

# Paz Oil Company Ltd. Paz Ashdod Refinery Ltd.

March 31, 2019

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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>

**2018 was a challenging year for companies in the Israeli fuel market, both due to the decrease in the regulated gasoline octane 95 marketing margin and due to oil price volatility.** Paz's operating income decreased by about 3% in 2018, mainly due to a decrease in refining margins which adversely affected the refining division's operating results. The Industries division also presented in 2018 a decrease of about 6% in operating income, due to a decline of Pazgas profitability following a relatively warm and dry winter. On the other hand, despite the decrease in marketing margin in May 2018, Paz's Retail & Wholesale division presented similar results to 2017.

**We expect the Company to maintain its profit margins in its various areas of operation in 2019.** We expect refining margin (annual average) to slightly improve compared with 2018 due to our projections of lower oil prices (about \$60 per barrel in 2019 compared with \$70 per barrel in 2018) and the refinery's utilization rate to remain similar to 2018. As a result, we expect a slight improvement in the Refining division's operating results in 2019. We expect the Retail & Wholesale division and the Industries division to present similar operating results as in 2018, mainly due to maintaining similar margins in the industry companies.

As Series E bonds (about NIS 560 million) will fully mature in 2022 and Series D bonds (about NIS 1.6 billion) will fully mature in 2024, we believe the Company will prepare in advance and issue debt in the upcoming years. Accordingly, in our base case scenario we estimate that in 2019-2020 Paz will show an adjusted debt to EBITDA ratio of about 2.7x-3.7x and an adjusted FFO (funds from operations) to debt ratio of 20%-30%.

### Outlook: Stable

The stable outlook reflects our assessment that in the next 12-18 months Paz Oil Company Ltd. ("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. Material debt issuance or more aggressive dividend distribution than expected may also 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 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**

- Stable profit margins in all of the Company's divisions in 2019;
- Stability in the gas station portfolio;
- Capital expenditures of about NIS 400 million in 2019;
- Debt repayment of about NIS 3 billion (Series C) in 2019. We note that, in order to calculate adjusted debt to EBITDA in 2019, we deducted short-term bank deposits earmarked for debt repayment from total debt.
- Dividend distribution of about 70% of 2018 income, according to company policy.
- We do not take into account the Company's intention to participate in the tender to construct a power station in Alon Tavor, due to uncertainty regarding the results and conditions of the tender.

### **Key Metrics**

	<b>2018A</b>	<b>2019E</b>	<b>2020E</b>
<b>FFO/debt</b>	28.6%	20%-30%	20%-30%
<b>Debt/EBITDA</b>	2.7x	2.7x-3.7x	2.7x-3.7x

A – Actual. E – Estimate.

## **Base Case Projections**

### **Maintaining stable margins in the refining, industries, and retail & wholesale sectors**

In our base case scenario we estimate that the refinery's utilization rate in 2019 will remain similar to 2018 and that refining margins will slightly improve (annual average). As a result, we expect a slight improvement in Paz's Refining division in 2019. We estimate that the Retail & Wholesale and Industries division will show operating results similar to 2018, mainly due to maintaining similar margins in the industry companies. These sectors have been contributing on average about 70% of the group's operating income in the past four years.

We estimate that the Company will prepare in advance to the final maturity of Series E bonds in 2022 and Series D bonds in 2024, and will issue debt in the upcoming years. Accordingly, in our base case scenario we estimate that in 2019-2020 Paz will present adjusted debt to EBITDA of about 2.7x-3.7x and FFO to adjusted debt of 20%-30%.

## **Company Description**

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, Ashdod Refinery, 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 Assets and Paz Aviation Services, 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**

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. Refining margin volatility, partly stemming from exogenous factors, materially affect the Company's operating results, and is difficult to forecast. However, 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.

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. 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.

## **Financial Risk**

In 2018, Paz's operating income decreased by about 3%, to about NIS 657 million in 2018 from about NIS 679 million in 2017. This was mainly due to the decrease in refining margins in the past year. The Refining division's adjusted operating income in 2018 amounted to approximately NIS 130 million, compared with NIS 157 million in 2017 (an average of \$7.5 per barrel in 2018 compared to \$8.9 per barrel in 2017). In addition, the Industries division presented a decrease of about 6.2% in operating income, mainly due to decreasing margins in Pazgas as a result of lower sales due to the relatively warm and dry winter.

On the other hand, operating income in the Retail & Wholesale division remained similar to the previous year, about NIS 412 million compared with about NIS 415 million in 2017. The increase in marketing and sales expenses was mitigated by growth in liters sold at fueling stations and higher profitability of Yellow stores. The entire group's debt to adjusted EBITDA in 2018 was about 2.7x, and its FFO (funds from operations) to adjusted debt ratio was about 28.6%. We note that starting in 2017, the company implements a dividend policy, according to which it will distribute 70% of its forecasted net annual profit. In 2017 the Company distributed a dividend of about NIS 300 million and in 2018 it distributed a dividend of about NIS 400 million. We estimate that the Company's free cash flow will remain positive in the medium run even after the distribution of similar dividend amounts.

In our base case scenario we estimate that refining margins will somewhat improve in 2019, and that the refinery's utilization rate will remain constant. As a result, we expect an improvement in the Refining division's operating results in 2019. We believe the operating performance of the Retail & Wholesale and Industries division will be similar to 2018.

The Company benefits from good relationships with banks and the local capital market, and in recent years has issued debt at favorable interest rates, in order to prepare for the repayment of Series C bonds in May of this year, totaling about NIS 3 billion. This reflects the implementation of a sound financial policy.

Table 1.

