STANDARD &POOR'S Maalot

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Israel Corporation

Company rating downgraded and removed from CreditWatch

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Standard & Poor's Maalot (hereinafter '**S&P Maalot**') has lowered its rating to 'ilAA-/Negative' from 'ilAA/CW Negative', on the Israel Corporation's (hereinafter **'Israel Corp.**' or '**Company**') series 2-8 bonds.

The downgrade mostly reflects a rise in the Company's business risk following the downgrade of its subsidiary "Oil Refineries Ltd." (hereinafter '**ORL**') and our view that there has been a rise in the credit risk of its subsidiary Zim Shipping Services (hereinafter '**Zim**'). The Company is heavily dependent on the operations of its subsidiary Israel Chemicals (hereinafter '**ICL**'), a dependence which we believe will increase in light of our expectation for negative free operating cash flow[i] from ORL as a result of its Capex program, and a continuing operating deficit in Zim, together with the latter's aggressive investment plans.

Despite our expectations that ICL's financial results will worsen compared with 2008, following a trend of falling prices and lower demand for potash and phosphates together with falling demand for bromide products, we believe that the long term trends in the potash market remain positive and that ICL's financial performance will be good in an historical perspective.

The negative outlook reflects the uncertainty concerning Zim's financial needs in the next two years and the probability, in our opinion, that the Israel Corporation will support Zim with significantly higher sums than it has announced, based on S&P Maalot's belief that Zim is a strategic holding for the Israel Corporation.

[i] Operating cash flow less capital expenditures.

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Rating Methodology – How we view holding companies

General

We differentiate between three categories of holding companies.

For companies classified as "**operating holding companies**", the core holdings are operating companies in which the company has control. An operating holding company has significant influence on the management and business strategy of the held companies, though its investments are managed as independent operating units which it regards as long-term strategic investments. An operating holding company focuses on the creation of cash flows in its subsidiaries and feeds on dividend income. Accordingly, an operating holding company is exposed to the entire business operations of each company in its portfolio, and not just to fluctuations in share prices. Most companies in this category also hold low ownership stakes in a range of companies, where they see potential for future disposal and capital gains, though these are not part of the group's strategic holdings. This investment portfolio usually includes listed companies and contributes to the company's financial flexibility, allowing it to reduce its level of solo debt through the relatively quick sale of shares and use of proceeds for immediate needs. We should note that even in the absence of a liquid investment portfolio, the fact that the operating holding company holds (listed) shares as its principal assets grants it greater financial flexibility than an operating company.

As with operating holding companies, holding companies designated as "**conglomerates**" are also fed by dividends, and their involvement in their subsidiaries' management is deeper, even reaching operational matters. Conglomerates generally hold very high stakes in their subsidiaries, and in many cases, have full ownership. Conglomerates are highly identified with their subsidiaries, which is also often expressed in the names given to the subsidiaries. Conglomerates do not generate shareholder value through selling and buying of shares, neither in the short or medium term, and they usually do not hold a liquid investment portfolio. The conglomerate in practice functions as an operating group. As with most operating holding companies, conglomerates usually draw generous dividends from their major subsidiaries, but also support them through capital injections.

The third category is that of a "**pure investment company**". These companies focus on generating value by buying and selling shares with no involvement in the management or strategy of the held companies. A pure investment company holds minority stakes, frequently changing the composition of its portfolio, and is not closely identified with any of its holdings.

We can learn from the above that operating holding companies are hybrids, a cross between a conglomerate and a pure investment company. Consequently, each company that operates through subsidiaries has unique features that require a rating approach which is consistent with managements' view of its holdings, its managerial involvement in subsidiaries, its "willingness to sell" in the short or medium term, and its model for generating value (capital gains from the sale of shares as opposed to investing and drawing dividends in the long term).

Analytic approach

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The closer a company is to the conglomerate model, the more our analysis will focus on the company's consolidated financial statements. The closer the company is to the operating holding company model, the more we examine the unconsolidated statements, with particular attention to the company's financial flexibility ("**portfolio approach**").

Evaluating business risk

Business risk is assessed based on the business and financial aspects of each major subsidiary. For conglomerates, we conduct a weighted average of the business risk of each holding (or segment of its activity), while for operating holding companies and pure investment companies, using the portfolio method, we conduct a weighted average of the total stand-alone creditworthiness of each significant company in the portfolio. In addition, we examine portfolio features to include portfolio size; number of principal holdings; business diversity; geographic diversity; marketability of the held company; volatility of share prices; synergies between holdings; level of control in major holdings and dividend potential from held companies.

