

Equity | Israel | Banks-Retail
01 June 2009

Q1 2009 initial comment



RESEARCH

Haim Israel >> +972 3 607 2007
Research Analyst
Merrill Lynch (Israel)
haim_israel@ml.com

Micha Goldberg >> +972 3 607 2002
Research Analyst
Merrill Lynch (Israel)
micha_goldberg@ml.com

Q1 2009: better than expected

Israel Discount Bank (DSCT) reported better-than-expected Q1 2009 results, with NI excluding one-offs totalling ILS157mn vs BAS-MLe ILS100mn, representing a ROE of 6.8%. However, the better bottom line is primarily due to notable FX-related tax gains (ILS86mn vs BAS-MLe tax provision of ILS31mn) and sizable trading gains (c.ILS165mn). Operating profit (PBT = ILS59mn) came in below BAS-MLe ILS140mn, mainly on the back of higher-than-expected loan loss provisions (0.9% vs BAS-MLe 0.8%: the sector's highest in Q1) as problematic loans increased by 12% QoQ. PPop totalled ILS311mn slightly below BAS-MLe (ILS318mn), while CIR remained exceptionally high at c.80%. Credit grew by 3.3% QoQ, primarily due to strong loan growth in the bank's corporate segment.

Regulatory capital remains a concern at DSCT

Regulatory capital remains our main concern at DSCT, as core Tier 1 (CT1) dropped to 6.43% vs 6.54% at YE08 and 7.12% in Q1 2008. Even without RWA growth, we believe DSCT would need to raise its CT1 levels, possibly via an equity issuance. Likewise, the YE09 transition to Basel II could substantially reduce CAR, potentially leaving DSCT's CT1 below the mandatory 6%, further increasing the need for the bank to raise CT1 levels.

Reiterate Underperform; too many risks

DSCT continues to trade at a discount to its book value (0.5x) and to local peers. However, the risks remain substantial, in our view: structurally lower efficiency (CIR c.80%), higher leverage (>21x), and a potential deterioration in asset quality on the back of the bank's aggressive loan growth policy at the end of the business cycle and low capital ratios. We reiterate our Underperform rating.

Estimates (Dec)

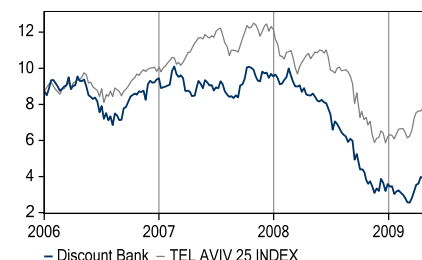
(ILS)	2007A	2008A	2009E	2010E	2011E
Net Profit	1,265	245	417	562	854
EPS (Reported Diluted)	0.72	0.26	0.43	0.57	0.87
Dividend / Share	0	0.25	0	0	0
Adjusted NAV PS	9.39	8.97	9.23	9.80	10.7

Valuation (Dec)

	2007A	2008A	2009E	2010E	2011E
EPS Change (YoY)	124%	-63.9%	63.5%	34.7%	52.0%
Price / BV	0.52x	0.55x	0.53x	0.50x	0.46x
Price / NAV	0.52x	0.55x	0.53x	0.50x	0.46x
Net Yield	0%	5.21%	0%	0%	0%
DPS Change (YoY)	NA	NA	-100%	NA	NA
Price / GOP	2.77x	3.55x	2.54x	2.33x	2.09x

Stock Data

Price	ILS4.89
Price Objective	ILS3.30
Date Established	20-May-2009
Investment Opinion	C-3-9
Volatility Risk	HIGH
52-Week Range	ILS2.47-ILS8.49
Mkt Val / Shares Out (mn)	ILS4,798 / 980.6
Average Daily Volume	6,872,861
ML Symbol / Exchange	ISDCF / TLV
Bloomberg / Reuters	DSCT IT / DSCT.TA
ROE (2009E)	4.7%
Total Dbt to Cap (Dec-2008A)	0%
Est. 5-Yr EPS / DPS Growth	16.3% / 0%
Free Float	49.0%



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Refer to important disclosures on page 7 to 9. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5.

