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

Ratings Endorsement Policy
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Fitch Ratings-Warsaw/London-18 March 2014: Fitch Ratings has affirmed Bulgarian Energy Holding EAD's (BEH) Long term foreign currency Issuer Default Rating (IDR) and Long-term local currency IDR at 'BB+' with a Stable Outlook. BEH's 2018 EUR500m bond has been affirmed at foreign currency senior unsecured rating 'BB+'.

The ratings reflect BEH's and its 100%-owned subsidiaries' (BEH group) dominant position in the country's electricity and gas markets, and its strong links with the Bulgarian state (BBB-/Stable), mainly evidenced by state guarantees for about 30% of the group's debt and strong operational and strategic ties. The ratings also incorporate the weakness of the Bulgarian regulatory framework despite some recent improvements in relation to BEH, corporate governance limitations and the group's large capex plan for 2013-2017 that will likely increase its financial leverage.

The rating for the unsecured bonds of BEH reflects our view that the structural subordination of the holding company's creditors to the external creditors lending directly to its operating companies is mitigated by the increased 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

Dominant Market Position
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, and in accordance with the agency's Parent and Subsidiary Rating Linkage criteria. The strong linkage is mainly evidenced by state guarantees for about 30% of the group's debt (as of end-2013), its strong operational ties with the state and its strategic importance. In line with our expectations the share of state-guaranteed debt decreased in 2013 to 30% from about 50% as all new debt raised in 2013, in particular the EUR500m bond, was without state guarantees. The state plans to guarantee a new EUR80m loan related to the gas interconnection project between Bulgaria and Greece.

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 networks 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. Adverse regulatory decisions have had a negative impact on the financial profile of several operating subsidiaries of BEH, in particular, public power supplier National Electric Company EAD (NEK). Despite recent positive developments, which are likely to result in improved profitability of BEH group in 2014, we have yet to see a reliable track record and full transparency of the regulatory framework.

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 NEK, with inter-company loans. At end-2013 total shareholders loans to subsidiaries amounted to BGN1.46bn, out of which BGN1.23bn were lent to NEK.

Higher Leverage
Fitch projects funds from operations (FFO) adjusted net leverage to weaken to about 2.5x-3x by 2015 from 1.7x in 2012, due to negative free cash flow on the back of higher capex. BEH's projected leverage of about 3x is in line with Fitch's 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 because of the weaknesses of Bulgaria's regulatory regime and BEH's corporate governance limitations, including a lack of qualified audit opinion for BEH group's 2009-2012 financial statements.

In a scenario assuming BEH's equity contributions to the South Stream project are fully debt- funded leverage may temporarily exceed 3x in 2016-2017, which we see as the maximum level for the current rating. This would lead to limited rating headroom in this period.

Rising Share of Holding Company's Debt
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. With the EUR500m eurobond issue by the holding company in November 2013, together with the repayment of some subsidiary debt, the share of holding company's debt in total group debt increased to 55% 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 decreased to about 1.3x from 1.5x (based on 2012 audited EBITDA). This ratio is well below our threshold of 2x, whereby we would consider rating unsecured debt one notch lower due to the subordination effect from material levels of prior-ranking obligations.

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

The group's liquidity is sufficient following the EUR500m (BGN980m) five-year bond issue in November 2013. At end-2013 BEH group had cash of BGN510m versus short term debt of BGN161m. BEH has also diversified its cash and cash equivalents with several local and international banks, a development which reduces the concentration risk highlighted by Fitch in the past.

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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