# CARMEL OLEFINS LTD.

## Rating Action, December 2008

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# Carmel Olefins Ltd.

| Series Rating (Issue) | A1 | Outlook: Stable |
|---|---|---|

**Midroog is downgrading its rating for the bonds series issued by Carmel Olefins Ltd. ("CAOL" or "the Company") from Aa2 with a negative outlook to A1 with a stable outlook. The downgrade is due to the fact that the Company did not meet the leverage targets set by Midroog in the initial rating. Among other things, this was due to weak financial results caused by sharp fluctuations in the prices of raw materials, combined with a rise in debt in 2007-2008 exceeding the forecasts. This debt was used to complete the implementation of the investments plan and to finance the acquisition of a company. Midroog believes that the economic slowdown in Israel and worldwide may have a negative impact on the volume of demands in the domestic market, which is oriented towards exports to the US and Europe, and drive sales prices down. It should nevertheless be noted that professionally knowledgeable sources forecast stable global demand for polymers in the coming years.[1]**

**The stable outlook is supported by Midroog's assessment of the existence of factors favoring an improvement in financial results, particularly the drop in oil prices, which is expected to improve the operating cash flow and coverage ratios in 2009. It should be noted, however, that Midroog has assumed that the opening margin trend will reach its lowest point in Q4/2008, owing to inventory prices that are still high compared to sale prices. Midroog believes that the Company will post an operating and net loss in this quarter.**

**Midroog believes that the Company's credit repayment capability is high, which is due first and foremost to its ability to generate a strong cash flow, as demonstrated in recent years. Midroog adds that the Company's status in the domestic market is dominant and stable. In addition, the Company has succeeded in channeling its increased production capacity over the past year into exports to nearby countries; it utilized about 90% of its production capacity in the third quarter of the year.**

**Oil Refineries Ltd. and Israel Petrochemical Enterprises Ltd. signed an agreement on June 24, 2008. Under this agreement, Oil Refineries will purchase 50% of CAOL's shares owned by Israel Petrochemical Enterprises; following implementation of the agreement, Oil Refineries will own 100% of the Company's shares, as opposed to its current 50% holding. This transaction has not yet been completed.**

[1] CMAI research company forecasts dated September 2008 stress that global demand for polymers will grow 2.9%-5.6% in 2008-2013,. The growth rates forecast by CMAI do not vary materially from those presented in the forecast of September 2007.

**Midroog maintains that a great degree of operational synergy exists between the respective business of Oil Refineries and CAOL, the full benefit of which will be felt after the two companies' operations are consolidated. At the same time, the impact of the merger on CAOL's results, taking into account raw material purchase prices and cost cutting, can be evaluated only when the process has been completed.**

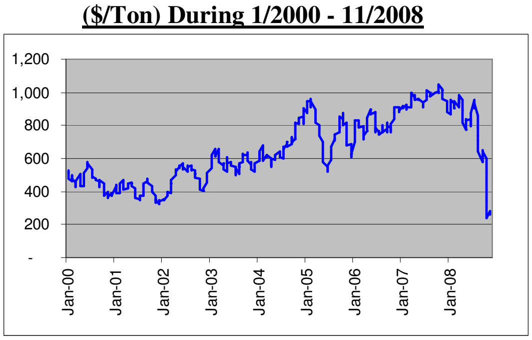
**The following bonds are included in the rating:**

| Bond Series | Issue Date | Coupon | Linkage | Balance as of Sept. 30, 2008 NIS M | Repayment Years | Principal Payment Frequency |
|---|---|---|---|---|---|---|
| Private placement for institutions | 3.2007 | 4.94% | CPI | 921 | 2013-2020 | Annual |

## Key Business Developments[2]

**The rise in oil prices continued to narrow the margin during the first three quarters of 2008, which had a negative impact on gross and operating profit. The fourth quarter is expected to more fully reflect the drop in inventory prices, with a negative effect on profit for the entire year.**

**Propylene price less naphtha price prevailing about two months earlier ($/Ton) During 1/2000 - 11/2008**




The rise in naphtha prices in recent years, particularly the surge that began in mid-2007, has narrowed the margin at which the Company operates, due to an objective difficulty in adjusting sale prices for polymers to higher raw material prices. Some of these difficulties are triggered by speculative demands in the global oil market. This is an inherent characteristic of the petrochemicals sector.[3]

[2] These are the key developments since the preceding rating was published in May 2008. This rating can be viewed on the www.midroog.co.il website. See also the initial rating from March 2007.
[3] For a more thorough discussion of the characteristics of this sector, see the initial rating report dated March 2007.

