Osem Investments Ltd.

Monitoring Report | February 2015

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Osem Investments Ltd.

ISSUER RATING	Aaa	Outlook: **Stable**

Midroog reaffirms its Aaa/stable rating for the overall solvency/Issuer rating of Osem Investments Ltd.

Summary of Main Rationale

Osem is one of the leading food concerns in Israel, with revenues of approximately NIS 4.2 billion in the 12 months ending on September 30, 2014, approximately 85% of which stemmed from the domestic market. The Company's products span a range of food categories. Osem has a basket of strong brands, with the biggest or second-biggest market share in each category of activity. Management is focused, stable and conservative, and is buttressed by the Company belonging to the biggest food corporation in the world, Nestlé (63.68%). These characteristics are supportive of high profit restoration ability by the Company over time.

Over time, Osem has shown high internal growth capacity, beyond that of the Israeli food industry, which was characterized by moderate or even negative growth in the last year. However, we believe that growth this year will pose challenges for Osem, because of the drop in private consumption of food, a trend that began in 2014, and also the likelihood that competition by private labels will intensify. Over time, we project that Osem has the ability to present growth in the domestic market, based on innovative marketing and penetrating new categories of activity, and based on the development and marketing platform of Nestlé. In parallel, in recent years the Company has been expanding its international activity in meat substitutes, chilled salads and kosher food. The volume of that activity is not broad yet, constituting approximately 15% of total revenues.

The Company's senior status in the domestic food market is expressed in high, very stable gross profitability, which is also supported by extended processes of mechanization and efficiency in production processes, as well as use of Nestlé's international procurement system. On the other hand, we project that mounting competition over consumers creates pressure on sales prices and reduces pricing flexibility, including when prices of inputs are rising. The Law for Enhancement of Competition in the Israeli Food Sector ("the Food Law"), which is meant to boost competitiveness in the sector and lower food prices, came into force in January 2015. Its ramifications remain unclear, but we project that it does pose challenges for Osem at the level of marketing, and could also affect price flexibility. We are taking into account pressure on prices in the domestic market in 2015 because of the market conditions.

Osem's financial profile is strong and stable. The Company's leverage level remains low. Osem's financial positioning is the result of financial conservatism, business focus and low working capital needs. The Company financed its capital expenditures on fixed assets and on acquisitions in recent years, mainly by cash flow from operations. The Company has a steady dividend policy that is appropriate to its cash flow abilities, and which does not impair its financial flexibility.

The stable outlook is supported by expectations of stable profitability over time and sustaining a high ability to generate cash flow, and low leverage.

Osem Investments Ltd. (Consolidated) - Key Financial Data (NIS millions):

	1-9 2014	1-9 2013	FY 2013	FY 2012	FY 2011	FY 2010
Revenues	3,224	3,155	4,190	4,092	3,961	3,807
Operating profit	409	398	529	511	502	485
Net income	300	285	376	357	341	316
% change in revenues	2.2%	2.4%	2.4%	3.3%	4.0%	12.1%
Operating profit rate	12.7%	12.6%	12.6%	12.5%	12.7%	12.7%
Paid dividend	(150)	(150)	(150)	(150)	(300)	(150)
Liquidity balance	511	221	328	60	104	129
Debt	32	122	29	62	141	225
Other liabilities*	333	351	343	357	547	676
Equity to Total assets	63.0%	60.2%	61.9%	59.7%	53.3%	50.5%
Debt to EBITDAR**	1.0	1.1	1.0	1.1	1.5	1.8
Debt to FFOR**	1.2	1.5	1.3	1.4	1.8	2.2

* Conditional liability on the acquisition of 49% of Materna (consolidated company)

** Coverage ratios adjusted for other liabilities and operational leasing liabilities

Key Rating Rationale

Osem is a leading company in the Israeli food sector, with a broad, defensive basket of products and high internal growth, relative to the market

Osem is one of the three leading food companies in Israel, with domestic sales of approximately NIS 3.6 billion in the 12 months ending on September 30, 2014 (out of total sales of approximately NIS 4.2 billion for the period). Israel is the Company's main market, providing approximately 85% of sales. The Company has a diversified basket of products, spanning a wide range of product categories in the field of packaged food, but it does not operate in dairy and is a relatively small player in beverages. In recent years the Company

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expanded its activity in Israel, mainly by entering new categories (baby food, tea drinks). Osem has very strong brands in each of its categories, as demonstrated by very high market shares in each category (first or second place). Osem has a very strong reputation and a high perception of quality and reliability.

