INITIATION

CREDIT SUISSE | FIRST BOSTON
Equity Research

SAE.TA
HOLD
Shk 16.5

29 April 2002
European / Israel
Food Retailing

Research team

Ehud Helft
972 9 885 5902
ehud.helft@csfb.com

Kenny Green
972 9 885 4105
kenny.green@csfb.com

Super-Sol

Initiation of coverage with a Hold

GROWTH OPPORTUNITIES IN THE ISRAELI FOOD RETAIL SECTOR

The Israeli food retail sector still offers attractive growth opportunities, in our view. This is because of 1) the relatively low penetration of supermarket chains (50% compared with the European average of 65%); 2) ongoing population growth of 2–2.5% a year; and 3) a 'convenient' competitive environment in which there are only two major players and no prospect of foreign competition.

SUPER-SOL: WELL POSITIONED COMPETITIVELY

Out of the three listed food retailers in Israel, we prefer Super-Sol because we believe it is better positioned to capture the above growth opportunities.

BUT MACRO ENVIRONMENT CONCERNS

We initiate coverage on Super-Sol with a Hold recommendation in light of the current poor macro conditions in Israel. We believe investors will have a better entry point once the macro environment shows signs of improvement.

Super-Sol SAE.TA

HOLD

Price (25 Apr 02)	Shk 16.5
Target price (12 months)	Shk 20.0
Shk / US$ exchange rate	4.88
Market cap.	US$694
Enterprise value	US$785

Year	12/00A	12/01A	12/02E	12/03E
Food revenues (Shk m)	5,916	6,371	6,849	7,465
Gross margins (%)	27.7	28.2	28.0	27.7
Operating profit (Shk m)	283	322	368	409
Operating margins (%)	4.8	5.1	5.4	5.5
EPS (CSFB adj.) (Shk)	0.83	0.94	1.04	1.16
P/E (x)	19.8	17.6	15.9	14.2
Pre-tax profit (Shk m)	267	296	345	386
EBITDA (Shk m)	442	505	560	620
EV/EBITDA (x)	8.7	7.6	6.8	6.2
EV/Revenues (x)	0.65	0.60	0.56	0.51
Year-end net debt (Shk m)	477.6	455.0	442.5	397.5

Dividend 2001 (Shk m)	96	Number of shares (m)	205
Dividend yield (%)	1.4		—

Company Description

Super-Sol is Israel's leading food retailer with an organised food retail market share of around 40%, operating a number of different format stores.

Strategic Analysis

Existing Strengths: Super-Sol has the leading market share of food retail in Israel, albeit by a small margin. It currently enjoys a reasonably stable position in a duopoly with Blue Square. It operates an efficient distribution centre and is a well-run business, in our view.

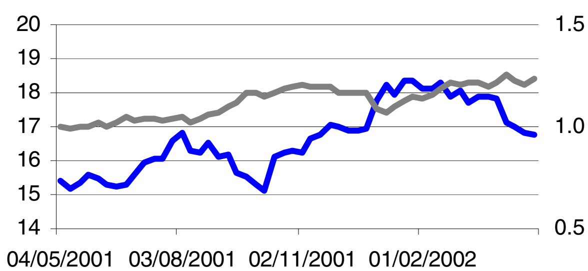
Existing Weaknesses: In the rush to establish new stores, Super-Sol has been cannibalising sales from its existing stores. Historically, Super-Sol is slightly behind Blue Square on a margin comparison. However, this we believe may change over the next two years.

Existing Opportunities: The organised food retail market is in a state of growth. 50% of revenue generated comes from the supermarket sector, having grown 3-4% per year over the past few years, compared with the European average of 65%. We believe there is still a few years of excess growth left in the organised food retail sector which Super-Sol will be able to take advantage of.

Existing Threats: Clubmarket, the #3 food retailer is restructuring to become more competitive. This may upset the established market balance. In addition, the security situation and economic outlook remain uncertain which is maintaining downward pressure on consumer spending.

Source: CSFB research

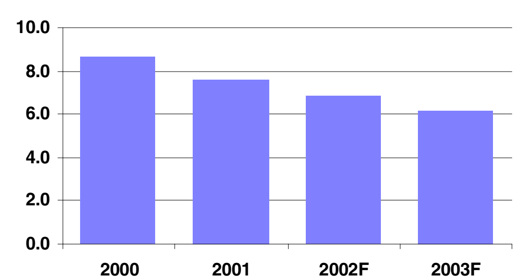
Share price (LHS) and price relative to TA100 (RHS, grey line)



On 25/04/02, the TA100 closed at 370.9.
On 25/04/02, the Shk/US$ exchange rate closed at 4.88.

Performance over	1mths	3mths	12mths
Absolute (%)	-7.96	-8.92	7.18
Relative (%)	1.64	7.81	20.20

EV/EBITDA



Source: Bloomberg, Datastream, CREDIT SUISSE FIRST BOSTON (EUROPE) LIMITED (CSFB) estimates

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Investment summary

Three questions

In this initiation report, we focus on the following three questions:

1. Should foreign investors gain exposure to the Israeli food retail sector?
2. Is Super-Sol the right choice or should investors prefer Blue Square?
3. Is Super-Sol trading on an attractive valuation?

The answers

Should investors gain exposure to the Israeli food retail sector?

The sector did particularly well in 2001, a year of severe recession in Israel. We believe the organised Israeli food retail sector is not only a shield against recession, but also a growth market. We estimate an underlying growth trend in the sector of around 7% per year, and we expect this to be maintained for the next five years. We believe this growth rate is driven by natural population growth in the country, the increased penetration by supermarkets of the food retail sector and an improving economy over the next few years.

Out of the whole food retail sector (including open-air markets and small local-food stores), the penetration of the organised food retail sector (organised supermarkets) stood at 50% at the end of 2001, having increased by 3–4% per year over the last few years.

The European average is 65%. We believe a number of drivers should allow the organised food retail sector to reach this average over the next five years. These include the convenience of supermarket shopping, its cost effectiveness and the potential of untapped population sectors. We expect this process of increasing penetration to be easier in Israel than in other places, owing to Israel's high population density and currently low penetration rates.

The risk is that the market may be closer to saturation than what we believe. If this is the case, then overcapacity could result in lower margins and diminishing returns on investments.

We believe the market is well shielded from foreign competition by some very significant barriers to entry. Importantly, Israel is a small country compared with any in Europe, and the political situation and cultural differences would deter any foreign entrant.

On the downside the Israeli economy is in a deep recession. In addition, the current political and security situation continues to depress the economy further.

The answer to the first question is: Yes. We do believe investors should gain exposure to the Israeli food sector. However, given the current economic and political situation, we believe investors will have a better entry point in the future once the macro situation shows signs of improvement.

Which one? Super-Sol or Blue Square?

Super-Sol is currently the market leader. We believe Super-Sol is better placed than any of its competitors to increase its market share and may be able to capture market share from Clubmarket, the number-three chain.

Super-Sol has focused on opening new stores over the last two years, with almost 30 new stores compared with Blue Square's ten since the start of 2000. We believe that as the market is still in a growth stage, this strategy will pay off. This is because the most important three factors for consumers when it comes to deciding where to shop is 'location, location, location'.

Blue Square does have better operating margins. However, we believe Super-Sol is well positioned and has the IT infrastructure in place to focus on reducing its operating costs. In addition, Super-Sol's gross margins are better than Blue Square's thanks to its state-of-the-art distribution centre. We believe Blue Square's distribution centre is being utilised at almost full capacity and that Blue Square will have to upgrade it to remain competitive with Super-Sol.

Other strategies to increase margins include a private label programme and the sales of non-food items. In both categories, we believe Super-Sol's programmes will be more successful than Blue Square's and will contribute positively to margins in the future.

So in answer to our question—Blue Square or Super-Sol?—we believe investors should choose Super-Sol.

Is Super-Sol trading on an attractive valuation?

Super-Sol trades at a 6% discount on a 2003E P/E comparison with Blue Square, but at a 8% premium to the European food retail sector average.

We believe Super-Sol is a slightly higher growth business than Blue Square and is better placed competitively. We therefore believe the relative valuation discount at which Super-Sol trades against Blue Square is unjustifiable.

As Super-Sol is in a growth market and Europe is at the end of its growth stage, we believe a premium valuation against Europe is justified.

Our VDF analysis shows that the market's growth expectations embedded in Super-Sol's share price are too low when compared to Blue Square. We extract a target share price of Shk 20. At around 20% above the current price, this makes Super-Sol look undervalued, but not a bargain.

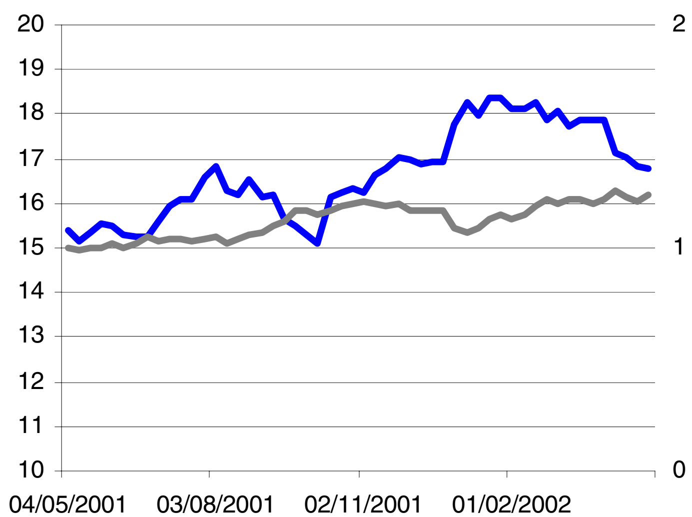
By investing in Super-Sol, we believe investors can enjoy a low-risk, reasonably-priced, recession-defensive stock, making money in a growing market. However, given the current political tensions in the country, we believe there will be a better entry point in the future. We therefore initiate with a Hold recommendation, but will be watching macro factors closely. As soon as the outlook improves, we will look to upgrade.

Food retail market in Israel

Food retail sector—not just a recession shield

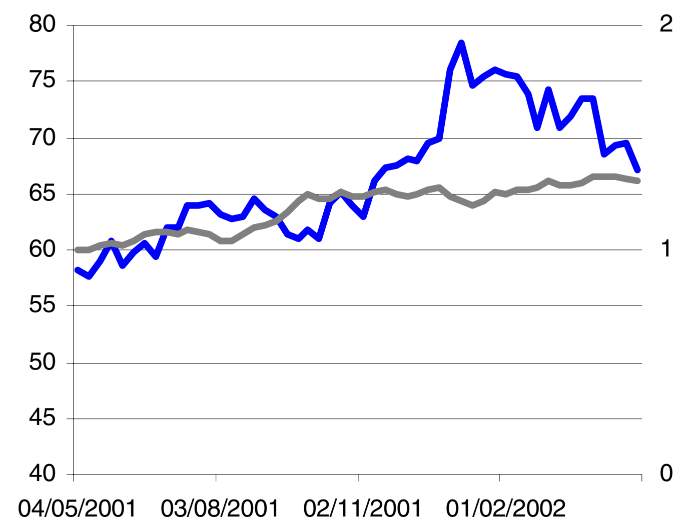
The two major food retail stocks in Israel, Super-Sol and Blue Square Israel, both performed well in 2001, despite the economic recession and political upheaval. Since the start of 2002, both companies have dropped from their highs at the end of 2001. In shekel terms, since the start of 2001, Blue Square and Super-Sol have both outperformed the TA-100 by around 30% and 20%, respectively. We argue that this performance is due not only to the defensive nature of the Israeli food retail sector, but also to the fact that the sector in Israel can still be considered a growth market.