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iQprofileSM Israel Discount Bank Ltd

Key Income Statement Data (Dec)	2007A	2008A	2009E	2010E	2011E
(ILS Millions)					
Net Interest Income	4,225	4,127	4,700	4,946	5,162
Net Fee Income	2,216	2,339	2,397	2,481	2,630
Securities Gains / (Losses)	58.0	51.0	23.0	30.0	114
Other Income	298	100	175	145	167
Total Non-Interest Income	2,572	2,490	2,595	2,656	2,911
Total Operating Income	6,797	6,617	7,295	7,602	8,073
Operating Expenses	(5,066)	(5,265)	(5,407)	(5,540)	(5,773)
Pre-Provision Profit	1,731	1,352	1,888	2,062	2,301
Provisions Expense	(447)	(780)	(1,191)	(1,239)	(1,031)
Operating Profit	1,284	572	697	823	1,270
Non-Operating Items	45.0	(70.0)	30.0	88.0	92.0
Pre-Tax Income	1,329	502	727	911	1,362
Net Income to sh/holders	707	255	417	562	854
Adjusted Cash Earnings	1,265	245	417	562	854

Key Balance Sheet Data

Total Assets	168,810	182,248	185,051	191,616	198,108
Average Interest Earning Assets	157,130	165,576	172,776	177,392	183,837
Weighted Risk Assets	122,138	136,081	142,885	150,029	159,031
Total Gross Customer Loans	107,874	123,102	128,396	133,939	138,852
Total Customer Deposits	130,518	139,232	143,409	147,711	152,881
Tier 1 Capital	9,952	10,130	10,901	11,868	12,726
Tangible Equity	9,204	8,797	9,048	9,610	10,463
Common Shareholders' Equity	9,204	8,797	9,048	9,610	10,463

Key Metrics

Net Interest Margin	2.69%	2.49%	2.72%	2.79%	2.81%
Tier 1 Ratio	8.15%	7.44%	7.63%	7.91%	8.00%
Effective Tax Rate	42.6%	33.7%	33.7%	32.2%	33.2%
Loan / Assets Ratio	60.4%	64.1%	65.6%	65.9%	66.3%
Loan / Deposit Ratio	78.1%	83.9%	84.7%	85.5%	85.9%
Oper Leverage (Inc Growth - Cost Growth)	9.62%	-6.58%	7.55%	1.74%	2.01%
Gearing (Assets / Equity)	18.3x	20.7x	20.5x	19.9x	18.9x
Tangible Equity / Assets	5.45%	4.83%	4.89%	5.02%	5.28%
Tangible Equity / WRAs	7.54%	6.46%	6.33%	6.41%	6.58%

Business Performance

Revenue Growth	10.5%	-2.65%	10.2%	4.21%	6.20%
Operating Expense Growth	0.92%	3.93%	2.69%	2.47%	4.19%
Provisions Expense Growth	-21.6%	74.5%	52.7%	4.00%	-16.8%
Operating Revenue / Average Assets	0.78%	0.33%	0.38%	0.44%	0.65%
Operating Expenses / Average Assets	-3.06%	-3.00%	-2.94%	-2.94%	-2.96%
Pre-Provision ROA	1.04%	0.77%	1.03%	1.09%	1.18%
ROA	0.76%	0.14%	0.23%	0.30%	0.44%
Pre-Provision ROE	20.2%	15.0%	21.2%	22.1%	22.9%
ROE	14.7%	2.72%	4.67%	6.02%	8.51%
RoTE	14.7%	2.72%	4.67%	6.02%	8.51%
RoWRAs	1.09%	0.19%	0.30%	0.38%	0.55%
Dividend Payout Ratio	0%	102%	0%	0%	0%
Efficiency Ratio (Cost / Income Ratio)	74.5%	79.6%	74.1%	72.9%	71.5%

