

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 the refining industry, characterized by high volatility beyond the company's control.• Exposure to operating risk in the Ashdod refinery.• Exposure to environmental regulation.	<ul style="list-style-type: none">• Moderate leverage level.• High financial flexibility and strong liquidity.• Sound financial policy.• Material dividend distributions.

Outlook: Stable

The stable outlook reflects our assessment that Paz Oil Company Ltd. ("Paz") will maintain its leading position in the Israeli energy market and that its coverage ratios will remain commensurate with the current rating, i.e. an adjusted debt to EBITDA ratio 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 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. Material debt issuance or more aggressive dividend distribution than expected may lead to a deviation from the target metric commensurate with the current rating.

Upside Scenario

We may consider a positive rating action if Paz's debt to EBITDA drops 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

Principal Assumptions	Key Metrics*			
<ul style="list-style-type: none"> 10%-15% increase in the refining division's profitability in 2018; Stability in the gas station portfolio; Capital expenditures of about NIS 400 million in 2018; Dividend distribution of about 70% of 2017 profit. 		2017A	2018E	2019E
	FFO/debt	27.1%	20%-30%	20%-30%
	Debt/EBIDTA	3.0x	2.5x-3.5x	2.5x-3.5x
	*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.

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

Paz's business risk profile is supported on the following factors:

- High competitive position, positively affected by vertical integration and synergy between sectors throughout the value chain.
- Leading 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.

Paz's business risk profile is, however, constrained by the following factors:

- 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 operating risk at the Ashdod refinery, like the fire at the diesel fuel treatment unit in 2017 and failure in the Israel Electric Corporation's sea connector terminal in Ashdod which the refinery uses to load and unload raw materials and to export Mazut. 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.
- 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 we believe the implementation of the Energy Ministry's recommendation regarding decreasing the 95 octane gasoline self-service margin by 8 Agorot and decreasing the full-service cost by 4 Agorot will adversely affect the Company's results. However, we estimate that the Company has already considered actions and reorganization steps to deal with the expected implications of any implementation of these recommendations on its operating performance.

Financial Risk Profile

Moderate leverage level and strong liquidity

In accordance with our predictions, Paz's 2017 operating results were weaker than in 2016, as a result of periodic maintenance work in the Ashdod refinery, which was shut down for a period of about 70 days, leading to a relatively low utilization rate, as well as the decrease in the USD/NIS exchange rate., which was partly offset by the increase in refining margin. The Refining division's adjusted operating income in 2017 amounted to approximately NIS 157 million, compared to NIS 193 million in 2016 (an average of \$8.9 per barrel in 2017 compared to \$7.3 per barrel in 2016). The Industries division presented a 23% decrease in operating income, mainly due to decreasing margins in Pazgas and industries companies, partly offset by the increase in sales and by the fact that NIS 27 capital gains were recognized in 2016. On the other hand, the Retail & Wholesale division's operating income remained similar to last year, approximately NIS 415 million compared with approximately NIS 420 in 2016, as decrease in gasoline margins were offset by an increase in sales of fuel and Yellow convenience store products, with one-off expenses paid this year in respect of previous years.

The entire group's debt to adjusted EBITDA in 2017 was about 3.0x, and its FFO (funds from operations) to adjusted debt ratio was about 27.1%. We note that starting in 2017, the company implements a dividend policy, according to which it will distribute 70% of its expected net annual profit. In accordance with this policy, the Company recently announced the distribution of about NIS 400 million. In 2017 the Company distributed about NIS 300 million in dividends.

In our base case scenario we estimate that refining margins in 2018 will remain similar to 2017, and that the refinery's utilization rate will be higher than last year, the year of its periodic maintenance work. As a result, we expect an increase in Paz's operating results in 2018. We believe the operating performance of the Retail &

Wholesale and Industries division will be similar to 2017, as streamlining measures will be partly offset by a decrease in the marketing margin. In the past three years, these sectors have been generating on average about 70% of the group's operating income. Accordingly, in our base case scenario we estimate that in 2018, Paz's adjusted debt to EBITDA will be about 2.5x-3.5x 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)	2017	2016
Revenues	11,285.0	10,885.0
EBITDA	1,175.5	1,267.5
Funds from operations (FFO)	967.6	991.0
Net income from continuing operations	572.0	545.0
Cash flow from operations	1,378.6	1,033.0
Capital expenditures	597.0	293.0
Debt	3,567.0	4,019.0
Adjusted ratios		
EBITDA margin (%)	10.4	11.6
Debt/EBITDA (x)	3.0	3.2
FFO/debt (%)	27.1	24.7

Liquidity: Strong

Paz's liquidity profile is "strong", reflecting the company's cash on hand, large operating cash flow, capital expenses, dividend distribution and the lack of material maturities until May 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 2018. This assessment mainly reflects expected operating cash flow, which can support the company's investment needs and dividend distribution in that year. At the time of this report, the company holds long-term bank deposits amounting to NIS 2.2 billion, earmarked for a NIS 3 billion debt payment due in May 2019. We do not consider these deposits as a liquidity source when calculating the liquidity ratio for 2018, 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, 2017:

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> Cash and liquid investments of about NIS 1,042 million. Operating cash flow of about NIS 750-800 million. 	<ul style="list-style-type: none"> Debt maturities of about NIS 60 million. Capital expenditures of about NIS 400 million in 2018. Dividend distribution of about NIS 400 million in 2018 (70% of 2017 net profit, according to Paz dividend policy).