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Narrowing the margin resulted in a steep drop in profit in the first three quarters of the year, and led to an operating loss (although insignificant). The decline was also impacted by the weakening of the dollar against the shekel, thereby raising wage costs and other NIS-denominated fixed expenditures. On top of that, transportation costs spiked due to the high volume of the Company's exports in recent quarters owing to increased production capacity after launching operations at the new polypropylene facility. Prices of polymers sold by the Company began to fall in the fourth quarter of the year following the slide in prices of oil and derivatives. At the same time, since the Company purchases its feedstock at the market prices prevailing two months before the month of sale, margins in a falling market sink below the margins in current prices. The timing gap is expected to further worsen the financial results for the fourth quarter of the year. Company management estimates that the changes in the prices of feedstock occurring by the reported date could alter the value of inventory in the Company's balance sheet by $32 million, compared with its value as of September 30, 2008. The Company is taking measures to streamline expenditures, while at the same time it will incur large one-time costs in Q4/2008 and in 2009.

***As of Q3/2008, the Company has been working at about 90% production capacity, while substantially boosting export volumes, which typically contribute less to profitability due to the high shipping costs***

In July 2007 the Company launched operations at its new polypropylene production facility, built in 2004-2007 for a direct investment of $350 million. In late 2007, at the end of the initial operating period, the polypropylene facilities were working at 70%. The Company said that utilization of production capacity at its polypropylene plants was currently 85%, and that it was working to increase this. The polyethylene facility is operating at full capacity. Utilization of polypropylene production capacity at the facilities of Domo Polypropylene B.V. ("Domo")[4] has been over 90% since the date on which its financial results were first consolidated (in May 2008).

According to the Company's plan, raising production capacity has led to higher export sales, which accounted for about 60% of revenues in the first three quarters of 2008, up from 40% in 2007 and 25% in 2006. Most exports are to Turkey, which Company management says has surplus demand for the type of polypropylene that the Company manufactures. The acquisition of the Dutch company ,Domo, intended to serve as a marketing platform in Europe for the Company, constitutes potential for a further increase in sales to Europe.[5] At the same time, the profit margins on exports are lower than domestic market sales margins as the Company bears the shipping expenses. Domo's profit margins are also lower than those of the Company, because Domo's production facilities use purchased monomers rather than producing their

[4] The Company acquired a 49% stake in Domo in May 2008

[5] According to September 2008 forecasts by research company CMAI, the global demand for polymers is expected to grow by 2.9%-5.6% in 2008-2013. The growth rates forecast by CMAI do not vary materially from those presented in the forecast dated September 2007.

own, as CAOL does at its facilities in Israel.. Domo posted a 5.5% EBITDA in 2007 (compared with 14.8% for the Company), and 2.6% in the first nine months of 2008, due to the decline in margin.

