FitchRatings

Fitch Rates Bulgarian Energy Holding 'BB+'; Stable Outlook

Ratings Endorsement Policy
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Fitch Ratings-London/Warsaw-01 March 2013: Fitch Ratings has assigned Bulgarian Energy Holding EAD (BEH), Bulgaria's largest electric and gas utility company, a Long-term foreign currency Issuer Default Rating (IDR) of 'BB+' and Long-term local currency IDR of 'BB+' with Stable Outlooks.

The ratings reflect BEH's and its 100%-owned subsidiaries' (BEH group) dominant position in the country's electricity and gas markets, its strong links with the Bulgarian state ('BBB-'/Stable) and evidence of tangible state support. The ratings also incorporate the weakness of the Bulgarian regulatory framework, corporate governance limitations and the group's large capex plan for 2013-2015 that will likely increase its financial leverage.

KEY RATING DRIVERS
--Dominant Market Position
BEH group has a vertically integrated position in the electricity market with operations spanning from lignite mining, power generation to power transmission and supply. In the gas market, BEH group is the owner and operator of the country's transmission gas network and generates revenues from the transit of Russian gas through Bulgaria. It is also the public supplier of gas in the country. Most of the gas supplied to end customers comes from imports from Russia within a long-term take-or-pay contract with OAO Gazprom ('BBB'/Stable).

--Solid Asset Base
BEH has a solid asset base enabling the company to maintain its leading domestic market position. It owns Bulgaria's strategic assets - electricity and gas transmission networks, and two large power plants, a nuclear power plant and a lignite-fired power plant, which are used as the main baseload capacity in the country. BEH group's market share in the country's power generation is 63%.

The most important segment, based on EBITDA contribution, is power generation (44% of 2011 EBITDA) followed by electricity transmission, 27%, and gas transmission and transit, 18%. Lignite mining contributed 13% of EBITDA in 2011.

--State Ownership And Strategic Importance
Fitch gives BEH a one-notch uplift for state support over its standalone rating of 'BB'/Stable, reflecting the group's strong linkage with the state. The strong linkage is mainly evidenced by state guarantees for about 40% of the group's debt, equity injections in 2008-2009 and strategic importance to the state due to BEH group's dominant market position in the electricity and gas markets. The BEH group is the country's biggest state-owned company and the Bulgarian counterparty in several strategic projects supported by the government, such as Nabucco, South Stream and the gas interconnector between Bulgaria and Greece, which aim to improve the security of gas supplies to Bulgaria. We expect the share of government guaranteed debt to decrease in the long term as the guaranteed loans are repaid and new debt is unlikely to benefit from guarantees.

--Rated On A Consolidated Basis
Fitch rates BEH based on the consolidated business and financial profile. Although BEH is a holding company, it has 100% ownership of all the main subsidiaries. The group was created by the government in 2008 within the restructuring and consolidation process 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. We expect future debt to be

raised at BEH level, thus mitigating any structural subordination within the group.

--Weakness Of Regulatory Framework
A substantial portion of BEH's operations are regulated networks - transmission of electricity or gas. The regulated business accounts for about 30% of EBITDA (further 20% of EBITDA is contributed by gas transit which is exposed to volume risk as is not seen as fully comparable to domestic regulated network activities). However, the regulatory framework in Bulgaria is less developed than in most other EU countries and provides for lower and less predictable remuneration.

We do not view the sale of power at regulated prices, set below the market level, as a supporting factor for BEH's credit profile. While it provides some cash flow visibility, it also does not support investment due to insufficient remuneration. In addition, higher than expected costs in one-year regulatory period are not fully reflected in tariffs and may lead to much lower cash flows for BEH. This happened in 2011-2012 due to a boom in renewables energy, which resulted in additional costs for BEH not covered by the tariffs.

Until recently, the gas supply business was unprofitable as the gas prices for customers set by the regulator were lower than the price that the company was paying to Gazprom for imported gas. The situation has improved since late 2012, when BEH group has renegotiated its contract with Gazprom and achieved a 20% reduction of the imported gas price.

--Large Capex
BEH group intends to substantially increase its capex in 2013-2017. The capex plan for this period totals BGN4.7bn (EUR2.4bn). The annual spending for 2013-2017 averages BGN951m, which is 32% more than the average of BGN718m for 2008-2011. The growth in planned capex primarily stems from much higher investments planned by the holding company. These investments relate to two large projects, the Nabucco pipeline (BGN1bn) and the gas interconnector between Bulgaria and Greece (BGN200m).

--Cash Flow and Leverage
Fitch projects funds from operations (FFO) to fall in 2012 by almost 50% compared with 2011 due to weaker profitability of the power supply and transmission businesses and nuclear power generation. The agency expects FFO to partially recover in 2013-15, but to remain below the 2011 level. The agency expects BEH to report negative free cash flow in 2013-2016 as the group increases its capex and continues to pay dividends.

Fitch projects FFO adjusted net leverage to weaken to about 2.5x in 2014 and 3x in 2015 from 1x in 2011. This is due to negative free cash flow on the back of weaker FFO and higher capex. BEH's leverage of 2.5x-3x is in line with Fitch's 2014-2015 leverage expectation for central European utilities, which are rated higher than the Bulgarian company. However, we view BEH's debt capacity as lower than that of Fitch-rated central European peers.

--Corporate Governance
The group's auditor, Ernst & Young issued a qualified audit opinion for the 2009-2011 consolidated and separate financial statements. The qualifications in the consolidated statements included several items, such as the lack of provisions for nuclear decommissioning costs and the lack of recognition of separate assets for the group's rights to receive reimbursements for a portion of these costs from national and international funds. Another qualification referred to the inability to obtain sufficient audit evidence as to recoverability of the assets related to the stopped construction of the Belene nuclear power plant and the fair value of about 40% of property, plant and equipment. The agency views this and generally developing corporate governance as a concern for the rating.

--Sufficient Liquidity
At end-September 2012, the group's liquidity was sufficient as it had cash of BGN717m against short-term debt of BGN520m. The relatively high short-term debt is mostly driven by the upcoming maturity of a EUR195m (BGN382m) loan of BEH's subsidiary (NEK EAD), which is due in May 2013. BEH plans to refinance this loan with a corporate bond or a syndicated loan facility at the holding level.

Fitch notes the group's weak diversification of cash and cash equivalents by bank. At end-September 2012, about 87% of the group's cash and cash equivalents was held in a single bank. We understand that the selection of financing institutions for cash holdings is done in accordance to instructions stipulated by the

Ministry of Finance.

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 lowered 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, for instance, significant reduction of the share of state guaranteed debt and/or lack of additional tangible support if needed
- A negative change in Bulgaria's ratings could affect BEH's ratings if the company's ratings become capped by the sovereign
- Failure to maintain sufficient liquidity

Contact:
Principal Analyst
Jacek Kawalczewski, CFA
Associate Director
+48 22 338 6291

Supervisory Analyst
Arkadiusz Wicik, CFA
Senior Director
+48 22 338 6286
Fitch Polska S.A.
Krolewska 16
00-103 Warsaw

Committee Chair
Josef Pospisil, CFA
Senior Director
+44 20 3530 1287

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable criteria, 'Corporate Rating Methodology', dated 8 August 2012, and is available at www.fitchratings.com.

Applicable Criteria and Related Research
Corporate Rating Methodology

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