Maalot
S&P Global Ratings

Oil Refineries Ltd.

March 17, 2021

Rating Affirmation

'ilA-' Rating Affirmed, 2021 Set To Be Challenging Despite Margin Improvement; Outlook Negative

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Rating Action Overview

- The coronavirus pandemic led to a decrease in refining margins that weighed in on Oil Refineries Ltd.’s (“Bazan”) financial results due to a decrease in demand for gasoline, gasoil and jet fuel. However, data from early 2021 indicate a recovery in refining margins.
- Polypropylene and Polyethylene margins, on the other hand, remained stable throughout the year, increased in Q4 2020 and even more in Q1 2021. This increase is mainly the result of increased demand for Polyethylene in the textile, hygiene and food packaging industries and in the Asian market, and decreased supply due to the shutdown of U.S. facilities, inter alia due to the winter storm.
- On March 17, 2021, we affirmed our ‘iilA-’ issuer rating on Oil Refineries Ltd. and our ‘ilA-’ issue rating on its unsecured bonds.
- The negative outlook reflects our assessment that, despite the Company’s large cash balances and business position in Israel, there is still some uncertainty regarding the pace of its return to pre-covid operation, and if refining margins and demand for traffic fuels do not improve in 2021, the Company’s financial ratios could deteriorate to a level that would entail another downgrade.

Rating Action Rationale

2020 was a challenging year for the Company and for the entire refining sector due to the outbreak of the coronavirus pandemic, and 2021 is also expected to be challenging. Brent oil prices were particularly volatile in the past year. They dropped in Q1 2020 as a result of a price war between Russia and Saudi Arabia and multiple lockdowns that led to a material decrease in traffic. In Q2 and Q3 they recovered due to the signing of an output cut agreement between OPEC countries. In Q4 they continued to increase, as demand grew following the approval of anti-covid vaccines and the easing of lockdown measures. In an article published on March 8, 2021, S&P Global Ratings estimated that OPEC would not allow Brent prices to remain above $70 per barrel for a long period, due to concerns regarding an increase in oil production by U.S. shale oil producers. We therefore assume that Brent prices in 2021 and 2022 will be $60 per barrel.

Oil price volatility and decreased demand for traffic fuels and for the Company’s distillates due to traffic limitations and social distancing measures in 2020 were reflected in a decrease in refining volumes in 2020. The Company's distilled crude oil and refined gasoil in 2020 was 8,705 tons and the utilization of its refining facilities was 80%, compared with 10,307 tons and 94%, respectively, in 2019.

In January and February 2021, when the Israeli economy was in lockdown, the Company's sales dropped by about 25% compared with the same period last year. Most of this drop was due to a drop of about 88% in jet fuel sales as a result of air traffic limitations, but gasoil and gasoline sales also dropped by about 11% and 24%, respectively, compared with the same period last year. In March 2021 sales are expected to decrease by about 5% compared with March 2020 due to the decrease in jet fuel sales, with no material change in gasoline and gasoil sales.

The polymer sector currently benefits from large polypropylene and polyethylene margins, inter alia as a result of the closing of U.S. factories in Q4 2020 due to the hurricane season, and increased demand in the far east. Polypropylene is used, during the pandemic, in the production of disposable masks and other protection products. Polyethylene is used in the food, medical equipment, textile and hygiene industries. On the other hand, in 2020 demand for propylene in the car industry decreased.

Bazan was proactive during the crisis, and took several actions in 2020 to mitigate the decrease in revenue. Among other things, Bazan increased its short-term credit facilities to $390 million and extended them until September 30, 2021; reduced investments and dividend distribution in a way which, according to the Company, would not jeopardize its operating capabilities and its compliance with environmental standards; pushed forward a ~$90 million refinancing for 2021 maturities and extended its debt's average duration by issuing a new bond series; signed a bridging agreement for the purchase of natural gas which is expected to save ~$35 million-$45 million, mostly in 2021; and implemented an early retirement plan costing about $23 million.

Outlook

The affirmation and maintenance of the negative outlook reflect the dependency of the Company's recovery on the pace of the market's recovery from the coronavirus crisis, as well as on 2021 refining margins. We expect the Company's average adjusted debt to EBITDA to be about 4.2x in 2021-2022.

Downside Scenario

We may take a negative rating action if the Company's adjusted debt to EBITDA ratio continuously exceeds 5x. This could happen if demand for traffic fuels remains unchanged from 2020, among other things due to a slower recovery than expected, leading to a decrease in the Company's operating revenues, or if refining margins do not improve from low 2020 levels.

Upside Scenario

We may change the outlook to positive if we estimate that the Company's adjusted debt to EBITDA will not continuously exceeds 5x. This could happen if markets and demand return, even partially, to their pre-crisis condition, or if the Company takes mitigating action such as cutting dividend distributions and investments. If we estimate that the Company's adjusted debt to EBITDA drops below 3.5x, we may increase the rating back to 'ilA'.

Company Description

Bazan operates in the refining and petrochemical markets, mainly through a single manufacturing facility in the Haifa Bay. It uses a combined manufacturing process such that some of the refining products are used in petrochemical production and some petrochemical products are used in the refinery. Prior to the coronavirus crisis, Refining activity generates about 55% of the Company's EBITDA and petrochemical activity generates the remainder. Due to low refining margins throughout the year, Bazan's refining sector EBITDA was negative in 2020.

