.5 billion thereafter.
- We expect NEK's stand-alone performance to remain healthy, thanks to regulatory coverage of its public policy mandate and electricity market liberalization in Bulgaria, with legacy debt being the key factor keeping projected funds from operations (FFO) to debt below 12%.
- We are therefore raising the rating on NEK to 'BB-' from 'B+'.
- The stable outlook reflects our expectation that after record, strong credit metrics of 2021, the group's FFO to debt will stabilize at about 20%, and debt to EBITDA at about 4x, with risk management and liquidity remaining prudent and spending on any new large projects offset with state support.

Rating Action Rationale

The upgrade reflects ongoing improvements in the group's credit quality We believe that BEH has accumulated a track record of healthy operating performance. Under very favorable electricity market conditions in 2021, we expect the group's consolidated EBITDA to exceed BGN2.1 billion (€1.1 billion) and FFO to debt to be 25%-30%. Assuming normalized electricity prices and volumes in 2022-2023, we expect consolidated EBITDA to stabilize at BGN1.4 billion-BGN1.5 billion, with FFO to debt at about 20% and debt to EBITDA at about 4x. After commissioning the BGN2.5 billion (€1.3 billion) Balkan Stream gas pipeline in 2021, we expect BEH's capital expenditure (capex) to reduce to BGN600 million-BGN700 million annually, leading to positive free operating cash flow (FOCF). We believe the group's track record of strategic direction and risk management has been improving, and liquidity has stabilized after a successful €600 million Eurobond issue earlier this year.

We expect NEK's stand-alone performance to be healthy, with credit metrics constrained by legacy debt. We expect NEK to generate record high EBITDA in 2021, thanks to a combination of high electricity prices and favorable hydrological conditions. Even assuming normalized market prices and generation volumes close to historical levels, we expect NEK's EBITDA to stabilize at a healthy BGN220 million-BGN250 million, which alongside low capex needs results in positive FOCF and gradual debt reduction. NEK benefits from the liberalization of Bulgaria's electricity sector, which reduces its public policy mandate and leaves a higher share of low-cost hydropower available for profitable free market sales. Although Bulgaria's electricity regulations remain somewhat politicized and unpredictable, the track record shows that payments from the Security of Electricity Supply Fund have broadly covered the difference between regulated electricity prices and NEK's high electricity procurement costs. Also, NEK benefits from the recent increase in regulated prices to BGN108.37 per megawatt hour (/MWh) from BGN92.93.

Nevertheless, NEK remains relatively small and highly leveraged. NEK is still vulnerable to volatile power prices and hydrological conditions, and is relatively small compared with other rated European utilities. In addition, NEK's debt remains high, reflecting historical tariff deficits and litigation. Given the size of this debt (BGN3.7 billion on June 30, 2021), we don't expect NEK to deleverage quickly. We recognize that almost all NEK's debt is to its parent BEH and to the government of Bulgaria (BGN2.6 billion and BGN1 billion, respectively of BGN3.6 billion total debt on June 30, 2021), which are unlikely to trigger a default, and NEK's debt to banks is limited (only BGN8.5 million on June 30, 2021). Also, we believe that the ongoing extension of NEK's short-term loans to its parent BEH supports the company's liquidity. As a result, we continue to assess NEK's stand-alone credit quality at 'b'.

The rating on NEK continues to depend on BEH's credit quality. We view NEK as a highly strategic subsidiary (from strategically important before) of BEH, given the former's very important role in Bulgaria's energy system as a hydropower producer and supplier of last resort and public supplier of electricity, as well as NEK's transformation from a loss-making operation historically to a contributor of 14%-20% of BEH's EBITDA. Despite robust ongoing profitability, NEK has large legacy debt and therefore higher leverage than BEH. In 2022-2023, we expect NEK's FFO to debt to be 6%-8%, compared with more than 20% for BEH. Our rating on NEK therefore includes two notches uplift for parental support above our 'b' assessment of NEK's credit quality and is capped one notch below our 'bb' assessment of BEH's group credit profile.

Outlook

The stable outlook reflects our view that our rating on NEK will continue to depend on BEH's credit quality, due to the strong ties between the subsidiary and the parent and a two-notch differential between the rating and our assessment of NEK's stand-alone credit profile at 'b'.

We expect BEH's performance to remain profitable as regulation and liberalized markets mature. We anticipate that the group's FFO to debt will not fall materially below 20%, debt to EBITDA will not increase materially above 4x, capex and financial policy will be prudent (with no new large debt-financed projects), and liquidity will remain adequate.

In addition, we expect that NEK's stand-alone performance will remain robust, thanks to resilient EBITDA, ongoing tariff deficits being covered by the Security of Electricity Supply Fund, positive FOCF, and manageable liquidity, with most debt being to the parent and the government. After record-high 2021 metrics, we expect NEK's FFO to debt to stabilize at 6%-8%.

