

# 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**

### Overview

Key Strengths	Key Risks
<ul style="list-style-type: none"><li>• Leading position in the company's fields of operation in Israel.</li><li>• Vertical integration of the Refining division with the Retail &amp; Wholesale division.</li><li>• High financial flexibility.</li><li>• Sound financial policy.</li></ul>	<ul style="list-style-type: none"><li>• Exposure to the refining industry, characterized by high volatility beyond the company's control.</li><li>• Exposure to operating risk in the Ashdod refinery.</li><li>• Exposure to environmental regulation.</li></ul>

**Oil prices were extremely volatile in 2019, adversely affecting the refining industry.** Paz Oil Company Ltd.'s ("Paz") operating income decreased by about 26%, mainly due to a decrease in refining margins from about \$7.5 per barrel in 2018 to about \$5.9 per barrel in 2019. On the other hand, Paz's Industries & Services division and Retail & Wholesale division presented increases of about 6% and 4%, respectively, in operating income.

**We expect the operating income of Paz's refining sector to continue decreasing in 2020.** We expect refining margins to continue decreasing due to our projections of materially lower oil prices (about \$30 per barrel in 2020 compared with \$60 per barrel on average in 2019) as a result of the coronavirus outbreak and the price war between the U.S., Russia and Saudi Arabia. As a result, we expect a decrease of about 28% in the Refining division's profit margin in 2020. We will continue to monitor developments and their effects on the refining segment. We expect the Retail & Wholesale division and the Industries and Real Estate divisions to present similar operating results as in 2019, mainly due to maintaining similar margins.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: [www.spglobal.com/ratings](http://www.spglobal.com/ratings)). As the situation evolves, we will update our assumptions and estimates accordingly.

### Outlook: Stable

The stable outlook reflects our assessment that in the next 12-18 months Paz will maintain a stable business risk profile reflecting a leading position in the Israeli energy market. The stable outlook also reflects our assessment that the Company will continue generating stable free cash flows and avoid leveraged investments. In addition, we

estimate that the Company will maintain a financial risk profile commensurate with the current rating, and present coverage ratios commensurate with the current rating, i.e. adjusted debt to EBITDA between 3.0x and 4.0x.

### **Downside Scenario**

We may take a negative rating action if our updated forecasts indicate that the Company is unlikely to consistently meet the coverage ratio we defined as commensurate with the current rating. We believe this could happen if refining margins significantly decrease, with material adverse effects on operating results and on financial metrics. This could also happen if we believe the effects of the coronavirus crisis on the Company's performance is more thorough and persistent than expected. Material debt issuance or more aggressive dividend distribution than expected may also lead to a deviation from the ratio commensurate with the current rating.

### **Upside Scenario**

We may consider a positive rating action if Paz's debt to EBITDA consistently decreases to 2.0x-2.5x while it continues to maintain "adequate" liquidity or higher and at least its current level of operating margin. 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.

## **Base Case Scenario**

### **Key Assumption**

- ~28% decrease in profit margins in the refining segment, assuming a price of \$30 per barrel, due to a sharp price drop in the oil and gas sector, inter alia due to the coronavirus outbreak.
- Relatively stable profit margins in the Retail, Industries, Wholesale and Real Estate divisions in 2020.
- Stability in the gas station portfolio.
- Capital expenditures of about NIS 300 million in 2020.
- Debt repayment of about NIS 220 million in 2020.
- Dividend distribution of about 70% of 2019 income, according to company policy.

### **Key Metrics**

	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>
<b>FFO/debt</b>	22.2%	20%-25%	20%-25%
<b>Debt/EBITDA</b>	3.6x	3.5x-4.0x	3.5x-4.0x

A – Actual. E – Estimate. FFO – funds from operations

### **Base Case Projections**

#### **Sharp drop in the refining segment's profit margin, relative stability in other segments**

In our base case scenario we estimate that the refinery's utilization rate in 2020 will remain similar to 2019, but that refining margins will drop materially due to a consistent ad sharp drop in oil prices to about \$30 per barrel (annual average). As a result, we expect a ~28% decrease in the Refining division's income in 2020. We also

estimate that the Retail & Wholesale, Real Estate and Industries divisions will show operating results similar to 2019, mainly due to maintaining similar margins in the Retail & Wholesale divisions, which generates about 47% of the Group's total adjusted EBITDA. the Retail & Wholesale, Real Estate and Industries divisions have been contributing on average about 73% of the group's operating income in the past four years.

