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Israel  
Financial Services**Banks**

Earnings Preview

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LBIE, London**Preview for POLI, LUMI and DSCT****Sector View:**

New: 1-Positive

Old: 1-Positive

**Investment Conclusion**

- We expect steady performance from the banks in the 2Q reports next week. Small cap peer MZTF posted in-line results on Monday and although the mortgage focus at MZTF makes sweeping generalisations difficult, we do not believe that any real cracks appeared in the domestic economy in 2Q. Looking into 3Q is of course another story. We do anticipate the US led slow down to have an impact in Israel, but given the solid balance sheets at the banks and the lack of exposure to global credit issues, we see the Israeli banks as well placed right now as they continue to lend to good corporates and as retail consumers remain appropriately leveraged.

**Summary**

- In this environment we prefer POLI over LUMI given the cost story we see developing at POLI post its MBS saga. We do not see much room for divergence across exposure to the domestic economy.
- While many have "thrown in the towel" regarding DSCT, we expect to see patience rewarded especially at a valuation at a significant discount to BV.

**Domestic Economy Overview**

The domestic economy drives bank results and through the end of June most the economy remained robust. We expect provisioning to continue to be at low levels for the banks and have not heard of a significant number of Israeli corporates facing significant financial pressure.

We do expect to see the economy slow down in 2H08 and into 2009, but we do not see Israel moving into a recession based on this slow down. In fact, in the first seven months of 2008 exports have risen in \$US terms (even as the US\$ was weak) to \$32 billion from \$26 billion. This has been driven by sectors linked to the global commodity sectors primarily (chemicals, mining, and basic materials) even though these segments are less than 50% of total exports usually. Tourism, which affects multiple sectors in the economy, has remained quite strong in 2008 as well, up 25% over levels in January-July 2007.

In addition, given the lack of exposure to global credit issues, the Israeli banks remain "open for business" and the participation of the banks in financings for recent M&A transactions for Teva and others has been reported widely in the press (Haaretz, Bloomberg, etc).

There has been much discussion among investors and in the local press regarding the most recent fee reforms enacted by the Bank of Israel. We have addressed this in prior notes and stick to our call that this change will have a minimal short term impact on results. Articles in the local press (Haaretz) have begun placing Bol on the defensive as the savings to consumers do not appear to be immediately obvious (and thus support our thesis). This was the case stated by MZTF on its conference call which commented that it did not see any real change to its fees in July and August post enactment of the new ruling.

Over the course of 2007, the banks also grew their commissions from securities transactions quite substantially (21% at POLI and 18% at LUMI). Given the just about flat growth in this category at MZTF and given the volatile market conditions we expect to see growth rates in this segment decelerate in the 2Q results at the banks. However, the actual detail here is typically only provided on an annual basis.

Two other closely linked and watched economic items include inflation and interest rates and the related \$/ILS exchange rate. Inflation for 1H08 was 2.3%, 2.2% of which was in 2Q08 and on August 16, headline CPI of 1.1% was higher than expected with the annual rate now running at 4.8%. In general, high CPI helps net interest income for the banks given their respective portfolios. Lehman Brothers forecast for interest rates remains at the current 4.0%, based on our view that inflation has peaked; however, there may be some pressure for higher rates given the 1%-3% target of Bol. As recently as 2007 the linkage between inflation and the Shekel was quite

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strong, but a dramatic shift away from pricing apartments and other non-tradable services from \$US to Shekels has lessened the impact. The Shekel appreciated dramatically in 2008 rising to 3.20/\$ from an average of 4.11/\$ in 2007 (the average rate in 2008 has been ILS 3.50/\$US). Given the current policy of Bol to increase its \$US holdings to \$35-\$40 billion and its aggressive purchasing, combined with an overall appreciation of the \$ globally has the exchange rate at the 3.57/\$ level currently. The appreciation of the \$US vs. the Shekel is also a positive for the banks from a reporting perspective as loan books at the large banks can be 1/3 foreign currency with a \$US bias.

Derivative accounting has also played a role in the net interest income for the banks, in particular for POLI and LUMI where the effect can reach ILS 100 – ILS 300 million per quarter. This accounting, which should average out to having no economic impact over the course of a year was negative in 1Q08. It is difficult to forecast this precisely, but we estimate that derivative accounting could put a ceiling on some of the net interest income trends that we expect to be positive in the quarter.