**CAOL (Consolidated), Condensed Income Statement and Key Profitability Ratios***

**COL (Consolidated), Condensed Income Statement and Key Profitability Ratios***

| | 1-9/2008 | 1-9/2007 | 2007 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| | $M | | | NIS M | | | |
| | IFRS | | | Israeli GAAP | | | |
| Revenues | 766 | 466 | 685 | 2,800 | 1,986 | 2,139 | 1,653 |
| Gross profit | 40 | 67 | 97 | 386 | 226 | 423 | 302 |
| Selling & marketing expenses | 21 | 12 | 18 | 74 | 40 | 52 | 35 |
| G&A | 19 | 14 | 20 | 78 | 68 | 65 | 60 |
| Profit (loss) from ordinary operations | (1) | 42 | 59 | 234 | 117 | 306 | 208 |
| Other income** | 29 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net financing expenses | (22) | (28) | (49) | (74) | 16 | (31) | (4) |
| Pretax profit | 7 | 14 | 10 | 160 | 133 | 275 | 204 |
| Income tax (tax break) | (7) | (1) | (3) | 27 | 39 | 31 | 16 |
| Net profit for the period | 13 | 14 | 13 | 133 | 94 | 242 | 183 |
| | | | | | | | |
| Gross profit % | 5.2% | 14.5% | 14.2% | 13.8% | 11.4% | 11.4% | 19.8% |
| Selling and marketing % | 2.8% | 2.5% | 2.7% | 2.7% | 2.0% | 2.0% | 2.4% |
| G&A % | 2.5% | 3.0% | 2.9% | 2.8% | 3.4% | 3.4% | 3.0% |
| Profit from ordinary operations | -0.1% | 8.9% | 8.6% | 8.4% | 5.9% | 5.9% | 14.3% |
| EBITDA % | 5.0% | 15.5% | 14.8% | 14.8% | 10.1% | 18.2% | 17.1% |

* The Company adopted IFRS accounting standards on January 1, 2008, and consequently transitioned to reporting in the main operating currency – the US dollar.

** Other (non-cash flow) income resulting from negative goodwill from the acquisition of holdings in Domo was computed as the difference between Domo's total assets net of liabilities (about $79.5 million) and the total consideration for acquiring all the shares (about $50.5 million).

**CAOL (Consolidated), Key Cash Flows**

| | 1-9/2008 | 1-9/2007 | 2007 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| | $M | | | NIS M | | | |
| | IFRS | | | GAAP | | | |
| EBITDA | 38 | 72 | 101 | 415 | 201 | 389 | 283 |
| FFO | 28 | 59 | 74 | 293 | 199 | 274 | 200 |
| CFO | 68 | 18 | 74 | 320 | 155 | 145 | 159 |
| CAPEX | (25) | (69) | (77) | (345) | (1,083) | (529) | (127) |
| DIV | 0 | (26) | (26) | (110) | (85) | (126) | (233) |
| FCF | 43 | (78) | (29) | (135) | (1,013) | (510) | (201) |

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**CAOL (Consolidated), Key Working Capital Ratios**

| | 1-9/2008 | 1-9/2007 | 2007 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| | $M | | | NIS M | | | |
| | IFRS | | | Israeli GAAP | | | |
| Operating working capital*-to- revenues | 13% | 31% | 22% | 20% | 30% | 26% | 26% |
| Stock days | 65 | 64 | 58 | 55 | 48 | 42 | 40 |
| Customer credit days | 46 | 93 | 74 | 70 | 103 | 98 | 108 |
| Supplier credit days | 65 | 41 | 50 | 49 | 41 | 48 | 56 |

* Operating working capital includes accounts receivable (customers) plus inventory (stock) net of accounts payable (suppliers)

### *Rise in leverage despite the positive effect of the revaluation of fixed assets on shareholders' equity*

The Company's total assets grew 15% in the first nine months of 2008, due mostly to a quantitative increase in inventory that was financed through a rise in obligations to suppliers. This was coupled with an increase in liabilities in respect of the bond following the appreciation of the shekel, and offset by the registration of a financial asset for the fair value of the bond hedging transaction. It should be noted that , as of September 30, 2008, the Company had discounted $80 million in customers' debts. As this is a non-recourse discount, it does not appear in the balance sheet.

The growth in assets was not matched by a similar rate of increase in equity. The Company's equity-to-balance sheet total fell from 33% at the end of 2007 to 30% (according to the dollar-denominated balance sheet). It should be noted that the Company's equity includes influences totaling $150 million stemming mostly from a revaluation of assets, particularly fixed asset items (in Israel[6] and the Netherlands[7]), at fair value less the effect of the appreciation of the shekel against the dollar in 2007, on the value of fixed assets in the dollar-denominated balance sheet as of December 31, 2007. This total constituted 30% of equity as of September 30, 2008.

