S&P Global
Ratings

RatingsDirect®

Research Update:

Bulgarian Electricity Utility Natsionalna Elektricheska Kompania (NEK) Upgraded To 'B+'; Outlook Stable

Primary Credit Analyst:
Anna Brusinets, Moscow +7 (495) 7834060; anna.brusinets@spglobal.com

Secondary Contact:
Elena Anankina, CFA, Moscow (7) 495-783-4130; elena.anankina@spglobal.com

Table Of Contents

Research Update:

Bulgarian Electricity Utility Natsionalna Elektricheska Kompania (NEK) Upgraded To 'B+'; Outlook Stable

Overview

- In our view, thanks to improved credit metrics reported in 2017 and improved liquidity, Bulgarian Energy Holding (BEH) has increased its ability to support its subsidiaries.
- We continue to see Natsionalna Elektricheska Kompania EAD (NEK) as a strategically important subsidiary of BEH, and expect it will receive ongoing and extraordinary support from its parent.
- We are therefore raising our rating on NEK to 'B+' from 'B'.
- The stable outlook on NEK reflects our view that, despite the company's high leverage, ongoing regulatory reforms and continuing payments from the electricity fund will enable NEK to demonstrate sustainable positive EBITDA, and BEH will remain able and willing to support NEK's liquidity.

Rating Action

On Aug. 9, 2018, S&P Global Ratings raised its long-term issuer credit rating on Bulgarian electricity company Natsionalna Elektricheska Kompania EAD (NEK) to 'B+' from 'B'. The outlook is stable.

Rationale

The upgrade reflects our view that the creditworthiness of NEK's parent, Bulgarian Energy Holding (BEH), has improved and, as a result, BEH's ability to provide extraordinary and ongoing support to its subsidiary NEK has increased. In June and July 2018, BEH issued a total of €550 million in Eurobonds to refinance the €500 million bonds maturing in November 2018. Therefore, we believe the holding's liquidity is no longer under pressure. BEH's operating performance has stabilized on the back of regulatory and legislative reforms started in 2015, and we expected it will strengthen further in 2018-2019. NEK continues to receive compensation from the Security of the Electricity System Fund (SESF) established by the regulator, which we understand is to predominantly cover NEK's annual tariff deficit. This compensation supports NEK's and BEH's credit metrics and cash flows, and strengthens BEH's ability to support NEK. BEH's consolidated S&P Global Ratings-adjusted EBITDA for 2017 amounted to Bulgarian lev (BGN) 848 million (about €440 million), and we forecast it will exceed BGN1 billion in 2019. We now assess BEH's group credit profile (GCP) at 'bb-'.

We believe recent regulatory developments were positive for NEK and the group, and could support sustainable credit metrics for several years. Still, we continue to think that the regulatory environment in Bulgaria remains weak, evolving, untested, and possibly subject to political interference, constraining our view on BEH's creditworthiness and our assessment of NEK's stand-alone credit profile (SACP). We view compensation from the SESF as a temporary measure, and we believe that the government's energy reforms may take longer to fully materialize.

From July 1, 2018, the electricity market was further liberalized: All generators with installed capacities above 4 megawatts, who used to benefit from preferential prices and long-term contracts (such as renewable energy sources and highly efficient cogeneration plants), are obliged to sell electricity on the free market. However, up to 85% of NEK's cash flow, including the compensation from SESF, remains regulated. NEK continues to function as a public electricity provider in Bulgaria. We expect that, including compensation from SESF, NEK will report EBITDA of more than BGN200 million in 2018-2019, compared with S&P Global Ratings-adjusted EBITDA of BGN149 million in 2017, and positive funds from operations (FFO).

The energy reforms are not yet fully implemented, and we'll continue to monitor how the energy market changes will affect the company's and group's performance. In addition, the state's strategic decision on the company's historical tariff deficit, accumulated before 2016, is still pending. The estimated deficit varies from BGN1.4 billion (Energy and Water Regulatory Commission's decision in June 2014) to BGN1.9 billion (the World Bank's estimate in 2015).

