Maalot
S&P Global Ratings

S. Shlomo Holdings Ltd.
S. Shlomo Vehicle Ltd.

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Research Update

Rating on S. Shlomo Vehicle Ltd. Raised To 'ilAA-' On Improvement In Operating Performance And Decrease In Leverage; Outlook Stable

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Rating Action Overview

- The credit ratings within this article were assigned by deviating from S&P Global Ratings' published Criteria., as described in the Methodology section.
- S. Shlomo Vehicle's ("the Company" or "Shlomo Vehicle") operating performance, as reflected by its EBIT for 2020 and in our forecast for 2021, reflects a material improvement compared with our expectations. We therefore estimate that the multi-year weighted average of EBIT interest coverage will improve to approximately 4.3x from 1.8x last year. This material improvement is due to the increase in the Company's revenues and the pricing of leasing contracts, alongside streamlining processes in vehicle fleet management, which were reflected in higher profitability from the leasing and vehicle sale activities.
- The improvement in operating performance and the increase in equity, alongside the improvement in cash flow generation from the Company's current operations, supported the reduction in Shlomo Vehicle's multi-year weighted average of debt to debt and equity to below 75%.
- We therefore raise Shlomo Vehicle's issuer rating to 'ilAA-' from 'ilA+', and the rating on its secured bonds to 'ilAA' from 'ilAA-'.
- The stable outlook reflects our assessment of Shlomo Vehicle's reduced leverage and improved financial flexibility, as we measure them, which will continue to support the current rating in the next 12 months. We believe that the Company's leading market position and its high operating efficiency supports its ability to maintain the improvement in its operating performance and profitability.

Rating Action Rationale

We are raising our ratings on Shlomo Vehicle due to improved financial flexibility and reduced leverage as measured by EBIT interest coverage and by debt to debt and equity. The Company posted significant improvement in operating income in 2020, with its EBIT amounting to NIS 268 million compared with NIS 152 million at year-end 2019, despite the covid-19 outbreak and the challenging market conditions the company had to deal with. The Company's EBIT margin improved to 10% from about 6% in 2019, and is higher compared with most of its local peers which posted an average of 7.7% in 2020 compared with about 6.4% in 2019. As a result, the Company's EBIT interest coverage improved in 2020 to 5.3x compared with about 1.9x in 2019, and is higher than local peers with an average coverage ratio of about 2.2x in 2020.

In our view, most of the improvement in Shlomo Vehicle's performance is due to a process that lasted several years and included an improvement in the pricing of business leasing contracts and fleet structure optimization, and increasing focus on private leasing while taking advantage of its market position and size compared with local peers, in order to increase its market share in this segment. Shlomo Vehicle increased the efficiency of its fleet management as reflected by the gradual improvement in fleet utilization rates to over 90% in 2020. The improvement in utilization rates began to materialize in 2018-2019 when these were higher than 90%, and increased even more in 2020 due to one-time effects of the high demand for used vehicles. The process carried out by the company, a change in the fleet structure and the improvement in the pricing of business and private leasing contracts, are reflected in the car sales operations in general and in capital gains from the used car sales in particular. It is worth noting that the Company's operating income in 2020 was positively affected by a one-time decrease in expenses, mainly due to a decrease in the fleet's maintenance costs, a decrease in accident damages and the fact that some employees were on furlough.

The increase in demand for used vehicles in 2020 and the shortage of new vehicles due to disruptions in the global supply chain due to the covid-19 pandemic persist in 2021. This comes after a period of stabilization in used car prices in recent years, supported by the increase in new vehicle prices and by high demand for vehicles in Israel, a trend that we believe will persist in the next 12 months. Moreover, it is worth noting that in recent years the demand for purchasing used vehicles from operating leasing companies has gradually increased, and their share of total sales in the industry has consequently risen to 54% of “first-hand” car ownership transfers in 2020 compared with 46% in 2014.

We believe that the lack of effective substitutes for the use of private vehicles in Israel will support the demand for new and used vehicles and consequently for business and private leasing services. Our assessment is mainly based on the low efficiency of public transportation in Israel and the significant investment required over time in order to bring about a significant improvement in this aspect. However, we estimate that the unusually high demand for used vehicles is expected to subside towards 2022 as the functioning of the global supply chain for new vehicles returns to pre-crisis levels. We therefore anticipate that capital gains from the used car sales will decrease in 2022 compared with their level in 2020-2021, but remain high relative to their level before 2019, mainly due to better leasing contract pricing. Therefore, we expect Shlomo Vehicle’s high profitability will remain stable in the next 12 months.

