Maalot
S&P Global Ratings

Oil Refineries Ltd.

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Research Update

Issuer, Issue Ratings Raised To 'ilA' On Improved Financial Ratios; Outlook Stable

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Rating Action Summary

- The improvement in Oil Refineries Ltd.’s (”Bazan”) financial ratios continued in 2018, and we expect the Company to continue maintaining an adjusted debt to EBITDA ratio below 3x in the upcoming years. In our opinion, the Company has been successful in finding the balance between its various needs, in particular between investments and dividends and debt repayment, and is expected to continue decreasing its adjusted debt relative to EBITDA, even with forecasted stability in oil prices, in the next 1-2 years.
- However, Bazan is still exposed to a large range of environmental requirements and proceedings in light of its refining activity and its location in the Haifa Bay area. Unrelatedly, the Company may also be required to make extensive investments further on in order to adjust to a changing market, including a decrease in demand for gasoline due to increased penetration of electric vehicles and demand for specialty plastic products. The Company has started preparing for these changes, and we estimate that this preparation, alongside the decrease in debt to EBIDA, will allow it to best handle required investments with relatively little impact on financial ratios.
- We are raising our rating on refining and petrochemical company Oil Refineries Ltd. and its rated bond series to ‘ilA’ from ‘ilA-‘.
- The stable outlook reflects our assessment that the Company will succeed in consistently presenting an adjusted debt to EBITDA ratio below 3.5x while balancing its various capital requirements, including dividend distributions and new investments, and decreasing its dependence on external financing.

Rating Action Rationale

The upgrade reflects the continuous improvement in Bazan’s financial ratios. Despite the volatility of the refining market where prices of raw materials and final products are constantly changing, the Company succeeded in lowering its adjusted debt to EBITDA ratio to about 3x. This was done by finding an adequate balance between new investments, debt repayment and dividend distribution, leading to a continuous decrease in adjusted debt. For example, we estimate that in 2019 and in 2020 the Company’s investments and dividend distribution will amount to about $260 million, and if approved investments (that are currently at about $120 million in 2019 and about $140 million in 2020) are increased, dividends will decrease. We note that the Company has a distribution policy of 75% of net income, but we understand that its dividend distribution is subject to other considerations, including the abovementioned investments and the Company’s intention to continue decreasing its debt. In addition, the Company’s new debt issue amounts are lower than expected repayments. In 2019 the Company is expected to raise about $170 million (of which $100 million have already been raised), compared with about $245 million in maturities. The Company is also seeking to decrease its production costs, and in 2018 signed an agreement to purchase natural gas from Energean, which is developing the Karish and Tanin reservoirs, at a lower price than that for which it purchases natural gas from the Tamar reservoir. However, the effects of this agreement are only expected in a few years, after the Karish and Tanin reservoirs start to operate.

An adverse change in the Company's policy to decrease its debt and balance investments and dividend distribution may adversely affect its financial ratios such that it will fail to meet at least an adjusted debt to EBITDA ratio of 3.5x. This is particularly relevant given the long-term changes in the refining and petrochemicals market. These long-term changes mainly include environmental risks, as the Company is at the center of intense, continuous public and regulatory interest and details in its financial statements a material number of environmental requirements and proceedings, despite its material environmental investments in recent years, compliance with most required certificates and resolute actions to rectify irregularities. These risks also affect other companies operating in the same industry in Israel and abroad, but the focus on Bazan increases its risk compared to others, in our opinion.

In addition, the market for refined oil and its product is changing. On the one hand, IMO 2020 regulations limit the demand for high-Sulphur fuel, and the Company's ability to provide higher quality fuel may improve its business position and perhaps also its profitability. However, this situation is uncertain and was therefore not included in our base-case scenario. At the same time, government declaration regarding increasing import of alternative-fuel vehicles by 2030 may adversely affect demand for some of the Company's basic product. As a result, the Company may be required to change its production mix and thereby its production facilities through material capital expenditure.