Figure 1: **Super-Sol share price and relative graph**
Share price reported in Shk (LHS), relative to TA-100 (RHS, grey line)



Source: Bloomberg

Figure 2: **BSI share price and relative graph**
Share price reported in Shk (LHS), relative to TA-100 (RHS, grey line)

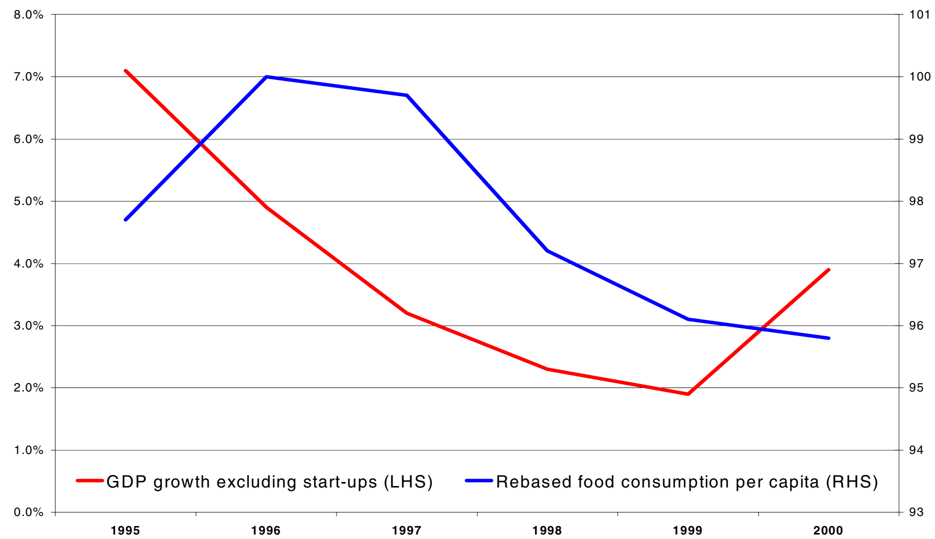


Source: Bloomberg

Food retail is traditionally viewed as a defensive sector in times of economic slowdown. This is based on the premise that retail food sales do not slow in a recession because food is the most basic spending item. It is often believed that restaurants lose their share of food spending to retailers in a downturn.

Whatever the logic, the practical outcome during this and the last recession is that food sales at retail rolled over with GDP, undermining the assumption that these stocks are good defensive investments in economic slowdowns. A slowdown in food sales is best explained by common-sense belt tightening by the consumer, most likely through buying cheaper goods or buying less.

Figure 3: Food consumption per capita against GDP growth in Israel
%



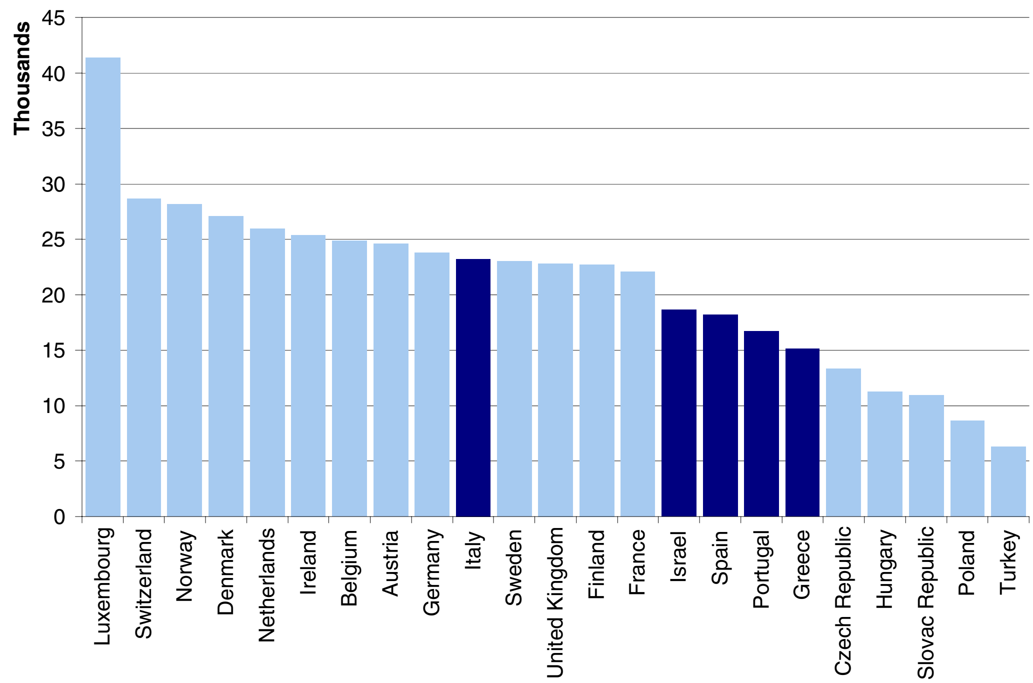
Source: Israel Central Bureau of Statistics

Figure 3 shows that as the Israeli domestic economy slowed down between 1996 and 1999, food retail sales per capita (re-based to the 1996 level) also dropped, albeit with a lag.

The food retail market in Europe

Culturally and in terms of consumer food spending patterns, we believe the closest comparables to Israel are the southern European countries with warmer climates, typically bordering the Mediterranean sea. These are in particular Italy, Greece, Spain and Portugal. We note that these countries are typified by a strong local food store presence and have seen recent strong growth among the large domestic and international food retailers in the local market. In addition, these countries have similar GDP per capita which would imply similar spending patterns amongst citizens. Figure 4 shows the European comparison for GDP per capita at purchasing power parity.

Figure 4: 1999 GDP per capita across Europe
US$ in thousands



Source: Israel Central Bureau of Statistics

We believe the Israel food retail market is a few years behind Europe, and that Israel has and will continue to follow the trend in Europe of a diminishing local store presence and a growing super or hypermarket presence. In the following sections, we demonstrate our belief that there are a number of drivers causing the Israeli food retail sector to tend towards the European model, whereby the local store will play a diminishing role in the market, being squeezed out by the large food retail players. However, we expect the difference in Israel will be that the process will be driven by the large domestic players, rather than a pan-European or an international player entering the market.

International European versus domestic Israel food retailers

Europe boasts some large pan-European food retailers. We believe the European (and US) food retail market is mature and much of the growth is achieved through acquisition rather than organically. Almost all of the leading European food retailers have activities outside their domestic markets and are continually looking for new markets and opportunities.

In contrast to Europe, the major food retailers in Israel are all domestic, limiting their activities to Israel. We believe that for the foreseeable future, Israel is well shielded from foreign entrants for several reasons.

1. *The Israeli food retail market is small compared with the average European country.* With only a little over 6m citizens, Israel is a small market on a European comparison.

2. *Politics*. Israel's current geopolitical problems with its neighbours will likely scare away any potential acquirer.

3. *Many of the Jewish citizens in Israel require their food to be 'kosher'.* We estimate around half of the Jewish citizens in Israel have some level of kosher requirements for the food they buy. This means there are certain foods or food ingredients they may not eat. Second, some people are strict in the sense that the food has to be prepared and cooked in a particular way to maintain its kosher status. For a supermarket to claim it is kosher, a licence from the local rabbinic authority is required, and in some cases a certified rabbi on-site to check food preparation remains kosher. This requires very specific religious knowledge, which is difficult for an outsider to obtain.

4. *Differing sub-cultures in Israel complicates matters.* Israel is a country with many immigrants and sub-cultures from all over the world. Each of these sub-cultures have their own food preferences and a supermarket needs to cater and understand all of these population sub-cultures.

Comparing the Israeli food retailers with Europe

Figure 5 compares Super-Sol's and Blue Square's 2002E operating and EBITDA margins with a number of European peers under CSFB coverage. On a comparison to the successful food retail chains in Europe, Super-Sol and Blue Square Israel both appear to run efficient operations. On a margin comparison, both rank slightly ahead of the European average. CSFB adjusted[1] EBITDA margins for 2002E for Super-Sol and Blue Square will be 7.6% and 7.7%, respectively. We calculate that 2002 adjusted operating margins for Super-Sol and Blue Square will be 4.9% for both.

[1] It is important to note that both Super-Sol and Blue Square offer credit to customers and allow them to pay their bills over a number a months. This was historically offered to customers as a way to differentiate from the competition, even though all supermarkets in Israel now offer it. However, Blue Square and Super-Sol both charge this 'discount' in their financial statements as a financial expense. To make a fair comparison with the rest of Europe, we believe this should be charged as an operating expense. We believe an average of 24 days of credit was given for free to customers of Blue Square and Super-Sol in 2001, and we expect this to stay steady over the next two years. We calculate that in 2002 this will cost Super-Sol Shk 36.5m and Blue Square, Shk 31.2m, reducing both operating margins and EBITDA margins by roughly 0.5% each.

Figure 5: Margin comparison for various supermarket chains across Europe, 2002E
%, unless otherwise stated

		CSFB adjusted operating margin (%)	Rank	CSFB adjusted EBITDA margin (%)	Rank
Blue Square Israel	**BSI.TA**	**4.9**	**5**	**7.7**	**5**
Super-Sol	**SAE.TA**	**4.9**	**5**	**7.6**	**7**
Ahold	AHLN.AS	4.1	10	6.6	9
AVA	AVAG.F	2.8	13	4.0	15
Carrefour	CARR.PA	3.7	11	6.6	9
Casino Guichard	CASP.PA	3.4	12	5.5	12
Colruyt	COLRt.BR	5.4	3	7.8	4
Delhaize	DELBt.BR	4.3	9	7.7	5
Jeronimo Martins	JRMN.IN	4.6	8	9.4	1
Metro	MEOG.F	2.3	14	4.6	14
Morrison (William)	MRW.L	5.6	2	8.1	2
Rinascente	RINI.MI	1.8	15	5.3	13
Safeway Plc	SFW.L	4.9	5	7.1	8
T & S Stores	TSS.L	5.0	4	6.3	11
Tesco	TSCO.L	5.8	1	8.0	3
Average		**4.2**		**6.8**	
Median		**4.6**		**7.1**	

Carrefour, CARR.PA, eu 49.52, Buy; Jeronimo Martins, JRMN.IN, eu 9.0, Sell; Rinascente, RINI.MI, eu 4.07, Hold; T&S Stores, TSS.L, 337.5p, Buy

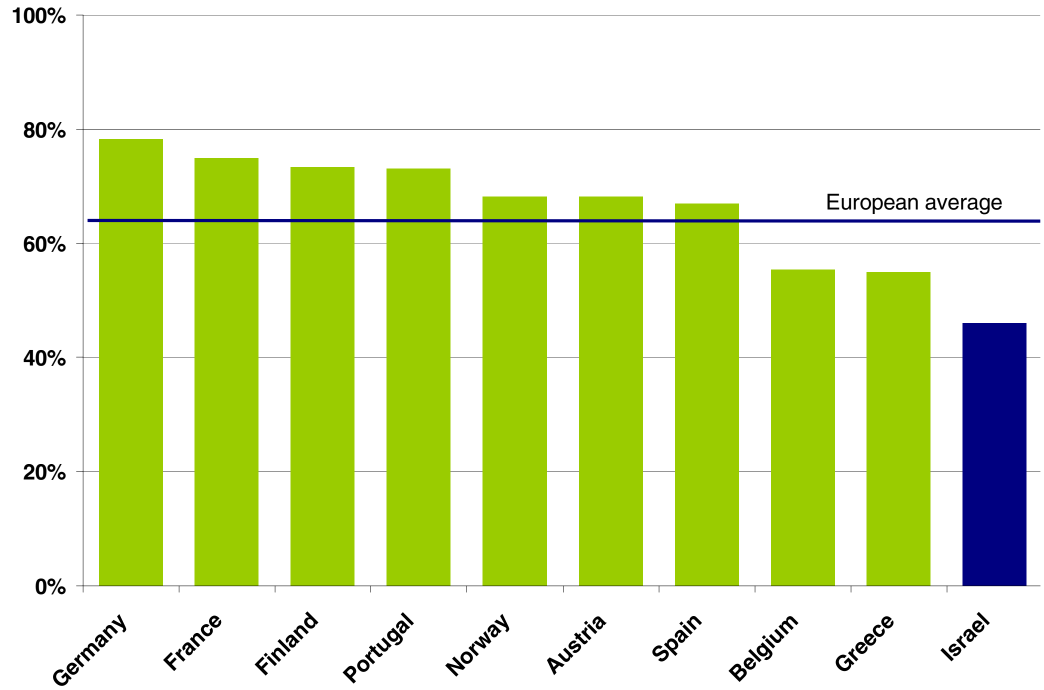
Source: Company data, CSFB estimates

The local food store

Across Europe, the hypermarket (defined as having a selling space of more than 2,500 square metres) and supermarket (400–2,500 square metres) are both growing at the expense of small local food stores (below 400 square metres). In the southern part of the continent, the local store plays a larger role in daily life—similar to Israel—but these countries are becoming more and more like their northern counterparts, characterised by a diminishing market share for the local food store. We believe Israel is no different in this respect and is tending towards the European average, its growth driven by the large domestic players.

