FitchRatings

Fitch Revises Bulgarian Energy Holding's Outlook to Stable; Affirms at 'BB-'

Fitch Ratings-Warsaw/London-12 August 2016: Fitch Ratings has revised Bulgarian Energy Holding EAD's (BEH) Outlook to Stable from Negative while affirming the Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BB-'. The agency has also affirmed BEH's foreign currency senior unsecured rating at 'BB-'.

The Outlook revision reflects BEH's improved liquidity position following the company's recent five-year EUR550m bond issue, which allowed BEH to refinance most of its large short-term debt.

The affirmation reflects BEH group's substantially improved funds from operations (FFO) in 2015 and 2016, from a low level in 2014, due to various legislative and regulatory changes implemented during 2015 and successful renegotiations of power purchase agreements (PPAs) with two thermal power plants. The ratings are notched up one level from BEH's standalone rating, reflecting the group's strong links with the Bulgarian state (BBB-/Stable), including guarantees for part of the BEH group's debt.

KEY RATING DRIVERS

Improved Liquidity after Bond Issue

The Outlook revision reflects BEH's improved liquidity following the company's recent bond issue. The issue allowed BEH to refinance most of its large short-term debt, mainly a bridge loan of EUR535m (BGN1bn) which was repaid in early August 2016. Liquidity is now sufficient to cover short-term debt and Fitch-projected negative free cash flow (FCF).

We expect the state to support BEH should the company's liquidity be insufficient in a scenario of full payment of the arbitration amount ordered by an arbitration court in June 2016 in relation to the terminated Belene nuclear power plant project.

Following the bond issue and bridge loan repayment, the next large debt maturity is in November 2018 when the EUR500m bond (BGN1bn) issued in 2013 matures. We expect BEH to start the bond refinancing process well ahead of maturity.

NEK's Improved Financial Position

The affirmation reflects the BEH group's substantially improved cash flow generation in 2015, after weak results for 2014. This is largely due to a narrowed power tariff deficit at BEH's subsidiary Natsionalna Elektricheska Kompania EAD (NEK), a public supplier of electricity in Bulgaria, following a number of legislative and regulatory changes implemented during 2015.

We expect NEK's cash flows to improve further in 2016 due to the full-year impact of 2015 legislative and regulatory changes and also due to the renegotiation of NEK's PPAs with two thermal power plants, AES-3C Maritsa East 1 EOOD and Contour Global Maritsa East 3 AD, which came into force following the repayment of NEK's overdue trade payables to these two plants in April 2016. As a result, we expect NEK to generate positive EBITDA of about BGN0.1bn in 2016 for the first time since 2012.

Regulatory Regime's Weakness

Despite recent positive developments addressing NEK's tariff deficit, BEH and its subsidiaries are yet to establish a track record of improved cash flows while the Bulgarian operating environment remains subject to high regulatory and political risk. This is a constraint on the ratings despite BEH's projected credit metrics being strong for the rating.

Decision on Belene Arbitration
An arbitration court has recently ordered NEK to pay EUR554m (BGN1.1bn) together with interest accrued to Russia's Atomstroyexport for the nuclear power plant equipment following a long arbitration process related to the terminated Belene nuclear power plant project.

We assume in our rating case projections that NEK will pay the ordered amount to the Russian party by end-2017. This would increase BEH's FFO adjusted net leverage in 2017 to 3.8x (compared with 2.4x in a scenario of no payment for the Belene arbitration), which is still strong for the current rating.

Senior Unsecured Debt Rating
The senior unsecured rating is at the same level as the IDR. However, if the ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH) to consolidated EBITDA is above 2x on a sustained basis then we would consider rating unsecured debt one notch lower than the IDR.

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 23% of the group's debt provided to certain subsidiaries (as of end-2015), down from 50% in 2012, the strong operational ties BEH has with the state and the group's strategic importance due to its dominant market position in the country's electricity and gas market.

We expect that the level of state guarantees will decline further in 2016-2017 as the state-guaranteed debt is amortised and most new debt is unlikely to be guaranteed, in our view. The only new state-guaranteed loan is for a gas interconnector with Greece (BGN215m) that BEH will take up in 2016. A declining share of state-guaranteed debt to less than 10%-15% of total group debt or lack of additional tangible support if needed would result in a possible removal of the currently applied one-notch uplift.

The Ministry of Energy of Bulgaria provided BEH with a letter of support before the recent bond issue, stating that the Bulgarian State will undertake necessary measures to financially support BEH so that it meets its obligations to the bondholders. The letter says that notification to the EU will be made before support is granted in line with the EU's state aid rules. We treat support letters as a weaker form of support than guarantees.

Corporate Governance Limitations
The ratings reflect BEH's corporate governance limitations, including a qualified audit opinion for BEH's 2009-2015 consolidated financial statements and frequent management changes. We view the group's financial transparency, including on business segments, as weak compared with its European peers.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for BEH include:
- NEK turning a BGN0.1bn EBITDA in 2016, following a BGN0.5bn loss in 2014 on the back of regulatory and legislative changes and renegotiation of PPAs. This is the key driver of BEH's improved profitability.
- Capex of BGN3bn in 2016-2019, co-funded with EU grants and CO_2 reimbursement; capex to add to negative FCF in the medium term.
- NEK to pay EUR554m (BGN1.1bn) together with interest accrued to the Russian party by end-2017.
- Forthcoming tangible state support in case of prolonged tight liquidity.

RATING SENSITIVITIES
Positive: Future developments that could lead to positive rating action include:
- Longer track record of a supportive regulatory and legislative environment leading to more predictable and less volatile operating cash flows, together with FFO adjusted net leverage below 4x on a sustained basis.
- Tangible government support, including additional state guarantees materially increasing the share

of state-guaranteed debt or cash injections to aid NEK's payment of the arbitration amount related to the terminated Belene nuclear project. This would continue to support the one-notch uplift over the standalone rating for strong links with the state in the longer term.
- Substantially lower payment for the Belene nuclear power plant equipment agreed with the Russian party compared with the amount ordered by the arbitration court.
- Longer track record of a shrinking accumulated 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.

Negative: Future developments that could lead to negative rating action include:
- FFO adjusted net leverage exceeding 5x on a sustained basis.
- Insufficient liquidity.
- 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 to above 2x EBITDA, which would be negative for the senior unsecured rating.

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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 (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

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