

Research Update:

# Bulgaria-Based Utility Company Natsionalna Elektricheska Kompania EAD Outlook Revised To Negative; 'B+' Rating Affirmed

August 30, 2019

## Rating Action Overview

- Natsionalna Elektricheska Kompania EAD's (NEK) parent company, Bulgarian Energy Holding EAD (BEH), is ramping up investments into key projects via its subsidiary, Bulgartransgaz.
- We think this could lead to a meaningful deterioration in the consolidated BEH group's credit quality.
- NEK's stand-alone performance remains weak, so it remains highly dependent on ongoing and extraordinary support from BEH.
- We are therefore revising the outlook on NEK to negative from stable and affirming our 'B+' issuer credit rating on the company.
- The negative outlook on NEK reflects our view that BEH's ability to support NEK could reduce if the sizable investments into gas pipeline infrastructure lead to a meaningful deterioration in BEH's credit quality.

## Rating Action Rationale

The outlook revision reflects our view that BEH's ability to provide extraordinary and ongoing support to its subsidiary NEK could deteriorate in the coming years. Given high leverage at the NEK level, the BEH group's credit quality and group support remain the key drivers of the rating on NEK.

The affirmation of the 'B+' rating on NEK reflects the balance between still weak--albeit stabilized--performance on the stand-alone level, and our expectation of continuing ongoing and extraordinary support from its parent BEH and, indirectly, from the Bulgarian government.

There is a lack of clarity regarding the actual timing, amount of investments, project structure, and additional government support for BEH and its large new projects. We also understand that exact terms are still under negotiation. However, we think that the projects are in line with the Bulgarian government's energy strategy, which focuses on security of gas supply and diversification of gas

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flows to Balkan and Eastern European regions.

Since BEH represents a main support for NEK, we take into consideration the consolidated group's key projects when assessing the rating on NEK. These include the construction of the Greece-Bulgaria gas interconnector project (IGB) and the construction of gas transmission infrastructure to connect the markets between Turkey and Serbia.

Bulgartransgaz, BEH's subsidiary, is now looking to find the main contractor for the expansion of the existing Bulgartransgaz gas transportation system between Turkey and Serbia, which will cost about Bulgarian lev (BGN) 2.8 billion, according to management's preliminary estimates. We understand that the engineering, procurement, and construction (EPC) contractor should provide long-term interest-bearing funding to Bulgartransgaz to cover the full project cost. We view such contractor financing as debt-like. We also understand that BEH will consolidate this EPC contractor funding in its financial statement and repay it with transit revenue from the project once it is commissioned. In addition, BEH has a 50% stake in the IGB, but we understand that grants from the European Energy Programme for Recovery and the Operational Programme "Innovation and Competitiveness", along with the €110 million secured by a state-guaranteed loan, will effectively cover the €260 million project cost.

Due to the size of these investments, we think that BEH's credit quality could come under pressure, with FFO to debt declining well below 20% in 2020-2021. BEH's consolidated adjusted debt in 2020 could rise by about 50% compared to Dec. 31, 2018. We also understand that tenders for the construction of new Belene power plant are under way, although the timing and size of this project remain unclear.

That said, we understand that BEH has yet to decide the capex schedule for the Balkan Gas Hub, and the appeal on the EPC contractor process adds uncertainty. We also expect BEH's stand-alone performance to improve, with EBITDA increasing to BGN885 million-BGN895 million in 2019-2020 from BGN479.7 million in 2018. If BEH's performance improves beyond our current expectations, this could further offset the impact on BEH's consolidated financials and improve its ability to support NEK.

We view NEK's stand-alone credit quality as relatively stable, despite much weaker-than-expected results in 2018. We understand that these were harmed by one-off factors, including a significant increase in carbon dioxide allowances and the fully provisioned BGN60 million litigation claim from WorleyParsons Nuclear Services JSC.

We think that NEK's performance will likely recover, with its debt-to-EBITDA ratio decreasing to 20x-25x by end-2021 from 46.7x currently. Given continuing market liberalization in Bulgaria, from July 1, 2019, NEK is obliged to purchase power only from RES and highly efficient combined heat and power producers with installed capacity of 1 megawatt and lower. This should improve NEK's cost structure. In addition, the Security of the Electricity System Fund remains in place and it will cover NEK's current tariff deficit going forward.

That said, the state has not yet fully implemented the energy reforms, and its strategic decision regarding the company's historical tariff deficit (accumulated before 2016) is still pending. The estimated deficit is between BGN1.4 billion (Energy and Water Regulatory Commission's decision in June 2014) and BGN1.9 billion (the World Bank's estimate in 2015). Overall, we do not expect NEK will be able to reduce leverage quickly, given its very large accumulated historical debt (BGN2.5 billion reported at Dec. 31, 2018).

The key positive factor for our stand-alone assessment of NEK is the favorable structure of NEK's debt portfolio. NEK owes most of its debt to its parent, BEH (71.1%) and the government (26.5%), with loans to banks making up less than 2.5% of total debt (amounting to BGN64.2 million as of Dec. 31, 2018). We treat the loans from the government and BEH as debt, rather than equity,

because they are not structurally subordinated to other liabilities. However, we still think that NEK has some flexibility regarding repayments to its parent, and that it will be able to make debt payments to banks according to schedule. We therefore assess NEK's stand-alone credit profile (SACP) at 'b-', factoring in ongoing support from the parent.