Israel still has local food stores and open markets taking around 50% of food retail revenues in 2001. This figure has dropped from around 55% in 1999, 63% in 1997 and 68% in 1995. This is below the current European average of 35% and US average of 25%. Figure 6 shows the penetration of the supermarket by looking at sales in supermarkets as a percentage of total food retail sales over selected countries for which the data is available in 1999. We find that compared with our group of western European countries, Israel had the lowest supermarket penetration of 45% against between 55% and 78% for the group. In 2001, we believe Israel caught up slightly with penetration of 50%, but we believe there is still room for growth up to 65%, the average for Europe.

Figure 6: **Supermarket penetration of food retail market across Europe, 1999**
Supermarket sales as a % of all food retail sales



Source: Retail Intelligence, CSFB research

Growth drivers

We believe there are a number of long-term drivers at play which will enable the supermarket to capture share from the local food store, bringing the Israeli penetration figure towards the European average. We expect the rate of decline of market share of the local store to average between 2% and 3% per year over the next five years, marginally slower than the rate of decline over the last few years, which was around 3–4% per year.

Convenient one-stop shopping

As more supermarkets open in local areas, the supermarket offers significant convenience to the consumer over the local store. These include shopping all under one roof, different payment options, customer loyalty schemes and ease of accessibility by car or public transport.

Food in a supermarket tends to be fresher, as the food goes through full turnover in less time than a local store. In addition, the supermarket is able to tap a large market for goods, having access to suppliers offering better quality and a wider range of non-local goods.

Cost effective

Supermarkets are able to use their economies of scale to source goods at a lower price, which the local store is unable to do. A large supermarket is better able to manage its inventory and the cost of storage space per square metre tends to be lower. In terms of logistics, only a large supermarket chain is able to reach significant efficiencies. This enables the supermarket to operate with a lower cost base than a local store. Thus, there are savings that can be passed back to the consumer in the form of cheaper goods.

Untapped population segments

Figures issued by the Bureau of Statistics show that the population of Israel is currently 6.5m. 1.2m of this population are Israeli Arabs. The majority of the Arab population tend to live in their own areas, and Super-Sol and Blue Square have only made very small strides to penetrate these areas. Super-Sol has only two supermarkets out of 166 selling to this community, even though Israeli Arabs make up 19% of the population. However, Super-Sol inform us that these two supermarkets have seen limited success but are increasing sales at a slow pace.

We believe the low penetration is in part due to politics and part a cultural issue. Politically, we believe both Super-Sol and Blue Square will wait for an end to the conflict with the Palestinians before making major strides into the Israeli Arab sectors. Second, culturally Arabs tend to prefer shopping locally or in open-air markets. Significant price savings and convenience will have to be proven before these shoppers change their habits, in our view.

Another sub-population, which has recently become more of a focus, is the ultra-orthodox Jewish segment. The large retailers have placed resources into attracting this population by providing savings on food with the correct stricter rabbinic kosher licences in competition with the trusted local stores. The supermarket penetration of this segment is below the 50% average penetration we find in Israel, but we estimate that this sector will catch up to the country average over the next two to three years.

The strictly kosher supermarkets have become more popular in recent times and as these supermarkets further gain the trust of the ultra-orthodox population and offer cost savings, we expect these stores to further capture market share. This is because the ultra-orthodox population is one the poorest segments of Israeli society, with typically large families to feed. Any saving, given the adequate rabbinic licence, is generally warmly received, even if it means transferring business away from the local store. However, as one of the poorest segments of the Israeli population, combined with the increased expense of kosher food, gross margins for in this sector are substantially squeezed, but since these supermarkets are much cheaper to run, operating margins tend to be higher.

Population growth

In addition to untapped populations, Israel enjoys a strong growth in population. The Jewish population has been growing on average by around 2.3% a year since 1980, with an Israeli-Arab population growing at average of around 3.8% in this period. This provides Israel with an inherent advantage over Europe whose population is more or less steady (having declined a total of only 0.2% between 1995 and 2000), a trend we expect to continue. We argue that food consumption of a country grows in line or slightly ahead of population growth—in other words, on a European comparison, Super-Sol's revenue pie has a comparably strong underlying growth rate.

The other factor affecting food consumption is GDP growth and GDP per capita. When GDP growth is high and consumers 'feel' wealthier, consumers are likely to spend more on food, buying more sophisticated products with higher margins such as organic milk or ready-made meals—similarly, as GDP per capita increases and the population actually does become wealthier. Figure 3, as we demonstrated earlier, shows the current situation in Israel. As GDP growth dropped in the last few years, food consumption per capita dropped and it appears that the situation has reached a trough.

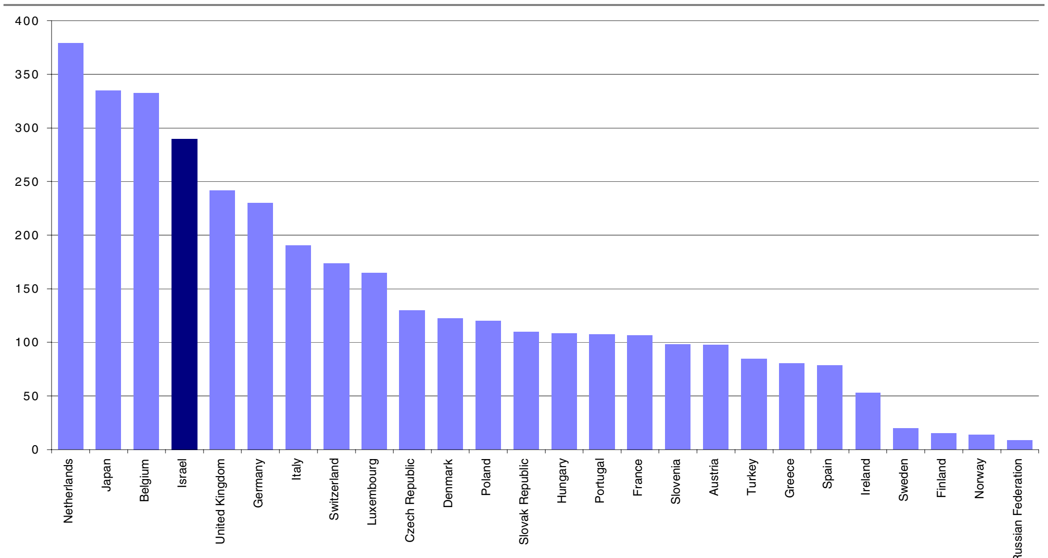
As the long-term trend is a positive GDP growth of 3–4% in Israel, combined with an average population growth of around 2.5%, we believe the long-term underlying food retail spending growth trend for the country is a little above 4% per year.

However, if we look at the trend for organised food retail, adding the expected 2–3% growth over the next five years, then the underlying organised food retail spending growth trend reaches around 7% per year.

Israel—everywhere is local

Israel is a good candidate enabling efficient supermarket growth. It has one of the highest population densities in European context, with 290 people per square kilometre and 65% of the population living in the narrow coastal plains that make up about 20% of the land mass. This means that a supermarket in Israel is accessible to a typically higher than (the European) average number of people. We would argue that this high population density enables supermarkets to compete more effectively with the local store.

Figure 7: Population density across Europe, 1999
in people per square kilometre



Source: Israel Bureau of Statistics

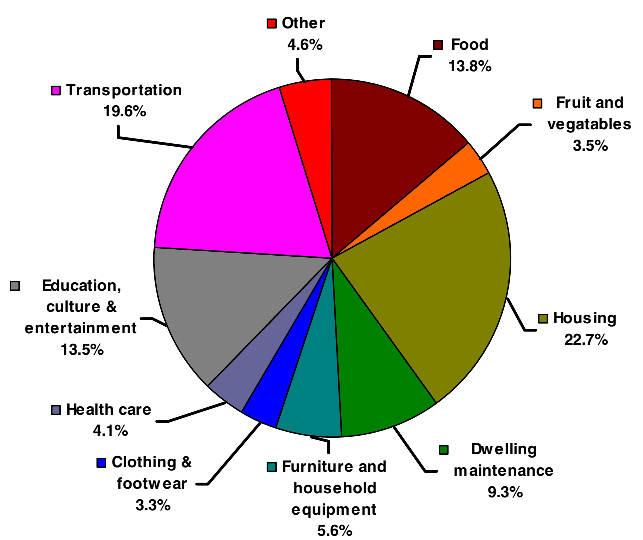
The centrality of food in Israeli life

Culturally, food is central part of Jewish-Israeli life. Traditionally, the sabbath, which occurs every Saturday in Israel, is a time families spend together and eat together. In addition, there are a number of holidays during the year, particularly the New Year and Passover holidays, where food plays a significant role. The food retailers normally show higher results during the quarters that contain or precede these holiday periods—normally the second and fourth quarters.

Figures 8 and 9 show that Israeli households spend a larger portion of their wealth than the average American household on food. Israeli's spend 13.8% on food and another 3.5% of fruit and vegetables, whereas American's spend 12.2% on food and only 1.4% on fruit and vegetables.

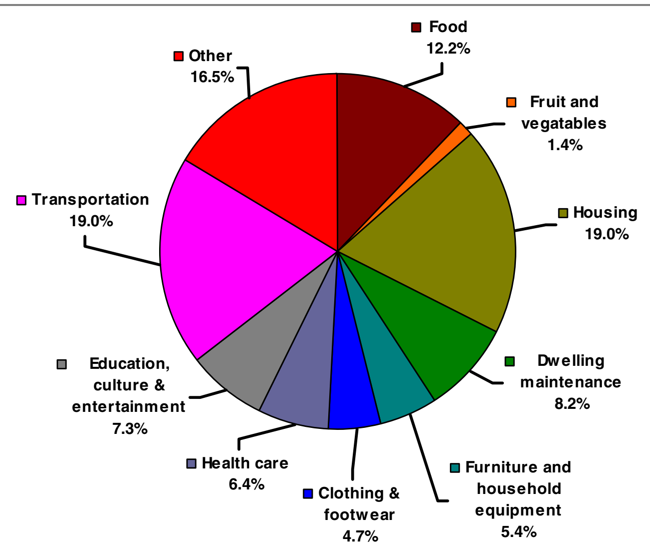
Figure 10 shows a European comparison of food sales as a percentage of retail sales. We find that 54% of retail sales in Israel is food. Sweden is the only country in western Europe to have a higher percentage of food retail sales as a percentage of all retail sales. We believe these figures demonstrate, in part, that culturally food is more central to life in Israel than elsewhere in Europe and the US.