Outlook

The upgrade mainly reflects the improvement in the Company's financial ratios. We estimate that the Company will succeed in continuously presenting an adjusted debt to EBITDA ratio below 3.5x following continuous deleveraging. The Company maintains a balance between investments and dividends, decreases its dependence on external funding and improves its ability to face changes that could arise as a result of market volatility or stricter environmental requirements. We expect this situation to reflect the Company's performance in upcoming years.

Downside Scenario

We may take a negative rating action if adjusted debt to EBITDA continuously exceeds 3.5x. This could happen if demand decreases for the Company's products and leads to a decrease in operating revenues and market share, if the Company adopts a more aggressive financial policy leading to larger than expected dividend distribution or if environmental requirements or legal proceedings lead to a deterioration in financial metrics.

Upside Scenario

A positive rating action would be possible if the Company continues to deleverage and sustainably achieves a debt to EBITDA ratio of 2x. This positive rating action would reflect the combination of a lower leverage and the risk of relying on a single manufacturing site. Such deleveraging, if accompanied by preserving market share and adequate liquidity, would allow the Company more financial flexibility to handle market changes.

Company Description

ORL operates in the refining and petrochemical markets, mainly through a single manufacturing facility in the Haifa Bay. It uses a combined manufacturing process such that some of the refining products are used in petrochemical production and some petrochemical products are used in the refinery. Refining activity generates about 55% of the Company's EBITDA and petrochemical activity generates the remainder.

Base-Case Scenario

Our base-case scenario is underpinned by the following key assumptions:

- Crude oil (Brent) price of $60 per barrel in 2019-2020, as per S&P Global assumptions.
- $6.3 margin over the price per barrel in 2019-2020.
- Contribution of about $465 per ton from the petrochemical segment in 2019-2020.
- Utilization rate of refining and petrochemical facilities similar to the Company's historical figures. In 2020 another decrease of a month and a half in petrochemical facilities utilization due to anticipated maintenance works.
- Demand covering the Company's production, preserving market share.
- Investments and dividends totaling about $260 million per year in 2019-2020, considering the Company's policy to distribute 75% of net income.
- Continued decrease in debt. The Company is expected to raise about $170 million per year in 2019-2020, compared with repayment of about $245 million per year.

Under our base-case scenario, we forecast debt coverage ratios to be as follows:

- Adjusted debt to EBITDA of about 3x in 2019-2020.

Liquidity

The Company's liquidity is "adequate", according to our criteria. We expect the ratio between the Company's sources and uses to exceed 1.3x in the next 12 months. In our liquidity scenario we include the $100 million debt issuance completed early this year, and a recent payment of about $20 million due to a settlement regarding piping and sewage levies. In addition, according to our criteria, we include the repayment of the Company's receivable's securitization, despite the clear possibility, based on the past, that it will be postponed.

In our base-case scenario we estimate the Company's main sources in the 12 months starting January 1, 2019 to be as follows:

- Cash and liquid investments of about $430 million;
- Cash flow from operations of about $370 million;
- Debt issuance of about $100 million.

Our assumptions regarding the Company's uses in the same period are as follows:

- Debt maturities oaf about $425 million (including the repayment of the receivable’s securitization);
- Investments and dividends of about $260 million.

Financial Covenants

The Company has several financial covenants, including minimum equity, minimum EBITDA, minimum cash and cash equivalents and a specific debt to EBITDA ratio, in accordance with specific definitions in the Company’s financing agreement. The Company is also required to maintain a cash balance of $75 million at all times. We understand the Company meets its financial covenants.

Recovery Analysis

Key analytical factors

- We are assigning our 'ilA' rating, identical to the issuer rating, to Bazan’s bond series. The recovery rating for these series is '4', reflecting our assessment that in the hypothetical default scenario, the recovery rate would be at the higher end of the 30%-50% range.