*Below we provide our specific forecasts for POLI, LUMI and DSCT.*

### Specific Forecasts and key question for the banks ahead of earnings reports

#### POLI

*Key questions from investors:*

1. *Lingering impact, actual or perceived from the MBS crisis including personnel changes and investigation of the ISA regarding the timing of disclosure of the impact of MBS.*
2. *On-going discussion of the international growth strategy of the bank.*

#### Figure 1: POLI 2Q08 Expectations

	2Q08e	2Q07a	y/y	2008e	2007a	y/y
Net Interest Income	2,058	1,995	3.2%	4,314	6,933	-37.8%
Provisions	(228)	(202)	12.6%	(730)	(513)	42.4%
Provision Rate	0.45%	0.43%	5.5%	0.35%	0.26%	31.7%
Total Operating and Other Income	1,281	1,254	2.1%	5,072	5,250	-3.4%
Operating Expenses	1,864	1,868	-0.2%	8,014	7,940	0.9%
Net Income (core)	998	716	39.4%	931	2,328	-60.0%
ROE	23.0%	21.7%		7.3%	12.8%	
Loan Growth	11.0%	2.8%		6.4%	9.9%	

Source: Lehman Brothers Estimates

#### LUMI

*Key questions from investors:*

1. *Update on privatisation*
2. *Update on non-core holdings given volatility of holding in ILCO, the potential sale of a stake in Bezeq and the proposed sale of stake in cable operator HOT.*
3. *Any commentary on Agency backed MBS holdings*

#### Figure 2: LUMI 2Q08 Expectations

	2Q08e	2Q07a	y/y	2008e	2007a	y/y
Net Interest Income	2,017	1,809	11.5%	8,317	7,648	8.8%
Provisions	-226	(38)	494.9%	-929	(407)	128.3%
Provision Rate	0.45%	0.08%	462.2%	0.40%	0.21%	87.9%
Total Operating and Other Income	997	1,131	-11.8%	3,910	4,222	-7.4%
Operating Expenses	1,729	1,656	4.4%	7,054	6,937	1.7%
Net Income (core)	738	913	-19.1%	2870	2,984	-3.8%
ROE	15.0%	21.6%		16.0%	19.2%	
Loan Growth	4.0%	9.0%		4.0%	8.0%	

Source: Lehman Brothers Estimates

## DSCT

Key questions from investors:

1. Progress of restructuring/ROE/Cost ratios
2. Update on profits and costs at NY branch
3. Any commentary on Agency backed MBS holdings

## Figure 3: DSCT 2Q08 Expectations

	2Q08e	2Q07a	y/y	2008e	2007a	y/y
Net Interest Income	1,127	916	23.1%	4,636	4,225	9.7%
Provisions	-104	-158	-34.2%	-408	(447)	-8.8%
Provision Rate	0.40%	0.68%	-41.4%	0.39%	0.47%	-16.9%
Total Operating and Other Income	687	675	1.7%	2623	2,572	2.0%
Operating Expenses	1327	1,163	14.1%	5357	5,066	5.8%
Net Income (core)	38	235	-83.8%	930.4	763	21.9%
ROE	11.1%	28.3%		10.1%	9.6%	
Loan Growth	10.0%	12.2%		7.0%	13.0%	

