STANDARD
&POOR'S
Maalot

07/07/2009

Oil Refineries Ltd.

'ilA' Rating Affirmed; Off CreditWatch Negative; Outlook Negative

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Overview

- We placed our rating of Oil Refineries Ltd.'s (ORL) bonds on CreditWatch with negative implications in April 2009, following our revised forecast of deterioration in the refining industry, the company's Capital Expenditure (Capex) funding and uncertainty regarding subsidiary, Carmel Olefins.
- In the recent quarter, our forecast of low cracking margins began to be realized and the company revised downward its capital expenditure plans costs.
- We are removing ORL's 'ilA' rating from CreditWatch and affirming the rating, as originally set in November 2008, with a negative outlook.
- The negative outlook reflects our concern that the low cracking margins in the medium term combined with the ambitious Capex plan may put the company's cash flow under pressure.

Rating Action

On July 07, 2009, Standard & Poor's Maalot affirmed its 'ilA' bonds rating on Oil Refineries Ltd. (ORL) and removed it from CreditWatch, where it was placed with negative implications on April 23, 2009. The outlook is negative.

Rationale

The negative outlook reflects our view of the increasingly challenging medium-term outlook for the refining industry and expected resulting pressure on cash flows, in combination with ORL's medium-term ambitious Capital Expenditure (Capex) plan—notably its Hydrocracker project—which is likely to result in significant increase in debt. On the other hand, the rating affirmation takes into account management's ability to lower Capex levels, and we also assume that an acquisition of Carmel Olefins (Caol), should it take place, will not involve any increase in debt.

Refining industry conditions have worsened materially since March 2009 and we believe operating margins will remain under pressure at least for the next 12 months. ORL, which is only partially vertically integrated with petrochemical activities and lacks stable cash-generation activities, may become more vulnerable in the event of a prolonged, medium-term, weak refining environment, which would put pressure on the ratings. We assume URAL Med prices, ORL's benchmark, to stay within the $2-$3/bbl range in 2009-2010 (lower than what we anticipated in November 2008). As for the petrochemical industry, we equally expect this industry to suffer from weak profitability over the medium term as seen in recent quarters.

Recently, ORL updated its Capex program, cutting the costs of its Hydrocracker project to about $500 million from $670 million, while maintaining the same time for completion, in the last quarter of 2011. The company's intentions to secure a financing package for the Capex program before submitting orders for the equipment mitigates some of our concerns about going ahead with such an investment in the current environment. While such investment will ultimately strengthen the group's profitability and asset quality, it is expected to be fully debt-funded and hence increase leverage substantially. The company's debt cover ratios may remain as high as the level recorded in 2008: debt-to-EBITDA (adjusted) of about 7.2x. We believe a recovery of the refining margins and of the EBITDA by 2012 remains subject to major uncertainty. According to the company, the global crisis and the uncertainty in the industry will delay future Capex programs.

Merging ORL with its currently 50% owned petrochemical subsidiary, Caol, could make strategic sense, but such an action will be subject to the dynamic between the shareholders Israel Corporation Ltd. (ICL; ilAA-/Negative) (45.1%) and Israel Petrochemical Enterprise Ltd. (not rated) (15.8%), and their need for cash or available assets for sale. We currently assume that any future merger, should it take place, would not involve increased debt for ORL. Regarding breaches in Caol's loan covenants, we assume these won't have any material effect on ORL (even if the future understanding with the banks includes restricting Caol's dividends).

Liquidity

ORL's liquidity position is viewed as adequate for the rating based on cash in hand (as of March 2009, about $172 million) and relatively favorable maturities in the coming years. Moreover, the company's intention to only embark on its large Hydrocracker investment when external funding sources are in place, should ensure that cash flow from operations will allow the company to serve its on-going operations including serving the current maturities.

As at March 31, 2009, the company had consolidated financial debt of $1,344 million ($321 million with Caol), of which $270 million are in short-term loans (at the parent level) financing the company's working capital. Though the company has no available facility under its committed credit facilities, we view the company's ability to revolve short-term loans (against uncommitted credit facilities) to finance inventory as fair. We believe the company's inventory level for operating and trade needs provides an additional buffer for the company to cover periodical cash shortfalls.

Outlook

The negative outlook reflects our concerns about possible pressure on the rating due to further deterioration in the refining cracking margins, which would push debt-to-EBITDA (adjusted) to peak levels of 8.0x-10.0x in the years 2009-2010.

We may revise the outlook in the event of more supportive indicators of the cracking margins, which would support debt-to-EBITDA (adjusted) at current levels of about 7.0x. We view as positive improved EBITDA generation capacity once the Hydrocracker is operational in late 2011, though this contribution, in our view, is currently offset by uncertainty over debt in the medium term and refining margins in the long term (2012 and beyond).

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Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Oil Refineries Ltd.		
Private Series	ilA/Negative	ilA/Watch Neg
Series A	ilA/Negative	ilA/Watch Neg
Series B	ilA/Negative	ilA/Watch Neg
Series C	ilA/Negative	ilA/Watch Neg