FitchRatings

Fitch Rates Bulgarian Energy Holding's Upcoming Eurobond 'BB+(EXP)'

Ratings Endorsement Policy

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Fitch Ratings-Warsaw/London-25 October 2013: Fitch Ratings has assigned Bulgarian Energy Holding EAD (BEH) a foreign currency senior unsecured rating of 'BB+' and planned debut eurobond an expected foreign currency senior unsecured rating of 'BB+(EXP)'.

The final rating is contingent on the receipt of final documents conforming materially to the preliminary documentation. A full list of BEH's ratings is provided at the end of this commentary.

The rating for the unsecured bonds of BEH, the holding company, is at the same level as BEH's Long-term foreign currency Issuer Default Rating (IDR) of 'BB+'/Stable, which is based on the group's consolidated financial and business profile. We believe that the structural subordination of the holding company's creditors to the external creditors lending directly to its operating companies is mitigated by the rising share of the holding company's debt in total debt and the low ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH) to consolidated EBITDA.

KEY RATING DRIVERS FOR BEH'S UNSECURED DEBT

Rising Share of Holding Company's Debt
We expect that the planned eurobond issue and additional planned financing of BGN216m by the holding company, together with the repayment of some subsidiary debt, will increase the share of holding company's debt in total group debt to 56% at end-2013 from 30% at end-June 2013. At the same time, the ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH) to consolidated EBITDA will decrease to 1.2x from 1.5x (based on 2012 audited EBITDA). This ratio is well below our threshold of 2x, when we would consider rating unsecured debt one-notch lower due to the subordination effect from material levels of prior-ranking obligations.

Central Funding Strategy
There are no upstream guarantees from material subsidiaries to the upcoming bond to be issued at the holding company level. If there were, these would contractually equalise the position of the holding company's creditors with the creditors of operating subsidiaries. The group's funding strategy is to raise debt at the BEH level and repay some subsidiary debt, thus over time mitigating structural subordination within the group.

Key Features of Proposed Notes
The preliminary bond documentation includes a negative pledge clause monitoring the creation of secured debt (defined as relevant indebtedness) of BEH and its material subsidiaries, a change of control put option and also a cross-default provision related to BEH and its material subsidiaries. There is also a financial covenant related to incurrence of additional indebtedness if the ratio of consolidated EBITDA to consolidated fixed charge is below 4x.

KEY RATING DRIVERS FOR BEH

Dominant Market Position
BEH, together with its subsidiaries (BEH group), has a dominant position in Bulgaria's electricity and gas markets. The group's key segments, based on EBITDA contribution, are electricity generation, electricity transmission and gas transmission and transit.

Strong Links with the State

BEH is notched up one level from its standalone rating of 'BB'/Stable, reflecting the group's strong links with the Bulgarian state (BBB-/Stable). The strong linkage is mainly evidenced by state guarantees for about 50% of the group's debt, its strong operational ties with the state and its strategic importance. We expect the share of state-guaranteed debt to gradually decrease in the long term.

Regulatory Regime's Weakness
The regulatory framework in Bulgaria is less developed than in most other EU countries and provides for lower and less predictable remuneration for electricity and gas network businesses and for electricity and gas supply. Another constraint relates to electricity price setting which is often influenced by political decisions. A substantial part of power generation is subject to price regulation.

Rated on a Consolidated Basis
BEH is rated based on a consolidated business and financial profile. Although BEH is a holding company, it has 100% ownership of all its main subsidiaries. The group was created by the government in 2008 as part of the restructuring of the energy sector through an in-kind contribution of the shares of several state-owned power companies to the predecessor of BEH. The government views the whole BEH group as the state's strategic asset in the electricity and gas markets.

The main source of recurring cash flow for the holding company is dividends from subsidiaries. BEH supports some of its financially weaker operating subsidiaries, in particular National Electric Company EAD (NEK), with inter-company loans. In May 2013 it refinanced NEK's EUR195m syndicated bank loan with a bridge loan at the holding level.

Higher Leverage
Fitch projects funds from operations (FFO) adjusted net leverage to weaken to about 2x-3x in 2014-2015 from 1.7x in 2012 (0.6x in 2011) due to negative free cash flow on the back of higher capex. BEH's leverage of 2x-3x is in line with Fitch's 2014-2015 leverage expectation for most central European (CE) utilities, which are rated higher than the company. However, we view BEH's debt capacity as lower than that of Fitch-rated CE peers.

Corporate Governance
The ratings are negatively affected by corporate governance limitations, including a qualified audit opinion for BEH group's 2009-2012 financial statements.

RATING SENSITIVITIES

Positive: Future developments that could lead to positive rating actions include:
- FFO net adjusted leverage below 1.5x on a sustained basis, for instance due to a reduced capex plan and an improved financial performance, including liquidity management and debt maturity profile
- Rising and more predictable remuneration for regulated activities
- Progress in the liberalisation of the electricity market through a rising share of market-based pricing in the generation sector
- Stronger corporate governance

Negative: Future developments that could lead to negative rating action include:
- FFO net adjusted leverage exceeding 3x on a sustained basis, for instance due to financial underperformance or substantial payments related to the ongoing litigation concerning the terminated Belene nuclear project
- Weakening links between BEH and Bulgaria through, for instance, a reduction of the share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed
- A negative change in Bulgaria's ratings, which could affect BEH's ratings if the company's ratings become capped by the sovereign
- Failure to maintain sufficient liquidity

LIQUIDITY AND DEBT STRUCTURE

Stretched Liquidity
At end-June 2013, the group's liquidity was temporarily stretched as it had cash of BGN492m versus short-term debt of BGN578m. The relatively high short-term debt is mostly driven by the upcoming maturity of a

EUR195m (BGN382m) bridge loan, which is due in November 2013. BEH plans to refinance this loan with the upcoming long-term eurobond, which should improve the group's liquidity position. The group faces weak diversification of cash and cash equivalents as most of the cash was held in a single bank as of end-June 2013.

Secured debt
Some subsidiary debt is secured on assets. However, we believe that the amount of secured debt is not material to the senior unsecured rating given that secured debt accounted for about 0.5x EBITDA or 22% of total debt at end-2012.

Fitch rates BEH as follows:
Long-term foreign currency IDR of 'BB+'; Stable Outlook
Long-term local currency IDR of 'BB+'; Stable Outlook
Foreign currency senior unsecured rating of 'BB+'
Expected foreign currency senior unsecured rating of 'BB+(EXP)' for the upcoming eurobond

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage', dated 5 August 2013, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage

Additional Disclosure
Solicitation Status