Source: Lehman Brothers Estimates

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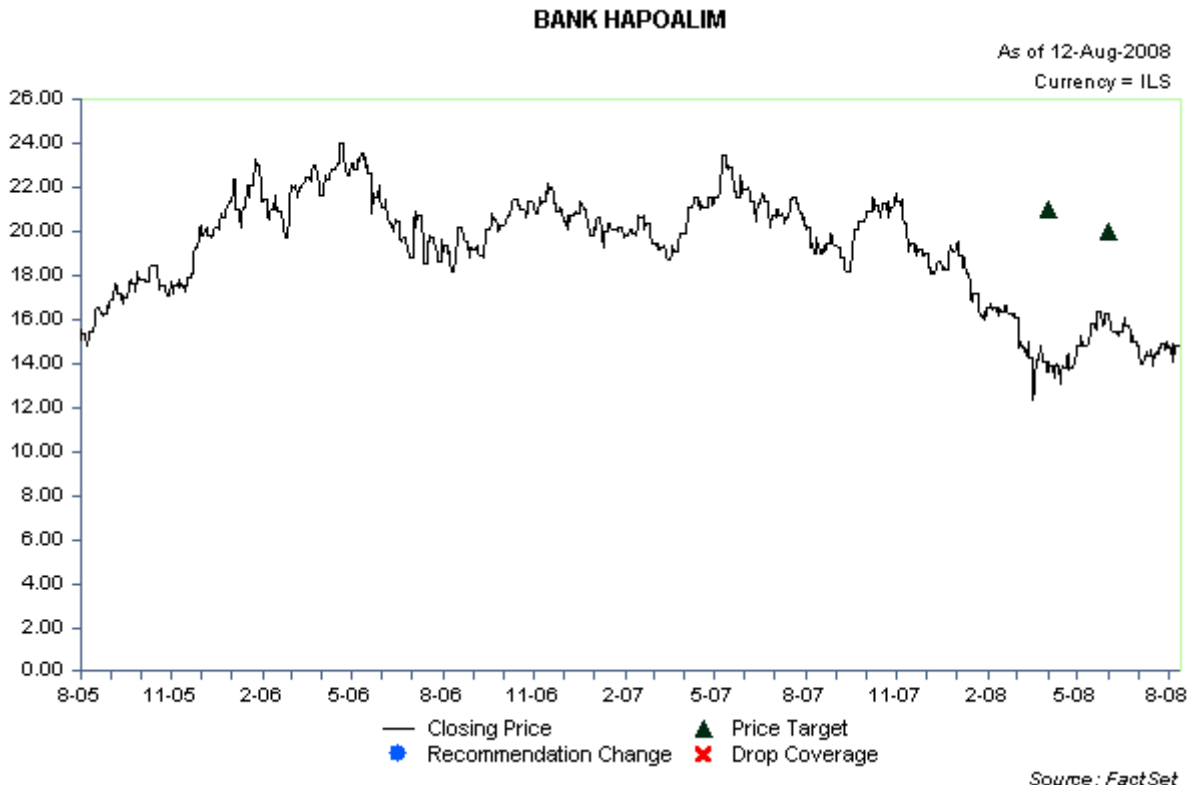
Important Disclosures:

**Bank Hapoalim (POLI.TA)**

**ILS 15.12 (15-Aug-2008)**

**1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=ILS

Date	Closing Price	Rating	Price Target	Date	Closing Price	Rating	Price Target
02-Jun-08	16.08		20.00	01-Apr-08	13.60		21.00

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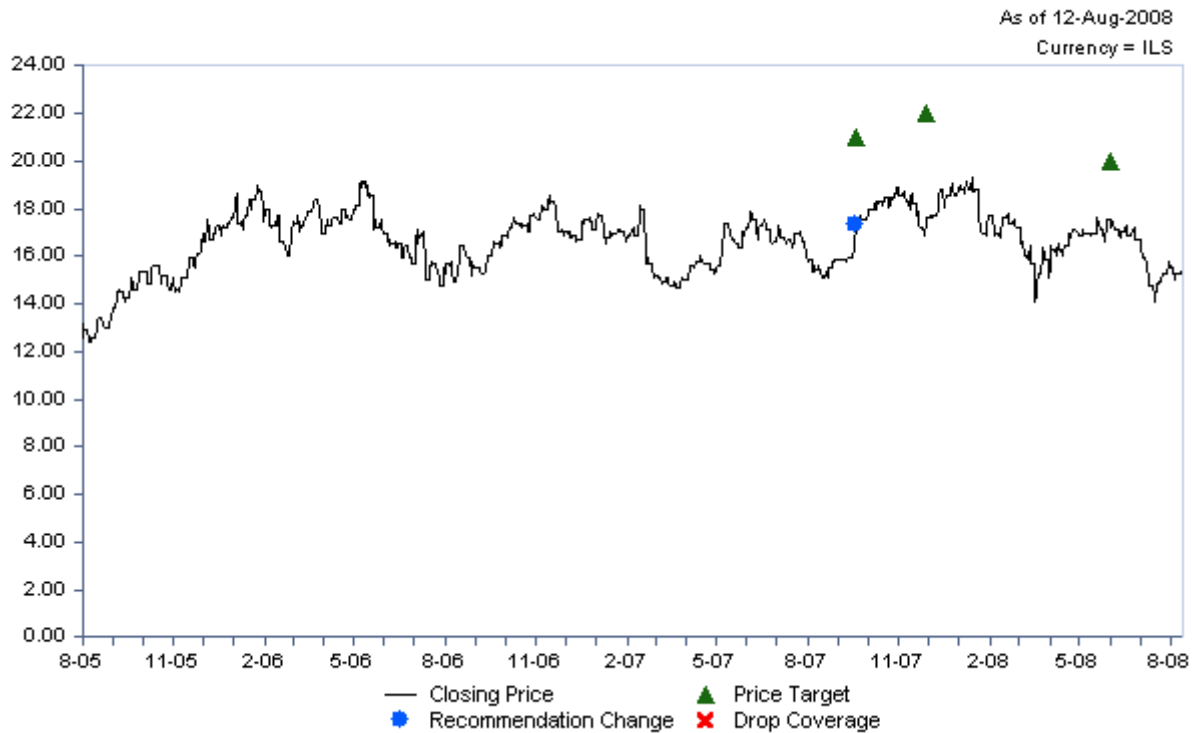
**Bank Leumi (LUMI.TA)**

