FitchRatings

Fitch Affirms Bulgarian Energy Holding at 'BB'; Downgrades Eurobonds to 'BB-'

Fitch Ratings - Warsaw - 17 October 2019:

Fitch Ratings has affirmed Bulgarian Energy Holding EAD's (BEH) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BB' with a Stable Outlook. BEH's senior unsecured rating, including the rating of BEH's EUR550 million (due 2021) and EUR600 million (due 2025) bonds, has been downgraded to 'BB-' from 'BB'.

The affirmation of the IDR follows the revision of BEH's standalone credit profile (SCP) to 'b' from 'bb-' and an increase in the notching-up for strong links with the sole owner, the Bulgarian state (BBB/Positive), to three from one.

The weaker SCP takes into account BEH's 100% subsidiary, Bulgartransgaz EAD, recent involvement in the construction of capex-intensive expansion of the gas transmission and transit infrastructure from the Bulgarian-Turkish to the Bulgarian-Serbian border. The project will be financed mostly from a debt-like facility (EUR1.1 billion) from the constructing consortium, which we add to Fitch-adjusted debt. We have increased the notching as the SCP is now more than four notches below the state's, based on Fitch's Government-Related Entities (GRE) rating criteria. It also reflects our view of the TurkStream extension project as an additional indication of BEH group's close links with the Bulgarian state, it being part of the updated National Energy Strategy and an important step to set up a gas hub in Bulgaria.

The downgrade of the senior unsecured rating to 'BB-' reflects our expectation that the share of prior-ranking debt to EBITDA will exceed 2x (mostly because of the EUR1.1 billion debt-like facility added at Bulgartransgaz), increasing structural subordination of bondholders at BEH level.

Key Rating Drivers

Strong Market Position: BEH is a leading Bulgarian utility focusing on electricity generation. In 2018 the group generated 28TWh of electricity, of which 57% is from nuclear (NPP Kozloduy), 30% from lignite (TPP Maritsa 2) and 13% from hydro power plants (NEK) having a low carbon exposure. Beyond generation the group is active in more stable electricity transmission (ESO) and gas transmission and transit (Bulgartransgaz), which currently contributes around 30% to the group's EBITDA, supporting its credit profile. BEH is present also in electricity (NEK) and gas supply (Bulgargaz), excavates lignite (Mini Maritsa) and runs a telecom business (Bulgartel).

Constraints to SCP: Fitch assesses BEH's SCP at 'b', which is low for the group's strong market position and a diversified business mix. However, the SCP is constrained by our expectations of high capex (in particular in relation to the expansion of the gas transmission and transit infrastructure), leverage increase, a weak regulatory framework, negative outcome of legal cases and corporate governance limitations.

TurkStream Extension: In September 2019, Bulgartransgaz signed an agreement with a consortium of companies led by Saudi energy services company, Arkad Engineering and Construction Co. (Arkad), to expand the gas transmission and transit infrastructure between the Bulgarian-Turkish and Bulgarian-Serbian border, which will also be an extension of the TurkStream pipeline. This project is of strategic importance for Bulgaria, contributing to diversification of gas supply routes to the country given that it will allow Bulgaria to import Russian gas from Turkey in addition to the route via Ukraine and allow its export to other countries.

Bulgartransgaz will own the Bulgarian part of the pipeline and contribute its share of capex. However, EUR1.1 billion will be provided by the construction consortium and will be repaid by Bulgartransgaz over 10 years, which includes both principal and coupon payments. We perceive this financing as debt-like and add it to Fitch-adjusted debt.

Large Capex Plans: We expect BEH's own capex to increase to around BGN0.8 billion per annum over 2019-2021 and BGN0.7 billion over 2022-2023 from BGN0.4 billion over 2014-2018. The reasons for the increase are on one hand cyclical with 77% of capex qualified as maintenance. However, there are also large expansionary projects included in the capex plan, which include Bulgartransgaz' share in the TurkStream extension project, but also the gas interconnector between Greece and Bulgaria (ICGB).