Quality of Earnings

Total Non-Interest Inc / Operating Inc	37.8%	37.6%	35.6%	34.9%	36.1%
Market-Related Revenue / Total Revenues	0%	0%	0%	0%	0%
Provisioning Burden as % of PPP	25.8%	57.7%	63.1%	60.1%	44.8%
NPLs plus Foreclosed Real Estate / Loans	2.19%	1.92%	2.58%	2.73%	2.42%
Loan Loss Reserves / NPLs	268%	281%	221%	220%	235%
Loan Loss Reserves / Total Loans	5.86%	5.40%	5.70%	6.02%	5.68%
Provisions Expense / Average Loans	0.47%	0.71%	1.00%	1.00%	0.80%

Company Description

Israel Discount Bank is Israel's third largest banking group with US\$ 40bn in assets and an 18% market share. The group provides full banking services to all arrays of the economy through its 200+ branch network. In addition to its domestic operations, the bank also has a significant international exposure, primarily through its NY subsidiary, which accounts for some 30% of the group's capital.

Investment Thesis

We believe DSCT's main weakness is its high cost and lower profitability, which we view as structural. With capital levels somewhat constrained, we do not expect any real cost cutting in the short term, and hence see only moderate ROAA uplift. At a COE of 13.2%, it is unlikely DSCT will be able to create value for shareholders in the foreseeable future, in our view. With profitability well below that of domestic peers, we believe DSCT warrants a discount even to the already-low Israeli standard.

Stock Data

Price to Book Value 0.5x

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Quarterly variance tables

Table 1: Israel Discount Bank: Q109 income statement summary

ILS mn	Q109A	Q108A	Q408A	YoY (%)	QoQ (%)	Q109E	% Vs MLe
Net Interest Income	940	1,065	873	-11.7%	7.7%	1,000	-6.0%
Non Interest Income	717	561	726	27.8%	-1.2%	659	8.8%
-Fees and Commissions	642	589	609	9.0%	5.4%	599	7.2%
-Other Operating Revenue	2	-30	94			0	!
-Management and Distribution Fees	73	2	23	3550.0%	217.4%	60	21.7%
Total Banking Revenues	1,657	1,626	1,599	1.9%	3.6%	1,659	-0.1%
Operating Expenses	1,346	1,357	1,449	-0.8%	-7.1%	1,341	0.4%
Salary and Other Personnel Costs	780	860	865	-9.3%	-9.8%	769	1.4%
Depreciation and Maintenance Costs	245	216	239	13.4%	2.5%	250	-2.0%
Non-Salary Operating Costs	321	281	345	14.2%	34.3%	322	-0.2%
Pre-Provision Profit	311	269	150	15.6%	107.3%	318	-2.3%
Loan Provision Charge	252	93	366	171.0%	-31.1%	178	41.7%
Profit Before Tax	59	176	-216	-66.5%	-127.3%	140	-58.0%
Tax Provision	-86	133	-228	-164.7%	-62.3%	31	-375.1%
Net Income	145	43	12	237.2%	1108.3%	109	32.8%
Income (Expenses) from investee earnings	28	10	-96	180.0%	-129.2%	8	
Minority Interest	-16	-15	-31			-16	
Attributable Group Net Income	157	38	-115	313.2%	-236.5%	100	56.3%
Extraordinary Income	-17	-3	-6			0	
Reported Group Net Income	140	35	-121	300.0%	-215.7%	100	39.4%