**ILS 15.50 (15-Aug-2008)**

**2-Equal weight / 1-Positive**

**Rating and Price Target Chart:**

### BANK LEUMI



Currency=ILS

Date	Closing Price	Rating	Price Target
02-Jun-08	17.26		20.00
29-Nov-07	17.65		22.00

Date	Closing Price	Rating	Price Target
20-Sep-07	17.31		21.00
20-Sep-07	17.31	1 -Overweight	

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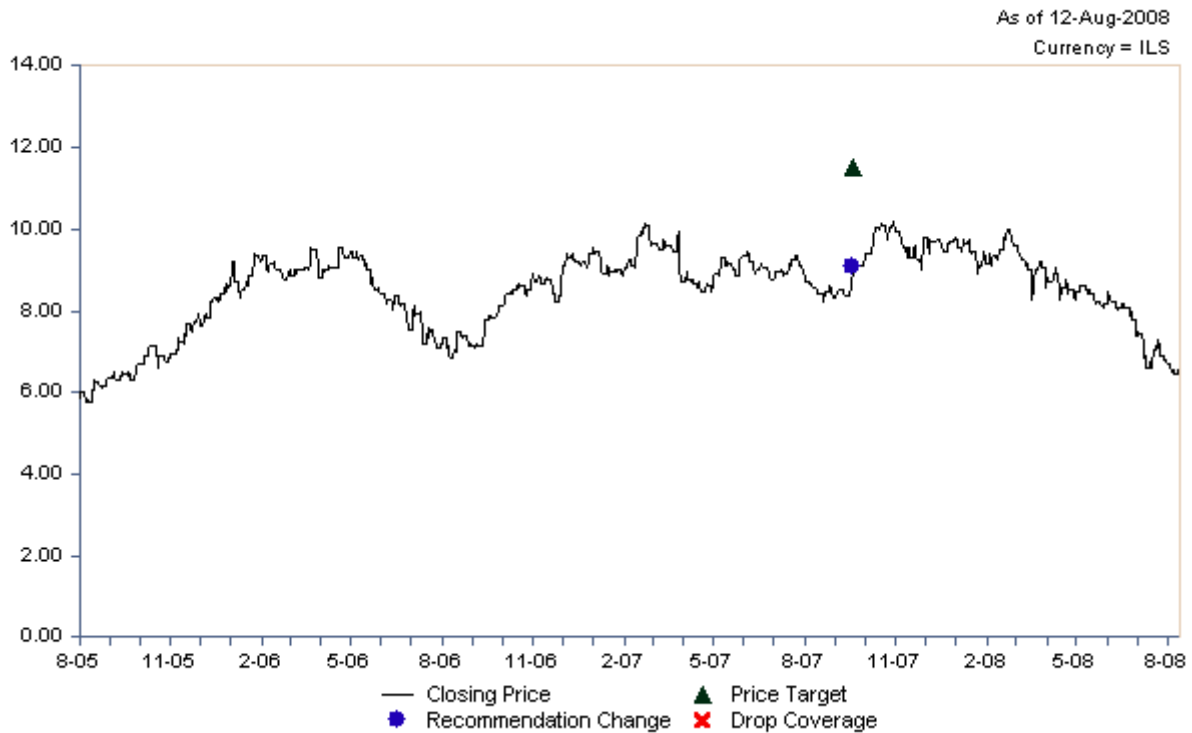
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**Israel Discount Bank (DSCT.TA)**  
**Rating and Price Target Chart:**