We continue to regard NEK as a strategically important subsidiary of BEH and consequently add two notches of uplift from NEK's 'b-' SACP. We cap our rating on NEK one notch below the 'bb-' group credit profile (GCP). Although we do not rate BEH, we factor its credit quality into our rating on NEK. We regard BEH as a government-related entity with a moderate likelihood of receiving extraordinary state support. The 'bb-' GCP takes into account our view of potential extraordinary state support.

## **Outlook**

The negative outlook reflects our view that the parent's ability to support NEK could reduce. This could happen if the abovementioned sizable investment projects lead to meaningful deterioration of BEH's credit quality, and improvements in BEH's performance beyond our current expectations, state support, capex delays, and the project structure are not sufficient to offset this deterioration. The outlook revision also reflects our view that NEK will likely remain highly dependent on parental support.

## **Downside scenario**

We would likely lower the rating on NEK if BEH's credit quality deteriorates to 'b+', based on weaker operating performance, higher leverage, weaker liquidity, or a sovereign downgrade. We could also lower the rating if parental support from BEH diminishes meaningfully. Finally, we could downgrade NEK if we saw a significant deterioration in its liquidity and in its ability to generate sufficient cash flow to repay its relatively modest external debt. However, this is not part of our base case.

## **Upside scenario**

A revision of the outlook to stable would largely depend on BEH's performance stabilizing at the 'bb-' level. This would mainly depend on:

- The actual terms of coming investment projects--in particular, the timing and volume of investments or potential government support;
- Debt-to-EBITDA dropping below 4.0x and FFO to debt rising above 20% on a sustainable basis; and
- Maintenance of adequate liquidity.

We could also take a positive rating action on NEK if we saw the successful implementation of market liberalization in Bulgaria, strategic decisions by the company to remove its old accumulated tariff deficit or to dispose of its assets in Belene, and the consequent repayment of the loan to the Bulgarian government.

## Company Description

NEK is a Bulgarian public provider of electricity to protected customers. It also owns and operates all large hydro power plants (HPPs) in Bulgaria. It purchases electricity and then uses it, alongside its own generated power, to ensure supply in regulated and free markets. In 2018, NEK's total revenue amounted to BGN3.2 billion as per International Financial Reporting Standards.

## Our Base-Case Scenario

In our base case for 2019-2020, we assume:

- Real GDP growth in Bulgaria of 3.3% in 2019 and 3.2% in 2020, compared with 3.1% in 2018. Consumer price inflation of 2.5% in 2019 and 2.2% in 2020, compared to 2.6% in 2018.
- Further electricity market liberalization in Bulgaria. However, we expect NEK will remain an exception, with a share of unregulated revenue of 16% in 2019 and 2020, up from 9% in 2018.
- Capital expenditure (capex) of about BGN60 million in 2019 and BGN100 million-BGN115 million in 2020, reflecting the required modernization and rehabilitation of assets.
- A €0.6 billion loan obtained from the government in December 2016, which we treat as debt rather than equity.
- No dividends.
- Ongoing support from BEH, such as flexibility to renegotiate the terms of the loans from the parent.
- EBITDA of BGN130 million-BGN170 million in 2019-2020.
- Debt to EBITDA of about 20x-25x in 2019-2020.

## Liquidity

We view NEK's liquidity as weak, based on the company's stand-alone liquidity arrangements. We understand that BEH is willing and so far able to provide sufficient liquidity support to NEK in a timely manner, and that NEK has some flexibility regarding interest payments in loans from BEH.

We expect principal liquidity sources for NEK during the 12 months from July 1, 2019 will include:

- Approximately BGN35 million of cash and cash equivalents;
- Cash FFO of BGN33.6 million; and
- BGN31.7 million of grants received to fund capital projects.

We expect principle liquidity uses over the same period will include:

- BGN153 million of debt amortization, although we understand most of it relates to loans provided by BEH; and
- Capex of BGN85.6 million.

## Covenants

We understand that NEK remains in breach of its current financial ratio covenant on some of its loans. However, we think there is a low risk of the loan maturities being accelerated, since most of the loans under this covenant benefit from a government guarantee and receive waivers from creditors.

## Environmental, Social, And Governance

The rating on NEK incorporates environmental, social and governance factors.

Social factors are the key reasons for NEK's accumulation of its historical tariff deficit. These factors remain the key challenge in ongoing electricity sector reform. NEK has an important social role in maintaining a reliable, safe, and sustainable electricity supply. We understand NEK complies with the terms of its operating license and regulatory requirements.

In terms of governance, the company is fully owned by the government through BEH and its activities are strongly aligned with government policy. We think the government's influence has had an adverse effect on the company, rather than a favorable one, with a long track record of unsupportive regulation leading to a substantial accumulated tariff deficit. The liberalization process has started, so we expect to see some positive developments that should allow the company to improve its performance and serve its external debt without parental support.

Environmental risks are currently less pronounced but they contribute to EBITDA volatility. NEK has two main operating segments: electricity supply and electricity generation. The company generates all of its electricity with renewable sources (HPPs). Although both segments have zero net emissions, NEK was exposed to a carbon dioxide price increase via purchased electricity. Furthermore, since the construction of the Belene nuclear power plant has returned to the agenda, environmental risk could rise in the future.

## Ratings Score Snapshot

Issuer Credit Rating: B+/Negative/--

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Very low
- Competitive position: Weak

Financial risk profile: Highly leveraged

- Cash flow/leverage: Highly leveraged (Standard volatility)

Anchor: b-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Weak (no impact)

- Financial policy: Neutral (no impact)
- Management and governance: Weak (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b-

Group status: Strategically important (+2 notches from SACP)

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Natsionalna Elektricheska Kompania EAD</b>		
Issuer Credit Rating	B+/Negative/--	B+/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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