Convenience translation from Hebrew
The binding version is the Hebrew version only as published by Standard & Poor's-Maalot

Oil Refineries Ltd.

May 17, 2015

Rating Update

Rating increases to ilBBB+ pursuant to improvement in operating results and coverage ratios;

ilBBB+ rating given for the issue of up to NIS 500 million par value new debentures.

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Summary

- The operating results of Oil Refineries Ltd. (Bazan) have also continued to be strong in 1Q15, pursuant to the positive trend which began in 2014. The operating results were positively influenced by the significant improvement observed in the market conditions of the refining segment, by the positive contribution of the Hydrocracking facility, by the decrease in energy costs stemming from the flow of natural gas from the Tamar reservoir, by the implementation of streamlining measures and by the improved profitability of the polymers segment.
- In light of the improvement in operating results, improvements in coverage ratios have also been observed. The debt to EBITDA ratio, adjusted for the 12-month period ended March 31, 2015 was 3.8x, compared to 4.3x as at the end of 2014, and to 8.6x as at the end of 2013.
- We increase the rating of Oil Refineries Ltd., which operates in refining and petrochemicals, to ilBBB+ from ilBBB.
- Moreover, we gave a rating of ilBBB+ for up to NIS 500 million par value new debentures, which Bazan intends to issue by means of two new debenture series (Series E and Series F). The consideration of this issue will be used for the refinancing of existing debt and for meeting the current needs of the Company.
- The stable rating outlook reflects our assessment that Bazan will preserve its leading position in the Israeli energy market and the coverage ratios we consider as commensurate with the current rating, namely, an adjusted debt to EBITDA ratio that is lower than 6.0x. The rating also reflects our assessment that Bazan will continue to maintain a conservative financial policy, inter alia with respect to liquidity management and dividend distribution.

Rating

On May 17, 2015, Standard & Poor's Maalot increased the rating of Oil Refineries Ltd., which operates in refining and petrochemicals, to ilBBB+ from ilBBB. The rating outlook is stable. Moreover, Standard & Poor's Maalot gave an ilBBB+ rating for NIS 500 million par value new debentures, which the company intends to issue.

Principal Rating Considerations

The increased rating reflects the ongoing improvement of Bazan's operating results and coverage ratios. Bazan's operating results have also continued to be strong also in 1Q15, pursuant to the positive trend which began in 2014. The operating results were positively influenced by a significant improvement of the market conditions in the refining segment, primarily in light of the decrease in oil prices which began in the third quarter of 2014. The average adjusted refining margin of the company amounted to USD 11.7 a barrel in the first quarter of 2015, and to USD 6.4 a barrel on average in 2014 as a whole. Since the beginning of the operation of the hydrocracker facility in 1Q13 and since natural gas began flowing from the Tamar reservoir, Bazan has been consistently showing a refining margin that is approximately USD 4 higher than the industry's reference margin. The profitability of the polymers division has also improved, primarily as a result of the streamlining of the raw materials segment, which was achieved through exploiting the synergy afforded by obtaining raw materials from the refinery. In addition, the implementation of a streamlining plan which includes, inter alia, the reduction of fixed expenses and the introduction of improvements into production processes, has resulted in an additional improvement in the company's overall profitability. The company's adjusted EBITDA amounted to USD 220 million in the first quarter of 2015, compared to USD 440 and USD 295 million in 2014 and 2013, respectively. We shall further note that the reduction which began in global crude oil prices, from USD 115 a barrel in June 2014 to USD 60 a barrel today, contributes to Bazan's financial flexibility, as it allows the company to reduce its investment in working capital as well as its use of short-term credit lines (as of 1Q15, the total amount of credit used was only USD 67 million, out of a total credit line of USD 485 million). In light of the above, the debt to EBITDA ratio, adjusted for the 12-month period ended March 31, 2015, was 3.8x, compared to 4.3x as at the end of 2014, and to 8.6x as at the end of 2013.

Under our basic operating scenario, we assess that the reference margin will remain relatively high in the short-term. However, we believe that the current margins are not sustainable, and therefore the margin will be lower again in the medium to long term, as a result of the relative weakness of the macroeconomic environment and as a result of the inherent excess supply of the industry. Under our basic operating scenario, we assess that Bazan will continue presenting a refining margin that is USD 3.5-4.5 higher (per barrel) when compared to the reference margin. In our assessment, the performance of the polymer division will remain relatively stable, owing to supportive market conditions and the continued implementation of streamlining measures. In 2015 and 2016, the company is expected to engage in periodic maintenance operations, which will include the shutdown of some of the refining facilities. Accordingly, we expect that, under our basic scenario, the production capacity utilization will amount to 85%-90% in those years. While we do not expect any significant changes in global crude oil prices in the near future, we estimate that that the company will be required to increase its investment in working capital in 2015 as part of its preparations for the periodic maintenance works. Moreover, given the public pressure relating to the air pollution in Haifa Bay and Bazan's role in creating that pollution, we believe that the company is expected to face significant pressure from regulators to continue making investments designed to decrease the amount of air pollution emitted from its facilities. Under our basic scenario, we assess that in 2016 the company will begin distributing dividends that amount to 75% of its net profit, in accordance with its official policy, subject to compliance with the financial covenants that apply to it. Based on these assumptions, we predict that the company's adjusted EBITDA will amount to USD 480-500 million in 2015 and USD 380-400 million in 2016. We estimate that the adjusted debt to EBITDA ratio will amount to 4.0x-5.0x in 2015 and 2016.

