FitchRatings

Fitch Downgrades Bulgarian Energy Holding to 'BB-'; Negative Outlook

Fitch Ratings-Warsaw/London-16 September 2015: Fitch Ratings has downgraded Bulgarian Energy Holding EAD's (BEH) Long-term foreign and local currency Issuer Default Ratings (IDR) and its foreign currency senior unsecured rating to 'BB-' from 'BB'. The ratings have been removed from Rating Watch Negative (RWN), where they were placed on 18 March 2015. The Outlook is Negative.

The rating downgrade reflects our expectations that BEH group's credit ratios will be weak in 2015-2016, largely due to accumulated power tariff deficit at BEH's subsidiary Natsionalna Elektricheska Kompania EAD (NEK). The rating downgrade is limited to one notch as we expect funds from operations (FFO) in 2015-2016 to improve from low 2014 levels on the back of a smaller tariff deficit at NEK. This is due to various legislative and regulatory changes in 2015 and renegotiation of NEK's long-term power purchase agreements (PPAs) with two thermal power plants, AES-3C Maritsa East 1 EOOD and Contour Global Maritsa East 3 AD.

The Negative Outlook incorporates our projected FFO adjusted net leverage above the 5x guideline for the current ratings by 2016 before decreasing to below 5x in 2017. The Outlook also reflects the BEH group's weak liquidity position in light of large overdue trade payables at NEK and also the possible removal of the single-notch uplift for BEH for state support in the next one to two years if most of its new debt is raised without state guarantees.

The ratings are notched up one level from BEH's standalone rating, reflecting the BEH group's strong links with the Bulgarian state (BBB-/Stable), including guarantees for part of the BEH group's debt. We expect that the state will support BEH in case of liquidity shortfall.

KEY RATING DRIVERS

Weak Financial Position of NEK
NEK, which acts as a public supplier of electricity in Bulgaria, reported heavy losses on its core activity in 2014, due to an unfavourable regulatory and market environment. Inability to fully recover the costs of purchased electricity from various generation sources, including renewable energy sources, cogeneration plants and thermal power plants with PPAs, given the insufficient level of NEK's regulated sale prices, resulted in an EBITDA loss of BGN0.5bn at NEK in 2014 compared with an EBITDA loss of BGN46m in 2013. This in turn had a material negative impact on BEH's consolidated cash flows and credit metrics.

The widened tariff deficit of NEK has created liquidity issues for the company and an increase of overdue trade payables to its suppliers. BEH continues to support NEK through inter-company loans of BGN1.2bn. Large overdue trade payables by NEK has created late payment problems for the whole energy sector in Bulgaria, including some counterparties of the BEH group.

Favourable Regulatory and Legislative Changes
Several legislative and regulatory changes aimed at narrowing NEK's tariff deficit were put in force in 2015. These include the creation of a Security of the Electricity System Fund (SESF), which will collect revenues for the co-funding of NEK's deficit from a new 5% charge on sales of electricity producers and proceeds from the sale of CO2 allowances by the state. In addition, an obligation-to-society fee paid to NEK by customers on the free market was increased for the regulatory period from August 2015 to June 2016, though the positive impact of this change was partially reduced by a cut of NEK's sale price on the regulated market. In addition, NEK's obligations to purchase electricity from renewable energy sources and highly efficient cogeneration sources at above-market preferential prices were reduced.

Despite recent positive developments addressing NEK's tariff deficit the company is yet to establish a track record of improved cash flows while the Bulgarian operating environment remains subject to high regulatory and political risk.

Renegotiation of NEK's PPAs
In April 2015, NEK agreed renegotiation of two long-terms PPAs with two thermal power plants, CountourGlobal Maritsa East 3 and AES 3C Maritsa East 1 EOOD. NEK agreed to lower the capacity tariffs it pays to both power plants by about 15% and at the same time agreed to repay its outstanding trade payables to both plants. The reduction of the capacity tariffs will become effective once NEK repays its overdue liabilities to these two plants in the next few months.

BEH announced on 3 September 2015 that it plans to raise a bank loan or issue bonds for up to EUR650m (BGN1.3bn) with part of the proceeds to be used to repay overdue trade payables to the plants. NEK owed these plants about BGN900m (EUR450m) at end-June 2015.

Positively, the renegotiation of the PPAs will lead to cost savings from capacity price reduction of about BGN100m per year or BGN1bn till the end of the PPA term, but the liquidity position may remain tight.

According to our calculations the legislative and regulatory changes and the PPAs renegotiation will shrink NEK's deficit by close to BGN0.2bn in 2015 (as changes are being implemented during the year) and near BGN0.5bn in 2016 (full-year impact). As a result, NEK's EBITDA should improve to around break-even in 2016 from minus BGN0.5bn in 2014.