[6] As mentioned, the Company revaluated its assets in Israel at fair value, resulting in a NIS 601 million increase in fixed assets in its shekel -denominated financial statements as of January 1, 2007. Of this amount, NIS 458 million was attributed to equity (amounting to $108 million at the January 1, 2007 shekel-dollar exchange rate). The application of international financial reporting standards (IFRS), including a transition to reporting in dollars and denominating the December 31, 2007 balance sheet in dollars, led to a $58 million drop in equity, compared with total fixed assets in the shekel-denominated financial statements for the same date, at the shekel--dollar exchange rate for that date. The addition to equity, net of the effect of the shekel-dollar exchange rate, was $50 million as of December 31, 2007.

[7] In the wake of the Domo acquisition, the Company revalued the production facilities and intangible assets in the Netherlands at fair value. This caused a $60 million increase in consolidated assets (€39 million at a 1.5537 dollar-euro exchange rate). The valuation was conducted according to the cost method (for construction of identical production facilities on the assessment date). As of September 30, 2008, $44 million was attributed to surplus equity, after deducting tax.

The Company upped its debt significantly in 2006-2007, including through a bond issue, largely intended to finance the implementation of large-scale investments in production facilities in Israel. Most of the debt was taken in dollars or hedged against the dollar. Total debt as of September 30, 2008 amounted to $567 dollars, or $494 million, net of liquid balances and hedging assets. Net debt-to-CAP fell to 50%, down from 52% at the end of 2007.

**Sources & Uses Report for 2005-2008 in NIS Millions**

| | Total, Net 1/2005-9/2008 | Q3/08 | FY 07 | FY 06 | FY 05 |
|---|---|---|---|---|---|
| | NIS M | NIS M | | | |
| Cash flow from operating activity before working capital | 862 | 96 | 293 | 199 | 274 |
| Cash flow from changes in working capital items | - | 142 | 26 | - | - |
| Raising debt from bank, nets | 997 | | 0 | 1,016 | 543 |
| Bond issue | 850 | | 850 | | |
| Decrease in cash balances | - | 35 | | 3 | |
| **Total Resources** | 2,710 | 273 | 1,170 | 1,218 | 817 |
| Cash used for changes in working capital items | (4) | - | - | (43) | (129) |
| Investment in fixed assets and know-how | (2,164) | (84) | (433) | (1,090) | (556) |
| Acquisition of a subsidiary | (99) | (99) | | | |
| Dividend paid | (321) | | (110) | (85) | (126) |
| Debt repayment to banks | - | (68) | (493) | | |
| Increase in cash balances | (98) | | (131) | | (6) |
| Other | (23) | (22) | (3) | 0 | 0 |
| **Total Uses** | (2,710) | (273) | (1,170) | (1,218) | (817) |

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## CAOL (Consolidated), Leverage & Financial Strength Ratios

| | Sept. 08 | Sept. 07 | Dec. 07 | Dec. 07 | Dec. 06 | Dec. 05 | Dec. 04 |
|---|---|---|---|---|---|---|---|
| | $M | | | NIS M | | | |
| | IFRS | | | Israeli GAAP | | | |
| Short-term debt | 30 | 37 | 29 | 112 | 681 | 6 | 222 |
| Long-term debt | 536 | 493 | 494 | 1897 | 1020 | 761 | 0 |
| Total Debt | 567 | 530 | 523 | 2009 | 1701 | 766 | 222 |
| Liquid balances | 31 | 8 | 37 | 143 | 12 | 15 | 9 |
| Hedging assets | 41 | - | 3 | - | - | - | - |
| Net debt | 494 | 522 | 483 | 1866 | 1689 | 752 | 212 |
| Equity | 374 | 365 | 363 | 1619 | 1138 | 1129 | 1020 |
| Total balance sheet assets | 1245 | 1072 | 1083 | 4454 | 3327 | 2403 | 1739 |
| Deferred taxes | 82 | 78 | 76 | 358 | 186 | 169 | 202 |
| CAP | 1022 | 973 | 963 | 3986 | 3025 | 2065 | 1444 |
| Net CAP | 991 | 965 | 925 | 3843 | 3013 | 2050 | 1434 |
| Equity-to-balance sheet assets | 30.1% | 34.1% | 33.6% | 36.4% | 34.2% | 47.0% | 58.7% |
| Debt-to-CAP | 55.4% | 54.5% | 54.4% | 50.4% | 56.2% | 37.1% | 15.4% |
| Debt-to-total balance sheet assets | 45.5% | 49.4% | 48.3% | 45.1% | 51.1% | 31.9% | 12.7% |
| Net debt-to-net CAP | 49.9% | 54.1% | 52.2% | 48.6% | 56.1% | N.R. | N.R. |

