Israel Discount Bank Ltd

Estimate Change NEUTRAL

Equity | Israel | Banks-Retail
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First glance at Q2: Decent Q, but still way off course

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Q2 2008 NI 15% below our estimate

Israel Discount Bank (DSCT) reported Q2 2008 earnings below our forecast (PBT -4.8%; NI -15% vs MLe). Adjusted ROE totalled 9.8% in Q2. We have cut NI by 10% in 2008E to ILS763mn and by 7% in 2009E on lower assumed revenues and lower income from associates. We expect Q2's lower-than-expected staff costs (-7.7% vs MLe) to be seasonal and temporary, as was the case in Q2 2007.

Dividend premature in our view; will need to raise capital

Along with its first dividend in over a decade (ILS250mn), DSCT notes that it will have to raise additional capital. We expect the bank to raise ILS0.5bn in hybrid Tier 1 by YE08 and a further ILS2.5bn in Tier 2 by YE09, indicating that the current dividend is not the result of excess capital. This could be why the bank will only decide upon an official dividend policy (if at all) in Q1 2009.

Q2 focus: improving but still way off 13% 2010 ROE target

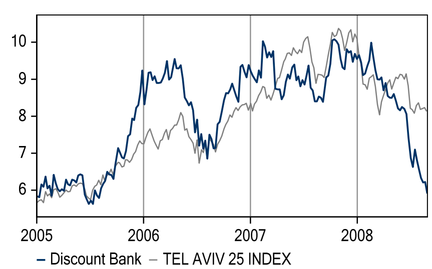
With ROE in H2 at 5.7% (1/2 of COE), DSCT will need to generate an implausible ILS680mn in H2 (or ROE of 14%) to reach an ROE of 10% for FY08. More importantly though, for DSCT to reach its targeted 13% ROE by 2010 it will need to double its net earnings. We remain sceptical that it will be able to accomplish that, especially with the economy expected to slow considerably in 2009.

Remaining Neutral

DSCT's structurally lower ROE warrants a healthy discount even to the already-low Israeli standard, in our view. With economic activity slowing and no turnaround benefits before 2010, DSCT will find it difficult to improve profitability to above 10% in the coming years, in our view. Accordingly, we remain Neutral.

Stock Data

Price	ILS5.91
Price Objective	ILS7.30
Date Established	5-Aug-2008
Investment Opinion	C-2-9
Volatility Risk	HIGH
52-Week Range	ILS5.84-ILS10.30
Mrkt Val / Shares Out (mn)	ILS5,798 / 980.6
Average Daily Volume	3,159,046
ML Symbol / Exchange	ISDCF / TLV
Bloomberg / Reuters	DSCT IT / DSCT.TA
ROE (2008E)	8.1%
Total Dbt to Cap (Dec-2007A)	0%
Est. 5-Yr EPS / DPS Growth	16.3% / 0%
Free Float	49.0%



Estimates (Dec)

(ILS)	2006A	2007A	2008E	2009E	2010E
	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP
Net Profit	836	1,265	763	950	1,220
EPS (Reported Diluted)	0.32	0.72	0.78	0.97	1.24
Dividend / Share	0	0	0.19	0	0
Adjusted NAV PS	8.12	9.39	9.92	10.9	12.1

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
EPS Change (YoY)	-31.2%	124%	8.53%	23.8%	28.4%
Price / BV	0.73x	0.63x	0.60x	0.54x	0.49x
Price / NAV	0.73x	0.63x	0.60x	0.54x	0.49x
Net Yield	0%	0%	3.29%	0%	0%
DPS Change (YoY)	NA	NA	NA	-100%	NA
Price / GOP	5.14x	3.35x	3.22x	2.96x	2.40x

Refer to important disclosures on page 8 to 9. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6.

