Israel Electric Corp. Ltd.

Rating Action | October 2010

Authors:
Author:
Nir Turner, CPA, Analyst
nirt@midroog.co.il

Contacts:
Merav Ben Cnaan-Heler, CPA, VP and Head of Structured Project Finance
meravb@midroog.co.il

ISRAEL ELECTRIC CORPORATION LTD.

Issuer Rating	Aa2	Outlook: Negative
Issue Rating[1]	Aa2	Outlook: Negative

The State of Israel has a closed electricity economy. The Company is a monopoly in the electricity sector, both in market terms and in terms of infrastructure ownership. The Company has been designated an essential service provider in the economy.

The Company is owned by the Government of Israel and receives government support. Over the years, the Government of Israel has demonstrated reliability in backing the obligations of government companies. The government's support and the relationship between Israel Electric Corp. and the Government of Israel are key factors in the rating, since they reflect, among other things, the Company's strategic importance. The assignment of a negative outlook reflects the regulatory uncertainty surrounding the structural change in the Company, the disagreement over the electricity tariff, the Company's poor financial ratios and its low liquidity, which may result, among other things, in difficulties in raising capital and/or increased interest rates.

Midroog is assigning an Aa2/negative outlook to a total bond issue of up to NIS 4 billion with a duration of about 8 years. The issue proceeds will be used by Israel Electric Corp. (hereinafter: the "Company) to refinance a debt a and to finance the investments plan.

Condensed Financial Data of the Company, NIS Millions

	H1/10	H1/09	2009	2008	2007
Revenues	7,941	9,612	18,829	24,142	20,870
Income from operating the electricity system	616	1,817	3,942	**5,291**	**4,363**
Income (loss) from continuing operation	(41)	1,156	2,582	3,546	2,981
Financing expenses*	1,107	1,480	2,155	1,842	838
Net income (Loss)	(1,078)	(54)	1,246	770	823
FFO	**1,802**	**2,182**	**5,421**	3,324	**3,931**
EBITDA	**2,800**	**3,169**	**6,535**	**7,184**	**6,700**
Capex	**1,744**	**2,233**	**3,898**	**2,552**	**3,782**

[1] Up to an issuance limit of NIS 4 billion to be decided by the Company's board of directors.

	H1/10	H1/09	2009	2008	2007
Balance sheet total	79,124	81,621	80,049	81,235	77,606
Of which: Fixed assets, net	60,259	61,654	61,343	60,752	61,875
Of which: Underfunded pension assets, net	4,260	4,266	4,276	**4,103	**3,554
Of which: Cash and cash equivalents	4,345	3,848	3,911	3,670	492
Liabilities (current and non-current)	63,261	65,980	63,108	65,644	62,785
Of which: Financial debt***	46,315	50,464	46,842	50,540	47,372
Equity	15,863	15,641	16,941	15,591	14,821

Adjusted to the shekel of June 2010, except for data for 2007 and 2008 which are adjusted to shekel of December 2009.

* Not including capitalization of financing expenses and transfer to regulatory asset.

** After restatement.

***Including Government of Israel bonds and other liabilities.

Key Business Developments

In September, the board of directors approved the election of a new chairman of Israel Electric Corporation – Major General (res.) Yiftach Ron-Tal, who for the last three years served as chairman of the Israel Ports Company.

The Company's board of directors approved a special collective agreement regarding changing the pension update mechanism and the regulation of payments determined in the past as excessive salaries. The new agreement regulates the pension issue which for a long time was in dispute. The estimated actuary cost of implementing the agreement is approximately NIS 2.9 billion. The final signing of the agreement is expected to involve a onetime increment in operating expenses in the financial statements of about NIS 660 million.

Within the framework of the Budget Law, the government decided to bring Israel Electric into the communication infrastructure market (fiber optics). Talks are underway regarding the nature of the license (general or specific) that will be granted to the Company in imposing certain restrictions and conditions.

The Company ended the first and second quarters of 2010 with an operating loss, stemming from the slight drop in consumption in the first quarter of the year, both due to a reduction in electricity rates from February this year and the onetime write-off of assets. The Company forecasts a reversal in the revenues trend in 2011, and this year will end with growth of about 4% compared to 2009. The Company's forecasts are based on projections of future updates in the distribution and transmission rate bases as well as updates in the electricity generation rate base which was set in February of this year. These assumptions include a recognition of present and future assets and investments as well as actual operating costs which the Electricity Authority has still not recognized and non-imposition of the "penalties" mechanism determined by the Authority for a delay for putting units into operation.

Development of Financial Results

Financial ratios continue to point to low financial strength

The Company's leverage ratios and coverage ratios remain weak. Moreover, there has been a downturn in the Company's profitability ratios. The first half of the year ended with an operating loss and an after-tax loss, and this trend is expected for the end of the fiscal year. The Company's slow return to profitability will further erode its financial strength. It should be noted that the assumption of government support is a key factor in the rating.