Weak Credit Ratios
The BEH group's FFO declined almost 60% in 2014, though cash flow from operations was temporarily boosted by working capital inflows mainly due to increased overdue trade payables. Lower FFO resulted in a substantial worsening of credit metrics despite net debt being almost 10% lower in 2014 compared with 2013. FFO adjusted net leverage increased to about 5x in 2014 from

3.1x in 2013. Including NEK's overdue trade payables to electricity producers (BGN0.7bn at end-2014) in adjusted net debt, FFO adjusted net leverage would have been 8x in 2014.

We assume that BEH will raise new debt of EUR650m by end-2015 with most of the proceeds to be used for repayment of NEK's overdue trade payables by end-2015. We expect FFO adjusted net leverage of 6x in 2015 and 5x in 2016 and slightly above 4x in 2017. Net leverage above 5x on a sustained basis is not commensurate with the current ratings given BEH's business profile, its weak corporate governance, the low predictability of the Bulgarian regulatory environment and political risk within the tariff framework.

Liquidity May Weaken

At end-June 2015, the BEH group had sufficient cash (BGN695m) in relation to short-term debt (BGN179m) but not for the large overdue trade payables to electricity producers at NEK (BGN0.9bn). The planned repayment of trade payables of NEK by end-2015 is likely to lead to a working capital outflow of about BGN1bn (net of likely repayment of trade receivables from some customers). We expect this, together with capex, to lead to negative free cash flow (FCF) of BGN1.1bn in 2015. BEH expects to fund this with new debt of up to EUR650m (BGN1.3bn) to be raised in the next few months. However, the BEH group's liquidity position may remain tight, putting pressure on the ratings.

Most of BEH's existing debt is due in 2018 when the EUR500m bond (BGN1bn) issued in 2013 matures. We expect BEH to start the bond refinancing process well ahead of maturity.

Eurobond Covenant

A debt incurrence covenant (consolidated EBITDA to consolidated fixed charge of no less than 4x), as defined in the EUR500m eurobond documentation, was met at end-December 2014 (6.5x) despite weak underlying EBITDA driven by the widened deficit at NEK. BEH management expects the group to have met the eurobond covenant at end-June 2015 as underlying EBITDA improved in 1H15.

In our view, a breach of the eurobond covenant resulting in limitation to raise debt would substantially worsen BEH group's liquidity position and could result in a liquidity crunch. We expect that the state would support BEH in such an event.

Senior Unsecured Debt Rating

Failure to substantially improve BEH group's EBITDA in 2015-2016 such that the ratio of prior-ranking debt (the debt of subsidiaries which do not guarantee BEH) to consolidated Fitch-adjusted EBITDA returns to below 2x may lead us to notch down the rating for senior unsecured debt of the holding company (ie, the EUR500m bonds) from the IDR. This would be due to the structural subordination of the holding company's creditors to the external creditors lending directly to its operating companies.

Strong Links with the State

The IDR is notched up one level from BEH's standalone rating, reflecting the group's strong links with the Bulgarian state. This is mainly evidenced by state guarantees for 26% of the group's debt (as of end-2014), down from 50% in 2012, its strong operational ties with the state and its strategic importance due to its dominant market position in the country's electricity and gas market.

We expect that the level of state guarantees is likely to decline further in 2016-2017 as the state-guaranteed debt is amortised and most of new debt is unlikely to be guaranteed in our view. This would signal weakening links with the government and lead to a downgrade.

Corporate Governance Limitations
The ratings reflect BEH's corporate governance limitations, including a qualified audit opinion for BEH group's 2009-2014 financial statements and frequent management changes. We view the group's transparency, including on segments, and timeliness of financial reporting as weak compared with its European peers.

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for BEH include:

-Gradual improvement in NEK's EBITDA from a BGN0.5bn loss in 2014 to break-even by 2016 on the back of regulatory and legislative changes and renegotiation of PPAs
-The repayment of overdue trade payables of NEK, largely by raising new debt
-Capex of BGN3.4bn in 2015-2019, co-funded with EU grants and CO2 reimbursement; capex to add to negative FCF in the medium term
-Forthcoming tangible state support in case of prolonged tight liquidity position
-No dividend pay-outs in 2015-2017

RATING SENSITIVITIES

Negative: Future developments that could lead to negative rating action include:
- FFO adjusted net leverage exceeding 5x on a sustained basis, for instance due to failure to materially improve the group's EBITDA and FFO from weak 2014 levels or substantial payments related to the ongoing litigation concerning the terminated Belene nuclear project
- Prolonged tight liquidity position
- Weakening links between BEH and Bulgaria through, for instance, a reduction in the share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed
- Sustained increase in prior-ranking debt above 2x EBITDA, which would be negative for the senior unsecured rating

Positive: The Outlook is Negative and Fitch thus does not anticipate an upgrade, nonetheless, future developments that could lead to a positive rating action (revision of Outlook to Stable) include:
- Improved liquidity position
- Tangible government support, including additional state guarantees
- FFO adjusted net leverage below 5x on a sustained basis
- Longer track record of a shrinking tariff deficit at NEK
- Progress in the liberalisation of the electricity market through a rising share of market-based pricing in the generation sector

- Stronger corporate governance

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Applicable Criteria

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

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