Research Update:

Bulgarian Power Company NEK Upgraded To 'BB' On Parent's Lower Leverage And Higher Likelihood Of Support; Outlook Stable

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Rating Action Overview

- We anticipate Natsionalna Elektricheska Kompania EAD (NEK)'s parent, state-owned Bulgarian Energy Holding (BEH), will keep adjusted debt to EBITDA below 1.0x in 2023-2025, supported by high prices amid liberalization of the retail electricity market, which improve BEH's earnings profile and ability to support its subsidiaries.
- We believe the likelihood of BEH receiving support from the Bulgarian government has increased, as shown by recent state loans and guarantees provided to BEH's subsidiaries and BEH's central role in the country's proposed national energy strategy.
- We continue to see NEK as a highly strategic subsidiary of BEH and expect it will receive ongoing and extraordinary support from its parent.
- We are therefore raising our rating on NEK to 'BB' from 'BB-'.
- The stable outlook indicates that we believe BEH will remain able and willing to support's NEK liquidity and maintain a low leverage profile with funds from operations (FFO) to debt staying above 50% over 2023-2025.

Rating Action Rationale

The upgrade reflects NEK's parent BEH's exceptional performance in 2022 and our expectation of continuously low leverage at BEH in 2023-2025. In 2022, BEH reported EBITDA of Bulgarian lev (BGN) 4.2 billion (about €2.1 billion), and limited capital expenditure (capex) and dividends of BGN507 million and BGN191 million, respectively. This led to rapid deleveraging with gross debt decreasing by BGN452 million to BGN4.5 billion and the accumulation of BGN4.6 billion of cash on the balance sheet. These strong results were mainly due to a rise in average power prices on the Bulgarian electricity exchange market (IBEX) beyond BGN500 per megawatt hour (/MWh), from which BEH's fixed-cost nuclear and hydro power producer subsidiaries benefitted greatly. We now net BEH's cash against its debt owing to enhanced visibility over the evolution of Bulgaria's power market and power prices after 2022 spike, leading to credit metrics of FFO to debt higher than 100% and debt to EBITDA lower than 1x. In 2023-2025, we expect power prices to normalize at about BGN200/MWh on average, still relatively high compared with pre-pandemic levels. This, alongside the retail power market's postponed liberalization, will likely materially reduce BEH's EBITDA to BGN1.9 billion-BGN2.1 billion, on average, which is lower than our previous forecast of BGN4.0 billion-BGN4.2 billion. Nevertheless, we expect BEH's debt to EBITDA to stay below 1.0x during that period off 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 BGN1.4 billion in 2023-2024, notably to fund the new interconnector and expansion of Bulgartransgaz's underground gas storage facility in Chiren.

The retail power market's liberalization was postponed to 2025 from midyear 2023 and there is a risk of government intervention. Although the wholesale market should be fully liberalized by year-end 2023, the slower pace of the retail market's liberalization will likely weaken NEK's margins due to the company's prolonged public supplier role in 2023-2025. The compensatory mechanism put in place by the government to support non-household customers ended in June 2023 and we assume BEH's contributions to the Security of the Electricity System Fund (SESF) will remain low in the second half of 2023. At the same time, BEH remains exposed to government intervention, and we cannot rule out additional contributions to SESF or extraordinary dividends in 2024. We factor in our rating assessment this potential rapid increase in leverage as well as a possible rise in capex should the Bulgarian government accelerate the development of nuclear new builds, which the strategic energy plan proposed early this year anticipates by 2053.

NEK's stand-alone credit quality will remain constrained due to postponement of the retail power market liberalization to 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, when its public supplier mandate will be terminated. This will result in relatively weak and volatile credit metrics for NEK over 2023-2025, with S&P Global Ratings-adjusted FFO to debt expected to decline toward 10% on average from the 56.3% reported in 2022 and adjusted debt to EBITDA increasing toward 10x in 2025 from 1.6x reported in 2022. We now expect a gradual improvement in NEK's EBITDA margin to be delayed to 2026 once the company's mandate as a public power supplier is terminated. Until then, NEK will sell electricity to customers at regulated prices of BGN100/MWh-BGN110/MWh for which purchased volumes are only partly covered by fixed-price contracts with thermal power producers ContourGlobal and AES that mature in 2024 and 2026, respectively. NEK will likely experience squeezed margins in 2023-2025 because its costs are only partly compensated by the SESF with a time lag. From 2026, if the retail power market's liberalization is implemented as planned, the company will resume selling its low-variable-cost hydro power at market prices.

We perceive a higher likelihood of support for BEH from the Bulgarian government as demonstrated by a track record of state support. We now assess the likelihood of support for BEH from the Bulgarian government as moderately high rather than moderate. A stronger link between BEH and the government has been demonstrated by a track record of extraordinary support provided to BEH's subsidiaries in the form of state guarantees, state loans, and cash capital injections. Also, in 2016, NEK received interest-free financial aid from the Bulgarian government, which it repaid in April 2022. We expect such willingness to provide government support would continue in the future as 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 stability of the new government and the evolution of the rule of law and institutional framework in Bulgaria, since these could impair our view of the government's timeliness or willingness to support BEH.

