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Standard & Poor's Maalot
S&P Global

Oil Refineries Ltd.

April 9, 2017

Rating Update

Rating increased to ilA- in view of the Company's continued achievement of coverage ratios commensurate with the current rating

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Overview

- In accordance with our forecast, the operating results of Oil Refineries Ltd. ("Bazan") in 2016 dropped in comparison with 2015, as a result of the weakening of market conditions, chiefly in the refining sector, and the performance of a periodic turnaround of the main part of the production facilities of the Company and its subsidiary, Carmel Olefins Ltd. ("CAOL").
- Despite the aforesaid, the Company's debt coverage ratios remained stable in 2016 at approximately 3.9x, within a range that is compatible with the positive scenario that we have set out for the upgrading of the rating. We expect that the annual adjusted debt to EBITDA ratio will be at the levels commensurate with the rating in the next two years, including in the years in which a periodic turnaround is carried out, or in periods when the market conditions are challenging.
- We are increasing the rating of Oil Refineries Ltd. (Bazan), which operates in the refining and petrochemicals sector, from ilBBB+ to ilA-.
- The Stable rating outlook reflects our assessment that the Company will continue to show coverage ratios that are commensurate with the current rating, namely an adjusted debt to EBITDA ratio not exceeding 4.5x for the entire business cycle, while continuing to maintain a conservative financial policy with respect to the management of its liquidity, and a balanced dividend distribution.

Rating Action

On April 9, 2017, Standard & Poor's Maalot upgraded the rating of Oil Refineries Ltd., which operates in the refining and petrochemicals sector, from ilBBB+ to ilA-. The rating outlook is Stable.

Main Rating Considerations

The upgrading of the rating reflects our assessment that Bazan will be able to maintain the adjusted debt to EBITDA ratio of up to 4.5x for the entire business cycle, while continuing to maintain a conservative financial policy, "adequate" liquidity and a balanced dividend distribution.

In accordance with our forecast, the consolidated operating results of Bazan in 2016 were low compared to 2015, due to the periodic turnaround carried out on the main part of the Company's production facilities, and as a result of the weakening of market conditions in the refining sector. The Company's average adjusted refining margin was USD 6.2 per barrel, compared to USD 9.2 per barrel on average in 2015. In addition, in 2016 Bazan and the subsidiary CAOL started to carry out a periodic turnaround of the production facilities, which involved, *inter alia*, shutting down each of the renovated facilities for 35-50 days. Hence, the Company's adjusted EBITDA for 2016 amounted to USD 427 million, compared to USD 677 million in 2015. However, at the end of 2016 the Company had an adjusted debt to EBITDA ratio of 3.9x, which is in the range below 4.5x, and commensurate with the positive scenario that we have set out for the rating upgrade.

We believe that there are significant regulatory risks regarding environmental protection that could adversely affect the Company's operations. Two recent events point to this trend. On December 25, 2016 a fire erupted in a gasoline storage tank at the refinery in the Haifa Bay. According to the Company, the fire broke out in a tank of 12 thousand cubic meters containing less than 10% of its capacity. In addition, the Company announced that on December 25, 2016 the temporary permit granted under the Business Licensing Law expired. In view of the Haifa municipality's refusal to extend the temporary permit, the Company filed an urgent petition to the Administrative Court, and in the end the municipality extended the permit for two months. At the end of April, the temporary permit is due to expire and Bazan is working to renew the term of the permit. We should note that in view of the existing public pressure concerning air pollution in the Haifa Bay, we believe that as long as the Company continues to face intense pressure from the environmental protection regulatory authorities, it will continue to make extensive capital investments in order to reduce the emissions from its facilities. It is our understanding that the Company has taken all the measures required of it, as of today, to comply with the regulatory requirements. However, the increase of the risk in this area, including via stricter regulatory requirements or the non-renewal of the Company's business license, are liable to lead to a negative rating action.

Under our basic scenario, we believe that in 2017 the refining margins will remain at a level similar to 2016. Due to the continuation of the periodic turnaround of the Company's facilities and the facilities of its subsidiary, Gadiv, in Q1 2017, we estimate that the production capacity utilization will amount to approximately 85% in 2017. In accordance with the latest forecasts by S&P Global Ratings in December 2016, we estimate that the average price of crude oil in 2017 and 2018 will be approximately USD 50 per barrel. As of the end of 2016, we estimate that the performance of the polymers division will remain relatively stable, due to supportive market conditions. On the basis of these assumptions, we expect that the Company's adjusted EBITDA will amount to USD 380-420 million in 2017.

Our basic scenario is based on the following key assumptions:

- Production capacity utilization of the refining facilities of approximately 85% in 2017.
- A refining margin of USD 6 per barrel.
- Stable prices of polymers and naphtha at USD 1,000-1,200 per ton and USD 400 per ton, respectively, in 2017.
- Capital investments of USD 185 million in 2017, *inter alia* in connection with the turnarounds carried out in Q1 of this year.
- A dividend distribution of 75% of the net profit of the previous year.