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

**Industry Sector: Oil Refining & Marketing**

	2018	2017	2016	2015	2014
Revenues	14,107.0	11,285.0	10,885.0	12,860.0	18,513.0
EBITDA	1,260.5	1,175.5	1,267.5	1,538.5	1,189.0
FFO	957.7	967.6	991.0	1,271.3	823.9
Net income from continuing operations	401.0	572.0	545.0	716.0	172.0
Cash flow from operations	1,121.7	1,378.6	1,033.0	747.3	170.9
Capital expenditures	364.0	597.0	293.0	216.0	221.0
Free operating cash flow	757.7	781.6	740.0	531.3	(50.1)
Debt	3,352.4	3,567.0	4,019.0	4,601.5	4,803.7
<b>Adjusted ratios</b>					
EBITDA margin (%)	8.9	10.4	11.6	12.0	6.4
Debt/EBITDA (x)	2.7	3.0	3.2	3.0	4.0
FFO/debt (%)	28.6	27.1	24.7	27.6	17.2

**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, large operating cash flow, capital expenditures and dividend distribution.

At the time of this report, the company holds long-term bank deposits amounting to NIS 2.9 billion, earmarked for a NIS 3 billion debt payment (Series C bonds) due in May 2019. Therefore, our liquidity assessment for 2019 includes both bank deposits (as a principal source) and the last payment on Series C bonds (as a principal use).

We note that in recent years, the Company has been preparing for the maturity this May by several debt issuance at favorable rates, in light of its long standing good relationship with the local bank system and capital market.

Following are the company's principal sources and uses for the 12 month period starting January 1, 2019:

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> <li>Cash and liquid investments of about NIS 4.3 billion.</li> <li>Operating cash flow of about NIS 800 million – NIS 820 million.</li> </ul>	<ul style="list-style-type: none"> <li>Debt maturities of about NIS 3 billion.</li> <li>Capital expenditures of about NIS 400 million in 2019.</li> <li>Dividend distribution of about NIS 250 million – NIS 300 million in 2019 (70% of 2018 net profit, according to Paz's dividend policy).</li> </ul>

Debt Maturities					
Year	2019	2020	2021	2022	2023 and later
Maturities (Mil NIS)	3,037	157	157	566	2,591

## Covenant Analysis

### Compliance Expectations

As of December 31, 2018, 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 'iIAA-' issue rating, identical to the issuer rating, on Paz Oil Company Ltd.'s unsecured bond series (Series C, D, E, F, G) and on Paz Ashdod Refinery Ltd.'s unsecured bond series (Series 43, 43b). The recovery rating for this series is '3', reflecting our assessment that in the hypothetical default scenario, the recovery rate would be at the higher end of the 50%-70% 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 by secured or senior debt on the way to default, and because at an 'iIAA-' rating the likely default event is at a later date so that waterfall projections are less certain.



### Simulated default assumptions

- Year of hypothetical default: 2023
- 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 (institutions etc.) to sell and distribute fuels. In additions, the land in Paz's location has economic value that may be materialized in the event of a hypothetical default.

### Simplified waterfall at default

- EBITDA at default: NIS 410 million
- EBITDA multiplier: 6.0x
- Gross enterprise value according to multiplier method: about NIS 2,460 million
- Administrative and operating costs: 5%
- Total unsecured debt: NIS 3,204 million
- Unsecured debt recovery expectation (Series C, D, E, F, G): 50%-70% (constrained as noted above)
- Unsecured debt recovery rating (Series C, D, E, F, G) (1 to 6): 3
- Unsecured debt recovery expectation (Series 43, 43b): 50%-70% (constrained as noted above)
- Unsecured debt recovery rating (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 (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. Following are the main adjustments we made on Paz Oil Company Ltd.'s consolidated data for 2018:

- Deducting surplus cash, as we define it, from reported financial debt (including bank deposits restricted until May 2019 which are earmarked for bond maturity payments in 2019)
- Adding discounted long-term operating leasing contracts to 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, 2018**

### Paz Oil Company Ltd. reported amounts

	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	6,479.0	4,124.0	1,106.0	734.0	159.0	1,106.0	1,148.0
<b>S&amp;P Global Ratings adjustments</b>							
Interest expense (reported)	--	--	--	--	--	(159.0)	--
Interest income (reported)	--	--	--	--	--	46.0	--
Current tax expense (reported)	--	--	--	--	--	(128.0)	--
Operating leases	787.6	--	158.5	55.8	55.8	102.7	102.7
Postretirement benefit obligations/deferred compensation	48.5	--	3.0	3.0	6.0	(3.0)	--
Surplus cash	(3,962.7)	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	46.0	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(129.0)
Non-controlling Interest/Minority interest	--	13.0	--	--	--	--	--
EBITDA - Derivatives	--	--	(7.0)	(7.0)	--	(7.0)	--
<b>Total adjustments</b>	<b>(3,126.6)</b>	<b>13.0</b>	<b>154.5</b>	<b>97.8</b>	<b>61.8</b>	<b>(148.3)</b>	<b>(26.3)</b>

### S&P Global Ratings adjusted amounts

	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	3,352.4	4,137.0	1,260.5	831.8	220.8	957.7	1,121.7

## 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
- [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](#), December 27, 2014
- [Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers](#), December 16, 2014
- [Recovery Rating Criteria For Speculative-Grade Corporate Issuers](#), December 7, 2016
- [Methodology For National And Regional Scale Credit Ratings](#), June 25, 2018
- [S&P Global Ratings Definitions](#), October 31, 2018

## Ratings List

### Rating Details (As of 31-March-2019)

#### 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 13:40 31/03/2019

Time when the analyst first learned of the event 13:40 31/03/2019

Rating requested by Issuer

### **Credit Rating Surveillance**

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