

August 26, 2008

Israel
European Chemicals

Israel Chemicals (ICL.TA - ILS 60.00) 1-Overweight

Change of Earnings Forecast

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Further Comments on ICL; Updated Model
Investment Conclusion

- We reiterate our 1-OW and ILS 100TP on ICL. Shares, which rallied into earnings last week, have since sold off. We expect the volatility to continue; the almost immediate linkage between ICL's price, oil pricing, and corn pricing is both undeniable and unlikely to change in the short run. On the other hand, industry fundamentals point to increasing strength in the business, and we expect patient investors to be rewarded.

FY Dec Currency US\$	2007A	2008E		2009E		2010E	
	Actual	Old	New	Old	New	Old	New
Revenue (m)	4103	7504	8105	9930	10660	11371	10547
Net Income (m)	553	2010	2827	3214	4348	3856	3984
EPS	0.43	1.56	2.20	2.50	3.38	3.00	3.10
EV/Revenues	5.63	N/A	2.78	N/A	1.90	N/A	1.73
EV/EBITDA	25.41	N/A	6.13	N/A	3.59	N/A	3.48
P/E	40.0	11.0	7.8	6.9	5.1	5.7	5.5

Summary

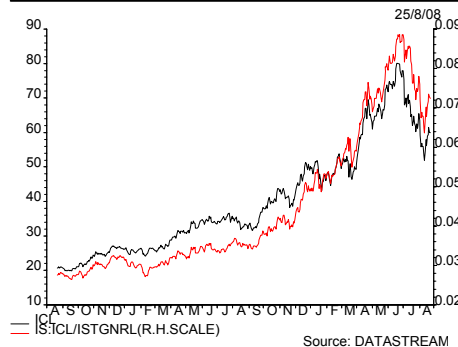
- Given the magnitude by which ICL exceeded our forecasts in 2Q, we reviewed our model quite carefully before updating. We have boosted our 2008 revenue and EPS estimates to \$8,105m and \$2.20 from \$7,504 and \$1.56. For 2009 we boost our rev and EPS ests to \$10,660m and \$3.38 from \$9,930m and \$2.50.
- In anticipation of growth in supply and potential cyclical behavior, we now model peak prices for potash and phosphates in 2009/2010. We stress that this is a directional call and not one supported by any hard data. For 2010 we estimate \$10,547m in sales and EPS of \$3.10.

Market Data

Market Cap (m)	77238
Units Outstanding (m)	1287.3
Float (%)	38
Net Distribution Yield (%)	1.54
Convertible	No
Shares per ADR	N/A

Financial Summary

Target Growth (%)	0.0
Discounted Growth (%)	0.0
Net Debt (m)	1243
Non-Financial Liabilities	0.0
WACC (%)	9.0

Stock Overview

 Reuters ICL.TA
 Bloomberg ICL IT
 ADR

Performance	1M	3M	12M
Absolute %	-5	-9	84
Rel. Market %	-5	0	100
Rel. Sector %	1	3	25

52 Week Range 80.07 - 31.54

Stock Rating
Target Price

New: 1-Overweight	New: ILS 100.00
Old: 1-Overweight	Old: ILS 100.00

Sector View: 2-Neutral

Great Qtr – What's next?

On Wednesday Aug 20, ICL posted results that bested even the most aggressive forecasts as average selling price for potash exceeded that of its industry peers, and as operating leverage continued to surprise on the upside. We published two brief emails detailing the drivers of the upside and present the results compared our expectations in the tables below.

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Figure 1: ICL 2Q08 Results vs. Expectations

	2Q08e	2Q08a	% difference	2008e	2007a	% difference
Potash Sales	529	854	61.60%	3,705	1,386	167%
Phosphate Sales	450	536	19.12%	2,090	813	157%
Total Sales	1,574	2,080	32.17%	8,105	4,103	98%
Total Expenses	269	284	5.68%	1,159	804	44%
Gross Profit	731	1,147	57.03%	4,638	1,547	200%
Operating Profit	465	863	85.55%	3,479	743	369%
Net Income	347	703	102.84%	2,827	553	411%
EPS	0.27	0.55	102.84%	2.20	0.43	411%

Source: Company reports, Lehman Brothers estimates

Issues we see weighing on the stock

Despite the strength of the business, the stock (along with its global peers) has clearly lost some of its lustre.

While ICL is up 20% year to date, compared to the TA-25 which has lost 15%, it has dropped 27.5% since peaking at ILS 80.07 on June 18. Over the same time period the TA-25 has shed 8.1%, Potash Corp is off 24%, Agrium is off 23%, Yara is down 29%, and K+S is off 16%.

In the commodity sector, which clearly has begun to impact the fertilizer stocks in a manner we have not seen before, corn is off 22% since June 18 and crude oil is off 16% (crude has fallen 21% from its peak in early July).