iQprofile℠ Israel Discount Bank Ltd

Key Income Statement Data (Dec)	2006A	2007A	2008E	2009E	2010E
(ILS Millions)	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP
Net Interest Income	3,790	4,225	4,494	4,781	5,152
Net Fee Income	1,911	2,216	2,196	2,306	2,456
Securities Gains / (Losses)	65.0	58.0	81.0	23.0	30.0
Other Income	383	298	106	135	185
Total Non-Interest Income	2,359	2,572	2,383	2,464	2,671
Total Operating Income	6,149	6,797	6,877	7,244	7,822
Operating Expenses	(5,020)	(5,066)	(5,077)	(5,285)	(5,403)
Pre-Provision Profit	1,129	1,731	1,800	1,959	2,419
Provisions Expense	(570)	(447)	(509)	(657)	(697)
Operating Profit	559	1,284	1,292	1,302	1,723
Non-Operating Items	188	45.0	116	170	150
Pre-Tax Income	747	1,329	1,408	1,472	1,873
Net Income to sh/holders	315	707	767	950	1,220
Adjusted Cash Earnings	836	1,265	763	950	1,220
Key Balance Sheet Data					
Total Assets	162,538	168,810	173,970	182,485	191,489
Average Interest Earning Assets	150,635	157,130	162,275	169,047	177,770
Weighted Risk Assets	109,163	122,138	134,352	143,756	153,819
Total Gross Customer Loans	96,289	107,874	115,913	122,410	129,306
Total Customer Deposits	130,517	130,518	135,739	141,168	146,815
Tier 1 Capital	8,637	9,952	10,926	11,879	13,102
Tangible Equity	7,965	9,204	9,731	10,682	11,901
Common Shareholders' Equity	7,965	9,204	9,731	10,682	11,901
Key Metrics					
Net Interest Margin	2.52%	2.69%	2.77%	2.83%	2.90%
Tier 1 Ratio	7.91%	8.15%	8.13%	8.26%	8.52%
Effective Tax Rate	46.9%	42.6%	41.5%	31.8%	32.3%
Loan / Assets Ratio	55.5%	60.4%	63.3%	63.9%	64.6%
Loan / Deposit Ratio	69.1%	78.1%	81.1%	82.6%	84.2%
Oper Leverage (Inc Growth - Cost Growth)	-5.40%	9.62%	0.97%	1.23%	5.75%
Gearing (Assets / Equity)	20.4x	18.3x	17.9x	17.1x	16.1x
Tangible Equity / Assets	4.90%	5.45%	5.59%	5.85%	6.22%
Tangible Equity / WRAs	7.30%	7.54%	7.24%	7.43%	7.74%
Business Performance					
Revenue Growth	0.75%	10.5%	1.18%	5.34%	7.98%
Operating Expense Growth	6.15%	0.92%	0.21%	4.11%	2.22%
Provisions Expense Growth	-17.5%	-21.6%	13.8%	29.2%	6.00%
Operating Revenue / Average Assets	0.35%	0.78%	0.75%	0.73%	0.92%
Operating Expenses / Average Assets	-3.16%	-3.06%	-2.96%	-2.97%	-2.89%
Pre-Provision ROA	0.71%	1.04%	1.05%	1.10%	1.29%
ROA	0.53%	0.76%	0.45%	0.53%	0.65%
Pre-Provision ROE	15.4%	20.2%	19.0%	19.2%	21.4%
ROE	11.4%	14.7%	8.06%	9.31%	10.8%
RoTE	11.4%	14.7%	8.06%	9.31%	10.8%
RoWRAs	0.78%	1.09%	0.60%	0.68%	0.82%
Dividend Payout Ratio	0%	0%	25.0%	0%	0%
Efficiency Ratio (Cost / Income Ratio)	81.6%	74.5%	73.8%	73.0%	69.1%
Quality of Earnings					
Total Non-Interest Inc / Operating Inc	38.4%	37.8%	34.7%	34.0%	34.1%
Market-Related Revenue / Total Revenues	0%	0%	0%	0%	0%
Provisioning Burden as % of PPP	50.5%	25.8%	28.3%	33.6%	28.8%
NPLs plus Foreclosed Real Estate / Loans	2.80%	2.19%	1.86%	1.62%	1.40%
Loan Loss Reserves / NPLs	242%	268%	286%	305%	326%
Loan Loss Reserves / Total Loans	6.78%	5.86%	5.33%	4.93%	4.57%
Provisions Expense / Average Loans	0.65%	0.47%	0.48%	0.58%	0.58%

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

DSCT main weakness is its high cost and the subsequently lower profitability, which we view as structural. With cost-cutting not a primary objective, we see only moderate ROAA uplift. At a COE of 11.4% DSCT will only start to create value for its shareholders by 2010. Even then, we worry that the current expansion strategy might be ill-timed, potentially causing longer-term damage. With profitability well below domestic peers, DSCT warrants a discount even to the already-low Israeli standard.

Stock Data

Price to Book Value	0.6x

Q2 earnings below ML estimate

DSCT reported Q2 2008 earnings below our forecast (PBT -4.8%; NI -15% vs MLe). We cut NI by 10% in 2008E to ILS763mn and by 7% to ILS950m in 2009E on lower assumed revenues and lower income from associates.