Figure 8: **Israeli household consumer expenditure, 1999**
%



Source: Israeli Central Bureau of Statistics

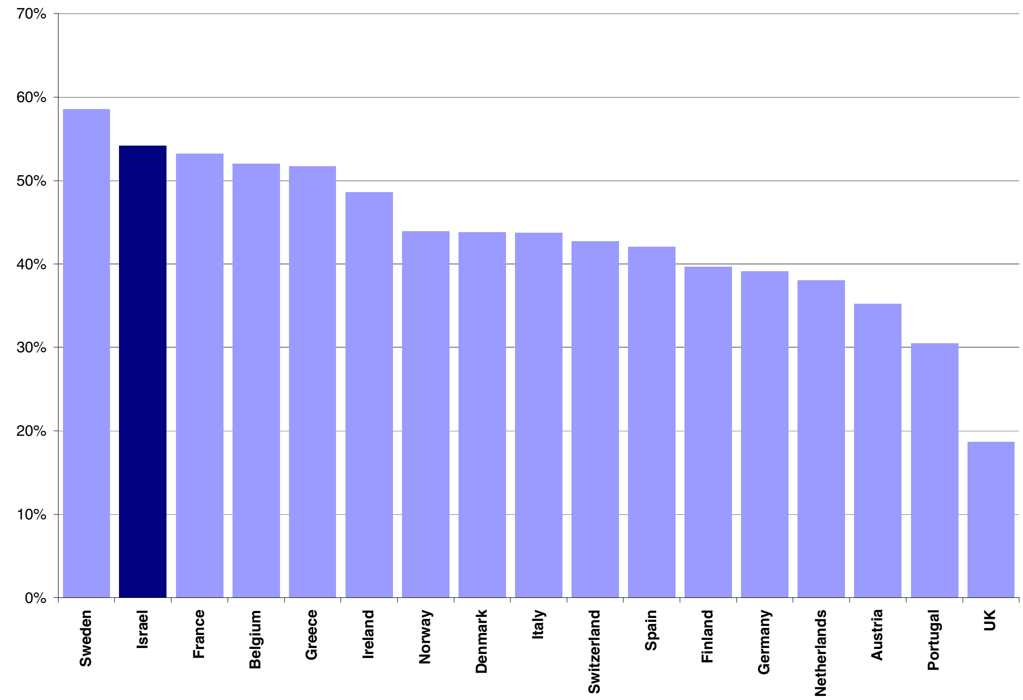
Figure 9: **US household consumer expenditure, 1999**
%



Source: US Department of Labour

Figure 10: Food sales as a percentage of retail sales across Europe, 2000

%



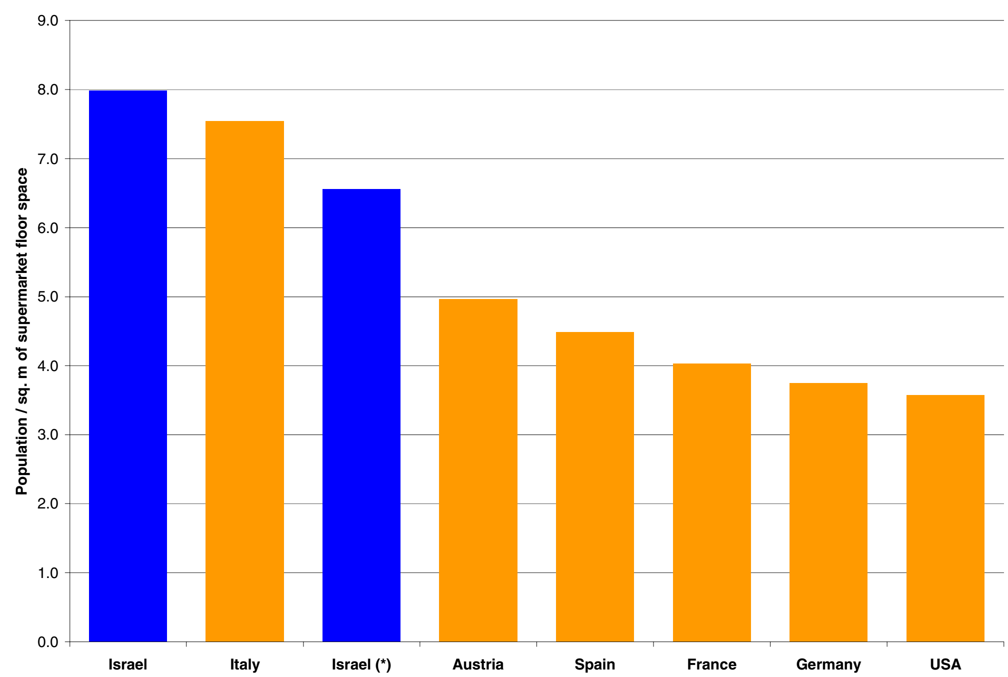
Source: Israeli Central Bureau of Statistics, CSFB research, Retail Intelligence

Not enough supermarkets to service the current population

If we take the population of a country and divide it by the total supermarket floor space within a country, we see that Israel has the highest number of people per square metre of supermarket floor space at 8.0 people per square metre of supermarket floor space. We have done this for Israeli population including and excluding the (mostly untapped) Arab segment of the population. Excluding this segment of the population, the figure is at 6.6. This compares with Italy at 7.5, Austria at 5.0 and Spain at 4.5.

This suggests to us that the number of supermarkets currently in the country could not adequately service the entire population. We believe these results imply that there is still room for growth for establishing new supermarkets—that is, opening new stores before saturation point is reached. Both Super-Sol and Blue Square have announced that they each intend to open between ten and 12 new stores this year.

Figure 11: Population per square metre of supermarket floor-space
in people per square metre



**Excluding the Israeli-Arab population*
Source: Retail intelligence, CSFB research

But in the short term . . .

The political and security situation in Israel has seen a number of suicide bombings including one in a Super-Sol in Jerusalem. The attacks have caused the population to avoid public places such as town centres, cafés and restaurants, shopping malls and open-air markets. This has had a positive and negative impact on supermarkets. The aversion to open-air markets and eating in restaurants is a positive for the supermarkets. However, the reduced number of people shopping in malls, town centres or public places, all places where the food retail chains have sited supermarkets, has had a negative impact on results. We believe the net effect places the supermarkets at a slight disadvantage to the local stores. Realistically, it cannot be predicted when the political and security situation will stabilise, although the recent upheaval seems to us to be drawing to a close.

The ongoing economic recession has motivated consumers to search for the lowest prices. This has caused a large growth in the revenues of the lower-margin discounted food retailers in Israel, many of which belong to either Super-Sol or Blue Square. Subsequently, both companies continually convert existing stores and establish new stores of this format type. We expect this to squeeze gross margins in the near term. However, as these stores have low SG&A costs, operating margins are not affected as much.

The recession has also had a significant effect on the local store in Israel. We estimate that a large proportion, up to 50%, are experiencing financial difficulties owing to the ongoing recession. If the recession continues, many local stores are likely to close down, transferring business to the supermarkets, which we believe are better able to weather the recession. This should have the effect of accelerating the supermarkets penetration of food retail sales.

We believe the recession will continue to affect results adversely for at least the first half of 2002, in particular as the recession feeds through and reduces consumer expenditure. We (optimistically) expect the second half of 2002 to see improvement in the Israeli economy, with a FY2002 GDP growth of 0.8%. We note that the unpredictable political and security situation will need to calm down to allow for this recovery.

The Clubmarket factor

Ownership of Israel’s third-largest food retail chain, Clubmarket, has recently changed hands. In August 2001, the Borovitz-Rosen group bought a 68.5% controlling interest in Clubmarket from the Co-Op Metro group for US$72m. In October 2001, the group purchased another 30% of the company from Darban Investments for US$25m. Darban Investments was formerly the controlling shareholder in the Greenberg retail chain, which merged with Clubmarket. After completing the acquisition, the group holds 98.5% of Clubmarket. Former Greenberg chain CEO, Giora Sarig, holds the remainder.

Clubmarket operates 171 stores; its revenue for 2001 stood at Shk 3.4bn translating into a market share of 10.7%. The chain lost around Shk 40m in 2001. We believe Clubmarket is losing market share because it is beset by a weak brand image and outdated operating systems. The company is undergoing a massive process of change and the management team has recently been replaced by a number of prominent ex-Super-Sol employees in order to turn the company around. The CEO, Mr. Ginsbourg, was originally a marketing vice-president at Super-Sol. We believe that given the current problems with the chain, a recovery is potentially likely to take some time.

However, we believe this chain could become a more significant factor in the industry, as it adopts a strategy similar to that employed by Super-Sol and Blue Square. We believe Clubmarket has the potential to upset the duopoly shared by Super-Sol and Blue Square, directly competing with them for a slice of the diminishing local store market. This would affect the growth rates of Super-Sol and Blue Square. However, if Clubmarket fails and continues to lose market share, its failure could be an opportunity for both Super-Sol and Blue Square to capture its market share.

Clubmarket clearly faces a tough struggle. In our view, it will require a commitment of significant investment to improve itself to enable it to compete adequately with both Super-Sol and Blue Square. Compared with Supersol and Blue Square, we believe its logistics infrastructure is lagging, and its inventory management and other IT systems are behind. Clubmarket does not have an advanced loyalty programme and its private label programme is less developed than its competitors. In addition, we believe both Blue Square and Super-Sol are well equipped to take on Clubmarket should it pose a more significant threat.

We believe that in the short term the most likely is that Clubmarket will focus on improving itself and bolstering its current position. We expect that it will not try to take on the two larger players head on. We believe it will only pose a threat once it has stabilised its current position, which could take a year or two.

Even though there are a number of factors that may challenge Super-Sol (and Blue Square) in the future, we expect Clubmarket to be the most significant threat in the medium term.

Main risks to our assumptions

We believe there are three key risks that could invalidate our assumptions. We summarise them in the following sections.

Saturation assumptions

We believe there is a risk that saturation of the food retail market by supermarkets could occur earlier than we expect and also at a lower penetration rate than we expect. We believe Israel is following the trend we have observed in Europe over the last few years and will continue to do so (reaching 65% penetration over the next five years). However, we also note that the Israeli food retail market has its differences to the European market and the trend Israel may not be completely convergent with that of Europe.

1. *The demise of the local store*. Even though many are finding it tough in the current environment, the local store is a place where a customer can ‘pop in’. Customers have typically built up a relationship with the local storeowner who can therefore offer a better personalised service. Furthermore, buying a small number of items quickly, such as milk or a bar of chocolate, is quicker and more convenient at the local store. Finally, the local store can offer fresh locally-produced goods, which the supermarkets will not offer. The practical outcome is that our expectation of a 65% penetration rate may be too high if consumers remain loyal to local stores.
2. *Israeli-Arab sector may not be penetrable*. Regarding the Israeli-Arab population in Israel, owing to cultural differences (and prolonged political problems) it may never be possible to penetrate this sector, independent of the incentives offered. Assuming this sector is impenetrable by the supermarkets, given a current 50% penetration rate, excluding purchases made by Israeli-Arabs will leave this rate at a figure closer to 60%. This only leaves the supermarkets with a year or two’s more growth at the expense of the local store before reaching saturation point.

Competitive risk

3. *Increased competition poses a serious threat as Clubmarket restructures itself*. Super-Sol and Blue Square currently enjoy a relatively stable duopoly. Clubmarket has the potential to upset this stability significantly. However, we do not believe Clubmarket poses a threat in the near term and in its current state may be an opportunity.
4. *Blue Square* may take over from Super-Sol and become the leader as it finds new and better ways to compete. Even though we believe Super-Sol is in a better competitive position at the moment, the situation can change.

Macro factors

5. *The Israeli economy is in recession*. Even though there have been signs of recent improvements, there is no guarantee that these improvement will be sustained, particularly in the backdrop of significant regional tension and instability.

6. *The Israeli-Palestinian conflict* has and still remains unpredictable and will likely continue for a while as we believe it is unlikely that the conflict will reach a quick resolution. This may place prolonged downwards pressure on the economy and our growth assumptions may be too high.

Conclusion

We have shown that the food retail sector in Israel should not be viewed as only a recession shield. Food retail is affected by recession, but has been resistant to the recession because we believe it remains a growth market in Israel.

We expect the growth in supermarket penetration of the food retail market to model the experience in western Europe over the last few years. However, we believe this will be driven by the domestic Israeli players rather than international players.

Israel still has local food stores and open markets taking around 50% of food retail revenues in 2001 compared with the European average of 35% and the US average of 25%. We expect local food stores and open market penetration to reduce down to 35%—the European average—over the next five years.

We believe this process will be driven by a number of factors:

1. *As more supermarkets open in local areas, the supermarket offers a number of advantages over local stores*. These include fresher food, greater variety, the ability to offer lower prices and shopping all under one roof.

2. *A number of population segments, we believe, remain untapped*. These include the ultra-orthodox and Arab-Israeli segment. However, we are seeing traction among the ultra-orthodox. With regard to the Arab-Israeli segment, we do expect any of the food retail chains to apply resources developing this segment in the near term.

3. *Israel has one of the highest population densities in comparison to Europe*. This means that the typical supermarket in Israel can potentially be exposed to a greater number of customers than a similar supermarket elsewhere in Europe.

4. *Culturally, food is central part of Jewish-Israeli life.* We find that Israeli's spend a higher portion of the wealth on food than American's or most Europeans. In addition, there are a number of Jewish holidays throughout the year where family meals are commonplace and sales increase at these times.