Evaluating financial risk

As mentioned above, the more the company in question resembles a conglomerate, the more we look at consolidated financial statements. In contrast, in the portfolio approach, the central parameter is the financial leverage of the holding company as expressed by the ratio of total net debt (solo) to portfolio value, and the debt service coverage ratio as expressed by the ratio of dividends and management fees received to financial expenses, SG&A and dividends paid to shareholders. As the stock market is by definition volatile, declines in the capital markets could harm the leverage ratio of some operating holding companies. Therefore, companies that do not act in time to reduce debt through the selling of shares risk a downgrade when the markets are consistently difficult, particularly (though not only) if these companies suffer at the same time from a deterioration in other parameters such as: their ability to support debt through drawing dividends; continued erosion in the operating performance of subsidiaries; and a rise in the credit risk of companies in the portfolio.

The Israel Corporation

Given the Israel Corporation's characteristics, S&P Maalot classifies it as an operating holding company, although the group has a conglomerate-like orientation. We have therefore used a dual approach in our analysis, with the business risk assessment based on the portfolio method, i.e. on the total credit risk of all held companies and on criteria that examine the diversity and liquidity of the portfolio. Our financial risk assessment relies principally on the portfolio approach with an eye towards the group's consolidated financial statements. Our analysis of the consolidated statements stems from the need to obtain a picture of the general cash flow situation, especially if leverage, as measured by the portfolio method, rises or falls (for

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example, due to sharp fluctuations in the stock market), with no coinciding trend in the group's ability to generate cash flows.

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Rating Rationale

Strengths:

- Strong financial profile stressing good liquidity, and high financial flexibility (as reflected in ratio of net debt to portfolio value)
- Strong business profile in the chemicals field, including good geographic spread in sales and production sites
- Potential for drawing significant dividends from ICL, which is highly rated and has relatively low financial leverage
- Flat debt payment schedule with long duration
- Control of major subsidiaries, and as a result, control of dividend flow.

Weaknesses:

- Operates in the highly cyclical sectors of refining, shipping and chemicals with volatile profit margins and cash flows (in particular shipping)
- Very high dependence on ICL, both due to its relative value in the portfolio and because of its overwhelming share of dividend contribution, thus limiting diversity of portfolio. Increasing exposure to ICL's operating performance in order to support the Company's other holdings
- The strategic subsidiary Zim reports operating losses and difficulties in financing that could use up more Company resources than planned
- Limited portfolio liquidity due to ICL's dominance and our belief that the Company's willingness to sell ICL shares is low.

The downgrade of Israel Corporation's rating reflects the rise in the credit risk of the Company's portfolio, as expressed in the downgrade of its ORL subsidiary as announced by S&P Maalot on Nov. 12, 2008, when it announced that the rating was revised to A/Negative from AA/Stable. Also the rise in portfolio risk is greatly affected by our belief that the negative trend in the subsidiary Zim will continue, in both its business and financial profile. The decrease in the credit quality of Israel Corporation's portfolio worsens the Company's business risk and we believe Zim's needs could be significant in the future, which will weigh heavily on Israel Corporation.

In our opinion, the deteriorating trend in Zim's business environment continued in recent months and we do not see signs of significant recovery. This will have negative implications on Zim's expected operating results for 2009, so we estimate that Zim will continue to report operating losses in 2009 and even negative EBITDA. In response to the market environment, Zim has begun taking comprehensive steps vis-à-vis its suppliers, financiers and ports, and has begun an efficiency drive, cutting operating expenses, in order to minimize the impact on its financial results. The difficult conditions in the shipping market are characterized by the trend of sharply falling haulage fees, low occupancy of shipping fleet and an expectation of excess supply, particularly on the Europe-Asia lanes, all of this while the financial markets have worsened significantly. Despite Zim's cost-cutting measures, together with an investment plan which it is currently attempting to rein in, we expect a worsening in Zim's financial profile (further negative operating cash flow) in the short term.

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ORL mainly operates in the refining of oil and its derivatives for the Israeli market and the petrochemical and plastic industries. ORL's rating downgrade in November 2008 reflected the rise in the company's financial risk in light of the forecast drop in profit margins in the refining and petrochemical industries, at a time when the company is about to implement an aggressive investment program and the macroeconomic environment is both uncertain and highly volatile. We believe that in the coming years, ORL will report a worsening in its debt coverage ratio compared with other rated Israeli industrial companies and compared with similar oil refineries rated by S&P. The decline in ORL's financial profile places ORL as particularly vulnerable to the challenges detailed above.