Table 1: Changes to earnings estimates

ILS mn	2008E			2009E		
	Old	New	% Chg	Old	New	% Chg
Revenues	6,962	6,877	-1.2%	7,340	7,244	-1.3%
PPoP	1,845	1,800	-2.4%	2,013	1,959	-2.7%
PBT	1,347	1,292	-4.1%	1,355	1,302	-4.0%
NI	844	763	-9.6%	1,018	950	-6.7%

Source: Merrill Lynch estimates

Reason for miss

Adjusted net income totalled ILS222mn, well below MLe of ILS260mn, primarily on the back of significantly lower associate income, as earnings at First International Bank (26.5% held) dropped by 44% YoY. PBT totalled ILS412mn, some 4.8% below our estimates as lower-than-expected revenues and higher loan loss provisions were somewhat offset by lower-than-expected staff costs (-7.7% vs MLe). However, while we believe that the decline in staff costs is primarily due to severe seasonality effects between quarters and will hence prove to be temporary, the decline in revenue seems to be of a more permanent nature. While overall revenues totalled ILS1,721mn (just 2.4% below MLe ILS1,763mn), the revenue mix was also less favourable, as low-quality trading gains came in above expectations (ILS23mn vs MLe ILS -3mn), offsetting lower-than-expected traditional fees (ILS538mn vs MLe ILS570mn), which declined by 5.4%, the sector's sharpest decline in Q2. Net interest income was also slightly lower than expected, but here we believe that our projections were simply too high and attribute no or little disappointment to DSCT's Q2 performance.

Table 2: Israel Discount Bank: Q208 income statement summary

	Q208A	Q207A	Q108A	YoY (%)	QoQ (%)	Q208E	% Vs MLe	Comments
Net Interest Income	1,132	916	1,075	23.6%	5.3%	1,175	-3.7%	Adj NII=1035mn; excl. MTM losses (26mn); FX gains (70mn)
Non Interest Income	589	675	626	-12.7%	-5.9%	588	0.2%	
-Fees and Commissions	538	540	585	-0.4%	-8.0%	570	-5.6%	Significantly lower capital market and FX related fees
-Other Operating Revenue	23	4	(16)			(3)		Thanks to BEZQ dividend (ILS17mn) and HOT CATV (ILS6mn)
-Management and Distribution Fees	28	131	57	-78.6%	-50.9%	21	33.3%	
Total Banking Revenues	1,721	1,591	1,701	8.2%	1.2%	1,763	-2.4%	
Operating Expenses	1,170	1,163	1,414	0.6%	-17.3%	1,207	-3.1%	
Salary and Other Personnel Costs	649	641	834	1.2%	-22.2%	703	-7.7%	Adj. staff costs=ILS730mn; excl. ILS95mn severance related gains
Depreciation and Maintenance Costs	215	194	223	10.8%	-3.6%	215	0.0%	
Non-Salary Operating Costs	306	328	357	-6.7%	37.2%	289	5.9%	
Pre-Provision Profit	551	428	287	28.7%	92.0%	556	-0.9%	
Loan Provision Charge	139	158	85	-12.0%	63.5%	123	13.0%	No major recoveries. Q3/Q4 likely to be in line
Profit Before Tax	412	270	202	52.6%	104.0%	433	-4.8%	
Tax Provision	199	69	135	188.4%	47.4%	204	-2.4%	Includes FX gains on hedge of ILS70mn (incl. in NII)
Net Income	213	201	67	6.0%	217.9%	229	-7.0%	
Income (Expenses) from investee earnings	24	47	(99)	-48.9%	-124.2%	44		ILS26mn from FTIN; and a ILS2mn loss from KFS investment
Minority Interest	(15)	(13)	(10)			(13)		
Attributable Group Net Income	222	235	(42)	-5.5%	-628.6%	260	-14.5%	
Extraordinary Income	(1)	392	83			0		
Reported Group Net Income	221	627	41	-64.8%	439.0%	260	-14.9%	

Source: Company data and Merrill Lynch

Is the current dividend premature?

Based on our calculations, DSCT will find it difficult to reach a CAR of 12% by YE09 without raising additional capital. However, as Tier 2 is currently already at the maximum level allowed (50% of Tier 1), the bank will be forced to raise Tier 1 capital. However, by paying out a dividend of ILS250mn (c.20bp in CAR terms), the bank is, in effect, reducing its core Tier capital. Accordingly, we expect DSCT to be forced to raise additional hybrid Tier 1 of around ILS0.5bn by YE08, in part to allow the bank to pay out the dividend. As can be seen from Table 3, assuming a net ILS1.5bn of net capital generation through YE09 and zero growth in RWAs, the CAR would still only just reach 12% by YE09. With RWA currently growing at some 9% per annum and an increasing probability that the US dollar will continue to strengthen against the ILS (a notable portion of DSCT's RWA is inked to the US$), capital ratios could be strained, which would probably force DSCT to raise additional capital, most likely in the form of upper Tier 2.

