BAZAN GROUP

Convenience translation from Hebrew

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Original produced by S&P Maalot

Re: RATING LOWERED TO ilBBB- AND PLACED ON CREDITWATCH WITH NEGATIVE OUTLOOK OWING TO WEAK OPERATING PERFORMANCE AND "WEAK" LIQUIDITY

Summary

- Operating performance of Oil Refineries Ltd. (ORL) in 2013 was adversely impacted by low refining margins and is expected to fall below earlier projections. Our revised projection and the coverage ratios stemming from it are not compatible with the former rating.
- Weak operating results have led to erosion of the company's liquidity profile, as reflected in the deficit between resources and expected uses to the end of 2014, with very high dependence on unsecured credit facilities and a risk of deviation from financial covenants.
- In our estimation, the recent sharp decline in the prices of the company's securities coupled with the deterioration in access to sources of finance, necessitate immediate action by the company to boost its liquidity profile, improve cash flow and identify alternative sources of finance.
- We are lowering the rating of ORL to ilBBB- (from ilBBB+) and placing the rating on CreditWatch with negative outlook.
- We intend to resolve the CreditWatch over the next 60 days, depending on and after review of the steps the company is expected to take in order to improve the level of its liquidity, including reaching agreements with the banking system and company's bondholders.

Rating action

On October 14, 2013, Standard & Poor's Maalot lowered the rating of Oil Refineries Ltd., a refining and petrochemicals company, to ilBBB- from ilBBB+, and placed the rating on CreditWatch with negative outlook for a period of up to 60 days.

Main considerations for the rating

Weak operating results are eroding ORL's liquidity profile, which depends, inter alia, on cash flow generated by the company from its from operating activities. In the wake of the decline in margins during the third quarter, there is increased likelihood that the company will deviate from financial covenants defined in connection with bank loans. At the company's request in September, the financing consortium granted a waiver in respect of the need to be in compliance with some of those covenants at the end of the third quarter. In our opinion, the sharp decline in the prices of the company's securities has harmed its access to sources of finance in the capital market, and that access is now limited. As a result, the company depends increasingly on unsecured short-term finance such as credit facilities which are not underwritten, customer deductions and extended supplier credit. We believe that the local banking system has a significant incentive to continue to support the working capital needs of ORL, inter alia in view of the strategic importance of the company for the domestic energy economy. From the company's managers we learned that contact with the banking system over the past few days has been constant, and that management believes at this stage that the banks are willing to continue to support the company. Nevertheless, it is our opinion that in the medium term, such willingness to continue recycling the company's short-term debt is doubtful if the company's operating results remain weak.

As we understand it, the company intends to take various steps to improve its liquidity profile, among them the implementation of a comprehensive efficiency plan and raising capital by means of a rights issue which we understand will be backed by Israel Corporation Ltd. (ilA+/Stable). We note that given the present rating of the company and subject to certain terms, modification of the loan schedule with the banking system or with the bondholders in a way that differs from the original terms of the agreement, could well fall under the category of distressed restructuring as defined in our criteria (see article referenced at the end this report).

ORL's operating performance in 2013 is being adversely impacted mainly by an environment of relatively low refining margins. Even though ORL's refining margin has been consistently high compared with the profit ratio, the operating results for 2013 are expected to be weak compared with our earlier scenario. Accordingly, we are revising our projections downwards and we now expect the company's adjusted EBITDA in 2013 to be USD 250 – 280 million, which reflects a refining margin of about $5 per barrel, compared with our earlier projection of an adjusted EBITDA of approximately USD 400 million and a refining margin of $6 per barrel. The refining margin was eroded in the third quarter as a result of a rise in the price of crude oil owing to concern about a military conflict between the US and Syria and without a corresponding adjustment of product prices. We note that although the EBITDA now foreseen in 2013 is lower than our projections, it is still a significant improvement over the adjusted EBITDA of approximately USD 129 million in 2012, against a backdrop of the start of natural gas supplies from the Tamar reservoir during the second quarter of the year and the start of operation of the Hydrocracker facility in the first quarter of the year. In our revised basic operating scenario, we now estimate that the company's EBITDA in 2014 will be USD 300 – 320 million. We foresee slight recovery of the refining margins in 2014, but believe that excess refining capacity in Europe and the relative weakness in the macroeconomic environment there will continue to weigh on the margins.

