



## RATING ACTION COMMENTARY

# Fitch Affirms Bulgarian Energy Holding at 'BB'; Stable Outlook

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Fitch Ratings - Warsaw - 22 Dec 2020: Fitch Ratings has affirmed Bulgarian Energy Holding EAD's (BEH) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BB' with a Stable Outlook. Fitch has also affirmed BEH's senior unsecured debt, including EUR550 million (due 2021) and EUR600 million (due 2025) bonds, at 'BB-'.

The IDR of BEH reflects its standalone credit profile (SCP) of 'b+', which is notched up twice for strong links with its sole owner, the Bulgarian state (BBB/Stable) to arrive at the 'BB' IDR. The senior unsecured rating, which is notched down once from the IDR, reflects a high share of debt at subsidiaries resulting in structural subordination of bondholders at the BEH level.

## KEY RATING DRIVERS

**Strong Market Position:** BEH is the largest utility in Bulgaria and has an integrated business profile. In 2019 the group generated 26TWh of electricity, of which 65% was from nuclear (NPP Kozloduy), 26% from lignite (TPP Maritsa East 2) and 9% from hydro power plants (NEK), leading to a low carbon exposure. Beyond generation the group is active in more stable electricity transmission (ESO) and gas transmission and transit (Bulgartransgaz), which contributed 30% to the group's reported EBITDA in 2019, supporting its credit profile. BEH is present also in electricity and gas supply (NEK and Bulgargaz, respectively), excavates lignite (Mini Maritsa) and indirectly controls a telecom business (Bulgartel).

**Improved SCP:** Fitch has revised up BEH's SCP to 'b+' from 'b' as we anticipate higher earnings (mainly from gas transit, but also market liberalisation) to result in more balanced free cash flows (FCF) and lower leverage from 2022. However, the SCP is still low for the group's strong market position and diversified business mix. The main constraints are high capex expectations (in particular over 2020-2021 in relation to the expansion of gas infrastructure), a fairly weak regulatory framework in Bulgaria and corporate-governance limitations.

**Gas Network Expansion:** BEH's main investment, under construction since 2019 by fully owned Bulgartransgaz, is the expansion of the gas transmission and transit infrastructure between the Bulgarian-Turkish and the Bulgarian-Serbian borders (Balkan Stream). The project is of strategic importance for Bulgaria by contributing to the diversification of gas-supply routes. Since completion of the project's first stage in 4Q19, Bulgaria has begun importing Russian gas from Turkey instead of the traditional route via Ukraine. The output capacity at the Serbian border (14bcm vs. 19bcm input at the Turkish border) will allow, upon completion in 2021, for gas transit to Serbia and further to Hungary and Austria.

The second large investment is the construction of a gas interconnector between Greece and Bulgaria (IGB). It will have a capacity of 3bcm (extendable to 5bcm) and should become operational in 2021.

**Large Capex Plans:** We expect BEH's capex (already high in 2019 at BGN1.1 billion) to remain large also over 2020 and 2021 at BGN1.1 billion and BGN0.8 billion, respectively. This will be driven by spending on the Balkan Stream and the IGB projects. We expect it to stabilise at around BGN0.6 billion from 2022.

**High Leverage to Decrease:** BEH's funds from operations (FFO) net leverage (2019: 4.7x) has increased due to high capex and new debt-like financing (EUR1.1 billion) from the Arkad-led consortium constructing the Balkan Stream, which we add to Fitch-adjusted debt from 2019. The leverage increase was lower than we originally expected due to strong results at NPP Kozloduy in 2019. FFO net leverage will remain high in 2020 and 2021 (on average 6x) as construction of the Balkan Stream and the IGB proceeds. However, it should then trend towards 4x over 2022-2024 as capex stabilises and the gas transit starts contributing EBITDA.

**Evolving Regulatory Framework:** Fitch deems the Bulgarian regulatory framework as more volatile and higher-risk than for BEH's peers in the EU. However, it has been evolving with notable success, e.g. reduction of the tariff deficit at NEK and reflection of higher CO2

prices in regulated tariffs at TPP Maritsa East 2. The electricity market has also become more liberalised.

**Liberalisation on Track:** The electricity market was 67% liberalised at end-2019 (vs. 33% regulated). The Bulgarian government plans to achieve full liberalisation of the wholesale segment by mid-2021 and of the retail segment in the following years (non-households are unregulated since October 2020). This should have a positive impact on BEH's SCP over time.

**Corporate-Governance Limitations:** BEH's corporate-governance limitations include in particular a qualified audit opinion for the group's 2009-2019 consolidated financial statements. Positively the group reports under IFRS, but its structure is quite complex and financial transparency, including on its business segments, is weaker than EU peers'.

**Support from State:** Reflecting links with the Bulgarian state, Fitch applies a two-notch uplift to BEH's SCP of 'b+', taking the group's IDR to 'BB'. 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', which altogether lead to a support score of 17.5. The uplift is a notch lower than the previously applied three notches as under the current support score BEH's IDR cannot be higher than a cap defined as sovereign rating minus three notches.