Downside scenario

We would likely lower the rating on NEK if BEH's credit quality deteriorates below 'bb', which could happen if the group's FFO to debt falls and stays materially below 20%, and debt to EBITDA increases and stays materially above 4x, or if the group's liquidity is stretched. In turn, this could stem from large debt-financed capex at the group level that is not offset with government or EU support. We could also lower the rating if NEK's liquidity pressures increase significantly, which is unlikely in the near term, given recent improvements in the performance of NEK and its parent, supported by regulatory changes and refinancing.

Upside scenario

Given the recent upgrade and metrics improvement being already captured in our base case, ratings upside is currently remote. In the longer term, we could consider a positive rating action if NEK's stand-alone credit profile improved to 'bb'. We believe such a significant improvement would likely take time and could stem from the combination of NEK strengthening its business profile and reducing debt, such as through resolution of historical tariff deficits or conversion of loans from the parent and government into equity. Rating upside could be supported by the group's credit profile improving to 'bb+', reflecting a sovereign upgrade, greater stability of the group's profitability, and deleveraging at the group level.

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 2020, it generated 5.8% of Bulgaria's total electricity production. Also, NEK has an important role as a public supplier to protected customers in Bulgaria. The company's S&P Global Ratings-adjusted EBITDA was BGN236.7 million as of 2020.

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, the electricity system operator, and 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 3.9% in 2021 and 4.3% in 2022. Consumer price index of 3.6% in 2021 and 2.4% in 2022.
- Unregulated electricity prices in Bulgaria stabilizing closer to historical levels after the 2021 hike; regulated prices at BGN108/MWh as per the latest regulatory decision.
- The difference between regulated electricity prices and NEK's costs of electricity purchases

from regulated producers and under legacy power purchase agreements to be fully covered by the Security of Electricity Supply Fund.

- NEK's generation volumes at 4 terrawatt hours (TWh) in 2021, thanks to record high hydro levels, and stabilizing at about 2.5 TWh thereafter, closer to historical levels.
- Annual capex of BGN40 million-BGN50 million, and no large debt-funded capex projects.
- Continued treatment of a BGN1 billion loan obtained from the government in December 2016 and maturing in December 2023 as debt rather than equity, in line with our criteria.
- Government's eventual restructuring of NEK's historical tariff deficit (estimated by the World Bank at about BGN1.9 billion) via bonds issued through the Security of Electricity Supply Fund in 2023-2024. However, because the plan is long term and will depend on execution, necessary approvals, and the market situation at the time, we don't include it in our base case at this stage.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of the loans from the parent if needed.

Key metrics

- S&P Global Ratings-adjusted EBITDA of BGN480 million-BGN540 million in 2021, stabilizing at BGN220 million-BGN250 million from 2022.
- FFO to debt stabilizing at 6%-8% in 2022-2023, after a record 13%-18% in 2021.
- Positive FOCF.

Liquidity

We view NEK's liquidity as less than adequate due to high short-term debt. This assessment also recognizes NEK's status as a highly strategic part of BEH group. Technically, the ratio of committed liquidity sources to liquidity needs was 0.3x on Sept. 30, 2021. Still, NEK's external debt is minimal, and most of its debt is to its parent BEH and the government. We understand that NEK has recently extended one of its short-term loans to BEH to seven years and is in the process of extending the remaining one. The first refinancing would bring the ratio of liquidity sources to liquidity needs to about 0.4x, and ongoing extension of the second BEH loan will bring NEK's short-term debt to minimal levels, leading to a very comfortable ratio of liquidity sources to liquidity needs.

As of Sept. 30, 2021, NEK's liquidity sources for the subsequent 12 months include:

- Cash and cash equivalents of BGN440 million.
- Cash FFO of BGN200 million-BGN250 million.

Principal liquidity uses for the same period:

- Debt maturities of BGN2.55 billion, of which BGN1.0 billion comprises the loan BEH extended in the fourth quarter of 2021 to seven years; the remaining BGN1.55 billion loan from BEH is being extended to 10 years.
- Maintenance capex of about BGN10 million.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Outlook/Stable

Business risk:

- Country risk: Moderately high
- Industry risk: 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: fair (no impact)
- Comparable rating analysis: neutral (no impact)

Stand-alone credit profile: b

- Group credit profile: bb
- Entity status within group: highly strategic (+2 notches)

ESG credit indicators: E-2 S-2 G-4

We have changed our governance credit indicator to G-4 from G-5 because the company and the group have accumulated a track record of improving risk management, culture, oversight.

Related Criteria

- 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
- 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 | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 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

Upgraded

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