Base Case Scenario

Our base case scenario is underpinned by the following assumptions:

- Brent crude oil price of $60 per barrel in 2021-2022, as per S&P Global Ratings assumptions.
- Refining margin of about $4.7-$6 per barrel in 2021-2022, according to different scenarios.
- Contribution of over $500 per ton from the petrochemical segment in 2021-2022.
- Utilization of about 85%-90% in the Company's refining facilities in 2021-2022 and utilization in the petrochemical facilities in line with the Company's historical performance.
- Maintenance of the Company's business position as the largest refining and petrochemical corporation in Israel.
- Investments of about $122 million in 2021 and about $150 million in 2022. The Company has flexibility in its investments.
- No dividend distribution in 2021-2022, due to the updated waiver for the syndication agreement signed on December 14, 2020 ("the Updated Waiver"), despite the Company's policy of distributing 75% of net income.
- Stable debt levels in 2021, to decrease starting 2022.

We forecast debt coverage ratios to be as follows:

Depending on different market conditions, adjusted debt to EBITDA that may exceed 4x-4.5x.

Liquidity

According to our criteria, the Company's liquidity is "adequate". We expect the ratio between the Company's sources and uses to be about 1.4x in the 12 months beginning January 1, 2021, in a scenario where refining margins are in line with the Company's historic average. In our stress scenario we also expect the Company's liquidity to remain "adequate" in the same period. The Company has short-term committed credit facilities of $390 million (of which $11 million are used), which we did not include in its resources since they expire less than a year from now, on September 30, 2021.

In our base-case scenario we estimate the Company's main sources in the 12 months starting January 1, 2021, to be as follows:

- Cash and liquid investments of about $814 million;
- Cash flow from operations of about $187 million.

Our assumptions regarding the Company's main uses for the same period are:

- Debt maturities of about $207 million;
- Negative working capital of about $385 million;
- Investments of about $122 million.

Covenant Analysis

The Company has several financial covenants, including minimum equity, minimum cash and cash equivalents and maximum debt to EBITDA, as per specific definitions in the Company's financing agreement. The Company is also required to maintain stand-alone cash and unused committed credit facilities, as defined in the Updated Waiver, of at least $250 million until December 31, 2021, and at least $75 million starting March 31, 2022. We understand the Company meets its financial covenants.

Recovery Analysis

Key analytical factors

- We are affirming our 'ilA-' issue rating, identical to the issuer rating, on Oil Refineries Ltd.'s unsecured bond series (Series E, F, I, J, L). The recovery rating for these series is '4', reflecting our assessment that in the hypothetical default scenario, the recovery rate would be 30%-50%.

Simulated default assumptions

- Simulated year of default: 2025
- A sharp decrease in oil prices, a drop in demand and a shutdown of some of the production facilities, alongside the need to refinance debt, will greatly decrease revenues and lead to a default.

- The company will continue operating as a going concern, an assessment supported by its importance as the supplier of about 60% of the demand for liquid fuels in the Israeli economy.
- In the hypothetical deterioration path, the Company will use most of its cash on hand.

Simplified Waterfall

- Gross enterprise value according to DAV method: about $612 million
- Administrative costs: 5%
- Enterprise value available for secured debt: about $582 million
- Secured debt: about 322 million
- Enterprise value available for unsecured debt: about $260 million
- Total unsecured debt: about $644 million
- Unsecured debt recovery expectation: 30%-50%
- Unsecured recovery rating (1 to 6): 4

All debt amounts include six months' prepetition interest.

Mapping Recovery Percentages To Recovery Ratings

Recovery expectations (%)	Description	Recovery rating	Notching above/below issuer rating
100%	Full recovery	1+	+3 notches
90%-100%	Very high recovery	1	+2 notches
70%-90%	Substantial recovery	2	+1 notch
50%-70%	Meaningful recovery	3	0 notches
30%-50%	Average recovery	4	0 notches
10%-30%	Modest recovery	5	-1 notch
0%-10%	Negligible recovery	6	-2 notches

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).

Modifiers

Diversification/portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management and governance: Neutral

Comparable ratings analysis: Negative

Related Criteria And Research

- Principles Of Credit Ratings, February 16, 2011
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, November 13, 2012
- Methodology: Industry Risk, November 19, 2013
- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Corporate Methodology, November 19, 2013
- Key Credit Factors For The Oil Refining And Marketing Industry, March 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
- Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Group Rating Methodology, July 1, 2019
- S&P Global Ratings Definitions, January 5, 2021

Ratings List

Oil Refineries Ltd.	Rating	Date when the rating was first published	Last date when the rating was updated
Issuer rating(s)			
Long term	ilA-/Negative	01/07/1995	31/03/2020
Issue rating(s)			
Senior Unsecured Debt			
Series E, F	ilA-	17/05/2015	31/03/2020
Series I	ilA-	09/04/2017	31/03/2020
Series J	ilA-	19/08/2019	31/03/2020
Series L	ilA-	01/09/2020	01/09/2020
Issuer Credit Rating history			
Long term			
March 31 ,2020	ilA-/Negative		
April 07, 2019	ilA/Stable		
April 03, 2018	ilA-/Positive		
April 09, 2017	ilA-/Stable		
May 31 ,2016	ilBBB+/Positive		
May 17 ,2015	ilBBB+/Stable		
January 01, 2015	ilBBB/Positive		
December 18, 2013	ilBBB/Stable		
October 14, 2013	ilBBB-/Watch Neg		
December 02, 2012	ilBBB+/Negative		
May 06 ,2012	ilBBB+/Stable		
November 30, 2011	ilA-/Watch Neg		
March 25 ,2010	ilA-/Stable		
July 07, 2009	ilA/Negative		
April 23, 2009	ilA\Watch Neg		
November 12, 2008	ilA/Negative		
November 11, 2007	ilAA/Stable		
March 16 ,2003	ilAA		
September 21, 1992	ilAAA		
Additional details			
Time of the event	17/03/2021 11:42		
Time when the event was learned of	17/03/2021 11:42		
Rating requested by	Issuer		

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