Table 3: Capital calculations point to possible constraints

		RWA	Tier 1		Tier 2		CAR		Change in
Date/Event	ILS mn	ILS mn	ILS mn	Ratio (%)	ILS mn	Ratio (%)	ILS mn	Ratio (%)	CAR
Q2 2008 data		127,056	10,194	8.02%	5,353	3.03%	14,050	11.06%	
Proposed dividend	250	127,056	9,944	7.83%	5,353	3.03%	13,800	10.86%	-0.20%
H208E earnings - ILS510mn	510	127,056	10,454	8.23%	5,353	3.03%	14,310	11.26%	+0.40%
FY09E earnings - ILS950mn	950	127,056	11,404	8.98%	5,753	3.35%	15,660	12.33%	+1.06%
Maximum RWA by YE08		130,091	10,454	8.04%	5,353	3.35%	14,310	11.00%	-0.26%
Implied growth in RWA for July-Dec.08		2.39%							
Maximum RWA by YE09		130,500	11,404	8.74%	5,753	3.35%	15,660	12.00%	+1.00%
CAGR growth limit on RWA		2.71%							

Source: Company data and Merrill Lynch estimates

Remaining Neutral

DSCT's structurally lower ROE warrants a healthy discount even to the already-low Israeli standard, in our view. With economic activity expected to slow considerably in 2009 and no turnaround benefits before 2010, DSCT will find it difficult to improve sustainable profitability to above 10% in the coming years. Accordingly, we remain Neutral.

Table 4: Israel Discount Bank: Q208 balance sheet summary

ILS mn	Q208A	Q207A	Q108A	YoY (%)	QoQ (%)
Cash, CB Reserves & Interbank Balances	13,649	26,135	23,238	-47.8%	-41.3%
Marketable Securities	34,681	40,313	40,796	-14.0%	-15.0%
Net Loans	107,395	95,000	96,463	13.0%	11.3%
Government Loans	1,448	25	12	5692.0%	11966.7%
Interest Earning Assets	157,173	161,473	160,509	-2.7%	-2.1%
Investment in Subsidiaries	2,025	1,450	1,527	39.7%	32.6%
Fixed Assets	2,908	2,678	2,715	8.6%	7.1%
Other Assets	4,849	4,405	4,620	10.1%	5.0%
Total Assets	166,955	170,006	169,371	-1.8%	-1.4%
Customer Deposits	126,154	133,189	135,439	-5.3%	-6.9%
Interbank Deposits	11,063	10,925	7,530	1.3%	46.9%
Deposits from the Government	373	123	124	203.3%	200.8%
Bonds and Notes	8,473	6,614	6,730	28.1%	25.9%
Other Liabilities	11,460	10,167	10,244	12.7%	11.9%
Minority Interest	177	120	136	47.5%	30.1%
Total Group Equity	9,255	8,868	9,168	4.4%	0.9%

Source: Company data

Table 5: Israel Discount Bank: Q208 asset quality indicators

	Q208A	Q108A	YE07A	YTD (%)	QoQ (%)
Net NPL - Reported	1,943	2,141	2,230	-12.9%	-9.2%
Restructured	190	149	311	-38.9%	27.5%
Arrears	363	400	387	-6.2%	-9.3%
Net NPLs - Adjusted	2,496	2,690	2,928	-14.8%	-7.2%
Watchlist	3,432	3,424	3,520	-2.5%	0.2%
Total Problematic Loans	5,928	6,114	6,448	-8.1%	-3.0%
Net NPLs/Net Loans	1.8%	2.3%	2.2%		
Total Capital Ratio	11.10%	11.00%	10.90%		
- Tier 1	8.00%	7.96%	8.15%		
- Tier 2	3.10%	3.04%	2.75%		