The negative developments detailed above intensify Israel Corporation's dependence on ICL and raise the Company's exposure to the latter's operating performance, which harms the level of diversity of the Company's portfolio. In the period January-September 2008, ICL accounted for about 90% of Israel Corporation's consolidated EBITDA, compared with a contribution of 62% in the same period of 2007[ii]. ICL (rated ilAA+/Stable) enjoys one of the highest business and financial profiles among industrial companies rated by S&P Maalot, though it operates in a cyclical industry which often causes sharp fluctuations in cash flow generation. We believe that ICL is going through an uncertain period regarding its future profitability. However, as a central part of the group, ICL enjoys low financial leverage and proven, strong cash flow capabilities, which we believe could support its activities, its debt servicing needs, the Israel Corporation's needs, and the needs of the group's weaker components, in the near future.

The Israel Corporation has good financial flexibility as its major assets are listed shares, of which about 70% are unpledged. About 80% of total portfolio is listed for trade, though ICL, which is the most highly traded share on the stock exchange, constitutes about 75% of this – a fact which greatly increases the concentration of the investment portfolio. Furthermore, we believe that the Company's willingness to sell ICL shares, in order to maintain its modest leverage level, is in doubt, which harms the portfolio's (actual) level of liquidity.

The Company has relatively low business diversity compared with other leading Israel holding companies. The group's major business activity ranges across chemicals, energy and shipping, but these three major sectors are highly correlated, linked to commodity prices and global macroeconomic activity. Also, the level of diversity is limited given the dominance of ICL in the portfolio.

As of the time of this report, the Israel Corporation has stand-alone (gross) debt of about $2.2 billion and portfolio value[iii] of about $7.4 billion. Deducting cash balances, the Company today has a ratio of net debt to portfolio value of about 24%. We believe that given the Company's rating, this leverage ratio is very good, and if it is maintained, will testify to a relatively high ability to refinance its existing financial debt. To maintain its current rating, and given our current estimate of business parameters including investment portfolio characteristics, we believe that the current rating is consistent with a ratio of net debt to portfolio of up to 35%.

We expect the Company's consolidated financial statements for 2008 to show an (adjusted[iv]) ratio of debt to EBITDA of between 2.6x and 3.0x and an (adjusted) FFO to debt of 30% to 35%. These ratios are better

[ii] ORL data consolidated in the second half of 2007 was taken pro forma for needs of comparison.
[iii] Public companies according to market value and private companies according to book value.
[iv] The group's financial debt, plus adjustments to the debt by S&P Maalot, including capitalization of leasing contracts and additions for liabilities to workers.

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than our current estimate of financial risk. However, we believe that these ratios will deteriorate in 2009 as a result of a worsening in the operating performance of some of the portfolio companies. We consider an (adjusted) debt to EBITDA of up to 5.0x and (adjusted) FFO to debt of no less than 15% as consistent with our current estimate of Israel Corporation's financial risk, and consistent with the Company's general rating.

Liquidity

The Israel Corporation's liquidity is measured at the holding company level and is very good. As of the end of 2008, the Company had cash of about $455 million and a flat payment schedule for the next two years (total payments of about $300 million). Given its liquid balances, potential dividend payments from ICL, its proven ability to refinance debt in the banking system and its cash-flow needs (SG&A, interest expense and principal maturities) we do not expect liquidity problems for the Company.

About 35% of the Company's financial debt is bank debt. Israel Corporation has two major financial covenants and the company is currently comfortably in line with those covenants.

Outlook Negative

The negative outlook mainly reflects the high level of uncertainty regarding Zim's financial needs and its business environment in the coming two years. Our outlook also reflects our belief that there is a high probability, despite the Company's announcement, that it will support Zim with larger amounts than currently planned ($150 million in 2009). On the chemicals side, which forms the backbone of Israel Corporation, there is some obscurity concerning the amount of potash to be sold and the prices to be agreed in major supply contracts between Russian manufacturers and Chinese importers. However, most market indicators point to reasonable parameters and we are less concerned about this issue.

We could change the outlook to stable after a conclusion to negotiations between Zim, the shipbuilders and the banks, at which time we will have a clearer picture as to Zim's expected deficit in 2009 and 2010. At this stage, the outcome could change to stable if we are convinced that the amounts likely to be demanded from the Israel Corporation will not surpass our internal assumptions. Removing the negative outlook is also dependent on obtaining firmer indications for potash prices in 2009.

The Company's rating could be lowered if Zim's current plan of action does not succeed in halting further significant deterioration in its business. The rating could also come under negative pressure if it turns out that ICL's ability to generate cash flow is more sharply affected than our expectations, putting ICL's ability to distribute dividends, which could support the needs of both the Israel Corporation and its held companies, in doubt. Negative developments for ICL have the potential to affect Israel Corporation's solo leverage and to cause financial parameters – both solo and consolidated – to deviate from our expectations as detailed in the rationale above.

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