Source: Company data, Banc of America Securities - Merrill Lynch estimates

Table 2: Israel Discount Bank: Q109 balance sheet summary

ILS mn	Q109A	Q108A	Q408A	YoY (%)	QoQ (%)
Cash, CB Reserves & Interbank Balances	22,584	17,323	21,554	30.4%	4.8%
Marketable Securities	35,972	36,716	31,560	-2.0%	14.0%
Net Loans	120,620	103,654	116,800	16.4%	3.3%
Government Loans	1,802	1,414	1,491	27.4%	20.9%
Interest Earning Assets	180,978	159,107	171,405	13.7%	5.6%
Investment in Subsidiaries	1,748	2,000	1,900	-12.6%	-8.0%
Fixed Assets	3,040	2,855	3,039	6.5%	0.0%
Other Assets	7,611	5,809	5,904	31.0%	28.9%
Total Assets	193,377	169,771	182,248	13.9%	6.1%
Customer Deposits	146,629	146,629	139,232	0.0%	5.3%
Interbank Deposits	15,273	12,139	11,749	25.8%	30.0%
Deposits from the Government	220	140	206	57.1%	6.8%
Bonds and Notes	9,318	8,245	9,373	13.0%	-0.6%
Other Liabilities	12,729	11,923	12,665	6.8%	0.5%
Minority Interest	243	161	226	50.9%	7.5%
Total Group Equity	8,965	9,194	8,797	-2.5%	1.9%

Source: Company data

Table 3: Israel Discount Bank: Q109 asset quality indicators

ILS mn	Q109A	Q408A	YE08A	YTD (%)	QoQ (%)
Net NPL - Reported	2,460	2,242	2,242	9.7%	9.7%
Restructured	422	585	585	-27.9%	-27.9%
Arrears	778	690	690	12.8%	12.8%
Net NPLs - Adjusted	3,660	3,517	3,517	4.1%	4.1%
Watchlist	5,130	4,330	4,330	18.5%	18.5%
Total Problematic Loans	8,790	7,847	7,847	12.0%	12.0%
Net NPLs/Net Loans	2.0%	1.9%	1.9%		
Total Capital Ratio	10.42%	10.27%	10.27%		
- Core tier 1	6.43%	6.55%	6.55%		
- Tier 1	7.54%	7.44%	7.44%		
- Tier 2	2.88%	2.83%	2.83%		

Source: Company data

Table 4: Israel Discount Bank: Q109 main financial ratios

ILS mn	Q109A	Q408A	Q308A	Q208A	Q108A
Net Interest Margins (on AIEA)	2.63%	2.11%	2.63%	2.85%	2.72%
Loan Provision Charge as % of Ave Loans	0.69%	1.34%	0.69%	0.55%	0.38%
Operating Revenues as % of Total Revenues	36.9%	45.4%	36.9%	34.2%	34.4%
Cost/Income Ratio	77.2%	90.6%	77.2%	68.0%	83.4%
Tax Rate	32.5%	105.6%	32.5%	48.3%	75.6%
ROAE - Reported	4.9%	-5.4%	4.9%	9.8%	1.6%
ROAA - Reported	0.3%	-0.3%	0.3%	0.5%	0.1%
One-time gains as % of Ave Equity	0.0%	-0.3%	0.0%	0.0%	-0.1%
ROAE - Adjusted	4.9%	-5.1%	4.9%	9.8%	1.7%
Equity Gearing	18.9	19.2	18.9	18.6	19.0
ROAA - Reported	0.3%	-0.3%	0.3%	0.5%	0.1%
One-time gains as % of Ave Assets	0.0%	0.0%	0.0%	0.0%	0.0%
ROAA - Adjusted	0.3%	-0.3%	0.3%	0.5%	0.1%

Source: Company data

Price objective basis & risk Discount Bank (ISDCF)

Our price objective for the company is ILS3.3/sh and is based on a simple Gordon growth model. We use a simple target price-book model with a mid-term sustainable ROE target of 6.3%, an 11.3% cost of equity and a 3.5% nominal terminal growth rate. Our COE uses a 36-month rolling average 10-year nominal government bond yield of 5.8% and a 1.1 beta (a 36-month rolling adjusted beta vs the TA-100). Our perpetual growth rate of 3.5% is nominal and assumes a real long-term growth rate of 1.5% and a 2% long-term inflation rate target.