5. *Based on population per unit floor space of supermarket, Israel has the highest ratio compared with other European countries*. This suggests that the market is far from being penetrated, and there is much room to open new supermarkets.

However, we believe that in the short term results may be negative owing to a number of macro factors affecting the Israeli economy as a whole:

1. *The economic recession continues*. We expect an upturn in the second half of this year, but improvements depend on the security situation, which remains unpredictable.

2. *The Israeli-Palestinian conflict has had an affect on the way people shop*. This has affected results—we believe, on the whole, the effect is negative.

We believe that in the medium term, both Super-Sol and Blue Square face the challenge of renewed competition from the number-three chain, Clubmarket. Clubmarket has recently seen a change in ownership and management and in future may become a significant threat to the duopoly that Super-Sol and Blue Square share.

Super-Sol versus Blue Square

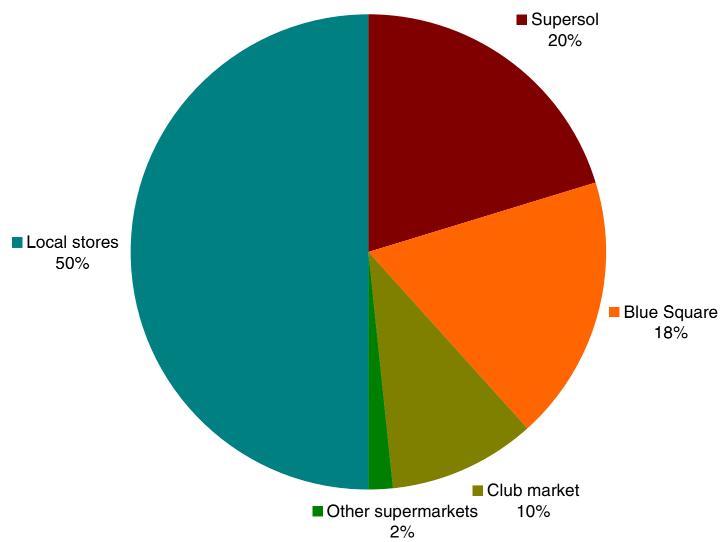
Market shares

Over the course of 2001 the two main supermarket chains, Super-Sol and Blue Square, captured market share. This came mainly at the expense of the local stores and the Clubmarket chain.

Super-Sol is currently the leader with an organised food retail market share of 40.3%, up from 37.9% at the start of 2000. Blue Square is in second place with 35.3%, up marginally from 35.1% at the start of 2000. Both these companies are profitable. Clubmarket has a 21.5% market share, having seen a decline of 1.7% since the beginning of 2000.

Figure 12: **Market share of food retail market in Israel, 31 December 2001**

%



Source: Company data, CSFB research

Super-Sol or Blue Square? A strategic perspective

Super-Sol and Blue Square Israel have adopted similar strategies of massive expansion through new store openings and continuous reorganisation to promote efficiency.

Main reasons to choose Super-Sol

Super-Sol has applied its strategy more strongly with regard to the rate of new store openings, outlet size and volume of products sold in each store. Super-Sol opened 11 new stores in 2001 and another four in the first quarter of 2002. This compares with Blue Square's opening of three stores in 2001. However, both added a similar amount of floor space in 2001. Blue Square did this by expanding existing stores or closing down smaller stores and opening larger stores. Blue Square's average store size still remains smaller than Super-Sol's. However, based on guidance given in the Blue Square conference call and based on our discussions with Super-Sol's management, we expect both companies to open 10–12 new stores this year.

A higher number of new store openings has allowed Super-Sol to increase its share in the market more than anyone else, but has generated a process of cannibalisation whereby the chain hurts its own stores. Thus, for most of 2001, Super-Sol suffered more from declining sales in its existing stores than Blue Square. However, the last quarter of 2001 saw a significant turnaround, with Super-Sol actually raising same store sales by 0.6%, while Blue Square's same-store sales dropped by 5.9%. This brought the full-year same-store sales growth figures for both to a negative -3.2%. However, Super-Sol's fourth-quarter figures suggest that Super-Sol may have reached the turning point and its new store openings in 2001 have started to be successful.

In 2001, Super-Sol grew revenues by 7.7% in real terms compared with Blue Square's 5.8% in real terms, over 2000. This led to Super-Sol's market share growth of the organised food retail market of 0.7% to 40.3% over 2001 compared with no growth for Blue Square, with a market share of 35.3%. However, if we look at the overall food retail market, Super-Sol grew its market share to 20.2% and Blue Square to 17.7% from 18.2% and 16.2%, respectively.

Super-Sol has a lead over Blue Square in self-distribution, which contributes significantly to gross profitability, and the company does have higher gross margins at 28.2% compared with Blue Square's 27.3% for 2001. Super-Sol operates a large modern centralised distribution centre whose capacity can easily be expanded. In addition, the centre allows Super-Sol to increase selling space per store, as less stock needs to be held there. Currently, 55% of goods are processed through the centre. The company's long-term target is 75%. Conversely, 28% of Blue Square's goods are processed through its distribution centre and we believe that this is close to its upper limits. In order to enlarge the number of products in its self-distribution programme, we believe the company will have to erect a new distribution centre.

Why would I choose Blue Square?

Blue Square has focused on attempting to maximise revenues and profits per sales space whilst squeezing operating expenses on a store basis. The company boasts a consistently higher sales per square metre of Shk 20,800 in 2001, compared with Super-Sol's Shk 18,700. We believe this is in part because Blue Square devotes less sales space to non-food products which have lower sales per square metre. Non-food products account for 4.5% of selling space in Blue Square compared with 8% for Super-Sol.

Blue Square operates smaller stores that allow closer control. However, most significantly we argue that Blue Square runs a more efficient operation than Super-Sol. Historically, Blue Square's operating and EBITDA margins are consistently higher than Super-Sol's. Operating margins for 2001 were 5.4% for Blue Square against 5.0% for Super-Sol. EBITDA margins for 2001 were 8.2% for Blue Square against 7.8% for Super-Sol. However, we believe the focus on efficiency may come at the expense of long-term market share growth. In addition, to continue to compete with Super-Sol effectively, we believe Blue Square will have to improve its distribution centre as its gross margins are consistently lower than Super-Sol's.

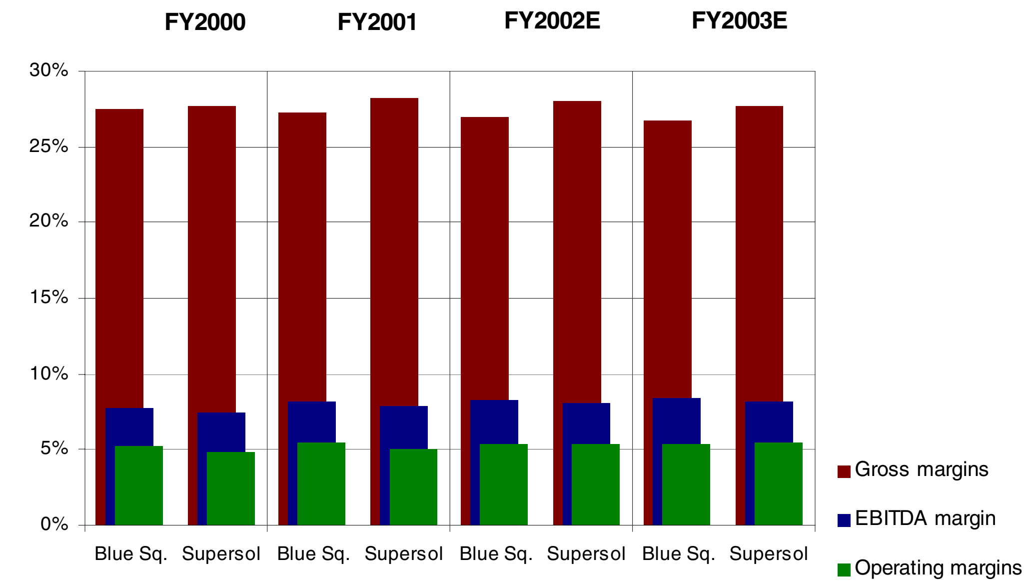
Figure 13: Yearly operating results and expectations compared

	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol
	FY2000		FY2001		FY2002E		FY2003E	
Revenue and net income growth								
Food Revenue excluding rentals(Shk m)	5272	5916	5577	6371	5940	6849	6356	7465
Food Revenue growth year on year (%)	5.5	**9.5**	5.8	**7.7**	6.5	**7.5**	7.0	**9.0**
EPS growth year on year (%)	37.7	**39.9**	10.0	**12.8**	8.5	**10.2**	8.9	**12.1**
Margins (based on food revenue only)								
Gross margins (%)	27.5	**27.7**	27.3	**28.2**	27.0	**28.0**	26.8	**27.7**
Operating margins (%)	**5.2**	4.7	**5.4**	5.0	5.4	5.4	5.4	**5.5**
EBITDA margin (%)	**7.8**	7.4	**8.2**	7.8	**8.3**	8.1	**8.3**	8.2
Sales area and sales ratio								
Total sales area at period-start (sq m)	239,000	264,900	258,000	331,600	279,100	356,100	304,100	386,100
Total sales area at period-end (sq m)	258,000	331,600	279,100	356,100	304,100	386,100	329,100	416,100
Sales area added during period (sq m)	19,000	**66,700**	21,100	**24,500**	25,000	**30,000**	25,000	**30,000**
Growth in sales area (%)	7.9	**25.2**	**8.2**	7.4	**9.0**	8.4	**8.2**	7.8
Growth in same store sales (reported) (%)	-4.4	**-2.2**	-3.3	**-3.2**	-3.0	-1.0	-1.0	0.0
Sales (Shk 000s) per sq m (sales/average floor space)	**21.2**	19.8	**20.8**	18.5	**20.4**	18.5	**20.1**	18.6
New stores stats								
Number of stores at period-start	165	138	168	151	171	162	181	174
Number of stores at period-end	168	151	171	162	181	174	191	186
Number of new stores added during period	3	13	3	11	10	12	10	12
Average area per store at period-start (sq m)	1,448	1,920	1,536	2,196	1,632	2,198	1,680	2,219
Average area per store at period-end (sq m)	1,536	2,196	1,632	2,198	1,680	2,219	1,723	2,237
Growth in average area per store over period (%)	6.0	**14.4**	**6.3**	0.1	**2.9**	0.9	**2.6**	0.8
Sales per store (sales/average number of stores) (Shk m)	31.7	**40.9**	32.9	**40.7**	33.8	**40.8**	34.2	**41.5**
Capex/store	2.1	**2.4**	2.0	**2.0**	**2.0**	1.8	**1.9**	1.8

The bolded figures indicate the higher value on comparison of Blue Square and Super-Sol's figures
Source: Company data, CSFB estimates.

Figure 14: **Blue Square and Super-Sol margins compared**

%



Source: Company data, CSFB estimates

Focus on business efficiency

There has been a trend to improve margins by increasing business efficiency and, as we demonstrated above, both Super-Sol and Blue Square boast strong margins on a European comparison. Based on our conversations with Super-Sol's management, we believe there is still room for improvement in margins as the company strives to operate more efficiently.

Distribution centres

As we have mentioned, Super-Sol has established an efficient distribution centre, with capacity that can easily be expanded. This has contributed to the improving margins that Super-Sol has seen over the past year. However, we believe there is still some room for further improvement in gross margins due to the distribution centre, but the majority of the improvement has now fed through into Super-Sol's results. We therefore expect the centre's contribution to margin improvements to continue to diminish.

We believe BSI's distribution centre is operating at maximum capacity now and in order to enlarge the number of products in its self-distribution program, the company will have to build a new distribution centre.

Private label

Both companies are vigorously pursuing private label programmes which offer cheaper products to the consumer, but also higher margins for the company. This greatly contributes to gross margins.

BSI's private label strategy is based on the Casino (a large French food retailer) private label brand name called Leader Price. BSI has the advantage that it can easily expand the variety of products it offers, but it is tied to one supplier—which reduces its capacity to shop around for the cheapest prices. In addition, Blue Square's private label programme is exposed to shekel/euro currency fluctuations, higher transportation costs, commission charges and difficulties in adjusting products for the local market. Until recently, Blue Square benefited from a weak euro, but now the weak shekel increases the cost of private label goods with a limited ability to pass these costs on to the consumer.