### **Debt issuance and higher leverage**

We estimate that the Company will continue to prepare in advance to the final maturity of Series D bonds in 2024, and will issue debt in the upcoming years. Accordingly, in our base case scenario we estimate that in 2020-2021 Paz will present adjusted debt to EBITDA of about 3.5x-4.0x and FFO to adjusted debt of 20%-25%. As mentioned above, we expect the Company's leverage to somewhat increase in 2020, but remain commensurate with the rating.

## **Company Description**

Paz is a public company operating in the energy field through four 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, Ashdod Refinery, markets electricity and operates a fuel storage and distribution terminal; the Industries and Services division, which includes, among other things, the companies Pazgas, Paz Lubricants and Chemicals, Pazkar, Paz Aviation Assets and Paz Aviation Services, and produces and markets energy and infrastructure products; and the Real Estate division, which rents out investment real estate (commercial spaces).

We believe there is a very strong connection between Paz's rating and the rating on 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**

Paz's business risk profile is underpinned by a high competitive position, positively affected by vertical integration and synergy between sectors throughout the value chain.

The Company operates in the fuel industry which is characterized by relatively inflexible demand in Israel and by high barriers to entry due to the need to make large investments, identify locations and raise large credit sources. Paz is a leading brand in the fuel marketing field, supported by wide distribution and by ancillary services in gas stations. In addition, the Company holds high quality assets thanks to prominent gas station locations.

Paz's business risk profile is, however, constrained by exposure to the refining sector which is highly volatile. The coronavirus outbreak has led to a sharp drop in oil prices. We believe that OPEC committee talks failure and the discontinuation of cooperation between global oil producers U.S.A., Russia and Saudi Arabia, may increase price volatility. Refining margin volatility, partly stemming from exogenous factors, materially affects the Company's operating results, and is difficult to forecast. However, we note that the Company's refinery is petrol-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.

The Company is exposed to regulatory changes concerning the environment and other competition-related conditions. We expect regulators to pressure the company to continue making investments, especially in the refining sector, while tightening relevant legislation.

The Company is also exposed to operating risk at the Ashdod refinery, like the fire at the diesel fuel treatment unit in 2017 and various failures in the power plant in 2019. We estimate that if the refinery is shut down due to the materialization of operating risk, output will decrease and the raw material mix will change, with possible adverse effects on the refining division.

In February, the Company's new management published the main points of its five-year strategic plan aimed at doubling the Company's value. This plan is based on four growth engines: operating efficiency in the refining sector, retail excellence, real estate development and strategic acquisitions. Due to the current market uncertainty following the coronavirus crisis, we did not include the implementation of this strategic plan in our forecasts.

## **Financial Risk**

In 2019, Paz's operating income decreased by about 26%, to about NIS 463 million (excluding a one-off reputation impairment of about NIS 566 million) from about NIS 626 million in 2018. This was mainly due to the decrease in refining margins in the past year and the refinery shutdown due to installation of the cat cooler, facility renovation and partial utilization of the power plant due to faults. The Refining division's adjusted operating loss in 2019 amounted to approximately NIS 74 million, compared with an operating income of about NIS 130 in 2018 (an average of \$5.9 per barrel in 2019 compared to \$7.5 per barrel in 2018)..

On the other hand, operating income in the Retail & Wholesale division amounted to about NIS 316 million in 2019 compared with about NIS 305 million in 2018, mainly due to increase in gas station sales and direct marketing. In addition, income in the Industries segment increased to about NIS 206 million from about NIS 194 in 2018, mainly due to increased sales of profitable products and a decrease in expenses following cost-cutting measures. The entire group's debt to adjusted EBITDA in 2019 was about 3.6x, and its FFO to adjusted debt ratio was about 22.2%.

