

Paz Oil Company Ltd. Paz Ashdod Refinery Ltd.

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Paz Oil Company Ltd.

Paz Ashdod Refinery Ltd.

Affirmed Corporate Credit Rating

ilAA-/Stable

Rationale

Business Risk Profile	Financial Risk Profile
<ul style="list-style-type: none">• Leading position in the company's fields of operation in Israel.• Vertical integration of the Refining division with the Retail & Wholesale division.• Relatively inelastic demand and high barriers to entry in the Israeli fuel industry.• Exposure to environmental regulation.• Exposure to the refining industry, characterized by high volatility beyond the company's control.	<ul style="list-style-type: none">• Moderate leverage level.• High financial flexibility and strong liquidity.• Sound financial policy.• Relatively material dividend distributions.

Outlook: Stable

The stable outlook reflects our assessment that Paz will maintain its leading position in the Israeli energy market and that its coverage ratios will remain commensurate with the current rating. We consider an adjusted debt to EBITDA ratio between 3.0x and 4.0x to be commensurate with the current rating.

Downside Scenario

We may take a negative rating action if our updated forecasts indicate that the company is unlikely to meet the leverage ratio we defined as commensurate with the current rating. We believe this could happen if refining margins significantly decrease beyond our expectations, with material adverse effects on operating results and on financial metrics. A leverage increase due to material debt issuance or more aggressive dividend distribution than expected may lead to a deviation from target metrics commensurate with the current rating.

Upside Scenario

We may consider a positive rating action if Paz's leverage level drops while it continues to maintain "adequate" liquidity or higher. This could happen if Paz's debt decreases and we estimate that the volatility characteristic of some of the company's fields of operation will not prevent it from maintaining low leverage levels on a sustained basis.

Standard & Poor's Base-Case Scenario

Principal Assumptions	Key Metrics*			
<ul style="list-style-type: none"> Relative stability in refining margins in 2017; Stability in the gas station portfolio; Capital expenditures of about NIS 510 million in 2017 due to periodic renovation and maintenance works at the Ashdod refinery; Dividend distribution of about 70% of 2017 profit. 		2016A	2017E	2018E
	FFO/debt	25%	20%-30%	20%-30%
	Debt/EBIDTA	3.2x	3.0x-4.0x	3.0x-4.0x
	*A – Actual, E – Estimate.			

Company Description

Paz Oil Company ("Paz") is a public company operating in the energy field through three major divisions: the Retail & Wholesale division, which operates a chain of gas stations, retail complexes, and convenience stores (under the Yellow brand) and directly markets oil products to commercial, industrial and institutional customers; the Refining division, which operates one of the only two refineries in Israel as well as marketing electricity and operating a fuel storage and distribution terminal; and the Industries and Services division, which includes, among other things, the companies Pazgas, Paz Lubricants and Chemicals, Pazkar, Paz Aviation Services and Paz Aviation Assets, and produces and markets energy and infrastructure products.

In late 2016, Mr. Zadik Bino ceased to be the controlling shareholder of Paz, in accordance with the Promotion of Competition and Reduction of Concentration Law, and he currently holds less than 5% of company shares. The remainder is held by institutional investors and the public.

We believe there is a very strong connection between Paz's rating and the rating of its fully owned subsidiary, Paz Ashdod Refinery Ltd., among other things in light of the latter's important position in Paz group's value chain. Accordingly, Paz Ashdod Refinery Ltd.'s rating is identical to Paz group's rating.

Business Risk Profile

Leading position in the Israeli energy market

Our assessment of Paz's business risk profile is based on the following factors:

- High competitive position, positively affected by vertical integration and synergy between sectors throughout the value chain.
- Strong brand in the fuel marketing field, supported by a wide distribution and ancillary services in gas stations and 74% of refinery sales sold to the local market.
- High asset quality, thanks to prominent gas station locations.
- Relatively inflexible demand and high barriers to entry in the Israeli fuel industry, due to the need to make large investments, identify locations and raise large credit sources.