Covenant Analysis

As of December 31, 2017, 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 S&P Global Ratings Adjusted Amounts (Mil. NIS)

--Rolling twelve month ended Dec. 31, 2017--

Paz Oil Co. Ltd. reported amounts.

	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	5,883.0	4,119.0	1,020.0	666.0	130.0	1,020.0	1,340.0
S&P Global Ratings adjustments							
Interest expense (reported)	--	--	--	--	--	(130.0)	--
Interest income (reported)	--	--	--	--	--	96.0	--
Current tax expense (reported)	--	--	--	--	--	(109.0)	--
Operating leases	805.7	--	159.5	57.4	57.4	102.1	102.1
Postretirement benefit obligations/deferred	48.6	--	4.0	4.0	8.0	(3.5)	(1.5)
Surplus cash	(3,170.3)	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	201.0	--	--	--
Reclassification of interest and dividend cash	--	--	--	--	--	--	(62.0)
Non-controlling Interest/Minority interest	--	13.0	--	--	--	--	--
EBITDA - Derivatives	--	--	(8.0)	(8.0)	--	(8.0)	--
Total adjustments	(2,316.0)	13.0	155.5	254.4	65.4	(52.4)	38.6
S&P Global Ratings adjusted amounts							

	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from Operations	Cash flow from operations
Adjusted	3,567.0	4,132.0	1,175.5	920.4	195.4	967.6	1,378.6

Recovery Analysis

Key analytical factors

- Following the first time implementation of our recovery rating criteria for corporate issuers, we are examining the recovery expectations of the various bond series in the case of a hypothetical default.
- We are assigning Paz Oil Company Ltd.'s unsecured bond series (Series C, D, E, F, G) and to Paz Ashdod Refinery Ltd.'s unsecured bond series (Series 43, 43b) an 'ilAA-' issue rating, identical to the issuer rating. The recovery rating for these series is '3', reflecting our assessment that in the case of default, the recovery rate would be in the higher end of the 50%-70% range.
- Our recovery rating assessment is constrained to the 50%-70% range despite the below mentioned waterfall due to our assessment that during its deterioration, the Company will exchange unsecured debt with secured or senior debt, and since with an 'ilAA-' rating the likelihood of a default is at a relatively later date so our waterfall forecast is less certain.

Simulated default assumptions

- Year of default: 2023
- Deep recession in the Israeli economy, with a significant decrease in refining margins and the materialization of operating risk in the Ashdod refinery which will shut down for an extended period, will have a material adverse effect on the Company's operating performance.
- The Company will continue operating as a going concern, an assessment supported by the Refining division which operates the second largest of the only two refineries in Israel, and by signed long-term contracts with customers (institutional and others) to sell, distribute and supply fuels. In addition, the Company operates about 273 public gas stations across Israel, with Yellow convenience stores in most of them, and the land on which they stand has potentially realizable economic value in a hypothetical default scenario.

Simplified waterfall

- EBITDA at emergence: about NIS 400 million.
- Implied EBITDA multiple: 6.0x
- Gross enterprise value at emergence: about NIS 2,400 million
- Administrative and operating costs: 5%
- Enterprise value available to first-lien secured creditors: about NIS 2,280 million
- Unsecured debt claims: NIS 2,630 million
- Unsecured debt recovery expectation (Series C, D, E, F, G): 50%-70% (constrained as mentioned above)
- Recovery rating for unsecured debt (Series C, D, E, F, G) (1 to 6): 3
- Unsecured debt recovery expectation (Series 43, 43b): 50%-70% (constrained as mentioned above)
- Recovery rating for unsecured debt (Series 43, 43b) (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 (for further detail, see Step 6, paragraphs 90-98 of Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016).

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
- [Group Rating Methodology](#), November 19, 2013
- [Corporate Methodology: Ratios And Adjustments](#), November 19, 2013
- [Corporate Methodology](#), November 19, 2013
- [Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns](#), 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
- [National And Regional Scale Credit Ratings](#), September 22, 2014
- [Methodology For Applying Recovery Ratings To National Scale Issue Ratings](#), September 22, 2014
- [Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers](#), December 16, 2014
- [Recovery Rating Criteria For Speculative-Grade Corporate Issuers](#), December 7, 2016
- [S&P Global Ratings' National And Regional Scale Mapping Tables](#), August 14, 2017
- [S&P Global Ratings Definitions](#), June 26, 2017

Rating Details (As of 28-March-2018)

Paz Oil Company Ltd.

Issuer rating(s)

Local Currency LT ilAA-/Stable

Issue rating(s)

Senior Unsecured Debt

Series C,D,E,F,G 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

Issue rating(s)

Senior Unsecured Debt

Series 43, 43b ilAA-

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	13:11 28/03/2018
Time when the analyst first learned of the event	13:11 28/03/2018
Rating requested by	Issuer

Credit Rating Surveillance

S&P Maalot is the commercial name of S&P Global Ratings Maalot Ltd. 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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