Super-Sol markets a line of private label products, called Super-Class. Currently, 8% of revenues come from these goods, which are produced by a number of manufacturers. Super-Sol has specific agreements with each manufacturer. Many of these manufacturers are local, reducing shipping costs and currency exposure. However, we believe it may be more complex for Super-Sol to increase the number of private label goods it can source since it needs to negotiate a new contract with each new supplier. Super-Sol has therefore employed Daymon Associates, a top consultancy, in advising on private label strategy. So far, we believe the company's private label strategy has been successful as it has met its targets. There is still a way to go and the company targets 15% by 2005. Should the strategy prove successful—and we believe it will—gross margins should benefit.

Loyalty programme, inventory management and Information Technology

Both Super-Sol and Blue Square operate successful loyalty programmes. A loyalty programme enables the companies to offer discounts to consumers by collecting points for purchases. In return, the companies gain information regarding shopping habits. Consumers' shopping habits can be tracked across all the particular company's stores, independent of format.

Consumer shopping information is collected at the POS systems. In particular, if the consumer is a member of the loyalty programme, these new purchases increase the information known about that particular consumer and his or her habits and are added to a data warehouse.

The POS system and data-warehouse system combined with information provided by an inventory management system provides analysis and reporting which can help decision-making within stores based on demography and shopping habits of the customer base.

Both Super-Sol and Blue Square operate advanced systems. We believe both companies still have a capacity to make further use of their systems and data. We expect that as these systems are advanced, better sales and marketing strategies, as well as improved inventory management strategy, will be identified. We believe this will allow for improvements that will contribute positively to margins over the next few years.

Discount stores

Discount stores have proven very popular in Israel, particularly in light of the current recession, with all food retailers continuing to convert stores to this format. There is heavy competition within this sector. This has affected stores by contributing a reduction to gross margins. However, these stores tend to have much lower operating costs and therefore operating margins are generally better.

Non-food sales

These items typically enjoy higher margins and will help the gross line, but they also sit on the floor in stock for a longer time than food contributing to a lower sales per square metre figure for Super-Sol. Super-Sol currently sees around 10% of its sales in the non-food category and targets 15%. We believe Super-Sol will be successful in reaching its target. It is interesting to note that Super-Sol was the top seller of laptops in 2001 in Israel.

Management believes that once the economy in Israel improves, this will be an area where the benefit will be significant.

Other areas for potential improvement

Based on conversations with management, we believe Super-Sol can further improve margins in the following areas:

1. Super-Sol allows shelving to be done externally. As part of their agreements with Super-Sol, various suppliers shelve their own products. This is not efficient as ideally higher margin products should be placed in positions most attractive to consumers—which tends to be at eye-level. We believe Super-Sol needs to renegotiate its agreements with suppliers and perform shelving itself.
2. Food retailers suffer from some inventory loss (as a result of theft or mismanagement), which better use of inventory management systems will help to avoid.

Branding

The most recent survey (September 2001), reported in the local papers in Israel, was conducted with a country-wide sample of 600 respondents from diverse socio-demographic backgrounds. Three key parameters, which together constitute a brand's marketing equity, were measured in the survey: brand awareness, quality perception and preference.

Even though in the past Blue Square’s Mega was the leading food retail brand, Super-Sol’s Hypernetto caught up with Mega in the latest report and they are both neck-and-neck as the top food retail brand. Blue Square’s Super Center is next, closely followed by Super-Sol’s local store (called Super-Sol). In total, Super-Sol’s various supermarket brand names increased by five points since the same survey last year, while Blue Square’s supermarkets dropped three points. Blue Square remains marginally ahead.

What about the shopping experience?

In terms of service and product choice, Super-Sol is not significantly differentiated from its leading competitor, Blue Square. We believe they both tend to offer similar levels of food quality and service. Both have been spending significant amounts of money upgrading stores. We calculate that in 2001, both spent an average of US$2m per store. However, Blue Square opened fewer new stores and spent more money on existing stores, while Super-Sol focused on new openings, spending less on upgrading existing stores.

Blue Square recently announced a technological innovation allowing shoppers to check items into their shopping carts, avoiding the check-out queue altogether. This technology is currently on trial and we expect a number of difficulties need to be overcome as well as a number of years before this kinds of shopping becomes accepted as mainstream.

Conclusion

We believe Super-Sol is in a marginally better position than Blue Square and we expect Super-Sol to maintain its marginal lead into the future. In terms of efficiency, long term we believe Super-Sol will gain the upper hand as well as having a leading market share.

Our view is that even though Blue Square may have been the more efficient business until now, Super-Sol has been sacrificing some efficiency to focus on growth. Since our fundamental view is that the food retail market is still a growth market in Israel, we believe this strategy will serve it well in the medium term (around three to four years) and Super-Sol will remain the market leader.

Blue Square, we believe, is focusing on efficiency because its distribution system is operating at the peak of its capacity, and for the company to focus on expansion, it would have to build a distribution centre similar to Super-Sol's. As the Israeli food retail market becomes saturated to the European level, we expect Super-Sol to focus less on increasing the number of stores and more on targeting its efficiency. At this point, we believe the distribution centre will place Super-Sol in a good position to streamline its operation, and drive its margins up.

The sale of Blue Square

Following a decision on the dissolution of the Consumers' Cooperative Society (the current majority owner of Blue Square Israel), we expect a struggle for control of Blue Square Israel to develop. This should place upward pressure on Blue Square's share price in the short term. We believe this will be followed by a merger of Blue Square Israel and Blue Square Investments and Properties, both of which are traded on the TASE. This will create a larger company with better liquidity.

Relative valuation

On a 2002E EV/EBITDA comparison, Blue Square Israel trades at 6.3 times. On this comparison, Super-Sol trades at around a 8% premium at 6.8.

On a 2002E and 2003E P/E comparison, Super-Sol trades at 15.9 and 14.2, respectively. This is at a 3% and 6% discount to Blue Square Israel's 2002E and 2003E P/E ratio, respectively. However, this is at a slight premium to the European sector at 10% and 8%, respectively.

Super-Sol offered a slightly higher ROE last year at 12.2% compared with BSI's 11.0%.

We believe that since the Israeli food retail sector is a growth sector, a premium to European peers is justified, even though we believe the premium could be greater. However, we believe Super-Sol should be trading at a premium to Blue Square and not at a discount—hence, we believe Super-Sol is undervalued compared with Blue Square.

Figure 15: Relative valuation against European food retail sector

Shk in millions, unless otherwise stated

Company Name	Ticker	CSFB rating	Closing price	Market cap.	52 week		Price below	P/E ratio		P/S ratio		EPS			ROE	Price to book	EV / EBITDA
			25/04/02	(US$M)	Lo	Hi	52W Hi	02E	03E	02E	03E	01E	02E	03E	01E	01E	02E
SUPER-SOL (ILS)	**SAE**	**Hold**	**16.5**	**694**	**14.6**	**18.8**	**12%**	**15.9**	**14.2**	**0.49**	**0.45**	**0.94**	**1.04**	**1.16**	**12.2%**	**1.94**	**6.8**
BLUE SQUARE-ISRAEL (ILS)	**BSI**	**Hold**	**67.1**	**528**	**56.5**	**80.7**	**17%**	**16.4**	**15.1**	**0.43**	**0.41**	**3.76**	**4.08**	**4.44**	**11.0%**	**2.02**	**6.3**
BLUE SQUARE CHAIN INV (ILS)	BLSQ	n.a.	69.3	465	56.5	88.4	22%	17.4	16.5	0.63	0.61	3.59	3.97	4.20	15.7%	2.74	8.8
CENTROS (EUR)	CRF	Buy	12.8	4796	10.4	17.3	26%	11.3	10.3	0.61	0.58	0.80	1.14	1.24	17.6%	1.85	5.9
AVA (EUR)	AVAG	Hold	40.0	1385	25.6	43.5	8%	14.5	13.9	0.24	0.23	2.51	2.76	2.89	19.9%	2.92	6.2
COLRUYT (EUR)	COLRt	Hold	47.3	1944	39.5	49.5	5%	16.5	15.1	0.59	0.55	2.73	2.87	3.13	29.2%	5.03	6.4
LAURUS (EUR)	LAUR	Sell	1.5	214	1.4	8.7	83%	5.2	3.4	0.03	0.03	0.03	0.29	0.43	13.9%	0.77	3.6
TESCO (GBP)	TSCO	Hold	2.6	12491	2.2	2.7	3%	21.6	19.5	0.77	0.69	0.11	0.12	0.13	15.6%	3.40	11.9
SAFEWAY (GBP)	SFW	Buy	2.9	2071	2.8	4.2	32%	11.7	10.7	0.35	0.34	0.22	0.25	0.27	11.9%	1.38	8.1
MORRISON (GBP)	MRW	Buy	2.2	2292	1.8	2.3	4%	22.2	20.1	0.85	0.78	0.09	0.10	0.11	13.5%	3.03	9.8
METRO AG (EUR)	MEOG	Buy	36.5	13208	30.0	52.4	30%	17.2	16.1	0.23	0.22	1.99	2.12	2.27	16.2%	2.86	7.2
DELHAIZE (EUR)	DELBt	Hold	54.0	5519	49.4	72.0	25%	11.4	10.1	0.22	0.22	4.26	4.75	5.37	11.7%	1.34	5.5
CASINO GUICHARD (EUR)	CASP	Hold	88.6	10325	74.6	106.5	17%	19.7	17.3	0.39	0.37	3.93	4.49	5.12	11.5%	2.96	8.7
KONINKLIJKE AHOLD (EUR)	AHLN	Hold	27.5	28023	26.3	37.4	26%	13.9	12.2	0.33	0.31	1.73	1.98	2.25	27.7%	4.35	6.5
Average							**23%**	**15.3**	**13.9**	**0.44**	**0.41**				**16.6%**	**2.66**	**7.3**

Source: Company data, Bloomberg, CSFB estimates, I/B/E/S estimates for BLSQ

CSFB Value Dynamics Framework

In comparing the two companies, we also used the CSFB VDF model, which gives an indication of MICAP or market-implied competitive advantage period. MICAP is an indicator of how long the market expects a company to create shareholder value. A company creates shareholder value when its incremental investments generate returns that exceed the cost of capital.

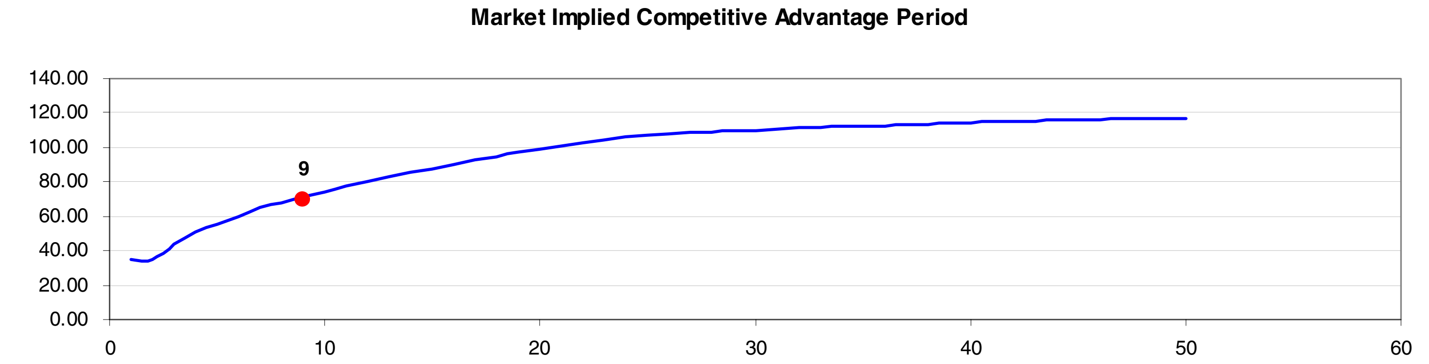
We use this methodology more to compare the two companies and try to extract the underlying MICAP embedded in the share price. Our model is based on the following assumptions:

- The risk-free rate was set at 4.6%, the current interbank rate set by the Bank of Israel.
- We used the market implied equity risk premium in Israel as calculated by our Bloomberg terminal, at 11.6%. This may seem high, but we believe given the current economic and security situation, as well as the poor liquidity in Israel, investors demand a high premium.
- We expect NOPAT margins to reach a terminal value of 8%.