In our base case scenario we estimate that refining margins will drop sharply in 2020 due to a price environment of about \$30 per barrel, following the coronavirus outbreak and oil prices between the U.S., Russia and Saudi Arabia. As a result, we expect the Refining division's operating performance to deteriorate in 2020. We estimate that the Retail & Wholesale and Industries divisions will generate operating results similar to 2019, mainly due to maintaining a similar level of margins.

The Company benefits from good relationships with banks and the local capital market, and in February issued about NIS 1.15 billion worth of debt at relatively favorable interest rates, in order to prepay about NIS 750 million of Series D bonds.. This reflects the implementation of a sound financial policy.

Table 1.

**Paz Oil Company Ltd. – Financial Summary (Mil. NIS)**

**Industry Sector: Oil Refining & Marketing**

	2019	2018	2017	2016	2015
Revenue	12,696.0	14,107.0	11,285.0	10,885.0	12,860.0
EBITDA	1,061.0	1,260.5	1,175.5	1,267.5	1,538.5
Funds from operations (FFO)	851.0	956.7	829.1	975.5	1,147.0
Interest expense	156.0	220.8	195.4	170.0	157.5
Cash interest paid	116.0	194.8	186.4	163.0	284.5
Cash flow from operations	583.0	1,121.7	1,380.1	1,034.5	745.0
Capital expenditure	300.0	364.0	597.0	293.0	216.0
Free operating cash flow (FOCF)	283.0	757.7	783.1	741.5	529.0
Discretionary cash flow (DCF)	(15.0)	354.7	480.1	571.5	270.0
Cash and short-term investments	1,388.0	1,364.0	1,042.0	726.0	60.0
Gross available cash	1,388.0	4,261.0	3,265.0	2,534.0	610.0
Debt	3,832.9	3,352.4	3,567.0	4,019.0	4,601.5
Equity	3,573.0	4,137.0	4,132.0	3,558.0	3,307.0
<b>Adjusted ratios</b>					
EBITDA margin (%)	8.4	8.9	10.4	11.6	12.0
Return on capital (%)	6.7	11.0	12.0	10.8	13.5
EBITDA interest coverage (x)	6.8	5.7	6.0	7.5	9.8
FFO cash interest coverage (x)	8.3	5.9	5.4	7.0	5.0
Debt/EBITDA (x)	3.6	2.7	3.0	3.2	3.0
FFO/debt (%)	22.2	28.5	23.2	24.3	24.9
Cash flow from operations/debt (%)	15.2	33.5	38.7	25.7	16.2
FOCF/debt (%)	7.4	22.6	22.0	18.4	11.5
DCF/debt (%)	(0.4)	10.6	13.5	14.2	5.9