## CAOL, Debt Coverage Ratios by Cash Flow

| | 1-9/2008 | 1-9/2007 | 2007 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| | IFRS | | | Israeli GAAP | | | |
| Debt-to-FFO | 15.4 | 6.8 | 7.1 | 6.8 | 8.6 | 2.8 | 1.1 |
| Debt-to-CFO | 6.2 | 22.2 | 7.0 | 6.3 | 10.9 | 5.3 | 1.4 |
| Debt-to-EBITDA | 11.2 | 5.5 | 5.2 | 4.8 | 8.5 | 2.0 | 0.8 |
| Net debt-to-FFO | 13.4 | 6.7 | 6.5 | 6.4 | 8.5 | 2.7 | 1.1 |
| Debt-to-CFO | 5.4 | 21.9 | 6.5 | 5.8 | 10.9 | 5.2 | 1.3 |
| Net debt-to-EBITDA | 9.7 | 5.4 | 4.8 | 4.5 | 8.4 | 1.9 | 0.8 |

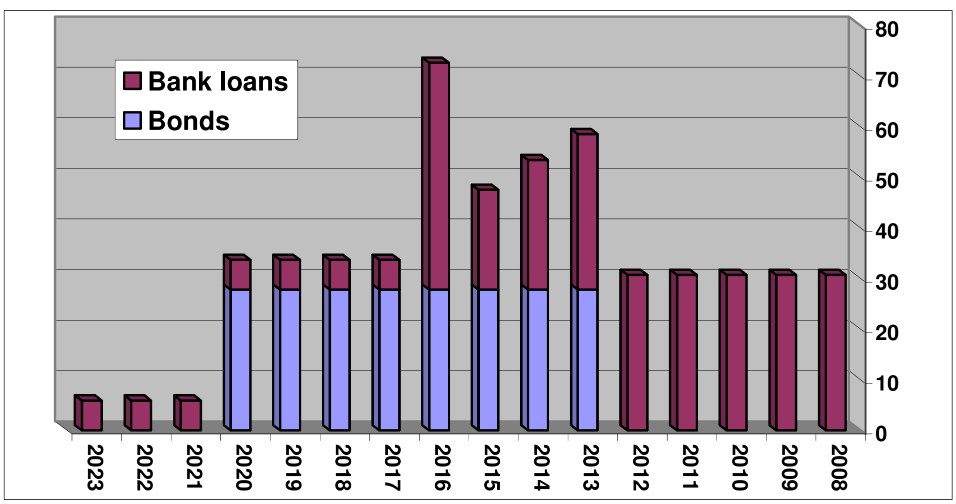
### *The Company has a relatively heavy repayment burden in 2013-2016. Midroog believes that the Company's cash flow capacity and financial flexibility are both high*

The repayment burden (principal) for both bank loans and bonds rise steeply, starting in 2013, when the bond repayments begin. Midroog believes that the Company's solvency is high, based mostly on cash flow generated from its business. Nevertheless, until now the Company has not kept substantial liquid balances, which is attributed, among other things, to the need for cash to finance its investment program.

In Midroog's estimation, the Company has so far demonstrated fairly good access to the banking system in Israel and overseas. This can be seen in the range of financiers, financing costs, and the size of its credit facilities. At the same time, lone borrower and borrowing group restrictions apply to the Company, since it belongs to the Israel Corporation Ltd. and Israel Petrochemical Enterprises Ltd. groups and the related companies of each of these groups. The Company says that this situation does not yet constitute an effective restriction on its ability to obtain credit.