Over time, the Company has demonstrated highly innovative marketing, contributing to its ability to present internal growth, slightly beyond the market, despite its large market shares, by introducing new products, stretching existing ones and forging into new categories. Osem's innovative ability is based in large part on the R&D platform of the parent company Nestlé.

During the period January-September 2014, the Company's local sales grew by approximately 1.8%, following growth of approximately 4.0% in 2013. According to figures from the market research company StoreNext, monetary sales in Israel's food market contracted by 0.7% in 2014 after growing by 3.2% in 2013. The drop was attributed to a decrease in sales prices, which had risen in 2013, and also to a decrease in the consumption basket. We project that Osem's domestic sales growth in 2015 will be moderate, but better than the market. In the medium to long term, we project growth in the range of 1.5% to 3%.

In recent years, Osem has been focusing strategic effort on developing and expanding its international activity in product categories, where it has technological advantages, mainly ready meals, chilled salads and meat substitutes in the U.S. market, and meat substitutes in the European market. In the European market Osem has large, stable market shares, notably in the Netherlands (through Tivall), while in the American market it faces intense, challenging competition (through Tribe), mainly by Sabra Salads (in which the Strauss Group is also a partner). Overseas sales constituted approximately 15% of Osem's revenues in January-September 2014, about the same as in 2013, with overseas sales growth of approximately 4.4% (approximately 6.3% after adjustment for exchange rates). Most of the growth was achieved in the American market. We project that the U.S. market will remain a growth driver for Osem in the years to come, as together with management focus on it in the last year, the market will also benefit from trends of a shift to convenience products and fresh food products, with an emphasis on ethnic and Mediterranean tastes.

Osem - Revenues and operating profit by sector (before adjustments for consolidation, in NIS millions and percent):

	Sales			Change in sales, %		
	1-9/14	1-9/13	2013	1-9/14	1-9/13	2013
Culinary	727	705	956	3.1%	-	3.2%
Pastries, drinks, snacks and breakfast cereals	871	845	1,119	3.1%	-	2.3%
International	497	479	630	3.7%	-	(5.8)%
Baby food	261	256	359	1.9%	-	1.0%
Professional market, gift packages	309	299	412	3.5%	-	5.2%
Other*	593	604	760	(1.9)%	-	8.9%
	Sector profit			**Operating profit rate (%)**		
	1-9/14	1-9/13	2013	1-9/14	1-9/13	2013
Culinary	78	88	123	10.7%	12.5%	12.9%
Pastries, drinks, snacks and breakfast cereals	198	180	242	22.8%	21.3%	21.7%
International	42	40	52	8.4%	8.4%	8.3%
Baby food	39	43	62	15.1%	16.8%	17.3%
Professional market, gift packages	20	14	25	6.5%	4.8%	6.2%
Other	37	39	32	6.2%	6.5%	4.2%

* Includes, among other things, ice creams and pet food

Solid industry, featuring moderate growth and a trend of erosion in pricing flexibility

The food industry is characterized by steady demand relative to the economic cycle, with differentiation between the various product categories, mainly the distinction between premium and luxury products and basic food products. The local industry has a number of big local manufacturers, following accelerated processes of consolidation over the last few decades, as well as a great number of small manufacturers and importers. Entry barriers to the industry, mainly for imports, have been lowered in recent years. Competition is brisk but relatively stable. The main competition over shelf space is with importers and private labels owned by the big chains. The food manufacturers are exposed to intense volatility in prices of raw materials and production inputs, such as energy and the minimum wage.

