STANDARD & POOR'S MAALOT

Oil Refineries Ltd.

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Rating Update

'ilBBB+' Rating Affirmed, Outlook Revised To Negative On Significant Maturities And Limited Room To Meet Possible Challenges

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Ratings Update

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Overview

- Israel-based oil refiner and petrochemical company, Oil Refineries Ltd. (ORL), is in the final stages of completing an investment plan, launching its hydrocracker in January 2013 and expecting natural gas delivery from the Tamar offshore field from the second quarter of next year, after which the company anticipates a significant improvement in profitability and cash flow.
- We believe ORL still faces operating risks for as long as the various units have not been fully integrated. These risks could translate into lower cash flow, but principally reduced access to sources for refinancing significant debt and unsecured credit lines in 2013.
- We are affirming the 'ilBBB+' corporate credit rating on ORL and revising the outlook to negative from stable.
- The negative outlook reflects our assessment that the rating could fall in the next six months if the risks associated with the completion of the investment plan are realized and the company's liquidity is materially affected.

Rating Action

On Dec. 2, 2012, Standard & Poor's Maalot affirmed its 'ilBBB+' its corporate credit rating on Israel-based oil refiner and petrochemical company, Oil Refineries Ltd. (ORL), and at the same time revised its outlook to negative from stable.

Rationale

The outlook revision to negative reflects our assessment of the operating risks associated with ORL's ability to significantly increase its profitability and cash flow in 2013 and to support the refinancing of $350 million of debt, and with the continuation of its unsecured local bank credit facilities in the coming months. In our opinion, any delay or obstacle in the supply of natural gas from the Tamar offshore field or in the full running of the hydrocracker could limit the company's access to the capital market and increase its dependence on the local banking establishment, without available and secured credit facilities.

We also regard the challenging business environment in the petrochemical field as a further weight on the company. We understand that bonds of subsidiary, Carmel Olefins Ltd. (not rated), include covenants with a rating trigger, where a breach of such could grant the bondholders the right to immediately call for repayment. In our base-case scenario, we do not assume debt pressure as a result of such a breach.

Conversely we regard the significant progress the company has achieved during the year in the construction of its hydrocracker as a positive factor, as well as the signing of a gas supply agreement from the Tamar project. These constitute significant milestones in the company's development. In our opinion, a successful completion of the investment plan could have a positive impact on the rating. However currently we give weight to the immediate risks rather than more optimistic potential scenarios.

We believe adjusted EBITDA will likely have risen to $150 million in 2012 (compared to our forecast from May 2012 of $240 million) from $99 million in 2011. In the first nine months of the year the company's performance was impacted by the low level of utilization of natural gas and low petrochemical margins, offset only slightly by the refining margins. We believe that ORL will likely present EBITDA of $440 million in 2013. This forecast is based on the assumptions:

- The Ural Med, which is used as a benchmark for the local refining industry, will be around $3.0 a barrel on average. We believe the supportive refining margins recorded in recent months are only temporary, and that the excess refining capacity in Europe together with the weak economic conditions on the continent will continue to predominate in the coming quarters.
- Full use of natural gas from the Tamar field from the second half of 2013 (compared to the forecast of the field's developers which predict full use from the second quarter).
- The hydrocracker will be commissioned in January 2013.

Based on the cash flow derived from expected profitability in the coming quarters, we believe that adjusted debt to EBITDA will likely fall to 6.0x in 2013, from more than 15x in 2012. This expected improvement in debt coverage takes into account the positive effect of extending commercial terms with suppliers that the company recently achieved and the significant drop in capital expenditure. We believe the company will likely be able to lower its debt level gradually from 2015.

Liquidity

We assess the level of ORL's liquidity at "less than adequate" according to our methodology. We believe that ORL's liquidity sources over uses will be 0.3x in 2013. (Though we estimate that this ratio will improve, in our opinion it will remain lower than 1.0x even assuming that short-term debt remains at its current level). The company's liquidity is particularly important at this time following the recent positive steps that ORL took in extending supplier credit and optimizing oil inventories (creating a one-time cash flow of about $700 million).

In our opinion, total debt of $2.3 billion-$2.4 billion makes ORL one of the most significant credit consumers in the local market and obliges the company to adopt a long-term policy that allows for the high volatility in financial performance. We regard the company's approach to extending its debt profile after the completion and stabilization of its projects as less conservative. Until the extension of its debt profile, we would expect the company to continue with its comprehensive use of unsecured short-term financing sources, including an uncommitted credit framework, trade receivables program and supplier credit extension. We believe that the local banks have a strong incentive to continue supporting ORL until the completion of its projects. However this approach may change if the company's cash flow does not meet expectations or if there is a significant rise in the price of oil.

We understand that in the first half of 2012 the company obtained an easing on its financial covenants regarding the financial package for its investment plan. In our working base-case scenario underlying the rating, we assume the company meets these covenants.

Under these assumptions, we assume that the liquidity sources available to the company as of Sept. 30, 2012 include:

- Cash and cash equivalent of $210 million, of which about $50 million is tied to operations;
- And cash flow from current operations of about $20 million in the fourth quarter of 2012 and about $290 million in 2013.

We assume the major uses of the company as of Sept. 30, 2012 are:

- $0.5 billion under the short-term credit line and receivables program;
- Refinancing of long-term loan maturities of $100 million in the fourth quarter of 2012 and about $350 million in 2013;
- Investment of about $100 million-$150 million up to the end of 2013;
- No dividends; we assume that the company will not distribute dividends in 2013. We realize that dividend distributions must be approved in advance by creditors;
- And working capital; we assume that the company will continue to reduce its minimum inventory required to operate the refinery, balancing the constant need to increase working capital requirements at higher levels of generation and a modest rise in oil to above $110 a barrel.

We regard the financial profile of ORL's major shareholder, Israel Petrochemical Enterprises (IPE; 30.7%; not rated) as a constraint on the company's financial profile, in light of IPE's needs for dividends to service its heavy debt burden. Accordingly we assume that ORL's dividend policy from 2014 will be to distribute 75% of net income. Hence we anticipate that any improvement in free cash flow shall mostly be channeled to repayment of downstream shareholder loans and not to significantly reducing the company's financial debt.

Outlook

The negative outlook reflects our assessment that we could lower ORL's rating by two notches in the coming six months, if the operating risks—full operation of the hydrocracker or/and supply of gas from Tamar—are borne out. In our opinion, these risks could significantly impact on the company's profit margins and cash flow in 2013 and could create an environment that supports neither the refinancing of debt maturities of $350 million nor the continuation of unsecured credit lines from the local banks in the coming quarters. The outlook also reflects the continued deterioration in Carmel Olefins' financial strength as well as the early repayment of some of the debt in a worse-case scenario.

We could revise the outlook to stable if the company completes and stabilizers its operating system in the first half of 2013 and moves to extend its debt profile. Such an outlook revision would also depend on the level of probability that we attach to the company successfully reaching a debt to EBITDA ratio of less than 6.0x by 2013.

Related Criteria And Research

- Key Credit Factors: Criteria For Rating The Global Oil Refining Industry, Nov. 28, 2011
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Principles Of Credit Ratings, Feb. 16, 2011

These articles may be found on Standard & Poor's website, www.standardandpoors.com

Ratings List

	To	From
Oil Refineries Ltd.		
Issuer credit rating	ilBBB+/Negative	ilBBB+/Stable
Private placement	ilBBB+	ilBBB+
Series A	ilBBB+	ilBBB+
Series B	ilBBB+	ilBBB+
Series C	ilBBB+	ilBBB+