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Research Update:

Israel-Based Rafael Advanced Defense Systems Ltd. Upgraded To 'A'; Outlook Stable

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Rating Action Overview

- Aerospace and defense company Rafael Advanced Defense Systems Ltd. continues to exhibit a strong operating performance, with an ongoing surge in demand for many of its products and services.
- A gradually strengthening competitive position and high demand for its platforms and services coupled with resilient profitability means we have reassessed Rafael's business risk profile to satisfactory from fair.
- A strong net cash position underpins our minimal (previously modest) financial risk profile.
- We continue to consider the likelihood of timely and sufficient extraordinary support–of Rafael from the Israeli government as high.
- We therefore raised our long-term issuer credit rating on Rafael to 'A' from 'A-'.
- The stable outlook signifies that we expect rising government budgets for defense spending to translate into strong demand for the company's products and services in the next two years, with Rafael maintaining a strong net cash position.

Rating Action Rationale

Rafael's order backlog continues to climb, benefitting from governments' increased defense budgets and the strengthening demand from the wider defense industry. Rafael now has an order backlog exceeding Israeli new shekel (ILS) 50 billion (about US$13 billion), representing about three years of revenue. Under our base-case scenario and given the strong new order intake, we project Rafael's revenue will continue to grow to more than ILS16 billion in 2024 and more than ILS17 billion in 2025. The wider defense industry continues to benefit from tailwinds, including rising budgets and the awarding of large contracts due to the ongoing wars between Russia and Ukraine, and Israel and Hamas. Rafael has continued to receive sizable advance payments and in our estimation, these receipts will drive Rafael's cash balances to more than ILS4 billion through 2024, maintaining its already strong net cash position. We also note that Rafael should attract a good interest rate on its cash deposits that will benefit the company's net finance cost/income.

Our view of Rafael's competitive advantage and improved profitability underpins our reassessment of its business risk profile. Rafael's improving competitive advantage on and high demand for many of its products and services mean it is well placed to capture customer demand, both of the Israeli ministry of defense and from overseas governments and militaries. Roughly half of Rafael's sales are to Israel and include critical products such as Iron Dome, SPIKE, Spice, and David's sling. We consider Rafael to be a purely defense company, with very little revenue or EBITDA generated from the civil sector. At the same time, we expect that S&P Global Ratings-adjusted EBITDA will rise gradually to comfortably more than ILS1.7 billion through 2024 and more than ILS1.8 billion in 2025, with margins resilient at about 11%. This solid competitive advantage, coupled with resilient profitability, means we have reassessed Rafael's business risk profile to satisfactory from fair.

Rafael is in a strong net cash position and maintains ample cash on balance sheet, and its cash flow should remain robust. We expect that the company will maintain a strong net cash position in 2024 and 2025. For this reason, we have reassessed Rafael's financial risk policy as minimal (from modest previously). Although our base-case scenario forecasts positive FOCF over 2024-2025, Rafael's working capital and cash flow, as is the case with many defense companies, are affected by the often-unpredictable timing of large advance payments and receipts from government customers, in particular the state of Israel. In 2021, 2022 and 2023, the company posted positive FOCF of more than ILS1 billion each year, but in the several years preceding that, FOCF was consistently negative. We assume that Rafael's FOCF will be strongly positive in 2024 and 2025, although the precise numbers are hard to predict. We note the company's relative capital expenditure (capex) intensity and expect capex spending to rise gradually to more than ILS1 billion for 2024 and slightly higher in 2025. In our forecast, we assume about ILS500 million for bolt-on acquisitions per year. We note that during 2023, Rafael acquired the remaining part of Aeronautics (now fully owned) for a consideration of about ILS500 million. We consider that Israeli state-owned companies have a generic policy of distributing 50% of their net income as a dividend. The delay or nonreceipt of expected advance payments, higher-than-expected dividends, or sizable opportunistic mergers and acquisitions (M&A) could cause volatility in Rafael's expected cash flow.