- Relatively high risk level in the refinery field (one of the three sectors the company operates in), as a result of high volatility in refining margins, partly stemming from factors that are exogenous to the company. We note that the company's refinery is gasoline-oriented, and petrol is characterized by growing demand. In addition, about half of the refinery's sales are to Paz gas stations, and the market is relatively closed due to limited economic viability of imports. We also note that the refining division has additional revenue sources, including electricity production and fuel distribution facilities.
- Exposure to regulatory changes concerning the environment and other competition-related conditions. We expect regulators to pressure the company to continue making investments, while tightening relevant legislation. We note that the company is currently completing environmental investments in gas stations (vapor recovery). In addition, in 2013 the company completed an extensive investment plan that included material investment in environment-related facilities.

Financial Risk Profile

Moderate leverage level and strong liquidity

In accordance with our predictions, Paz's 2016 operating results were weaker than in 2015, as a result of lower profitability in the refining sector. Due to a decrease in refining margins in 2016, the refining division's adjusted operating profit amounted to approximately NIS 193 million, compared to NIS 479 million in 2015 (an average of \$7.3 per barrel in 2016 compared to \$9.2 per barrel in 2015). On the other hand, the Industries division presented a 23% increase in operating profit, mainly due to continued increase in Pazgas's profits as a result of sales growth, capital gains and implementation of streamlining measures. The Retail & Wholesale division's operating profit amounted to approximately NIS 420 million, a 10% increase compared to approximately NIS 382 million in 2015 (excluding capital gains), mostly due to growth in gas station sales and higher profit margins in Yellow convenience stores. The entire group's debt to adjusted EBITDA in 2016 was about 3.2x, and its FFO (funds from operations) to adjusted debt ratio was about 25%. Starting in 2017, the company implements a dividend policy, according to which it will distribute 70% of its net annual profit.

In our base case scenario we estimate that refining margins in 2017 will remain similar to 2016. However, we expect some decrease in Paz's operating results in 2017 due to the scheduled periodic renovation of its refinery, which is expected to be shut down for about 45 days so that its utilization rate is likely to be relatively low. We estimate the cost of this periodic renovation at about NIS 200 million. We believe the operating performance of the Retail & Wholesale and Industries division will continue to improve in 2017, albeit at a relatively low rate. In the past three years, these sectors have been generating on average about 70% of the group's operating profit. Accordingly, in our base case scenario we estimate that in 2017, Paz's adjusted debt to EBITDA will be about 3.0x-4.0x and its FFO to adjusted debt will be 20%-30%.

Table 1.

Paz Oil Co. Ltd. – Financial Summary

	Fiscal year ended Dec. 31	
(Mil. NIS)	2016	2015
Revenues	10,885.0	12,860.0
EBITDA	1,267.5	1,538.5
Funds from operations (FFO)	991.0	1,271.3
Net income from continuing operations	545.0	716.0
Cash flow from operations	1,033.0	747.3
Capital expenditures	293.0	216.0
Debt	4,019.0	4,601.5
Adjusted ratios		
EBITDA margin (%)	11.6	12.0
Debt/EBITDA (x)	3.2	3.0
FFO/debt (%)	24.7	27.6

Liquidity: Strong

Paz's liquidity profile is "strong", reflecting the company's large operating cash flow, capital expenses, dividend distribution and the lack of material maturities until 2019. The company has good, long-lasting relations with the Israeli banking system and the local capital market, which enable it to issue debt at favorable rates. We believe the ratio between Paz's liquidity sources and uses will exceed 1.5x in 2017-2018. This assessment mainly reflects expected operating cash flow, which can support the company's investment needs and dividend distribution during that period. At the time of this report, the company holds long-term bank deposits amounting to NIS 1.8 billion, earmarked for a NIS 3 billion debt payment due in 2019. We do not consider these deposits as a liquidity source when calculating the liquidity ratio, as their due date is in 2019. However, we believe these deposits provide Paz with high flexibility when using short-term uncommitted credit facilities, since the banks are allowed to offset them.