The Company is committed to negative pledge. The Company also has made a series of financial undertakings to the banks and bondholders (which were revised in March 2008, following the adoption of the IFRS rules). As of September 30, 2008, the Company had fulfilled its undertakings.

**CAOL (Consolidated): Long-term Debt (Principal) Payments in 2008-2023, in $ Millions**



## Rating Outlook

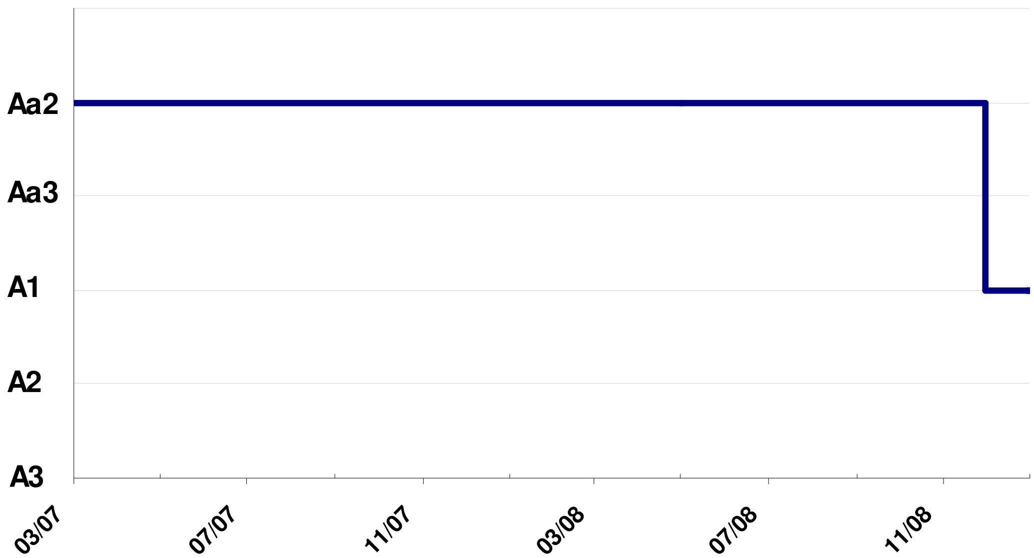
**Factors liable to upgrade the rating**

- A substantial and permanent drop in the Company's leverage ratios, accompanied by a large-scale and sustained improvement in debt coverage ratios

**Factors liable to downgrade the rating**

- If the net debt to EBITDA coverage ratio rises above 6.0 for three consecutive quarters. The net debt calculation uses the balance sheet debt, minus the liquid portfolio, minus/plus the fair value of the hedging transaction over the lifespan of the bonds. EBITDA is calculated according to the average profit from ordinary operations (before other income and expenditures) over the past four quarters, plus depreciation and amortization. Midroog will calculate this ratio, beginning with the results for the fourth quarter of 2009.
- A worsening in the evaluation of the Company's liquidity and financial flexibility with respect to the Company's ability to meet the debt payment requirements in the coming years.
- Distribution of a dividend that could undermine the Company's financial strength.
- Materialization of pending claims against the Company and/or future claims that could materially impair its financial soundness, cash flow and solvency, including claims associated with environmental protection issues.

## Rating History




## About the Company

Carmel Olefins Ltd. manufactures and markets polymers (low-density polyethylene and polypropylene). The process includes the use of feedstock (naphtha and LPG), from which monomers (ethylene and propylene) are initially produced, and culminating in polymers. The polymers are used as a principal raw material in the plastics industry. The Company expanded its polypropylene production capacity in July 2007 after launching operations at new facilities built in 2004-2007 at a direct investment of $350 million. The Company's complex of facilities in Israel,is connected by pipes and receives services from a centralized system arranged by Oil Refineries Ltd., the main supplier of feedstock to the Company. In the first nine months of 2008, exports accounted for 60% of sales, and the domestic market for the rest. Oil Refineries Ltd. and Israel Petrochemical Enterprises Ltd. own the Company privately in equal shares. After regulatory authorization is obtained, a transaction is expected to result in ownership of all the Company's shares by Oil Refineries Ltd