**ILS 6.35 (15-Aug-2008)**

**1-Overweight / 1-Positive**

### ISRAEL DISCOUNT BANK



Currency=ILS

Date	Closing Price	Rating	Price Target
20-Sep-07	9.05		11.50

Date	Closing Price	Rating	Price Target
20-Sep-07	9.05	1 -Overweight	

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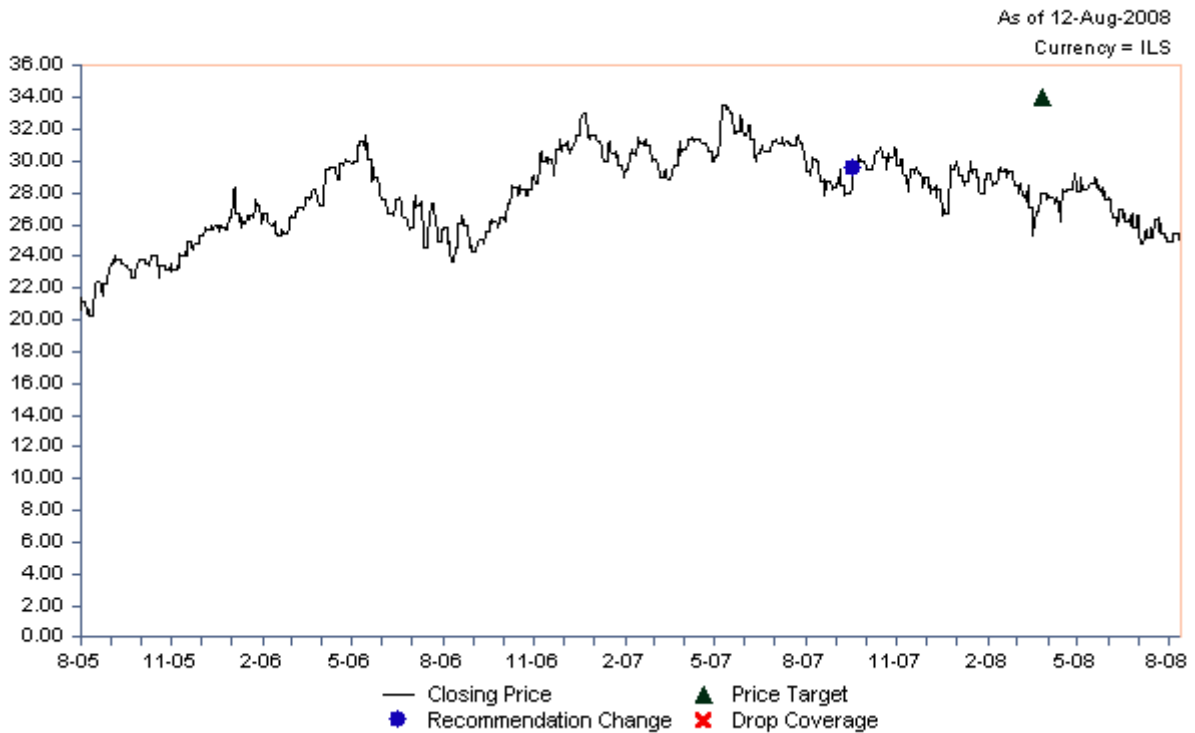
Mizrahi-Tefachot (MZTF.TA)

ILS 24.40 (15-Aug-2008)

2-Equal weight / 1-Positive

Rating and Price Target Chart:

### MIZRAHI-TEFACHOT



Currency=ILS

Date	Closing Price	Rating	Price Target
26-Mar-08	28.00		34.00

Date	Closing Price	Rating	Price Target
20-Sep-07	29.52	2 -Equal weight	

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Bank Leumi	LUMI.TA	ILS 15.50	15 Aug 2008	2-Equal weight / 1-Positive
Israel Discount Bank	DSCT.TA	ILS 6.35	15 Aug 2008	1-Overweight / 1-Positive
Mizrahi-Tefachot	MZTF.TA	ILS 24.40	15 Aug 2008	2-Equal weight / 1-Positive

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Bank Millennium (BIGW.WA)	Bank of Ireland (BKIR.I)
Bank Pekao (BAPE.WA)	Bankinter (BKT.MC)
Barclays (BARC.L)	BBVA (BBVA.MC)
BCP (BCP.LS)	BNP Paribas (BNPP.PA)
BPI (BBPI.LS)	Bradford & Bingley (BB.L)
BRE Bank (BREP.WA)	BZ WBK (BZWB.WA)
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