Outlook

The stable outlook signifies that we expect rising government budgets for defense spending to translate into good demand for the company's products and services in the next two years, supporting at least the current backlog. Our rating analysis assumes that the Israeli government has not altered its willingness to provide extraordinary support to Rafael, or the level of support, if needed, in the next two years.

Downside scenario

We could lower the rating if we saw that the current market conditions were short lived; the company looked unlikely to execute well on its backlog; or it reported EBITDA margins below 9% because of fierce competition, the inability to introduce new technologies, cost overruns, or sizable acquisitions that did not offer a clear contribution to EBITDA.

In addition, we could lower the rating if a change in the company's financial policy resulted in adjusted funds from operations (FFO) to debt deteriorating and staying below 60%. We could also lower the rating if we concluded that the likelihood of extraordinary support from the state had changed, or if we were to lower the sovereign rating on Israel (A+/Negative/A-1+).

Upside scenario

We see rating upside as remote over the next two years, considering the company's size and EBITDA base, compared with those of larger rated defense peers.

Company Description

Rafael is an Israel-based company that develops and manufactures high-end combat systems. It is one of Israel's largest defense companies, generated annual revenue of about ILS14 billion in 2023, and employs about 8,000 people. The company is fully owned by Israel.

Operations are split into three main divisions, including air and intelligence systems, air superiority systems, and land and naval systems. In 2023, Rafael sold about 47% of its products outside Israel, and the remainder in Israel.

Rafael's main domestic competitors are Israel Aerospace Industries Ltd. and Elbit Systems. Internationally, Rafael competes with various companies in the aerospace and defense industry.

Our Base-Case Scenario

Assumptions

- An increase in the backlog won't immediately affect results. We understand that the company will maintain its conservative approach to recording items ordered from the Israeli government.
- The company's backlog rising to more than ILS50 billion.
- Production rates remain broadly unaffected by the war and the call up of Israeli Defense Force reservists.
- We expect adjusted EBITDA margins will remain at 11% or above.
- We expect working capital will be positive in 2024 and 2025, supported by the receipt of sizable advance payments.
- We assume average capex of up to ILS1 billion in 2024, rising gradually in 2025. In our view, the company's expansion into new lines of business might require additional funds. The pace will be based on securing more contracts.
- We expect potential M&A investments in existing associated companies, as well as bolt-on acquisitions. We prudently assume M&A spending of about ILS500 million in 2024.
- We expect dividends of 50% of Rafael's net income, as per the generic policy for Israeli state-owned companies.
- We forecast no material change in shareholder structure in 2024 or 2025.
- For 2024-2025, we do not expect a repeat of the exceptional tax payment that Rafael paid in 2022.

Key metrics

Rafael Advanced Defense Systems--Key metrics*

	--Fiscal year ended Dec. 31--				
Mil. ILS	2021a	2022a	2023a	2024f	2025f
Backlog (bil. ILS)	28.7	35.6	about 50	>50	>50
Revenue (bil. ILS)	9.9	11.6	14.04	>16	>17.5
Adj. EBITDA	1,048	1,153	1,516	>1,700	>1,900
EBITDA margin (%)	10.6	10	10.8	about 11	about 11
Capex	770	825	872	about 1,050	about 1,150
FOCF	1,075	1,178	2,363	>1,500	>1,000
Dividends	0	0	0	about 450	about 350
Acquisitions	(114)	(557)	0	about 500	about 200
Adj. Debt to EBITDA (x)	1.8	0.9	N.M.	N.M.	N.M.
Adj. FFO to debt (%)	56.7	46.1	N.M.	N.M.	N.M.

*All figures adjusted by S&P Global Ratings. ILS--Israeli new shekel. a--Actual. e--Estimate. f--Forecast. Capex--capital expenditure. FOCF--Free operating cash flows. FFO-Funds from operations. N.M.--Not meaningful.

Liquidity

We have reassessed Rafael's liquidity as strong from adequate. This reflects our projection that sources of liquidity, including cash and projected cash flow, will exceed uses by more than 1.5x over the next two years.