Our basic scenario is based on the following principal assumptions:

- A production capacity utilization of 90% in 2015 and of 85% in 2016, owing to periodic infrastructure works at the refining facilities;
- A refining margin of USD 8-9 a barrel in 2015 and of USD 5-6 a barrel in 2016;
- Capital investments amounting to USD 130 million in 2015 and in 2016 as a result of the maintenance works;
- An investment in working capital of USD 280 million in 2015 as part of the preparations for the maintenance works;
- The non-distribution of dividends in 2015 according to the company's agreements with the financing entities. The distribution of 75% of the company's net profit in 2016.

Under our basic scenario, the projected debt coverage ratios will be as follows:

- Adjusted debt to EBITDA ratio of 4.0x-5.0x in 2015 and 2016;
- Adjusted FFO (funds from operations) to debt of 15%-20% in 2015 and 2016.

Liquidity

We assess that Bazan's liquidity level will be "less than adequate", according to our methodology. We estimate the ratio between the sources available to Bazan and its needs at 1.0x in 2015 (the short-term lines and the discounts from clients will be signed by the end of the year). As previously stated, we believe that the company's financial flexibility has improved pursuant to the reduction in oil prices and owing to the low level of short-term credit line usage. Despite the aforementioned improvement, we believe that the liquidity profile is still negatively affected by substantial debt repayments in upcoming years and by the high inherent fluctuations of the company's operating performance.

Under our basic scenario, we assume that the sources available to the company as of January 1, 2015 are as follows:

- Cash and cash equivalents amounting to USD 255 million, out of which, in our assessment, USD 100 million are needed for current operations;
- FFO amounting to USD 390 million by the end of 2015.

On the other hand, our assessments concerning the company's uses as of January 1, 2015 are as follows:

- Long-term debt repayment: USD 275 million by the end of 2015;
- Capital investments amounting to USD 130 million by the end of 2015;
- Investment in working capital amounting to USD 280 million in 2015.

While in recent years Bazan has been operating with a margin that is lower than its covenants and had even exceeded them on several occasions, we believe that, pursuant to the revision of the covenants which took place at the end of 2013 and in 1Q15, and owing to the improvement in the company's performance, the risk of exceeding the financial covenants has been reduced in the short term.

Rating Outlook

The stable rating outlook reflects our assessment that Bazan will maintain its leading position in the Israeli energy market as well as coverage ratios we consider as commensurate with its current rating, namely, an adjusted debt to EBITDA ratio that is lower than 6.0x, while maintaining current liquidity (at the very least).

Positive Scenario

We will consider increasing the rating should we observe that the company continues to present a positive free cash flow net of dividends, and that the debt to EBITDA ratio consistently remains lower than 4.0x over time, and that the company continues to maintain a conservative financial policy, inter alia with respect to liquidity management.

Negative Scenario

We would consider decreasing the rating should our revised projections indicate that the debt to EBITDA ratio will be higher than 6.0x. In our view, this scenario may materialize should there be a decline in refining and petrochemical margins, lower-than-expected outputs resulting from technical difficulties, sharp increases in oil prices or the implementation of an aggressive dividend policy. Furthermore, we may decrease the rating if Bazan's liquidity profile deteriorates.

Rating Adjustments

Segment Dispersion: unaffected

Capital Structure: unaffected

Liquidity: unaffected

Financial Policy: unaffected

Management, Strategy and Corporate Governance: unaffected

Comparison to Reference Group: unaffected

Methodology and Related Articles

- Assessment of issuer liquidity, September 2011.
- The link between global and local rating scales, February 2013.
- Advantages and limitations of credit ratings, May 2012.

List of Ratings

	Current Rating	Previous Rating
Oil Refineries Ltd.		
Rating of Issuer	ilBBB+/Stable	ilBBB/Positive
Series A	ilBBB+	ilBBB
Series B	ilBBB+	ilBBB
Series D	ilBBB+	ilBBB
Series E	ilBBB+	
Series F	ilBBB+	