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Research Update:

Bulgaria-Based Power Generator NEK Outlook Revised To Positive On Improving Credit Metrics; 'BB-' Rating Affirmed

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PRIMARY CREDIT ANALYST

Renata Gottliebova
Dublin
+ 00353 (1) 5680608
renata.gottliebova
@spglobal.com

SECONDARY CONTACTS

Pauline Pasquier
Paris
+ 33 14 420 6771
pauline.pasquier
@spglobal.com

Massimo Schiavo
Paris
+ 33 14 420 6718
Massimo.Schiavo
@spglobal.com

Rating Action Overview

- As part of the liberalization of the retail market in Bulgaria, NEK's mandate will be abolished from July 2023. This will allow the company to increase profitability in its business, which should result in exceptionally strong financial performance, on top of the continuously strong performance in hydro generation due to high power prices.
- We also expect Bulgarian Energy Holding (BEH), the 100% owner of NEK, to benefit from the liberalization of wholesale energy markets and from sustainedly high power prices, which will translate into strong leverage reduction. That said, political intervention in the form of windfall taxes and exposure to power prices could result in more volatile credit ratios for both BEH and NEK.
- We revised our outlook on NEK to positive and affirmed our 'BB-' long-term issuer credit rating on the company.
- The positive outlook on NEK reflects our expectations that NEK's and BEH's credit quality will benefit from exceptionally strong cash flows over the next two to three years, with improved margins due to the liberalization of the regulated supply market in July 2023.

Rating Action Rationale

The positive outlook on NEK reflects our expectation for further improvement in the group's credit quality. The improvement in the credit quality of Bulgaria Energy Holding (100% owner of NEK) is a result of high power prices, strong leverage reduction, and ongoing market liberalization in Bulgaria, which will result in higher margins.

The ongoing European energy crisis triggered by the Russia-Ukraine conflict has resulted in extremely volatile gas and power prices that have remained well above our previous base case. We now expect power prices to remain higher for longer, because we do not think the European energy market will return to the pre-war status quo even once the conflict ends. The average day ahead price in Bulgaria was €350 per megawatt hour (/MWh) as of Dec. 8, 2022 compared with €220 in December 2021, and BEH's fixed-cost nuclear and hydro generation will largely benefit from it. We forecast the group's consolidated S&P Global Ratings-adjusted EBITDA to reach a record high of BGN4.7 billion in 2022 (about €2.4 billion) up from an already healthy BGN2.3 billion in 2021, with funds from operations (FFO) to debt well above 60%, compared with about 35% in 2021. Given BEH's strong earnings in 2021 and 2022, the Bulgarian government started to intervene in order to mitigate high power prices for household and non-household customers, which it partly funded with the Security of the Electricity System Fund (SESF), into which BEH has so far paid BGN3.0 billion in 2022. That said, for 2023-2024, assuming power prices will slightly decline from the 2022 peak, we expect consolidated adjusted EBITDA of about BGN4.1 billion–BGN4.2 billion and FFO to debt of 65%-75%, which is well above our previous base case. Assuming moderate capital spending of about BGN960 million annually, a 100% dividend payout to the Bulgarian state (about BGN210 million–BGN230 million annually) will lead to very healthy discretionary cash flow, averaging BGN2.4 billion per year over 2022-2024. At the same time, the company remains exposed to political interference, and we cannot rule out additional contributions to SESF or extraordinary dividends in 2023.

Nevertheless, we think full liberalization of the wholesale markets will structurally improve the group's profitability because its low variable cost and low carbon hydro and nuclear fleet will be able to sell their entire output in the unregulated market, taking full advantage of high power prices. It also reduces exposure to the weak regulatory regime, resulting in a stronger business risk profile, although it also exposes the group to volatility in earnings. We will closely monitor potential affordability issues for final customers, which could result in NEK and BEH not being able to fully transfer the increased power prices on to final customers.

Overall, we expect improvement in the group's credit quality, which prompted us to revise the outlook on NEK to positive from stable.

NEK's financial performance continues to benefit from higher power prices, resulting in the improvement of its stand-alone credit quality. We expect NEK to generate record high adjusted EBITDA in 2022 of BGN1.2 billion (from BGN853 million in 2021), thanks to a combination of high electricity prices, average hydrological conditions, and the repayment of legacy debt to the government. In particular, during 2022, NEK managed to repay BGN1 billion of its legacy debt to the government of Bulgaria, partly with its own cash flows and partly with a €350 million loan from BEH, which should result in adjusted debt decreasing to about BGN2.6 billion for 2022 from about BGN3.5 billion in 2021.

High power prices resulted in much stronger margins for NEK's unregulated segment due to its low-carbon hydro production. This should result in a material upswing in earnings and cash flow generation over 2022 to 2024, coupled with gradual debt reduction. Even assuming lower market prices from 2023, we assume NEK will post very healthy adjusted EBITDA of BGN420 million–BGN650 million per year in 2023 and 2024. This performance should result in exceptionally strong credit metrics, even with the resumption of dividends paid to BEH, with FFO to debt reaching about 40% in 2022, then stabilizing at 20%-27%. This prompted us to revise upward the stand-alone credit profile to 'b+' from 'b'.

NEK benefits from the liberalization of Bulgaria's electricity sector, which reduces its public policy mandate and should improve the marginality of its retail business. We understand NEK's role as public supplier in the regulated power market will be abolished from June 2023 and NEK will be able to sell all of the output from its hydro portfolio on the much more lucrative unregulated market. We view this as positive for NEK because it will not be exposed to Bulgaria's electricity regulations, which we view as somewhat politicized and unpredictable. This is because

NEK's role as public supplier causes a structural deficit, since there is a significant mismatch between average off-take price paid to the generators and selling price charged to end-customer. That said, the company's track record shows that payments from the SESF have broadly covered the difference between regulated electricity prices and NEK's high electricity procurement costs.