Our assessment is supported by the company's notable cash on the balance sheet and its limited debt maturities in the next few years. These can be refinanced easily in the Israeli capital market, given the company's yields.

Rafael does not use bank lines for meaningful short-term funding. Instead, it uses its considerable advances from customers as primary funding sources. We do not view this as a major risk, given the company's credit quality and status as a government-related entity. As of June 30, 2024, the company's outstanding guarantees were about ILS3 billion to ILS4 billion by our estimation.

We expect principal liquidity sources over the 12 months from June 30, 2024, will comprise:

- Estimated cash balance of about ILS4.4 billion of cash and marketable securities; and
- FFO of more than ILS1.6 billion.

We expect principal liquidity uses over the 12 months from June 30, 2024, will comprise:

- Debt maturities, including short-term debt, of about ILS500 million;
- Capex of about ILS1 billion per year;
- Potential working capital swings, depending on customer advances, which, in turn, depend on the timing of new contract engagements and the adherence to the project timetable;
- Seasonal, intra-year working capital swings of up to ILS1 billion, which could become materially

negative if Israel's Ministry of Defense delays any sizable payments;

- Dividends of 50% of Rafael's net income, as per the generic policy for Israeli state-owned companies; and
- Acquisition spending of about ILS 500 million.

Covenants

Rafael has several financial covenants, including minimal equity, gearing, and leverage ratios. As of March 31, 2024, the company complied with the covenants. Under our base-case scenario, we assume Rafael will continue to comply with all the covenants for the next 12 months and will have sufficient headroom.

Environmental, Social, And Governance

ESG factors have an overall neutral influence on our credit rating analysis of Rafael. The company has a well-diversified end-market base and strong barriers to entry, thanks to its technological edge and competitive position as a defense company that typically benefits from long-term contracts with governments.

Social risks are moderate, but in line with peers in the aerospace and defense sector. Rafael relies on skilled labor to execute its projects on time and on budget. In addition, the company is responsible for workers' safety amid the use of large and dangerous equipment. Rafael has a good safety track record, with no material accidents in recent years.

We view the company's governance as satisfactory, reflecting its extensive planning process and ability to adapt to operational issues and changing market conditions.

Government Influence

We view the likelihood of timely and sufficient extraordinary financial support from the Israeli government for Rafael, as high, resulting in two notches of uplift to the stand-alone credit profile (SACP). We base this on our assessment of the company's:

- Very important role in Israel's economy due to the company's range of defense products, some of which are important for the defense ministry. The link between the two goes beyond the percentage of sales to the state; and
- Strong link with the Israeli government, which fully owns Rafael. As with other state-owned companies, the government has an observer on the board of directors and can influence strategy and financial decisions directly or indirectly through various means. Rafael's dividend policy is determined by the government, which can lower or raise it, as required. We believe the state is interested in Rafael's financial stability and performance. Given that the company's investment plans were approved by the board, we expect the government to ease the dividend policy if it creates a financial burden for Rafael.

Our view of potential governmental support does not include influence on the company in the form of research and development subsidies (a relatively common feature of the aerospace and defense industry), favorable contracts, or access to preferential funding or guarantees. By contrast, the Israeli government puts restrictions on Rafael, including limits on technology exports and acquiring companies overseas. We incorporate these factors in our SACP assessment.

Ratings Score Snapshot

Issuer Credit Rating	A/Stable/A-2
Business risk:	Satisfactory
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk:	Minimal
Cash flow/leverage	Minimal
Anchor	a-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile:	bbb+
Likelihood of government support	Moderately high (+2 notches from SACP)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Israel's Economic Recovery To Be Slower Than Past Comebacks, Despite A Rebound In GDP In The First Quarter, May 20, 2024
- Israel, May 13, 2024
- EMEA A&D Credit Quality Gains Altitude As Supply Chain Turbulence Persists, Oct. 16, 2023

Ratings List

Upgraded

	To	From
Rafael Advanced Defense Systems Ltd.		
Issuer Credit Rating	A/Stable/A-1	A-/Stable/A-2