Source: Company data

Table 6: Israel Discount Bank: Q208 main financial ratios

	Q208A	Q108A	Q407A	Q307A	Q207A
Net Interest Margins (on AIEA)	2.92%	2.72%	2.74%	3.10%	2.35%
Loan Provision Charge as % of Ave Loans	0.49%	0.38%	0.35%	0.46%	0.69%
Operating Revenues as % of Total Revenues	33.4%	34.4%	36.8%	33.9%	42.4%
Cost/Income Ratio	68.5%	83.4%	83.1%	68.6%	73.1%
Tax Rate	47.1%	75.6%	66.8%	41.8%	25.6%
ROAE - Reported	11.3%	1.6%	1.9%	18.8%	31.3%
ROAA - Reported	0.6%	0.1%	0.1%	1.0%	1.5%
One-time gains as % of Ave Equity	0.0%	-0.1%	3.9%	3.8%	19.6%
ROAE - Adjusted	11.3%	1.7%	-2.0%	14.9%	11.7%
Equity Gearing	18.6	19.0	19.0	19.7	20.6
ROAA - Reported	0.6%	0.1%	0.1%	1.0%	1.5%
One-time gains as % of Ave Assets	0.0%	0.0%	0.2%	0.2%	1.0%
ROAA - Adjusted	0.6%	0.1%	-0.1%	0.8%	0.6%

Source: Company data

Price objective basis & risk

Discount Bank (ISDCF)

Our price objective is ILS7.3. We are basing our valuation on a Gordon Growth Model, which gives us a target P/B multiple of 0.8x, and a 12 month forward fair value of ILS 7.3 per share. We use a mid-term ROE target of 9.5%, an 11.4% cost of equity and a 3.5% nominal terminal growth rate. Our COE uses a 24 month rolling government nominal bond yield of 5.9% and a beta of 1.1. 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 target. We group the risks into two categories: macroeconomic and microeconomic. On the macro level, the economy may slow either due to a possible slowdown in the global and/or US economy or due to deterioration in Israel security situation. This could put the banking sector under pressure, for both growth and asset quality. Likewise, deterioration in the US housing market could hurt the bank equity due to its ILS 9.5bn exposure to US MBS. The bank ability to sustain its net interest margin, its fee base and maintain prudent risk management is the microeconomic risk. Upside risk could stem from earlier-than-expected cost cutting and the lifting of the bank subsidiary cease and desist order earlier than expected.

Analyst Certification

I, Haim Israel, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Emerging EMEA - Israel Coverage Cluster

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

iQmethod SM Measures Definitions

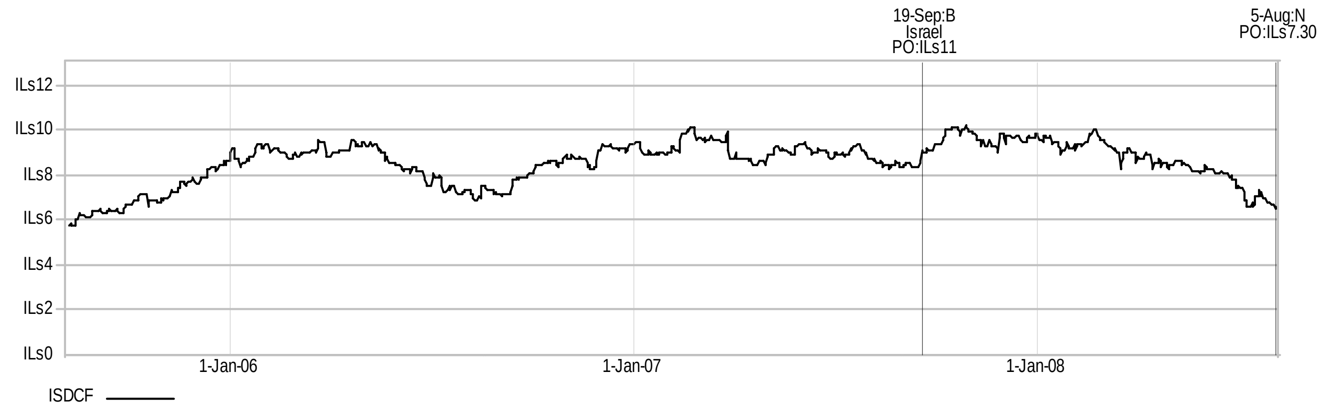
Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating 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	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod SM is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

Important Disclosures

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 July 31, 2008 or such later date as indicated.

Investment Rating Distribution: Banks Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	103	36.27%	Buy	46	56.10%
Neutral	75	26.41%	Neutral	34	51.52%
Sell	106	37.32%	Sell	51	54.84%

Investment Rating Distribution: Global Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1664	47.42%	Buy	441	29.46%
Neutral	803	22.88%	Neutral	224	31.46%
Sell	1042	29.70%	Sell	217	22.84%

* 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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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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