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During 2014, monetary sales of the food industry in Israel decreased, due to a drop in pricing levels, following expansion of special deals for shoppers and due to not raising prices, as well as a decrease in the consumption basket. The drop in a large number of food commodities and appreciation of the shekel mitigated the negative effect on the manufacturers' margins. We assume the negative trend could continue in 2015. In general, we project that the strengthening of public discontent regarding prices of consumer products, food especially, constrained pricing flexibility at brand companies, Osem included. On top of that, the big marketing chains are focusing more on private labels as an anchor to distinguish the chain and lower the cost of the shopping basket, which creates another competitive pressure on the sales prices of the branded manufacturers. Industry regulation concentrates chiefly on removing import barriers and on anti-trust. In January 2015, the Food Law came into force, with the aim of lowering food prices, among other things, imposing restrictions on trade agreements between manufacturers and marketing chains, limiting shelf space allocated to big manufacturers, restricting shelf arrangement by the manufacturers and lowering import barriers, mainly for dairy. It is still early days to estimate how the law will affect the level of competition in the industry, but it clearly creates a degree of uncertainty and challenges for the manufacturers, including Osem, on the operational and marketing fronts. For the first nine months of 2014 Osem recorded provisioning of NIS 7.3 million for anticipated changes in the trading system as it prepared for the Food Law to come into force.

High, stable profitability relative to the domestic market

Gross profitability remained stable during the first nine months of 2014, at approximately 42% of total sales, on the backdrop of declining food commodity prices, notably sugar, soy beans and wheat, in the previous quarters. On the other hand, prices of coffee and sesame seeds rose. Also, the decrease in the average exchange rate during this period helped reduce procurement, in shekel terms. Osem runs significant marketing and sales expenses, which support its extensive distribution channels, its branded basket, and innovation. In recent years these costs ran at a steady 22% of revenues. Osem's strong brands bring added value to the Company and bolster high gross margins (41%-42% on average in recent years). The Company's leading status strengthens its ability to adjust its sales prices over time to increases in prices of inputs, keeping profit stable. The Company's profitability also stems from its ability to demonstrate improvement in operating efficiency over time, based on investment in new production lines, consolidation of manufacturing facilities, improving processes, and improving efficiency in procurement, data systems and logistics. These improvement processes at the Company are based, among other things, on collaboration with Nestlé and utilizing its knowledge and data systems. For example, Osem makes use of Nestlé's global procurement reserve.

Even so, we project that Osem, like its industry, is contending with a trend of rising consumer power, which threatens pricing flexibility on the backdrop of a long-term trend of rising input prices. We believe that in the short term, Osem will have difficulty adjusting its sales prices to increases in input prices, which could create pressure on profitability. In our opinion, the company has a number of tools at its disposal that can help it to cope with these trends better than its rivals in the industry: the power of its brand, which continues to strengthen; its high presence in basic food categories; and further operational efficiency.

Quick coverage ratios, supported by very low leverage and strong cash flows from current activity

The Company has a solid, stable financial structure reflected in large equity, constituting about 63% of its total assets, and extremely low direct debt. Alongside its equity, the Company is financed chiefly by vendor credit, which averages about 100 days and constitutes approximately 20% of its balance sheet assets. The Company has strong cash flow from operations, substantially outstripping its rates of current capital expenditures and dividend distribution, and which enabled the Company to scale back its debt in recent years. The company's rate of investment in fixed assets should increase in 2015, because of an increase in investments in production lines and automation, to improve productivity per worker. In 2012-2014 the Company distributed ILS 150 million in dividends each year, constituting 40% of net profit. After the balance sheet date, Osem declared an ILS 150 million dividend to be paid in March 2015. In calculating the debt coverage ratio, Midroog takes into account, beyond lease capitalization, Osem's liabilities on put options provided to Materna minority shareholders. The Company's debt to EBIDTAR as of September 30, 2014 was 1.0x and its debt to FFOR was 1.2x. We assess that the Company will continue to service its investment and dividend needs mainly from its own sources and therefore, do not foresee a significant increase in debt in the short to medium run, and project that the Company will sustain its present coverage ratios.