Our revised projections foresee a debt-to-adjusted EBITDA ratio of x8.0 – x9.0 in 2013, and x7.0 – x8.0 in 2014, compared with a debt-to-EBITDA (adjusted) higher than x20 in 2012 and compared with a debt-to-EBITDA ratio of x6.0 – x7.0 that we set as appropriate for the previous rating.

Liquidity

According to our criteria, ORL's liquidity level is "weak". As mentioned, the liquidity profile was adversely affected by weak operating results and as a result of the company's high level of dependence on the willingness of the banking system to continue to recycle its debt and allow it to expand its use of short-term credit facilities. Assuming recycling of the short-term facilities it uses, we estimate the ratio of ORL's available resources to its needs at 1x.5 in the second half of 2013 and at x0.8 in 2014. Termination of the support of the banking system would have a materially negative impact of the company's liquidity profile, and therefore we see the banks' continuing support with short-term financing for the company as a critical factor for rating at the present time. We note that our basic liquidity scenario and our basic operating scenario do not take into account the possible support of interested parties.

We assume that the principal resources available to the company as of June 30, 2013, include –

- Cash and cash equivalents of approximately USD 126 million.
- Cash flow from operating activities of approximately USD 70 million in the second half of 2013 and USD 200 million in 2014.
- Receipts of USD 10 million from derivative transactions in the second half of 2013 and of USD 20 million in 2014.
- Raised capital of USD 110 million (already accomplished).

Conversely, we assume that the principal uses as of June 30, 2013, include –

- Repayment of approximately USD 165 million of short-term debt in the second half of 2013 and USD 330 million in 2014.
- Investment balance of approximately USD 115 million by the end of 2014.
- Dividends – we assume that the company will not distribute dividends in 2014, as agreed with its financers.

CREDIT WATCH

Placing the company's rating and the rating of its bonds on CreditWatch with negative outlook stems from our assessment that there is potential for further and dangerous deterioration in its liquidity profile in the near future. If indeed the banking system withdraws its support, which we see as a real possibility, we are likely to lower the rating sharply within the next few weeks if any change for the worse occurs in the company's relations with the banking system. Furthermore, we will review developments in the context of a possible change in the loan schedules, which could, as mentioned and subject to various terms, lead to distressed restructuring (debt settlement or restructuring of the company's liabilities under duress).

Removal of the CreditWatch and updating the rating forecast to "negative" or "stable" will be possible if the company's operating results improve and its liquidity profile stabilizes or improves and the possibility of distressed restructuring is removed.

Related research

- For information about our methodology for examining the liquidity of companies and the effect on rating, see: Methodology – "Assessment of an Issuer's Liquidity", September 2011. The article can be found on the Internet site of Standard & Poor's Maalot at:
  http://www.maalot.co.il/data/uploads/pdfs/haarahat_nezilut.pdf
- For information about our methodology for examining repeat purchases of debt under duress, see: Methodology – "Rating Implications of Debt Conversion Proposals and Restructuring", published May 2009. The article can be found on the Internet site of Standard & Poor's Maalot at:
  http://www.maalot.co.il/data/uploads/pdfs/exchangeoffers.pdf
- For information about our methodology for the use of low ratings attesting to high and immediate probability of insolvency, see: Methodology – "How Standard & Poor's Uses its 'CCC' Rating", December 12, 2008. The article can be found on the Internet site of Standard & Poor's Maalot at:
  http://www.maalot.co.il/publications/MT20120529105528.pdf

The above articles can be found on the S&P website at www.standardandpoors.com.

List of ratings

Oil Refineries Ltd.	Current rating	Previous rating
Issuer's rating	ilBBB-/CW Negative	ilBBB+/Negative
Series A	ilBBB-/CW Negative	BBB+
Series B	ilBBB-/CW Negative	BBB+
Series C	ilBBB-/CW Negative	BBB+