The rating on NEK continues to depend on BEH's credit quality. We view NEK as a highly strategic subsidiary 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 close to 20% of BEH's EBITDA. NEK's leverage is slightly higher than BEH's but is gradually reducing after NEK repaid large legacy debt (BGN1.176 billion in 2022) to the government. In 2023-2024, we expect NEK's FFO to debt to be 20%-27%, compared with more than 60% for BEH. Our rating on NEK therefore includes one notch of 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 positive outlook on NEK reflects our expectations that NEK's and BEH's credit quality will benefit from exceptionally strong cash flows over the next two to three years due to high-for-longer power prices compared with our previous base case and improved margins due to the liberalization of the regulated supply market in July 2023.

We expect BEH's performance to remain profitable as it benefits from the liberalization of Bulgaria's wholesale energy markets, which is reflected in its improved credit quality, although liberalized markets are still maturing. We anticipate that the group's credit metrics will remain elevated for the next two years with FFO to debt reaching 60%-70%, capital expenditure (capex) and financial policy will be prudent (with no new large debt-financed projects), there will be no negative government intervention, and liquidity will remain adequate.

In addition, we expect NEK's stand-alone performance will remain robust, thanks to resilient EBITDA, positive free operating cash flow, and manageable liquidity, and with the vast majority of its debt being to the parent. After record-high 2022 metrics, we expect NEK's FFO to debt to stabilize at 20%-27% for the next two years.

We could upgrade NEK in the next six to 12 months if its stand-alone profile improved to 'bb' or the group credit profile improved to 'bb+'. This could stem from:

- NEK strengthening its business profile and reducing debt, notably to its parent;
- A one-notch upgrade of Bulgaria;
- Increased stability and predictability of cash flow generation profile, for example with contractual diversification of energy sourcing, demonstration of solid market shares within liberalized markets, increased vertical integration, and the use of risk management tools such as the hedging of its generation portfolio; or
- Demonstrated improvement of the consolidated group's business model with an improved competitive position in its merchant business.

Downside scenario

We would likely revise the outlook back to stable if NEK and BEH's credit quality deteriorated materially, including the group's operating performance, leverage, and liquidity. We could also lower the rating if parental support from BEH diminished, or if NEK's liquidity pressures increased significantly, which is not our base case. We see a downside scenario as unlikely in the short term, given recent improvement in the performance of NEK and its parent, supported by elevated power prices and market liberalization. Should NEK or BEH start the construction of a new nuclear plant in Bulgaria, we would reassess our base-case scenario.

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 2021, it generated 5.8% 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 was BGN853.7 million as of 2021.

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 2021, BEH's adjusted EBITDA was BGN2.4 billion.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Bulgaria of 2.9% in 2022 and 1.75% in 2023, compared with 4.18% in 2021. Consumer price inflation of 15% in 2022 and 9% in 2023, compared with 2.85% in 2021
- Unregulated prices to remain elevated at €150/MWh-€200MWh for the next two years.
- NEK's role as public supplier to be abolished from July 2023.
- 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 SESF (as long as NEK acts as a public supplier)
- NEK's generation volumes at 4 terawatt hours (TWh) in 2021, thanks to record high hydro levels, and stabilizing at about 2.5TWh thereafter, closer to historical levels.
- We anticipate capex to be about BGN40 million–BGN50 million in 2022 and BGN70 million-BGN80 million in 2023 and beyond reflecting requiring modernization and rehabilitation of assets.
- No dividends to BEH in 2022; from 2023 onward follow 50% payout dividend policy but we understand that dividend policy is flexible.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of the loans from the parent if needed.

Key metrics

NEK--Key Metrics*

	--Fiscal year ended Dec. 31--				
Mil. BGN	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
EBITDA	236.7	853.7	1,000-1,200	650-850	400-600
Capital expenditure	17	13.2	40-50	65-75	80-90
Dividends	0	0	0	400-500	200-300
Debt	3,620	3,447	2,400-2,600	2,300-2,500	2,100-2,300
Funds from operations to debt (%)	6.5	24.0	37.0-42.0	23.0-28.0	17.0-22.0
Free operating cash flow to debt (%)	3.5	19.9	35.0-40.0	20.0-25.0	13.0-18.0

*All figures adjusted by S&P Global Ratings. a--Actual. BGN--Bulgarian lev. e--Estimate. f--Forecast.

Liquidity

We now view NEK's liquidity as adequate. 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 more than 1.2x on Sept. 30, 2022. That said, most of its debt is to its parent, BEH. NEK has recently extended one of its loans to BEH to seven years to 2028, and in 2022 it repaid the BGN1,176 million government loan due in 2023. This brings NEK's short-term debt to minimal levels, leading to a comfortable ratio of liquidity sources to liquidity needs.

We expect principal liquidity sources for the 12 months from Sept. 30, 2022 will include:

- No committed credit lines;
- Cash and cash equivalents of BGN205 million; and
- Cash FFO of about BGN700 million.

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

- Debt maturities of about BGN267 million comprising loans payable to BEH;
- Maintenance capex of about BGN65 million; and
- Dividends of about BGN370 million.

Ratings Score Snapshot

Issuer Credit Rating	BB-/Positive/--
Business risk	Weak
Country risk	Moderately High
Industry risk	Moderately High
Competitive position	Weak

Issuer Credit Rating	BB-/Positive/--
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 (ni impact)
Management and governance	Fair (ni impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	b+
Group credit profile	bb
Entity status within group	Highly strategic
Related government rating	BBB/Stable/--

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

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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Outlook Action; Ratings Affirmed

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