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, 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 20% of BEH's EBITDA. NEK's leverage is higher than BEH's but should gradually reduce once market liberalization is implemented. All NEK's debt is to its parent BEH, an illustration of what we consider to be ongoing funding support from the parent. In 2023-2024, we expect NEK's FFO to debt to be 10%, 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).

Outlook

The stable outlook reflects our view of NEK as a highly strategic subsidiary of BEH and our view of the group's stable credit quality. We expect BEH's cash flow generation to fully finance its capex and dividends as it benefits from the ongoing liberalization of Bulgaria's energy markets, supporting continuingly strong metrics, through 2025. We anticipate BEH will maintain minimal leverage, prudent capex and financial policy with no new large debt-financed projects, and adequate liquidity.

In addition, in 2023-2025, we expect NEK's leverage to increase because the end of its public supplier mandate was postponed to 2025. After record-high 2022 metrics, we expect NEK's FFO to debt to fluctuate at about 10% for the next two years as the company transitions away from the regulated power market.

Downside scenario

We would likely lower the rating on NEK if:

- We no longer saw NEK as highly strategic to BEH, for example because of operational weaknesses at its hydropower plants or demonstrated lack of support from its parent.
- BEH's GCP deteriorates to 'bb', which could follow weaker operating performance, higher leverage, or lower liquidity as a result of electricity prices dropping below our forecast and postponement of full market liberalization beyond 2025; and, at the same time, we see a lower likelihood of BEH receiving government support.

In both cases, we will monitor the Bulgarian government's stability and its ability to support BEH in a timely manner if needed and any negative intervention from the state beyond exceptional measures taken during the energy crisis.

A downgrade of Bulgaria by one notch would not lead to a downgrade of NEK.

Upside scenario

Although unlikely in the short term, rating upside could be triggered by the BEH group's credit profile improving to 'bbb-', reflecting 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 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. Nevertheless, 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.

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 2022, 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 BGN1.32 billion as of 2022.

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 2022, BEH's adjusted EBITDA was BGN4.3 billion.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Bulgaria of 1.3% in 2023 and 3.3% in 2024, and 3% in 2025 and 2026, compared with 3.4% in 2022.
- Domestic consumer price inflation of 9.5% in 2023 and 5% in 2024, compared with 13% in 2022.
- Unregulated power price of BGN250/MWh-BGN300/MWh in 2023-2025 and average regulated power price of BGN100/MWh-BGN110/MWh.
- NEK to achieve generation volumes of 2.2 terawatt hours (TWh) in 2023, amid poor hydro conditions, and stabilizing at about 3TWh thereafter.
- A share of unregulated electricity of about 30% in 2023 and gradually increasing toward 100% with the electricity market's full liberalization by the end of 2025. NEK's role as public supplier to be abolished from year-end 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 (as long as NEK acts as a public supplier).

- Capex of BGN120 million–BGN130 million in 2023 and BGN70 million-BGN80 million in 2024 and beyond, reflecting required modernization and rehabilitation of assets.
- A 50% dividend payout ratio in 2023-2025, although we understand the dividend policy is flexible.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of the loans from the parent.

Key metrics

Natsionalna Elektricheska Kompania EAD--Key Metrics*

	--Fiscal year ended Dec. 31--				
Mil. BGN	2021a	2022a	2023e	2024f	2025f
EBITDA	854	1,313	200-400	300-500	100-300
Capital expenditure	13	16	120-140	70-90	80-100
Dividends	0	0	200-250	0-100	100-200
Debt	3,446	2,125	2,100-2,300	1,900-2,100	2,000-2,200
Funds from operations to debt (%)	24.0	56.3	7.0-10.0	16.0-19.0	4.0-7.0
Free operating cash flow to debt (%)	19.9	54.1	2.0-5.0	12.0-15.0	0-3.0
Debt/EBITDA (x)	4.0	1.6	8.0-9.0	4.0-5.0	13.0-14.0

*All figures adjusted by S&P Global Ratings. a--Actual. BGN--Bulgarian lev. 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. 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 is to its parent, BEH. Factoring in all financings, NEK's committed liquidity sources covered its liquidity needs by only about 1.1x as of June 30, 2023. This comprises NEK's recent extension of the maturity of its BGN700 million loan to BEH to May 2029, leading to a ratio of liquidity sources to liquidity needs consistent with adequate liquidity.

We calculate principal liquidity sources for the 12 months from June 30, 2023, as:

- No committed credit lines;
- Cash and cash equivalents of BGN15 million; and
- Cash FFO of about BGN280 million.

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

- Debt maturities of about BGN1700 million comprising loans payable to BEH;
- Maintenance capex of about BGN100 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 for the rating on NEK, since NEK's parent BEH produces about 30% 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 is material. The rest of BEH's fleet produces low-carbon electricity, with the Kozloduy nuclear power plant generating about 60% of BEH's total production in 2022 and NEK's hydropower plants about 10%.

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

Ratings Score Snapshot

Issuer Credit Rating	BB/Stable/--
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	Fair (no 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

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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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/--	BB-/Positive/--