In our base case scenario we assume that Shlomo Vehicle's fleet will grow in 2021. The business leasing fleet is expected to grow against the background of the economic recovery in 2021, reflected in an increase in GDP and private consumption, alongside a decrease in the overall unemployment rate in the economy. Winning a tender for the Ministry of Defense also supports the increase in the fleet and revenues. We assume that the growth in the private leasing fleet is expected to be higher than the increase in the business fleet, as it is a young market with high growth potential compared with the traditional leasing market. In our assessment we take into account that the demand for traditional business leasing services may decrease in some sectors in the next two years, due to the transition to a hybrid working model. Nevertheless, we believe that in case of a decrease in business leasing renewals, the Company can reassign its vehicle fleet to its "private operational leasing" product which is part of its private leasing operation and has been growing quickly in the last two years.

We expect an increase of approximately NIS 400 million in Shlomo Vehicle's total financial debt, which is consistent with our assessment of the expected increase in the Company's fleet. We expect interest expenses to increase in 2021 following the increase in average debt and the inflation rate. At the same time, we expect the improvement in the Company's profitability to persist, so that EBIT interest coverage will be at least 4.7x in 2021, higher than the weighted multi-year average of 4.3x (which includes 2019 and 2020 and our estimate for 2021-2022) . Our assessment is supported, among other things, by the Company's performance in the first quarter of 2021, which reflects continued improvement in profitability. In our base case scenario we assume that Shlomo Vehicle will maintain an EBIT interest coverage ratio above 3.5x and a debt to debt and equity ratio of less than 75% in the next 12 months.

Liquidity

Similarly to its local peers, we assess Shlomo Vehicle's liquidity as as a negative rating factor, mainly due to material reliance on external sources to meet its liquidity needs. However, we believe that Shlomo Vehicle's good relationship with the banking system and its access to the capital market, even in challenging economic conditions, support the Company's debt refinancing capacity and its liquidity needs. According to our operating leasing criteria, we consider secured debt (collateralized by vehicles from the Company's fleet) issuances as liquidity sources for vehicles purchases in challenging market conditions. However, we assume that the financing will be received at lower LTV (loan to value) rates compared with the Company's average borrowings.

Contrary to its high on balance sheet cash balance in economic downturn, the Company tends, like its local peers, to keep a low cash balance on its balance sheet in normal business conditions.

According to our liquidity assessment for Shlomo Vehicle, the Company’s ratio of sources to uses is expected to be about 0.74x in the 12 months starting April 1, 2021.

We estimate the main sources at the Company’s disposal in the 12 months starting April 1, 2021, to be:

- NIS 149 million in cash
- Bond issuance and/or new loans secured by liens on vehicles from the Company’s fleet, totaling NIS 598 million
- FFO (funds from operations) of about NIS 832 million

Our assumptions regarding the Company’s main uses are:

- Net capital expenditures amounting to about NIS 1.05 billion, for the purpose of purchasing new vehicles
- Debt repayment and bank credit repayment in the amount of NIS 1.015 billion
- Dividend distribution of about NIS 80 million

Our assessment regarding debt maturities considers possible repayment of all short-term debt. We believe that Shlomo Vehicle will bridge the liquidity gap by issuing bonds or taking out bank loans not considered as sources according to our liquidity assessment. It is important to note that the capital expenditures for the purchase of new vehicles are not contractually binding throughout the period and depend on the Company's ability to obtain stable financing for this purpose.

Beyond the Company's existing debt refinancing capacity, its leasing fleet includes approximately 10,000 vehicles that are not encumbered by financing entities as of December 31, 2020. In our assessment, since year-end 2020, the number of unencumbered vehicles that are available to the Company for additional financing when needed in the next 12 months has increased.

Methodology

The leasing industry, in which some financing services companies such as Shlomo Vehicle and its local peers operate, is a capital-intensive industry (high depreciation and amortization). This limits the usefulness of EBITDA- and FFO-based profitability, leverage and cash flow metrics, which are both core ratios applied in our Corporate Methodology. We therefore apply in our rating process the criteria parameters of profitability, leverage, cash flow, capital structure, financial policy and liquidity provided in our criteria for the operating leasing industry, by way of an exception. We analyze profitability based on EBIT and EBIT margin and financial risk profile based on leverage and cash flow metrics such as EBIT interest coverage and debt to debt and equity. These are different metrics than the ones set for financial services companies in our Corporate Methodology, and better reflect the risk of leasing companies by avoiding the distortion created by the high depreciation expense. However, we do not apply our operating leasing criteria in its entirety because there remain sufficient differences between financial services companies operating in the leasing industry and companies that are in-scope for our operating leasing criteria. These differences warrant additional consideration, such as the nature of the overall activity and operating environment of the entity, industry risk evaluated on a global level and residual value risks. It should be noted that the use of the exception in itself did not affect the rating in this case. We also note that we apply the same methodologies for rating Shlomo Vehicle's local competitors and for rating its global peers, including Management Fleet Enterprise and Inc Wheels in the US, Motability in the UK and ALD in France.