High Leverage: We forecast that funds from operations (FFO) adjusted net leverage (2018: 4.0x) will increase to in-between 6x and 7x over 2019-2023, driven by high capex and debt-like financings. The main debt items are two senior unsecured Eurobonds issued by BEH of EUR550 million (maturing in 2021) and EUR600 million (maturing in 2025) as well as a state-provided financing to NEK of EUR602 million (maturing in 2023). From 2019 we add to debt also a state-guaranteed loan for the ICGB project (EUR110 million), the EUR1.1 billion financing from the Arkad-led consortium and a bank guarantee issued to cover EU gas claims (EUR77 million).

Weaker Regulatory Framework: Fitch deems the Bulgarian regulatory framework to be less predictable and higher-risk than for BEH's peers in the EU. The regulatory framework has been evolving with notable success, e.g. reduction of the tariff deficit at NEK. However, the inability of TPP Maritsa 2 to fully reflect higher CO_2 prices in 2018 in the regulated segment of the market created a deficit at the subsidiary and reduced the group's 2018 EBITDA by around BGN0.2 billion. The deficit has been eliminated in the current regulatory period (July 2019 to June 2020); nevertheless, recurrence of some form of tariff deficit will be negative for the group's credit profile.

We expect the Bulgarian energy market to become more liberalised over the next four years and more compliant with the EU's Third Energy Package. This should provide for elimination or at least smaller regulatory deficits and exert positive impact on the SCP of BEH over time.

Negative Outcome of Legal Cases: In December 2018 BEH, together with Bulgartransgaz and Bulgargaz, were fined (EUR77 million) by the EU Commission in the proceedings related to blocking competitors' access to key gas infrastructure in Bulgaria in violation of the EU antitrust rules. In September 2018 NEK lost a trial against Worley Parsons Nuclear Services and was ordered to pay BGN61 million (EUR31 million). BEH has appealed on both cases, but we conservatively assume that both claims will be paid over the next four years.

Corporate Governance Limitations: The group's corporate governance limitations include in particular a qualified audit opinion for BEH's 2009-2018 consolidated financial statements. Positively the group reports under IFRS, but its structure is quite complex and financial transparency, including on business segments, is weaker than EU peers'.

Support from the State: Reflecting links with the Bulgarian state, Fitch applies a three-notch uplift to BEH's SCP of 'b', taking the group's IDR to 'BB'. Based on Fitch's GRE Rating Criteria, we view the status, ownership and control links between BEH and the Bulgarian state as strong and support track record and expectations as moderate. The socio-political and financial implications of a BEH default for the Bulgarian state are also deemed as moderate.

Consequently, the support score under our GRE Rating Criteria is 17.5, which with the six-notch distance between BEH's SCP and the sovereign rating could lead to either a two- or three-notch uplift being included in BEH's IDR. We have chosen a three- rather than two-notch uplift as we see the expansion of the gas transmission and transit infrastructure between Turkey and Serbia as an additional indication of BEH's close links with the Bulgarian state.

Derivation Summary

BEH has a leading position in the Bulgarian gas and electricity market through its ownership of most of Bulgaria's power generation assets (including a nuclear power plant, lignite-fired and hydro power plants), the country's largest mining company, the country's electricity transmission network, gas transmission and transit networks and through its position as the public supplier of both electricity and gas in Bulgaria.

BEH's integrated business structure and strategic position in the domestic market makes the group comparable to some of central European peers such as CEZ, a.s. (A-/Stable) and PGE Polska Grupa Energetyczna SA (PGE, BBB+/Stable). However, BEH operates in a more volatile and less transparent regulatory environment than CEZ or PGE, has much higher leverage and its results are less predictable with some corporate governance issues. BEH's rating includes a three-notch uplift to reflect links with the sovereign, whereas this is not the case for CEZ or PGE.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Group EBITDA at around BGN0.8 billion in 2019-2021, rising to close to BGN1 billion in 2022-2023

- Total own capex at BGN3.8 billion over 2019-2023

- Capex contribution from the Arkad-led consortium at EUR1.1 billion in 2019 (on top of own capex), qualified as a debt-like liability

- State-guaranteed loan from EIB for the ICGB project (EUR110 million) added to debt from 2019

- Settlement of EU and Worley Parsons claims (successful appeal process would be an upside)

- Low dividends at 50% of net profit

- Refinancing of Eurobonds and state-provided financing to NEK at BEH level (on maturity)