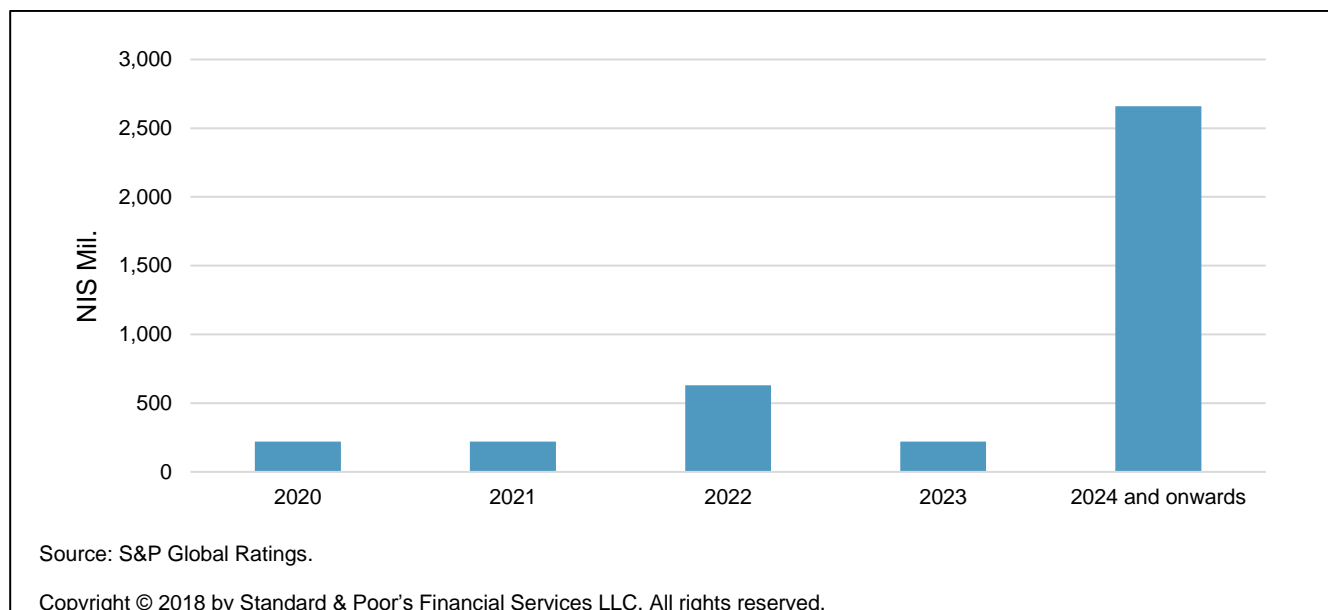
## Liquidity: Adequate

We assess Paz's liquidity as "adequate". We expect the ratio between Paz's liquidity sources and uses to exceed 1.2x in the next 12 months. This assessment mainly reflects Paz's cash balance, operating cash flow, capital expenditures and debt repayment.

Following are the company's principal sources and uses for the 12 month period starting January 1, 2020:

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> <li>Cash and liquid investments of about NIS 1.4 billion.</li> <li>Operating cash flow of about NIS 500 million – NIS 520 million.</li> <li>Debt refinancing of about NIS 1.1 billion.</li> </ul>	<ul style="list-style-type: none"> <li>Debt maturities of about NIS 220 million.</li> <li>Prepayment of D bonds of about NIS 750 million.</li> <li>Capital expenditures of about NIS 300 million.</li> </ul>

## Debt Maturities



## Covenant Analysis

### Compliance Expectations

As of December 31, 2019, the Company has adequate headroom on its financial covenants, and we estimate that it will maintain this headroom in the medium term

### Requirements

The Company's financial covenants include an equity requirement of at least NIS 1.9 billion and a maximum debt to cap of 75%.

## Modifiers

Diversification portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management/Governance: Neutral

Comparable ratings analysis: Neutral

## Recovery Analysis

### Key analytical factors

- We are affirming our 'ilAA-' issue rating, identical to the issuer rating, on Paz Oil Company Ltd.'s unsecured bond series (Series D, E, F, G, H). The recovery rating for this series is '3', reflecting our assessment that in the hypothetical default scenario, the recovery rate would be in the 50%-70% range (at the higher end of this range).



- Our recovery assessment is constrained to the 50%-70% range despite the simplified waterfall, due to our assessment that the Company will replace unsecured debt with secured or senior debt on the way to default, and because at an 'ilAA-' rating the likely default event is at a later date so that waterfall projections are less certain.

#### **Simulated default assumptions**

- Year of hypothetical default: 2025
- A deep recession in the Israeli economy, alongside a material drop in refining margins and the materialization of operating risk in the Ashdod refinery which will have to shut down for an extended period, will have material adverse effects on the Company's operating performance.
- The company will continue operating as a going concern, an assessment supported by the Refining division operating one of the only two refineries in Israel, and by long-term signed contract with clients to sell and distribute fuels. In additions, the land in Paz's locations has economic value that may be materialized in the event of a hypothetical default.