Under our basic scenario, the debt coverage ratios are forecast as follows:

- Adjusted debt to EDITDA ratio of approximately 4.0x.
- Adjusted FFO (funds from operations) to debt ratio of approximately 15%.

Liquidity

According to our methodology, Bazan's level of liquidity is "adequate." We estimate that the ratio of sources available to the Company to its needs will exceed 1.2x in the next 12 months. This estimate is based on the amount of cash in the bank and the positive cash flow from operations, the payment of maturities, capital investments and the distribution of dividends. We believe that the Company's financial flexibility has improved due to the extension of the average life of the debt in recent years, the low usage of the facilities in the short term and the existence of significant available facilities from suppliers (which are directly related to the low price of crude oil).

Under our basic scenario, we assume that the sources available to the Company as of January 1, 2017 are:

- Cash and cash equivalents of approximately USD 370 million.
- FFO of approximately USD 320 million by the end of 2017.

In contrast, our assumptions regarding the Company's needs as of January 1, 2017 are:

- Repayment of long-term debt of approximately USD 230 million by the end of 2017.
- Capital investments of approximately USD 185 million by the end of 2017.
- Distribution of a dividend of approximately USD 120 million (of which USD 85 million has already been distributed).

Rating Outlook

The stable rating outlook reflects our assessment that Bazan will maintain its leading position in the energy market in Israel, and its adjusted debt to EBITDA ratio of up to 4.5x for the entire business cycle, namely both in the years in which a periodic turnaround is carried out and in periods when the market conditions are challenging. The stable rating outlook also reflects our expectation that the Company will maintain a responsible policy for minimizing operational damage, and for complying with the requirements of regulatory bodies in the environmental protection field. In addition, we expect that the Company will maintain a conservative policy with respect to the management of its liquidity and a balanced dividend policy.

Negative Scenario

We would consider a negative rating action if the Company does not maintain the coverage ratios commensurate with the current rating, as defined above. In our view, this scenario may materialize if there is a decline in refining and petrochemical margins, lower than expected outputs due to technical difficulties, a sharp increase in crude oil prices or the implementation of an aggressive dividend policy. Furthermore, we may take a negative rating action if there is a decline in Bazan's liquidity profile or if the Company's operations are adversely affected following regulatory changes concerning environmental protection.

Positive Scenario

We would consider increasing the rating if our forecasts indicate that Bazan will continue to show an adjusted debt to EBITDA ratio not exceeding 3.5x for the entire business cycle, while continuing to maintain a conservative financial policy for the management of "adequate" liquidity and a balanced dividend distribution.

Rating Adjustments

Sectoral diversification: Unaffected

Capital structure: Unaffected

Liquidity: Unaffected

Financial policy: Unaffected

Management, strategy and corporate governance: Unaffected

Comparison with benchmark groups: Unaffected

Methodology and Related Articles

- 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
- Methodology: Key Factors in Rating Companies in the Energy Sector, November 19, 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 Commodity Chemicals Industry, December 31, 2013
- Key Credit Factors for the Oil Refining And Marketing Industry, March 27, 2014
- National and Regional Scale Credit Ratings, September 22, 2014

- Standard & Poor's Maalot (Israel) National Scale: Methodology for Nonfinancial Corporate Issue Ratings, September 22, 2014
- Methodology and Assumptions: Liquidity Descriptors for Global Corporate Issuers, December 16, 2014
- S&P Global Ratings National and Regional Scale Mapping Tables, June 1, 2016
- S&P Global Ratings Definitions, August 18, 2016
- Opinions and Interpretations: The Connection between the Global Rating Scale and the Israeli Rating Scale, January 25, 2016

General Details (as of April 9, 2017)

Oil Refineries Ltd.

Issuer Rating(s)

Domestic Rating – long term	ilA-/Stable

Issue Rating(s)

<u>Senior unsecured debt</u>

Series A, D, E, F, G	ilA-
March 2004 Series, index-linked, maturity in 2019	ilA-
November 2004 Series, maturity by 2019	ilA-

Issuer Rating History

Domestic Rating – long term

April 9, 2017	ilA-/Stable
May 31, 2016	ilBBB+/Positive
May 14, 2015	ilBBB+/Stable
December 29, 2014	ilBBB/Positive
December 18, 2013	ilBBB/Stable
October 14, 2013	ilBBB-/Watch Neg
December 2, 2012	ilBBB+/Negative
May 6, 2012	ilBBB+/Stable
November 30, 2011	ilA-/Watch Neg
March 25, 2010	ilA-/Stable
July 7, 2009	ilA/Negative
April 23, 2009	ilA/Watch Neg
December 11, 2008	ilA/Negative
November 11, 2007	ilAA/Stable
March 1, 2003	ilAA
September 21, 1992	ilAAA

Additional Details

Time of occurrence of event	April 9, 2017 2:39 PM
Time event first became known	April 9, 2017 2:39 PM
Rating ordered by	Rated Company