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Further tangible government support, such as additional state guarantees materially increasing the share of state-guaranteed debt or cash injections, which would more tightly link BEH's credit profile with Bulgaria's stronger credit profile

- Stronger SCP due to FFO adjusted net leverage falling below 5x on a sustained basis, lower regulatory and political risk, higher earnings predictability and better corporate governance

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Weaker links with the Bulgarian state

- Downgrade of the sovereign rating of Bulgaria as it would lower the "sovereign-less-three" cap for BEH's rating

- Weaker SCP, e.g. due to FFO adjusted net leverage exceeding 7x on a sustained basis, escalation of regulatory and political risk or insufficient liquidity

- Further material increase in prior-ranking debt, which would be negative for the senior unsecured rating of BEH

Liquidity and Debt Structure

Adequate Liquidity: At end-2018 BEH had BGN1,343 million of Fitch-calculated unrestricted cash against short-term financial liabilities of BGN124 million and negative free cash flow (FCF) of BGN0.2 billion in 2019 (which we expect to remain negative until 2022 due to large capex). Based on our forecast the group has sufficient liquidity until August 2021, when the EUR550 million bond matures.

Adjustments to Debt: BEH's main debt items include two Eurobonds of EUR550 million (maturity in 2021) and of EUR600 million (maturity in 2025). However, we add several other debt-like items to Fitch-adjusted debt.

This includes the state-provided financing to NEK in connection with the Belene arbitration of EUR602 million (maturity in 2023). From 2019 we add to Fitch-adjusted debt also the EUR1.1 billion amortising financing of Bulgartransgaz from the Arkad-led consortium as well as the EIB loan for the ICGB project of EUR110 million. We also add the bank guarantee provided in connection with the EU claims in the gas market of EUR77 million to Fitch-adjusted debt. Consequently, Fitch-adjusted debt at end-2019 reaches BGN6.1 billion.

State-related Debt: As per Fitch rating case, the state-guaranteed debt together with state-provided financing to NEK will account for 20% to 25% of Fitch-adjusted debt until NEK financing's maturity in 2023. We deem it as a considerable amount, showing close links between BEH and the sovereign owner.

Large Prior-Ranking Debt: As per Fitch rating case, the state-provided financing for NEK and the Arkad-led consortium financing for Bulgartransgaz is added to Fitch-adjusted debt of BEH. Both are large facilities taken by BEH's subsidiaries instead of BEH itself. Consequently, BEH's ratio of prior-ranking debt (the debt of subsidiaries who do not guarantee BEH)-to-EBITDA rises to around 4x over 2019-2021 (2018: 2.3x). As the ratio is above the limit of 2x EBITDA we notch down the senior unsecured rating of BEH once from the IDR to reflect increased structural subordination of BEH's bondholders.

Summary of Financial Adjustments

Financial debt at end-2018 is increased by BGN1,177 million (EUR602 million) of the face value of the state-financing given to NEK to settle Belene obligations and by a bank guarantee of BGN151 million (EUR77 million) given to BEH, Bulgartransgaz and Bulgargaz in March 2019 to cover EU claims announced in December 2018.

ESG Considerations

The highest level of ESG credit relevance is a score of 3. BEH has some exposure to emission regulatory risk and energy productivity risk via its lignite-fired power plant. However, the fuel mix is diversified containing also nuclear and hydro generation. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Bulgarian Energy Holding EAD	LT IDR BB ⭘ Affirmed		BB ⭘
	LC LT IDR BB ⭘ Affirmed		BB ⭘
senior unsecured	LT BB- Downgrade		BB

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FITCH RATINGS ANALYSTS

Primary Rating Analyst
Artur Galbarczyk

Director
+48 22 338 6291
Fitch Polska SA
Krolewska 16, 00-103
Warsaw

Secondary Rating Analyst
Nitka Katarzyna
Analyst
+48 22 330 6705

Committee Chairperson
Arkadiusz Wicik, CFA
Senior Director
+48 22 338 6286

MEDIA CONTACTS

Adrian Simpson
London
+44 20 3530 1010
adrian.simpson@thefitchgroup.com

Applicable Criteria

Government-Related Entities Rating Criteria (pub. 25 Oct 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)

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