Following are the company's main sources and uses for the 12 month period starting on December 31, 2016:

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> Cash and liquid investments of about NIS 730 million. Operating cash flow of about NIS 750-950 million. 	<ul style="list-style-type: none"> Debt maturities of about NIS 65 million. Capital expenditures of about NIS 510 million in 2017 due to maintenance and renovation work in the Ashdod refinery. Dividend distribution of 70% of 2017 projected profit.

Covenant Analysis

As of December 31, 2016, the company has sufficient headroom on its financial covenants, and we estimate that it will maintain this headroom in the medium term. The company's financial covenants include, inter alia, an equity threshold of NIS 1.7 billion and debt/cap below 77%.

Modifiers

Diversification portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management/Governance: Neutral

Comparable ratings analysis: Neutral

Reconciliation

In order to create a basis for comparison with other rated companies, we adjust the data reported in the company's financial statements which we use to calculate coverage ratios. The main adjustments we made on Paz Oil Company Ltd.'s consolidated data are deducting surplus cash (including bank deposits restricted until May 2019 which are earmarked for bond maturities payments in 2019), as we define it, from reported financial debt, and adding a long-term operating leasing contract to financial debt.

Table 2.

Reconciliation Of Paz Oil Co. Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. NIS)

--Fiscal year ended Dec. 31, 2016--							
Paz Oil Co. Ltd. reported amounts							
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	5,550.0	3,545.0	1,141.0	756.0	111.0	1,141.0	1,016.0
Standard & Poor's adjustments							
Interest expense (reported)	--	--	--	--	--	(111.0)	--
Interest income (reported)	--	--	--	--	--	54.0	--
Current tax expense (reported)	--	--	--	--	--	(161.0)	--
Operating leases	833.6	--	157.5	53.0	53.0	104.5	104.5
Postretirement benefit obligations/deferred compensation	42.8	--	3.0	3.0	6.0	(2.5)	(1.5)
Surplus cash	(2,407.3)	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	56.0	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(86.0)
Non-controlling Interest/Minority interest	--	13.0	--	--	--	--	--
EBITDA - Derivatives	--	--	(24.0)	(24.0)	--	(24.0)	--
EBITDA - Other	--	--	(10.0)	(10.0)	--	(10.0)	--
Total adjustments	(1,531.0)	13.0	126.5	78.0	59.0	(150.0)	17.0
Standard & Poor's adjusted amounts							
	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	4,019.0	3,558.0	1,267.5	834.0	170.0	991.0	1,033.0

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
- [Key Credit Factors For The Midstream Energy Industry](#), December 19, 2013
- [Key Credit Factors For The Retail And Restaurants Industry](#), 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

Rating Details (As of 2-April-2017)

Paz Oil Company Ltd.

Issuer rating(s)

Local Currency LT iIAA-/Stable

Issue rating(s)

Senior Unsecured Debt

Series C,D,E,F iIAA-

Issuer Rating history

Local Currency LT

30-March-2015 iIAA-/Stable

11-April-2014 iIA+/Stable

26-July-2013 iIA+/Negative

14-Dec-2011 iIA+/Stable

02-Aug-2011 iIAA-/Watch Neg

28-March-2010 iIAA-/Stable

29-Nov-2009 iIAA/Watch Neg

20-Dec-2007 iIAA/Stable

28-Nov-2006 iIAA-/Stable

26-Oct-2006 iIAA-

Paz Ashdod Refinery Ltd.

Issuer rating(s)

Local Currency LT iIAA-/Stable

Issue rating(s)

Senior Unsecured Debt

March 04 Due 2019 iIAA-

November 04 Due 2019 iIAA-

Issuer Rating history

Local Currency LT

30-March-2015 iIAA-/Stable

11-April-2014 iIA+/Stable

26-July-2013 iIA+/Negative

27-Dec-2011 iIA+/Stable

02-Aug-2011 iIAA-/Watch Neg

28-March-2010 iIAA-/Stable

21-Feb-2010 iIAA-/Watch Neg

07-March-2007 iIAA-/Stable

Other Details

Time of the event 15:38 02/04/2016

Time when the analyst first learned of the event 15:38 02/04/2016

Rating requested by Issuer

Credit Rating Surveillance

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.

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