We group the risks into two categories: macroeconomic and microeconomic. At the macro level, the economy may slide into a recession due to a prolonged slowdown in the US economy and/or deterioration in Israel's security situation. This could put the banking sector under pressure in terms of both growth and asset quality. DSCF has a larger-than-average exposure to the US economy through its relatively sizable US subsidiary IDBNY, its US\$2.2bn investment in GSE-backed MBS, and due to the fact that its US subsidiary is still under a cease and desist order. The bank's ability to sustain its net interest margin and its fee base, and maintain prudent risk management is the microeconomic risk, in our view. Upside risk could stem from earlier-than-expected cost cutting and the lifting of the bank subsidiary's cease and desist order earlier than expected.

Analyst Certification

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Emerging EMEA - Israel Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Bank Leumi	BLMIF	LUMI IT	Haim Israel
	Delek	XDLKF	DLEA IT	Haim Israel
	Israel Chemical	ISCHF	ICL IT	Haim Israel
NEUTRAL				
	Bank Hapoalim	BKHPF	POLI IT	Haim Israel
	Makhteshim-Agan	MAIXF	MAIN IT	Haim Israel
	Mizrahi Tefahot	UMZRF	MZTF IT	Haim Israel
UNDERPERFORM				
	Discount Bank	ISDCF	DSCT IT	Haim Israel
	Ormat Industries	OMTDF	ORMT IT	Haim Israel

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iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

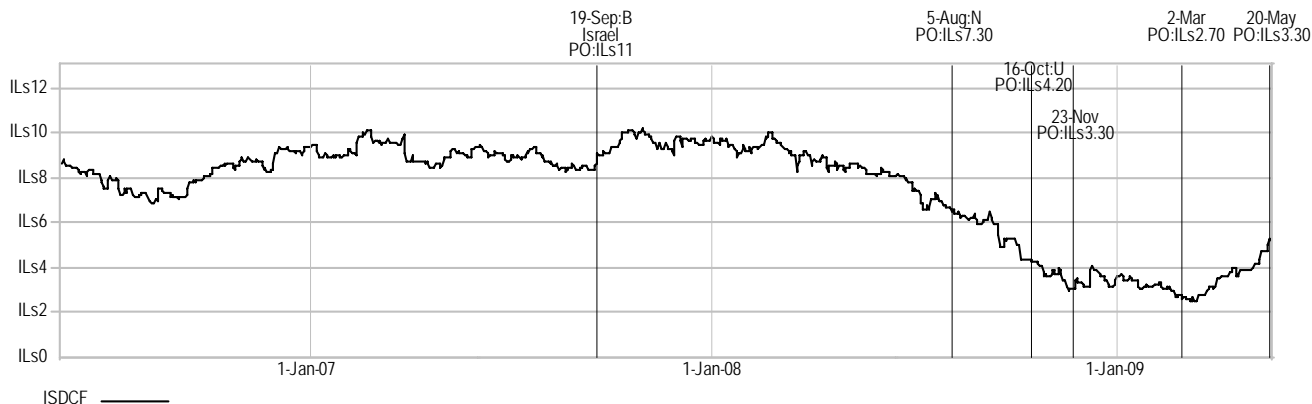
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ISDCF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of April 30, 2009 or such later date as indicated. BAS-ML price charts do not reflect analysts' coverage of the stock at prior firms. Historical price charts relating to companies covered as of April 30, 2009 by former Banc of America Securities LLC (BAS) analysts are available to BAS clients on the BAS website.™

Investment Rating Distribution: Banks Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	66	26.83%	Buy	27	49.09%
Neutral	61	24.80%	Neutral	31	57.41%
Sell	119	48.37%	Sell	63	60.58%

Investment Rating Distribution: Global Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1243	38.21%	Buy	520	46.39%
Neutral	841	25.85%	Neutral	349	47.04%
Sell	1169	35.94%	Sell	388	36.30%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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