We ran two scenarios. The first, our ‘floor’ scenario, assumes that from 2002, Super-Sol will grow at exactly the same rate on the same margins as Blue Square. Our second scenario, assumes our growth assumptions as implied by our Super-Sol models—with slightly higher revenue growth and higher margins going forward.

Given the above assumptions, our model calculates a MICAP of nine years for Blue Square.

Figure 16: MICAP for Blue Square Israel
MICAP in years (X) against share-price (Y)

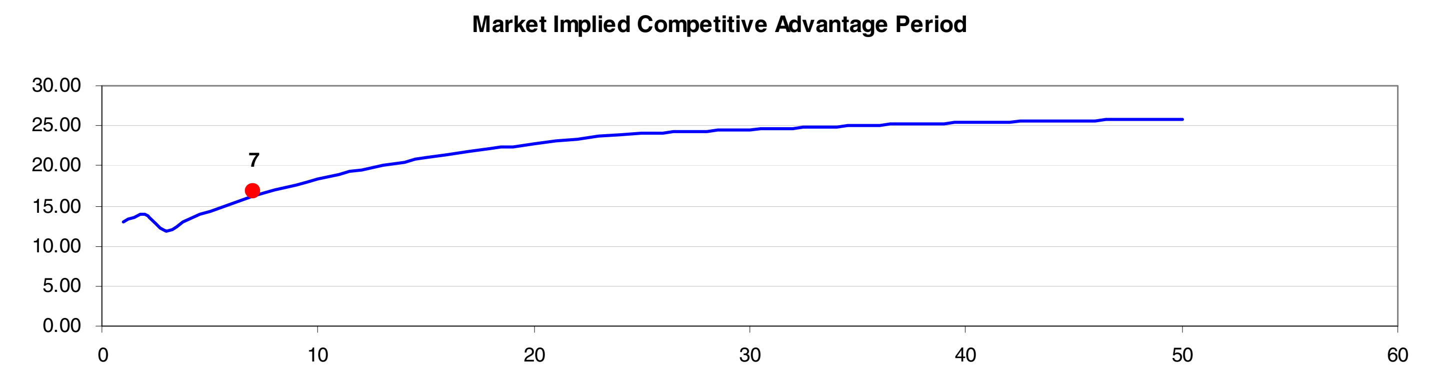


Source: CSFB research

Scenario 1: The floor scenario

The floor scenario assumes that Super-Sol revenues grow at the same rate as Blue Square, and margins are identical going forward. We find that our MICAP comes out at seven years, below Blue Square's nine years which suggests that the market values Super-Sol as a lower growth company. If we assume a similar MICAP to that of Blue Square (a MICAP of nine years), our model indicates an implied share price of Shk 18.3.

Figure 17: MICAP for Super-Sol – assuming Blue Square's growth expectations
MICAP in years (X) against share-price (Y)



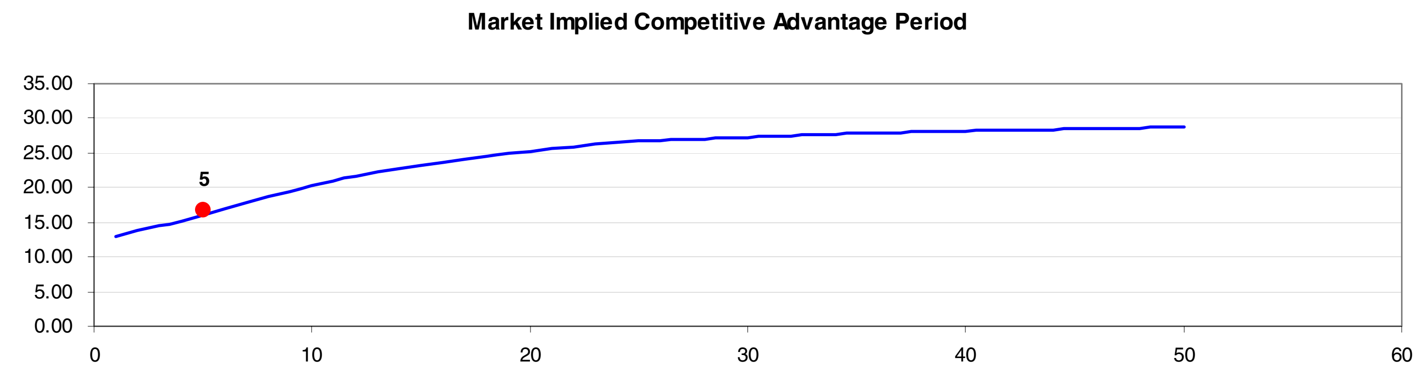
Source: CSFB research

Scenario 2

Until 2003, we use revenue growth rates as implied by our models. That is, the revenue growth rate for Super-Sol is 7.5% and 9.0% for 2002E and 2003E respectively. We assume that revenue growth will stay marginally ahead compared with Blue Square, but reach the terminal value of 5%. In addition, margins should remain slightly stronger for the next three years after which both should show more or less the same margins.

This scenario implies that the MICAP is only five years. Given that we expect a nine-year MICAP, the target share price would be Shk 20.

Figure 18: MICAP for Super-Sol—given our growth expectations for Super-Sol
MICAP in years (X) against share-price (Y)



Source: CSFB research

We believe the fact that Super-Sol's share price appears to be based on lower growth assumptions than Blue Square is unfair. We believe Super-Sol is the better-placed company in terms of competitiveness and efficiency in the foreseeable future.

Summary and recommendation

1. We find that on a European comparison of margins, Super-Sol and Blue Square are as efficient as any food retailer in Europe. Further, we believe the Israeli food retail market offers growth opportunities that Europe cannot offer, justifying a premium valuation over similar European companies.
2. We believe Super-Sol is a slightly higher-growth business than Blue Square and will become the more efficient business in the near future. We believe Super-Sol should trade at a premium to Blue Square.
3. Our VDF analysis provides a better handle on the underlying assumptions in the share price. Our analysis would imply that the market's growth expectations embedded in Super-Sol's share price are too low when compared to Blue Square. We extract a target price of Shk 20.

Our 'floor' target price at Shk 18.3 is only 10% above the current price and our target price embedding our growth assumptions at Shk 20 is around 20% above the current price. This makes Super-Sol look undervalued, but not a bargain.

By investing in Super-Sol, we believe investors will enjoy a low-risk, reasonably-undervalued, recession-defensive stock, with the potential to make money in a growing market. Second, if these investors believe the political outlook (and the economy) is set to improve and want to invest early while the stock is still undervalued, then we think Super-Sol's shares are very attractive.

However, given the current political tensions in the country, we do not expect to see many investors choosing to invest in domestic Israel stocks right now. We see few catalysts that would provide share-price upside for the moment. We therefore initiate with a Hold recommendation, but will be watching macro factors closely. As soon as the outlook improves, we will look to upgrade.

Company overview

History of Super-Sol

Super-Sol was the first supermarket chain to be established in Israel. The company was incorporated in 1957 and opened Israel's first supermarket in Tel Aviv in 1958. The company went public on the TASE in 1981, under the ticker 'SAE'. ADRs were offered in the US in 1997.

The company focuses primarily on food retail only in Israel. Its last foreign food-retail holding—Super Kozert in Hungary—was sold in 1998. The company also sold Super-Office, an office supply retailer, in 1997 and ACE hardware, a DIY retailer, in 1998. The company has recently embarked on a strategy to expand its offering to non-food items such as toiletries, kitchen utensils and other household items.

Store formats

The company operates a number of different formats focusing on different population segments and spending habits. As of year-end 2001, the company operated the following stores in Israel:

- 41 Super-Sol stores: The neighbourhood or local supermarket. People shop in these because they are local and easy to get to. They also offer a home delivery service to customers in the locale. The average purchase size for a customer is smaller than at the larger or discount stores. These stores compete directly with Blue Square's Co-Ops and other smaller local food stores, called 'makolets' in Israel. However, they are able to offer lower prices than the 'makolet' because of their economies of scale.
- 89 Hypernetto stores: These are larger discount stores, where the main determinant for shoppers is the price. Therefore, these stores tend to pack more goods per square metre and worry less about the format, the aesthetics of the store and service. Particularly in the current downturn, these stores have tended to be more popular and has helped Super-Sol weather the economic recession.
- 14 Cosmos stores: This is a one-stop-shop offering food as well as a host of other household and office items. These stores are generally very large and are mostly situated by major highways in Israel.
- 6 Machsanei Mazon: These stores are typically mid-sized offering mainly food at deep discounts, without needing to be a member.
- 7 Universe Club stores: This format is popular among Israelis and requires the customer to become a member the first time they shop, similar to the Costco store in the US. These stores are not local, but supposedly offer cheaper prices than the supermarket as well as special offers through direct-mailings. This store competes with Blue Square's Mega which in Israel is a better-known name.
- 8 Birkat Rachel stores: These stores focus on the ultra-orthodox Jewish segment of the population, providing food with the correct stricter rabbinic licenses which is acceptable to this population. The ultra-orthodox tend be densely populated into particular geographical areas, so these stores are considered to be the local

supermarkets to these populations. As one of the poorest segments of the Israeli population, the ultra-orthodox tend to be focused on price. These stores compete with Blue Square's Shefa Mehadrin stores, also focused on the ultra-orthodox segment.

- Hypercol stores: These were the large version of the Super-Sol stores but have all been converted to other formats in 2001.

Figure 19: **Store formats for Super-Sol, Blue Square and Clubmarket**

Super-Sol	Blue Square	Clubmarket	Target	Size	Price
Super-Sol	Super Co-Op	Co-Op 1	Local	Small	Highest
	Super Centre city		Regional	Large	Expensive
Hypernetto	Super Centre	Clubmarket	Local	Mid	Mid
Cosmos	Mega*	Jumbo	Regional	Large	Discount
Machsanei Mazon	King Centre		Local	Large	Deep Discount
Universe Club*			Regional	Large	Deep Discount
Birkat Rachel	Shefa Mehadrin	Glatmarket	Local	Small	Cheapest

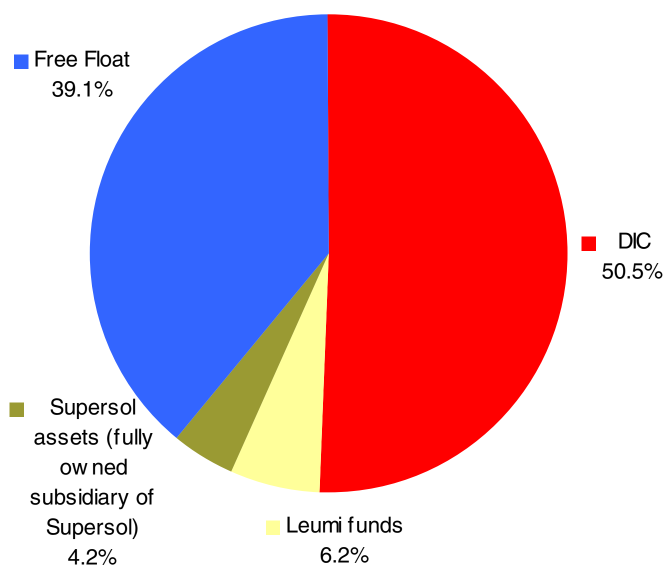
** Requires customers to pay a joining membership fee.*

Source: CSFB research

Shareholders

Figure 20: **Pie chart of Super-Sol's shareholders, year-end 2001**

%



Source: Company data, Bloomberg

Financials

We make the following assumptions in the financials:

1. *Revenue growth*. Because of the economic slowdown, revenue growth will likely be driven more by new space than by increase in same-store sales in the next 12 months. We believe revenue growth for 2002 will be 7.5%, which we expect will be a difficult year for the economy and will be slightly below that of 2001 (7.7%). However, we expect 2003 to be a significantly better year economically and revenue growth should be about 9% with same store sales turning slightly positive.
2. *Gross margins*. The downwards pressure on gross margins should continue as larger portion of revenue will likely be generated from large discount/cheaper stores which carry lower gross margins. This should be slightly offset by further increase in purchasing power over the suppliers, improvement in category management, and increasing share of higher margins private label products.
3. *SGA costs*. We expect these costs to be down in percentage of sales owing to improving efficiencies, and more advantage of economy of scale. This should be slightly offset by higher security-related costs as supermarkets spend on increased supermarket security.
4. *Operating margins*. As a result of the above, we expect a slight improvement in operating margins from 5.1% in 2001 to 5.4% in 2002 and 5.5% in 2003.
5. *Financial expenses*. We assume that these are slightly lower than the 2001 level because of lower interest rates.
6. *Tax rate*. We assume tax is charged at 38%.
7. *EPS growth.* Based on the above, our forecast is for EPS growth of 10.2% in 2002 and 12.1% in 2003.