Simulated default assumptions

- Year of hypothetical default: 2023
- A sharp increase in oil prices, a sharp decrease in refining margins and a long, unplanned shutdown of part of the production facilities, alongside the need to refinance debt, will gravely decrease revenues and lead to a default.
- The company will continue operating as a going concern, an assessment supported by its importance as the supplier of about 60% of the demand for liquid fuels in the Israeli economy.
- In the hypothetical deterioration path, the Company will use most of its cash on hand, except for $100 million, of which $75 million are required according to its financing agreements.

Simplified waterfall at emergence

- Gross discrete asset value as going concern: about $690 million
- Administrative costs: 5%
- Net value available to secured creditors: about $657 million
- Secured senior debt: about $295 million
- Net value available to unsecured creditors: about $362 million
- Unsecured debt: about $724 million
- Unsecured debt recovery expectation: 30%-50% (at the higher end of the range)
- Unsecured debt recovery rating (1 to 6): 4

All debt amounts include six months' prepetition interest.

Mapping Recovery Percentages To Recovery Ratings - Group A Jurisdiction				
For issuers with a speculative-grade issuer credit rating				
		Nominal recovery expectations		
Recovery rating*	Recovery description	Greater than or equal to	Less than	Issue rating notches relative to ICR
1+	Highest expectation, full recovery	100%	N/A	+3 notches
1	Very high recovery	90%	100%	+2 notches
2	Substantial recovery	70%	90%	+1 notch
3	Meaningful recovery	50%	70%	0 notches
4	Average recovery	30%	50%	0 notches
5	Modest recovery	10%	30%	-1 notch
6	Negligible recovery	0%	10%	-2 notch

Recovery ratings are capped in certain countries to adjust for reduced creditor recovery prospects in these jurisdictions. Recovery ratings on unsecured debt issues are generally also subject to caps (see Step 6, paragraphs 90-98 of Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016, for further detail). ICR--Issuer credit rating.

Modifiers

Diversification/Portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management and governance: Neutral

Comparable rating analysis: Neutral

Related Criteria And Research

- Use Of CreditWatch And Outlooks, September 14, 2009
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, November 13, 2012
- Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, October 24, 2013
- Group Rating Methodology, November 19, 2013
- Corporate Methodology: Ratios And Adjustments, November 19, 2013
- Corporate Methodology, November 19, 2013
- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Methodology: Industry Risk, November 19, 2013
- Key Credit Factors For The Oil Refining And Marketing Industry, March 27, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- S&P Global Ratings Definitions, October 31, 2018

Ratings List

Rating Details (As of 8-April-2019)	
Oil Refineries Ltd.	
Issuer rating(s)	
Local Currency LT	ilA/Stable
Issue rating(s)	
Senior Unsecured Debt	
Series A, D, E, F, G, I	ilA
November 2004 Series Repayment by 2019	ilA
Issuer Rating history	
Local Currency LT	
07-April-2019	ilA\Stable
03-April-2018	ilA-\Positive
09-April-2017	ilA-\Stable
31-May-2016	ilBBB+\Positive
14-May-2015	ilBBB+\Stable
29-Dec-2014	ilBBB\Positive
18-Dec-2013	ilBBB\Stable
14-Oct-2013	ilBBB-\Watch Neg
02-Dec-2012	ilBBB+\Negative
06-May-2012	ilBBB+\Stable
30-Nov-2011	ilA-\Watch Neg
25-March-2010	ilA-\Stable
07-July-2009	ilA\Negative
23-April-2009	ilA\Watch Neg
11-Dec-2008	ilA\Negative
11-Nov-2007	ilAA\Stable
01-March-2003	ilAA
21-Sept-1992	ilAAA
Other Details	
Time of the event	07/04/2019 15:53
Time when the analyst first learned of the event	07/04/2019 15:53
Rating requested by	Issuer

Credit Rating Surveillance

S&P Maalot is the commercial name of S&P Global Ratings Maalot Ltd. S&P Maalot conducts surveillance activities on developments which may affect the creditworthiness of issuers and specific bond series which it rates, on an ongoing basis. The purpose of such surveillance is to identify parameters which may lead to a change in the rating.