#### **Simplified waterfall at default**

- EBITDA at default: NIS 517 million
- EBITDA multiplier: 6.0x
- Gross enterprise value according to multiplier method: about NIS 3,100 million
- Administrative and operating costs: 5%
- Total unsecured debt: NIS 3,020 million
- Unsecured debt recovery expectation (Series D, E, F, G, H): 50%-70% (constrained as noted above)
- Unsecured debt recovery rating (Series D, E, F, G, H) (1 to 6): 3

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**

Recovery rating*	Recovery description	Nominal recovery expectations		Issue rating notches relative to ICR
		Greater than or equal to	Less than	
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.

## 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 adjustment we made on Paz Oil Company Ltd.'s consolidated data for 2019 is deducting surplus cash, as we define it, from reported financial debt.

**Table 2.**

### Reconciliation Of Paz Oil Company Ltd. Reported Amounts with S&P Global Ratings Adjusted Amounts (Mil. NIS) for the Fiscal Year Ended Dec 31, 2019

#### Paz Oil Company Ltd. reported amounts

	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
<b>Reported</b>	<b>3,860.0</b>	<b>3,568.0</b>	<b>1,045.0</b>	<b>463.0</b>	<b>150.0</b>	<b>1,061.0</b>	<b>695.0</b>
<b>S&amp;P Global Ratings adjustments</b>							
Cash taxes paid	--	--	--	--	--	(94.0)	--
Cash taxes paid: Other	--	--	--	--	--	--	--
Cash interest paid	--	--	--	--	--	(116.0)	--
Reported lease liabilities	1,102.0	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	58.5	--	3.0	3.0	6.0	--	--
Accessible cash and liquid investments	(1,187.6)	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	23.0	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(112.0)
Noncontrolling interest/minority interest	--	5.0	--	--	--	--	--
EBITDA: Other	--	--	13.0	13.0	--	--	--
<b>Total adjustments</b>	<b>(27.1)</b>	<b>5.0</b>	<b>16.0</b>	<b>39.0</b>	<b>6.0</b>	<b>(210.0)</b>	<b>(112.0)</b>

#### S&P Global Ratings adjusted amounts

	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	3,832.9	3,573.0	1,061.0	502.0	156.0	851.0	583.0

## 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 Retail And Restaurants Industry](#), 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](#), December 27, 2014
- [Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers](#), December 16, 2014
- [Key Credit Factors For The Agribusiness And Commodity Foods Industry](#), January 29, 2015
- [Recovery Rating Criteria For Speculative-Grade Corporate Issuers](#), December 7, 2016
- [Methodology For National And Regional Scale Credit Ratings](#), June 25, 2018
- [Corporate Methodology: Ratios And Adjustments](#), April 1, 2019
- [Group Rating Methodology](#), July 1, 2019
- [S&P Global Ratings Definitions](#), July 5, 2019

## Ratings List

### Rating Details (As of 05-April-2019)

#### Paz Oil Company Ltd.

##### Issuer rating(s)

Local Currency LT ilAA-/Stable

##### Issue rating(s)

##### Senior Unsecured Debt

Series D,E,F,G ilAA-

Series H ilAA-

##### Issuer Rating history

Local Currency LT

30-March-2015 ilAA-/Stable

11-April-2014 ilA+/Stable

26-July-2013 ilA+/Negative

14-Dec-2011 ilA+/Stable

02-Aug-2011 ilAA-/Watch Neg

28-March-2010 ilAA-/Stable

29-Nov-2009 ilAA/Watch Neg

20-Dec-2007 ilAA/Stable

28-Nov-2006 ilAA-/Stable

26-Oct-2006 ilAA-

#### Paz Ashdod Refinery Ltd.

##### Issuer rating(s)

Local Currency LT ilAA-/Stable

##### Issuer Rating history

Local Currency LT

30-March-2015 ilAA-/Stable

11-April-2014 ilA+/Stable

26-July-2013 ilA+/Negative

27-Dec-2011 ilA+/Stable

02-Aug-2011 ilAA-/Watch Neg

28-March-2010 ilAA-/Stable

21-Feb-2010 ilAA-/Watch Neg

07-March-2007 ilAA-/Stable

##### Other Details

Time of the event 09:50 05/04/2020

Time when the analyst first learned of the event 09:50 05/04/2020

Rating requested by Issuer

### **Credit Rating Surveillance**

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