## **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), is the country's largest mining company, the country's electricity transmission network, gas transmission and transit networks and through its position as public supplier of both electricity and gas in Bulgaria.

BEH's integrated business structure and strategic position in the domestic market make the group comparable to some of central European peers such as CEZ, a.s. (A-/Stable) and PGE Polska Grupa Energetyczna S.A. (PGE, BBB+/Stable). However, BEH operates in a more volatile and less transparent regulatory environment than CEZ or PGE, has higher leverage and its results are less predictable with some corporate-governance issues. BEH's rating includes a two-notch uplift from the SCP to reflect links with the sovereign, whereas this is not the case for CEZ or PGE.

## KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Group EBITDA averaging BGN1.1 billion a year over 2020-2024
- Total capex at BGN3.8 billion over 2020-2024
- Zero dividend payments until 2024
- Refinancing of the EUR550 million bond in 2Q21
- State-provided financing to NEK (EUR602 million) refinanced at the BEH level on maturity in 2023

## RATING SENSITIVITIES

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

- Further tangible government support, 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
- Stronger SCP due to FFO net leverage falling below 4x on a sustained basis, lower regulatory and political risk, higher earnings predictability and better corporate governance

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

- Weaker links with the Bulgarian state
- Downgrade of the sovereign rating of Bulgaria as it would lower the "sovereign-less-three" cap for BEH's rating
- Weaker SCP, e.g. due to FFO net leverage exceeding 6x on a sustained basis, escalation of regulatory and political risk or insufficient liquidity

## 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

Refinancing Required: At end-2019 BEH had BGN1,237 million of Fitch-calculated readily available cash against short-term financial liabilities of BGN481 million and negative Fitch-calculated free cash flow (FCF) for both 2020 and 2021. As per our forecast BEH will need to refinance its next large debt repayment, which is its EUR550 million bond maturing in August 2021. We expect BEH to complete a new bond issue no later than 2Q21.

Large Fitch-adjusted Debt: BEH's main debt items include two Eurobonds of EUR550 million (maturity in August 2021) and of EUR600 million (maturity in June 2025). However, we add several other debt-like items to Fitch-adjusted debt. This includes the state-provided financing to NEK in connection with the Belene arbitration of EUR602 million (maturity in 2023), financing provided to Bulgartransgaz by Arkad in connection with the Balkan Stream project of EUR1.1 billion (amortising over 10 years), and the bank guarantee provided for BEH, Bulgartransgaz and Bulgargaz in connection with EU claims in the gas market of EUR77 million. Consequently, Fitch-adjusted debt at end-2019, including some other smaller facilities, reached BGN6.3 billion.

State-related Debt: As per Fitch rating case, the state-guaranteed debt (at single-digit percentages of gross debt) together with state-provided financing to NEK will account for 20%-25% of Fitch-adjusted debt until NEK financing's maturity in 2023. We deem it as a still considerable amount, reflecting close links between BEH and its sovereign owner.

We expect that the NEK facility will be refinanced at the BEH level in 2023, similarly to the existing Eurobonds or, assuming better results than in the current rating case, repaid from on-balance-sheet cash. Either option should eliminate the notching down from IDR applied to the senior unsecured rating as we anticipate the ratio of prior-ranking debt (the debt of subsidiaries that do not guarantee BEH) to EBITDA to fall below 2x from 2023 (2019: 4x).

## **SUMMARY OF FINANCIAL ADJUSTMENTS**

Financial debt at end-2019 is increased by EUR602 million of the face value of the state-financing given to NEK to settle Belene obligations, by EUR1.1 billion of financing provided by Arkad-led consortium to Bulgartransgaz for the Balkan Stream project and by a bank guarantee of EUR77 million given to BEH, Bulgartransgaz and Bulgargaz to cover EU claims.

## **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 scores of 4 for "Group Structure" and "Financial Transparency" to reflect a relatively complex group structure, a qualified audit opinion and lower financial transparency than EU peers'. This ESG constraint has a negative impact on BEH's SCP in combination with other factors, in particular high capex and a volatile regulatory framework.

BEH has also some exposure to carbon intensive generation via its lignite-fired power plant. However, the fuel mix is diversified with most of electricity generated from nuclear and hydro sources, therefore the scores for "GHG Emissions & Air Quality" and "Energy Management" are at 3.

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](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Bulgarian Energy Holding EAD	LT IDR	BB Rating Outlook Stable	Affirmed	BB Rating Outlook Stable
	LC LT IDR	BB Rating Outlook Stable	Affirmed	BB Rating Outlook Stable
● senior unsecured	LT	BB-	Affirmed	BB-

[VIEW ADDITIONAL RATING DETAILS](#)

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## APPLICABLE CRITERIA

[Corporates Notching and Recovery Ratings Criteria \(pub. 14 Oct 2019\) \(including rating assumption sensitivity\)](#)

[Government-Related Entities Rating Criteria \(pub. 30 Sep 2020\)](#)

[Corporate Rating Criteria \(pub. 21 Dec 2020\) \(including rating assumption sensitivity\)](#)

## APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

## ADDITIONAL DISCLOSURES

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Bulgarian Energy Holding EAD

EU Office

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