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## Basic Terms

| Term (Hebrew) | Term (English) | Definition |
|---|---|---|
| Net income | Net Income | Net income (less discounts) from Income Statement |
| Interest expenses | Interest | Financing expenses from income statement + financing expenses capitalized for fixed assets. |
| Cash flow financing expenses | Cash Interest | Financing expenses from income statement + financing expenses capitalized for fixed assets - linkage differences. |
| Operating profit | EBIT | Income – operating expenses +(-) non-recurring expenses (income) that can be isolated from the statements. |
| Operating profit before amortizations | EBITA | EBIT + amortizations |
| Operating profit before depreciation and amortizations | EBITDA | EBIT + depreciation + amortizations |
| Assets | Assets | Company's total balance sheet assets |
| Financial debt | Debt | Short term debt + current maturities of long-term loans + long-term debt + leasing liabilities |
| Net financial debt | Net Debt | Short-term debt + current maturities of long-term loans + long-term debt + leasing liabilities – cash and cash equivalents - short-term investments |
| CAP (Capital base) | Capitalization (CAP) | Debt + shareholders' equity + minority interests + preferred stock (at redemption value) + deferred taxes |
| Capital investments | Capital Expenditures (Capex) | Gross investments in equipment and machinery. |
| Gross Cash Flow | Gross Cash Flow (GCF) | Net profit + depreciation + amortizations + deferred taxes + minority interest + cash dividend from subsidiaries + non-cash flow non-recurring expenses - non-cash capital income |
| Cash Flow from Operations | Cash Flow from Operation (CFO) | Definition 1 – Cash flow from operating activity stated in the consolidated statement.<br>Definition 2 – Total cash flow of all operations except for investing and financing operations. |
| Funds from Operation | Funds from Operation (FFO) | Definition 1 – CFO before changes in working capital.<br>Definition 2 – Net profit stated in financial statements + income and expenditures not involving cash flow. |
| Retained Cash Flow | Retained Cash Flow (RCF) | Gross cash flow (GCF) - dividend. |
| Free Cash Flow | Free Cash Flow (FCF) | Retained cash flow (RCF) - increase (+ decrease) in working capital – investments in fixed assets. |

# Obligations Rating Scale

| | | |
|---|---|---|
| **Investment grade** | Aaa | Obligations rated Aaa are those, which in Midroog's judgment, are of the highest quality and involve minimal credit risk. |
| | Aa | Obligations rated Aa are those, which in Midroog's judgment, are of high quality and involve very low credit risk. |
| | A | Obligations rated A are considered by Midroog to be in the upper-end of the middle rating, and involve low credit risk. |
| | Baa | Obligations rated Baa are those, which in Midroog's judgment, involve moderate credit risk. They are considered medium grade obligations and could have certain speculative characteristics. |
| **Speculative Investment** | Ba | Obligations rated Ba are those, which in Midroog's judgment, are speculative and involve a high degree of credit risk. |
| | B | Obligations rated B are those which, in Midroog's judgment, are speculative and involve a high credit risk. |
| | Caa | Obligations rated Caa are those, which in Midroog's judgment, have weak standing and involve very high credit risk. |
| | Ca | Obligations rated Ca are very speculative investments and are likely in, or very near, default, with some prospect of recovery of principal and interest. |
| | C | Obligations rated C are assigned the lowest rating and are generally in a situation of insolvency with remote prospects of repayment of principal and interest. |

Midroog applies numerical modifiers 1, 2 and 3 in each of the rating categories from Aa to Caa. Modifier 1 indicates that the bond ranks in the higher end of the letter-rating category. Modifier 2 indicates that the bonds are at the higher end of the letter-rating category; and modifier 3 indicates that the bonds are in the lower end of the letter-rating category.

**Report No.: CHA041208000M**

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