Selected Financial Ratios:

	H1/10	**H1/09**	2009	2008	**2007**
Financing expenses*/ (Financing expenses + FFO)	2.63	2.47	3.52	2.8	5.69
Debt/FFO**	12.9	11.6	8.6	15.2	12.1
FFO/Capex	103.3%	97.7%	139.1%	130.3%	103.9%
Debt/Cap	70.4%	71%	69.2%	71.1%	70.8%
%EBIT Margin	Loss	12.03%	13.71%	14.69%	14.28%

*Not including capitalization of financing expenses and transfer to regulatory asset.

** The semi-annual ratios were annualized.

Analysis of Revenues:

	H1/10	**% Change***	**H1/09**	**Q2/10**	**Q2/09**	**Q1/10**	**Q1/09**	**2009**
Electricity sales (million kWh)	23,757	3.2%	23,026	12,445	11,575	11,312	11,451	48,947
Revenues from electricity sales, net (NIS millions)	7,881	(17%)	9,496	4,245	4,326	3,636	5,170	18,610
Average gross revenue per kWh (agorot)	37.02	(17.4%)	44.82	35.32	44.45	38.89	45.24	43.36
Average net revenue per kWh (agorot)	33.17	(19.6%)	41.24	34.11	37.37	32.14	45.14	38.02

*H1/10 compared to H1/09

Decline in revenues despite stability and a resumed uptrend in electricity sales

The Company's revenues declined by about NIS 1.6 billion, falling by 17.4%, compared to the same period in 2009 (first half of 2009). This decline is despite a rise in electricity sales of 731 million kWh, accounting for about 3.2% growth in consumption. The decrease is attributable to an average reduction of about 11.64% in the electricity tariff in February 2010. Disregarding the increase in consumption, the Company's revenues dropped by about NIS 1.9 billion. In the second quarter of the year, electricity sales rose by 7.52% compared to the same period in 2009, whereas a decrease of 1.21% was posted in the first quarter of the year compared to the same period in 2009. The decline of about 30% in the Company's revenues in the first quarter narrowed down to about 17% in the first half of the year, since revenues in the second quarter fell by only about 2%. The Company anticipates a trend of a narrower decline in revenues and higher consumption compared to the same periods in 2009. The Company expects to end the third quarter of 2010 with about 10% growth in consumption and about 23% growth in revenues compared to the same period in 2009, which will mean an annual increase in consumption of about 4% and a decrease in revenues of about 3%.

The sharp decline in revenues coupled by an increase in depreciation and amortization expenses, which was not fully set off by the drop in fuel prices, resulted in an operating loss

The cost of fuel, which accounts for nearly 50% of revenues, dropped by about NIS 1.137 billion in the first half of the year or by about 23.95% compared to the same period in 2009. The decrease is attributable to lower consumption and lower prices of coal, diesel oil and crude oil, which are more expensive than gas. The drop in fuel costs was partially set off by the increase in gas prices (about 35.5% compared to the same period in 2009).

The savings in fuel costs is neutralized by a provision of NIS 562 million[2] for part of the cost of operating the electrical power system, since the Electricity Authority does not recognize the actual costs of implementing investment projects by means of the tariff. This is in addition to a NIS 94 million increase in depreciation expenses compared to the same period in 2009.

The decrease in revenues coupled with an increase in depreciation and amortization expenses were not fully set off by the drop in fuel expense. This resulted in a NIS 1.201 billion decline in profit from operating the electricity system, compared with the same period in 2009, and an operating loss of NIS 41 million. It should be noted in this context that the assumption of government support is a key factor in the rating.

[2] The total provision for fixed assets put into operation. An additional provision for fixed assets not put into operation is estimated at NIS 0.7 - 1 billion.

MIDROOG

Analysis of revenues and expenses by segment:

	Electricity Generation			Transmission			Distribution		
	H1/10	H1/09	2009	H1/10	H1/09	2009	H1/10	H1/09	2009
Revenues	5,990	7,475	14,372	569	756	1,697	1,382	1,381	2,760
Income (loss) from continuing operation	(243)	761	1,635	(10)	190	540	212	205	407
Net Income (Loss)	(683)	126	888	(249)	(69)	247	(146)	(111)	111
EBITDA	1,361	1,727	3,631	407	599	1,367	764	752	1,506
% Total revenues	76%	78%	76%	7%	8%	9%	17%	14%	15%
% of contribution to EBITDA	54%	56%	56%	16%	19%	21%	30%	25%	23%
% EBITDA Margin	23%	23%	25%	72%	79%	81%	55%	54%	55%

The production segment is responsible for 75% of revenues and for about half of the EBITDA

In recent years, revenues from the electricity generation segment accounted for about 75% of the Company's revenue, while the EBIT from this segment is significantly lower than that of the distribution and transmission segments. Due to its large percentage of the Company's revenues mix, a decline in this segment has significant implications on the Company's financial results. In recent years, the contribution of the production segment to EBITDA is around 50%, and this is owing to the contribution to EBITDA of the transmission and distribution segments, which is higher than their proportion of revenues as they are more profitable segments.