Figure 21: Comparative (Super-Sol and Blue Square Israel) 2001 quarterly operating results
Shk in millions, unless otherwise stated

	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol	Blue Sq.	Super-Sol
	Q1 2001		Q2 2001		Q3 2001		Q4 2001	
Revenue and net income growth								
Revenue	1322	1476	1424	1612	1478	1691	1353	1637
Revenue growth year on year (%)	8.5	**8.6**	5.2	**7.4**	6.4	**7.6**	3.2	**7.8**
Margins (%)								
Gross margins	28.1	**28.3**	27.0	**27.5**	26.9	**27.6**	27.1	**28.2**
Operating margins	**5.5**	4.9	**5.8**	4.8	5.2	**5.3**	5.2	5.2
EBITDA margin	**8.3**	7.9	**8.4**	7.7	7.5	**7.9**	**8.0**	7.9
Sales area and sales ratio								
Sales area added during period (sq m)	5,700	**5,400**	1,200	**3,700**	11,900	**9,500**	2,300	**5,900**
Growth in sales area (%)	2.2	**1.6**	**0.5**	1.1	**4.5**	2.8	**0.8**	1.7
Growth in same-store sales (reported) (%)	**0.1**	-3.7	**-3.3**	-5.4	**-3.6**	-4.3	-5.9	**0.6**
Sales (Shk 000s) per sq m	**5.1**	4.4	**5.4**	4.8	**5.5**	4.9	**4.9**	4.6
New stores stats								
Number of stores at period-end	168	154	169	156	171	159	171	162
Number of new stores added during period	0	3	1	2	2	3	0	3
Average area per store at period-end (sq m)	1,570	2,188	1,567	2,184	1,619	2,203	1,632	2,198
Growth in average area per store over period (%)	2.2	**-0.4**	**-0.1**	-0.2	**3.3**	0.8	**0.8**	-0.2
Sales per store (sales/average number of stores)	7.9	**9.7**	8.5	**10.4**	8.7	**10.7**	7.9	**10.2**

Source: Company data

Figure 22: Super-Sol: Quarterly income statement for 2002E

Shk in millions, unless otherwise stated

	Q1E	Q2E	Q3E	Q4E	FY2002E
Food sales	**1746.5**	**1609.5**	**1780.7**	**1712.2**	**6848.8**
Rental and shopping malls	17.6	17.6	17.6	17.6	70.4
Total sales	**1764.0**	**1627.1**	**1798.3**	**1729.8**	**6919.2**
COGS	-1273.3	-1192.5	-1296.1	-1239.6	-5001.5
Gross profit	**490.8**	**434.6**	**502.2**	**490.2**	**1917.7**
% of food sales	28.1	27.0	28.2	28.6	28.0
Total SG&A	-390.0	-375.0	-405.0	-379.9	-1549.9
% of sales	-22.3	-23.3	-22.7	-22.2	22.6
EBIT	**100.8**	**59.6**	**97.2**	**110.3**	**367.8**
% of sales	5.8	3.7	5.5	6.4	5.4
Net financial income (expense)	-5.0	-5.0	-5.0	-5.0	-20.0
Total other income (expenses)	-0.8	-0.8	-0.8	-0.8	-3.0
EBT	**95.0**	**53.8**	**91.4**	**104.6**	**344.8**
% of sales	5.4	3.3	5.1	6.1	5.0
Net taxes	-36.1	-20.4	-34.7	-39.7	-131.0
% of EBT	38.0	38.0	38.0	38.0	38.0
Profit after tax	**58.9**	**33.4**	**56.7**	**64.8**	**213.8**
% of sales	3.3	2.1	3.2	3.7	3.1
The company share in affiliated	-0.3	-0.3	-0.3	-0.3	-1.0
Net profit	**58.7**	**33.1**	**56.4**	**64.6**	**212.8**
EPS (Shk)	**0.29**	**0.16**	**0.27**	**0.31**	**1.04**
No. of shares (m)	205.4	205.4	205.4	205.4	205.4

Source: CSFB estimates

Figure 23: Super-Sol: Yearly income statement
Shk in millions, unless otherwise stated

	1999	2000	2001	2002E	2003E
Sales	5,404	5,916	6,371	6,849	7,465
Yoy growth (%)	6.0	9.5	7.7	7.5	9.0
Rental and shopping malls	42	55	67	70	74
Yoy growth (%)	22.3	31.7	22.4	5.0	5.0
Total sales	**5,445**	**5,971**	**6,438**	**6,919**	**7,539**
Yoy growth (%)	4.6	9.6	7.8	7.5	9.0
COGS	(4,042)	(4,331)	(4,639)	(5,002)	(5,471)
Gross profit	**1,403**	**1,640**	**1,799**	**1,918**	**2,068**
% of sales	26.0	27.7	28.2	28.0	27.7
Total SG&A	(1,215)	(1,357)	(1,477)	(1,550)	(1,659)
% of sales	22.3	22.7	22.9	22.4	22.0
EBIT	**189**	**283**	**322**	**368**	**409**
% of sales	3.5	4.8	5.1	5.4	5.5
EBITDA	326	442	505	560	620
% of sales	6.0	7.4	7.8	8.1	8.2
Net financial income (expense)	(5)	(23)	(23)	(20)	(20)
% of sales	0.1	0.4	0.4	0.3	0.3
Amortortisation of goodwill	0	0	0	0	0
Other income (expenses)	11	7	(3)	(3)	(3)
Total other income (expenses)	**11**	**7**	**(3)**	**(3)**	**(3)**
EBT	195	267	296	345	386
% of sales	3.6	4.5	4.6	5.0	5.2
Net taxes	(74)	(98)	(101)	(131)	(147)
% of EBT	38.0	36.9	34.1	38.0	38.0
Profit after tax	**121**	**168**	**195**	**214**	**239**
% of sales	2.2	2.8	3.1	3.1	3.2
Minority & affiliated	2	0	(2)	(1)	(1)
Net profit	**123**	**168**	**193**	**213**	**238**
% of sales	2.3	2.8	3.0	3.1	3.2
No of shares (m)	206	202	205	205	205
EPS (Shk)	**0.60**	**0.83**	**0.94**	**1.04**	**1.16**
Yoy change (%)	-3.0	39.9	12.8	10.2	12.1

Source: Company data, CSFB estimates

Figure 24: Super-Sol: Yearly balance sheet

Shk in millions, unless otherwise stated

	1999	2000	2001	2002E	2003E
Assets					
Cash & equivalents	46	17	38	25	20
Marketable securities	56	0	0	0	0
Customers receivable	657	544	582	616	672
% of sales	12.2	9.2	9.1	9.0	9.0
Other current assets	53	57	65	68	75
% of sales	1.0	1.0	1.0	1.0	1.0
Inventory	343	364	419	440	476
% of COGS	8.5	8.4	9.0	8.8	8.7
Current assets	**1154**	**982**	**1104**	**1150**	**1243**
Fixed assets	2082	2303	2426	2534	2643
Long-term loans and funds	46	41	21	21	21
Subsidiaries	30	30	24	24	24
Others	64	81	102	102	102
Total assets	**3376**	**3437**	**3677**	**3832**	**4033**
Liabilities & equity					
Short-term debt	63	69	78	53	3
Payable to suppliers	754	881	958	1000	1094
% of COGS	18.7	20.3	20.7	20.0	20.0
Creditors and credit balance	217	268	260	280	307
% of COGS	5.4	6.2	5.6	5.6	5.6
Dividend declared	291	49	96	96	96
Current liabilities	**1325**	**1267**	**1392**	**1430**	**1500**
Loans from banks and others	436	426	415	415	415
Sevency payments	6	7	4	4	4
Deferred taxes	41	49	67	67	67
Long-term liabilities	**483**	**482**	**486**	**486**	**486**
Total equity	**1568**	**1688**	**1799**	**1916**	**2047**
Total liabilities & equity	**3376**	**3437**	**3677**	**3832**	**4033**

Source: Company data, CSFB estimates

Figure 25: Super-Sol: Yearly cash-flow statement

Shk in millions, unless otherwise stated

	1999	2000	2001	2002E	2003E
OPERATING ACTIVITIES					
Profit after tax	123	168	193	213	238
Depreciation	137	159	174	192	211
Change in working capital					
Increase/(decr.) in inventory	39	-21	-55	-21	-36
Increase/(decr.) in trade receivables	-32	114	-38	-34	-55
Increase in current assets	17	2	-7	-3	-6
Increase in trade payables	46	104	88	42	94
Increase in other payables	43	54	-4	20	26
Effect of change in working capital	**112**	**252**	**-16**	**4**	**23**
Other non cash flows	**-15**	**-1**	**16**	**0**	**0**
Cash flow from operating activities	**356**	**579**	**365**	**408**	**472**
Free cash flow	51	231	59	108	152
INVESTING ACTIVITIES					
Net investment in fixed assets	-305	-348	-306	-300	-320
Investment in subsidiaries/affiliates	0	0	0	0	0
Other investment	44	38	2	0	0
Cash flow from investing activities	**-262**	**-310**	**-304**	**-300**	**-320**
FINANCING ACTIVITIES					
Increase/(decr.) in short- term debt	15	-2	-14	-25	-50
Increase/(decr.) in long-term debt	4	-3	12	0	0
Shares/warrants issued	6	3	11	0	0
Dividend paid	-40	-295	-49	-96	-107
Others	-78	0	0	0	0
Cash flow from financing activities	**-92**	**-297**	**-40**	**-121**	**-157**
Resultant change in cash	**2**	**-28**	**21**	**-13**	**-5**
Cash & equivalents at beginning of year	43	45	17	38	25
Cash & equivalents at year end	45	17	38	25	20

Source: Company data, CSFB estimates

AMSTERDAM 31 20 5754 890	MADRID 34 91 423 16 00	SEOUL 82 2 3707 3700
ATLANTA 1 404 656 9500	MELBOURNE 61 3 9280 1666	SHANGHAI 86 21 6881 8418
AUCKLAND 64 9 302 5500	MEXICO 52 5 283 89 00	SINGAPORE 65 212 2000
BALTIMORE 1 410 223 3000	MILAN 39 02 7702 1	SYDNEY 61 2 8205 4400
BEIJING 86 10 6410 6611	MOSCOW 7 501 967 8200	TAIPEI 886 2 2715 6388
BOSTON 1 617 556 5500	MUMBAI 91 22 230 6333	TOKYO 81 3 5404 9000
BUDAPEST 36 1 202 2188	NEW YORK 1 212 325 2000	TORONTO 1 416 352 4500
BUENOS AIRES 54 11 4394 3100	PALO ALTO 1 650 614 5000	VIENNA 43 1 512 3023
CHICAGO 1 312 750 3000	PARIS 33 1 40 76 8888	WARSAW 48 22 695 0050
FRANKFURT 49 69 75 38 0	PASADENA 1 626 395 5100	WASHINGTON 1 202 354 2600
GENEVA 41 22 394 70 00	PHILADELPHIA 1 215 851 1000	WELLINGTON 64 4 474 4400
HOUSTON 1 713 220 6700	PRAGUE 420 2 210 83111	ZUG 41 41 727 97 00
HONG KONG 852 2101 6000	SAN FRANCISCO 1 415 836 7600	ZURICH 41 1 333 55 55
LONDON 44 20 7888 8888	SÃO PAULO 55 11 3841 6000	

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