Rating Outlook

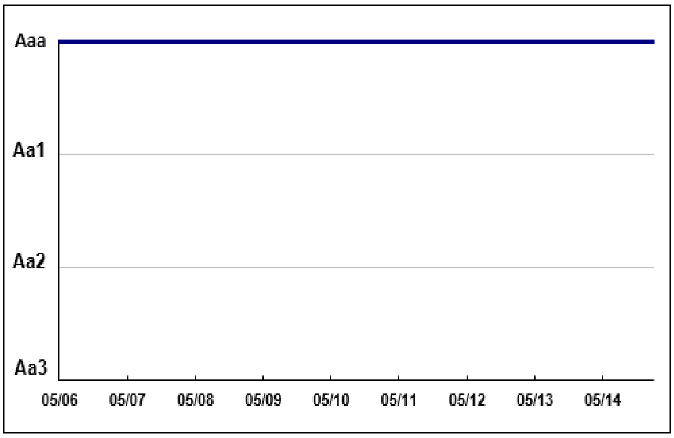
Factors that may lower the rating

- Increase in gross debt-to-EBITDAR over 1.5
- Significant impairment of the Company's goodwill and/or key brands

About the Company

Osem Investments Ltd., directly and in combination with a group of subsidiaries and investees, manufactures and markets food in Israel and overseas. It is one of the leading food concerns in Israel. The group manufactures over 2,000 different items at sites throughout Israel and abroad, which it markets through regional distribution centers. In November 2013 the Company's biggest shareholder, Nestlé SA (Nestlé), acquired most of the Osem shares that had been held by the Company's chairman, Mr. Dan Propper, increasing its stake to approximately 63.7% in share capital and voting rights. Nestlé is the biggest international food concern in the world. Among the group's main holdings are Migdanot Habait Ready Made Cakes Ltd. (100%), Tivall (1993) Ltd. (100%), partnership in Materna (51%), Sabra Salads Food Industries Ltd. (100%, via Tivall), and Beit Hashitah-Assis Food Industries Limited Partnership (100%). The Company's principal holdings overseas are: Tribe in the U.S., which manufactures and markets chilled Mediterranean salads and manufactures and markets chilled meat substitutes, marketed in the U.S. and Canada; also, the Company fully owns Osem USA and Osem UK, which market all the group's products in the U.S. and England. The CEO of Osem Group is Mr. Itzik Tzaig.

Rating History



Related Reports

Osem Investments Ltd. - Monitoring Report, March 2014 (Hebrew)

Methodology of Rating Industrial and Commercial Companies, October 2013 (Hebrew)

Methodology for Adjusting Financial Ratios to Leasing Liabilities, November 2011 (Hebrew)

The reports appear on the Midroog website at www.midroog.co.il

Date of Report: March 3, 2015

List of Basic Financial Terms:

Interest	Net financing expenses from Income Statement
Cash Flow Interest	Financing expenses from income statement after adjustments for non-cash flow expenditures from statement of cash flows
Operating profit (EBIT)	Profit before tax, financing and onetime expenses/profits
Operating profit before amortization (EBITA)	EBIT + amortization of intangible assets.
Operating profit before depreciation and amortization (EBITDA)	EBIT + depreciation + amortization of intangible assets.
Operating profit before depreciation, amortization and rent/leasing (EBITDAR)	EBIT + depreciation + amortization of intangible assets + rent + operational leasing.
Assets	Company's total balance sheet assets.
Debt	Short term debt + current maturities of long-term loans + long-term debt + liabilities on operational leasing
Net debt	Debt - cash and cash equivalent – long-term investments
Capitalization (CAP)	Debt + total shareholders' equity (including minority interest) + long-term deferred taxes in balance sheet
Capital investments Capital Expenditures (CAPEX)	Gross investments in equipment, machinery and intangible assets
Funds From Operations (FFO)*	Cash flow from operations before changes in working capital and before changes in other asset and liabilities
Cash Flow from Current Operations (CFO)*	Cash flow from operating activity according to consolidated cash flow statements
Disposable cash flow* Retained Cash Flow (RCF)	Funds from operations (FFO) less dividend paid to shareholders
Free Cash Flow (FCF)*	Cash flow from operating activity (CFO) - CAPEX - dividends

* It should be noted that in IFRS reports, interest payments and receipts, tax and dividends from investees will be included in the calculation of the operating cash flows, even if they are not entered in cash flow from operating activity.

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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. CIO010315000M

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