Although NEK's S&P Global Ratings-adjusted debt-to-EBITDA ratio (leverage) remains high, at more than 20x in 2016 and 2017, we note the favorable structure of NEK's debt portfolio. Most of NEK's debt is owed to the government (26%), or its parent BEH (71%), with loans to banks making up less than 5% of total debt and amounting to BGN83 million as of July 1, 2018. We treat the loans from the government and BEH as debt, rather than equity, because they're not structurally subordinated to other liabilities. However, we continue to believe that NEK has some flexibility regarding repayments to its parent, and that it will be able to make debt payments to banks according to the schedule. We also expect that BEH will cover NEK's continuous liquidity shortfalls if needed. We assess NEK's 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. Our rating on NEK is capped at one notch below the 'bb-' assessment of the 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. Our 'bb-' assessment of the GCP includes our view on potential extraordinary state support. It also reflects our expectation of the group's stabilized financial performance and prudent liquidity management, demonstrated by the issuance of €550 million of Eurobonds to refinance upcoming maturities in November 2018.

In our view, NEK should be able to avoid a default on its minimal external debt obligations over the next 12 months if it obtains timely financial support from BEH. If NEK fails to obtain such support, we may reassess our view of NEK's status in the group, and its importance for the government.

In our base case for 2018-2019 we assume:

- Real GDP growth of 3.9% in Bulgaria in 2018, compared with 3.6% in 2017. Deflation turned into inflation in 2017 (1.2%). We expect consumer price inflation of about 2% in 2018-2019.
- Further electricity market liberalization in Bulgaria. However, NEK will remain an exception, with the share of unregulated revenues expected to be 15% in 2018, compared with less than 10% in 2017.
- Mostly maintenance-focused capital expenditures (capex) of about BGN50 million-BGN60 million.
- A €0.6 billion loan obtained from the government in December 2016, treated 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 more than BGN200 million.
- Debt to EBITDA of about 15x.

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 on loans from BEH.

According to management data, principal liquidity sources for NEK during the 12 months from July 1, 2018, include:

- Approximately BGN23 million in unrestricted cash; and
- Our forecast of FFO of BGN95 million-BGN105 million.

Principle liquidity uses over the same period include:

- BGN158 million of debt amortization over the next 12 months, from which BGN36 million is external debt and the remainder is due to BEH;
- Capex of about BGN50 million-BGN60 million, subject to availability of financing; and
- No anticipated dividend distributions to BEH.

We understand that NEK continues to be in breach of its current financial ratio covenant on some of its loans. We think there is a low risk of the loan maturities being accelerated, however, because most of the loans under this covenant benefit from a government guarantee.

Outlook

The stable outlook on NEK reflects our expectation that payments from the SESF will continue to support sustainable profitability at NEK and, indirectly, at BEH, with no significant changes to the structure or amount of debt at either, and no liquidity pressures at BEH. We assume that NEK's leverage will remain very high until the historical tariff deficit is removed, but that ongoing liquidity pressures will be addressed by the parent in a timely manner.

Downside scenario

We would likely lower the rating on NEK if BEH's credit quality deteriorates materially, including the group's operating performance, leverage, and liquidity. We could also lower the rating if parental support from BEH diminishes, or if NEK's liquidity pressures increase significantly, which is not our base case. We see a downside scenario as unlikely in the near term, given recent improvements in the performance of NEK and its parent, supported by regulatory changes.

Upside scenario

Rating upside will largely depend on the parent's performance and its ability to provide support to NEK, because we do not expect NEK will be able to deleverage quickly, with debt to EBITDA exceeding 15x in our base case. We could take a positive rating action on NEK if we see further improvements in BEH's credit quality, all else being equal. This could come from further energy sector reforms supporting higher profitability and solid consolidated credit metrics, with BEH's debt to EBITDA below 3x on a sustainable basis, and maintenance of adequate liquidity. Rating upside may be supported by the successful implementation of liberalization, by a strategic decision to remove NEK's old accumulated tariff deficit, or by disposal of its assets in Belene, followed by repayment of the respective loan to the Bulgarian government.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Weak

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

Financial risk: Highly leveraged
- Cash flow/Leverage: Highly leveraged

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 ratings analysis: Neutral (no impact)

Stand-alone credit profile: b-

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

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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 - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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 And Insurers, Nov. 13, 2012

- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded

	To	From
Natsionalna Elektricheska Kompania EAD		
Issuer Credit Rating	B+/Stable/--	B/Stable/--

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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.