Relying heavily on outside sources of financing and an increase in internal sources of financing are vital in order to meet the Company's extensive investments and development plan

The Company's extensive investments plan calls for massively relying on raising new credit (bonds, banking debt, supplier credit, etc.), recognition of investments to be reflected in the tariff and obtaining outside sources of financing, such as bringing in strategic private investors. At the same time, the development plan calls for an increase in the Company's internal sources of financing by raising revenues and decreasing the basket of fuels (continued transition to production using natural gas). Midroog believes there is a direct connection between Israel Electric Corporation and the State of Israel, especially in light of the Company's strategic importance and its being an essential service provider for the Israeli economy, and that the Government will give its support, if necessary.

Rating Outlook

Factors likely to upgrade the rating

- Strengthening of the Company's capital and debt structure.
- Regulatory stability in the sector, including in the structure of the electricity economy and following agreements with the workers union.
- Significant sustained improvement in the Company's financial results, including liquidity.
- Large-scale participation from outside financing sources in the Company's investments and development plan.

Factors likely to downgrade the rating

- Continuing significant erosion in the Company's financial results, including failure to maintain liquid balances at an adequate rating level relative to the expected scope of activity and repayment burden.
- Difficulties in raising capital and/or increased interest rates.
- Deterioration in government support of the Company, including with respect to recognition of the Company's expenses and investments in tariffs and structural change.
- Slow and incomplete assimilation of the new rate structure and of the rate structures which are expected to be published for the transmission and distribution segments.
- Difficulty in refinancing the existing debt.
- Failure to meet the Company's forecasts for obtaining additional sources of financing.

Obligations Rating Scale

Investment grade	Aaa	Obligations rated Aaa are those that, in Midroog's judgment, are of the highest quality and involve minimal credit risk.
	Aa	Obligations rated Aa are those that, 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 that, 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 that, in Midroog's judgment, contain speculative elements, and involve a significant degree of credit risk.
	B	Obligations rated B are those that, in Midroog's judgment, are speculative and involve a high credit risk.
	Caa	Obligations rated Caa are those that, in Midroog's judgment, have weak standing and involve a very high credit risk.
	Ca	Obligations rated Ca are very speculative investments, and are likely to be in, or very near to, a situation of insolvency, 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 poor 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 in the middle of the letter-rating category; and modifier 3 indicates that the bonds are in the lower end of the letter-rating category.

Report No: SF-10-10-09

Midroog Ltd.., Millennium 17 Ha'Arba'a Street, Tel-Aviv 64739
Tel: 03-6844700, Fax: 03-6855002, www.midroog.co.il

All the information contained herein on which Midroog relied was submitted to it by sources it believes to be reliable and accurate. Midroog does not independently check the correctness, completeness, compliance, accuracy or reliability of the information (hereinafter: the "information") submitted to it, and it relies on the information submitted to it by the rated Company for assigning the rating.

The rating is subject to change as a result of changes in the information obtained or for any other reason, and therefore it is recommended to monitor its revision or modification on Midroog's website www.midroog.co.il. The ratings assigned by Midroog express a subjective opinion, and they do not constitute a recommendation to buy or not to buy bonds or other rated instruments. The ratings should not be referred as endorsements of the accuracy of any of the data or opinions, or attempts to independently assess or vouch for the financial condition of any company. The ratings should not be construed as an opinion on the attractiveness of their price or the return of bonds or other rated instruments. Midroog's ratings relate directly only to credit risks and not to any other risk, such as the risk that the market value of the rated debt will drop due to changes in interest rates or due to other factors impacting the capital market. Any other rating or opinion given by Midroog must be considered as an individual element in any investment decision made by the user of the Information contained in this document or by someone on his behalf. Accordingly, any user of the information contained in this document must conduct his own investment feasibility study on the Issuer, guarantor, debenture or other rated document that he intends to hold, buy or sell. Midroog's ratings are not designed to meet the investment needs of any particular investor. The investor should always seek the assistance of a professional for advice on investments, the law, or other professional matters. Midroog hereby declares that the Issuers of bonds or of other rated instruments or in connection with the issue thereof the rating is being assigned, have undertaken, even prior to performing the rating, to render Midroog a payment for valuation and rating services provided by Midroog.

Midroog is a 51% subsidiary of Moody's. Midroog's rating process is entirely independent of Moody's and Midroog has its own policies, procedures and independent rating committee; however, its methodologies are based on those of Moody's. For more information on Midroog's rating process, please see the relevant pages of this website.