Outlook

The stable outlook reflects our assessment that Shlomo Vehicle will maintain its business position as a market leader in the Israeli leasing industry in the next 12 months. Our assessment is based on material economies of scale and high operating efficiency. We believe the Company will be able to leverage this advantage to maintain its profitability and financial flexibility, so in our base case scenario we estimate that its EBIT interest coverage will remain above 3.5x in the next 12 months and that its debt to debt and equity ratio will remain below 75%.

Downside Scenario

We may take a negative rating action in the next 12 months if we estimate that Shlomo Vechicle's operating performance is expected to deteriorate such that its profitability is jeopardized and its EBIT interest coverage falls below 2.4x on a regular basis. This may also result from an unexpected increase in the Company's total debt or in its interest expenses. We may also take a negative rating action if the Company's debt to debt and equity ratio exceeds 80%, or if, contrary to our base case scenario, a decrease in the vehicles' residual value leads to a permanent decrease in profitability.

Upside Scenario

We believe a positive rating action is unlikely in the next 12 months. In the future, a positive rating action would be possible in the event of material improvement in the Company's liquidity profile. Such an improvement may result from a significant increase in the cash reserve on the Company's balance sheet as part of its cash balance management policy or the signing of committed credit lines for a period exceeding 12 months, such that the Company's source to uses ratio consistently exceeds 1.2x on an annual basis. At the same time, the interest coverage ratio should be consistently above 3.5x and the debt to debt and equity ratio less than 75%.

Recovery Analysis

Key analytical factors

- We are affirming our rating on S. Shlomo Holdings Ltd.'s secured bond series (Series 16, 17, 18), 'ilAA-', one notch above the issuer rating on S. Shlomo Vehicle Ltd. which guarantees the bond debt. The recovery rating for these series is '2', reflecting our assessment that in the case of a hypothetical default, the recovery rate would be 70%-90%.
- Our assessment of the recovery rate is determined primarily by the value of the fleet that secures the bond debt at the time of a hypothetical default. It is also based on the assessment that Shlomo Vehicle will continue to operate as a going concern, since we believe that it would undergo reorganization given its size, geographical spread and strong brand name.

Simulated default assumptions

- Simulated year of default: 2026
- A deep recession in the Israeli economy driven by geopolitical events will have adverse effects on the leasing industry due to rising unemployment and staff cutbacks by large customers and a decline in tourism impacting the car rental industry.
- The Company will continue to operate as a going concern, an assessment reflecting its large share in the leasing market, continued demand for its leasing services and considerable synergies between its different operations – leasing, rental and vehicle insurance.
- Recovery value of about 90% of net book value of the estimated minimum amount motor vehicles ordinarily required to be pledged as collateral against the bonds according to our estimation. In this context we note that the net book value is lower than the unadjusted, VAT-deducted Levi Yizhak price list referred to in the bond covenants.
- No value is assigned to S.Shlomo Hodlings Ltd.'s equity investment in Shlomo Vehicle and in S.Shlomo Transport (2007) Ltd., as we expect the main assets of these companies (motor vehicles) to be fully pledged to secured creditors such as banks and bondholders at the time of the hypothetical default. This reflects our assessment that a decline in vehicle value will lead the Company to increase the number of pledged vehicles as required by the bonds' mechanism.
- The value of the holding in the insurance company: 53% of its equity.
- Cash and cash equivalents: 0%.

Simplified Waterfall

- Gross enterprise value according to DAV method: NIS 1.321 billion
- Net enterprise value at emergence after administrative costs: NIS 1.255 billion
- Total first-lien debt: NIS 1.534 billion

- Rated secured debt (Series 16, 17, 18) recovery expectations: 70%-90%

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). ICR--Issuer credit rating.

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
- Corporate Methodology, November 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Guarantee Criteria, October 21, 2016
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Key Credit Factors For The Operating Leasing Industry, December 14, 2016
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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

S. Shlomo Vehicle Ltd.	Rating	Date when the rating was first published	Last date when the rating was updated
Issuer rating(s)			
Long term	ilAA-/Stable	01/05/2004	01/07/2020
Issue rating(s)			
Senior Secured Debt			
Series 16	ilAA	21/09/2015	01/07/2020
Series 17, 18	ilAA	02/07/2017	01/07/2020
Issuer Credit Rating history			
Long term			
June 29, 2021	ilAA-/Stable		
June 27, 2017	ilA+/Stable		
December 06, 2009	ilA/Stable		
December 18, 2008	ilA/Negative		
August 26, 2007	ilA/Stable		
March 28 ,2004	ilA		
Additional details			
Time of the event	29/06/2021 11:07		
Time when the event was learned of	29/06/2021 11:07		
Rating requested by	Issuer		

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