In our view the market is uncertain regarding the following questions, each of which contributes to the performance of the stock:

- Weaker oil and corn prices. The fertilizer industry's rapid growth over the last few years has largely been attributed by industry participants to increased demand for meat/protein in the diets of the growing middle class in emerging markets. However, there are those who believe (including the Governor of Texas as stated in a recent opinion piece in the Wall St. Journal) that at least some of the increase in corn pricing is directly attributable to growth in the ethanol market in the US. Accordingly, the link between oil pricing and fertilizer company stock market values has started to develop.

In our view, the determining factor will be the demand for food and planted acreage/harvest of grain. We believe that the real statistic to watch here is the low level of grain stocks and the planting/application of fertilizer that will be required to replenish inventories.

- Peak fertilizer pricing could be near. There is no question, in our view, that the rapid increases in fertilizer pricing in early 2008 were behind some of the appreciation in the Ag/Chem stocks. While ICL does not officially disclose realized price/tonne of potash, we estimate that ICL achieved an average of \$570/tonne in 2Q08, up from \$400 in 1Q08 and \$250 for FY07. In 2Q08, ICL appears to have realized higher pricing than the rest of the sector, which according to published reports averaged \$425-\$475/tonne. According to management, ICL's mix of business and geographic advantages which reduce time to market and shipping costs played a role in the higher realized pricing.

Looking ahead into 2H08 and 2009, industry pricing is still rising. Based on announced contracts in India and China and spot prices in the rest of the world, we expect to see ICL achieve prices at and above \$750/tonne in 3Q and 4Q08. For 2009 we expect to see prices approach \$900/tonne on average, with \$1,000/tonne in some locations.

Ahead of the 2Q08 earnings report we had forecast continued increased in pricing into 2010. Clearly, no one in the potash sector has any real visibility on pricing for 2010. Given the potential influences of supply coming on-line in 2011, the potential for a stronger US\$ and the influence that could have on Euro based pricing (which is ~40% of ICL demand), and a reasonable expectation for seasonality we have modelled a 5% decline in price for 2010.

Even if our conservative pricing assumption turns out to be incorrect, we do believe that the magnitude of the price increases experienced since the end of 2007 until now will not be repeated, in which case the positive impact we have seen on the pricing side of the business will likely begin to subside in 2010.

We stress that adding this layer of prudence to our model does not in any way detract from our bullish position on the sector or the stock. ICL's profitability continues to soar and if our above stated assumption about inventory replenishment is correct, the risk to our pricing assumptions will be to the upside.

We believe that at the current stock price, investors are being overly cautious and are essentially forecasting a 50% decline in fertilizer pricing from the current almost \$1,000 level to the range of \$400-\$500. While such a drop may be possible, we do not see it as likely.

Figure 2: Potash Sector Performance

	Net Sales		% Growth	Average Price		% Increase
	Q208	Q207		Q208	Q207	
Potash Corp	\$1,120	\$444	152%	\$411	\$157	162%
Mosaic	\$2,195	\$1,522	44%	\$335	\$144	133%
Agrium	\$244	\$95	157%	\$425	\$178	139%
Intrepid Potash	\$91	\$45	101%	\$385	\$165	133%
K+S	€613	€340	80.39%	€303	€163	86%
Israel Chemicals	\$854	\$303	182%	\$570	\$235	143%

Source: Company Reports and Lehman Brothers

- Increasing supply of fertilizers. There have been multiple announcements in the sector regarding expansion projects for potash. ICL compiled a chart that it presented with its earnings report indicating that supply and demand will not match-up until 2012. It also reminded investors that announcing new capacity and delivering it on time are quite different.

With regard to the phosphate market, the largest new facility in the sector is the Maadan project in Saudi Arabia which we believe is more of a 2011/2012 story as well.

- Technically, this is a crowded trade. Of all the overhangs on the stock, this claim is hardest to refute. ICL is the only stock in the TA-25 Index with a positive return year-to-date. We believe that in the short term, the concerns mentioned above are more likely to exert selling pressure on the stock than it is likely to find a new group of investors to buy this well known story.

Dividends

With its quarterly report, ICL announced a \$300 million dividend. This amounts to a 42% payout ratio. As the company has an "up to 70% of net income" pay-out policy stated in its financials for 2007 the company was ironically put on the defensive for paying out a dividend in 1H08 that equalled 85% of total dividends paid in 2007. If ICL achieves our estimates for 2008 and maintains a 45% payout ratio, we estimate it would return \$1,272 million to investors in 2008. Net income for 2007 was \$553 million.

We believe that investors should feel quite confident in the dividend commitment of ICL and would expect to see a yield of greater than 5% (assuming current stock price).

The rest of the business

ICL's other businesses are arguably of less interest to investors than they have been in the past, but here too the company showed positive momentum in 2Q08. In the bromine business, after over a year of difficulty, sales and margins have started to improve as pricing has been rising and ICL and its competitors have seemingly done a good job of reducing volumes to match demand and supporting higher pricing trends.

The upstream phosphate business - performance products soared in the quarter. In 2007, as phosphate prices began to rise, the performance products group was not able to pass along increases to its customers and sales grew only 7.2% in 2007 and operating margin dropped to 6% in 4Q07. 2008 has seen these products' price increase and sales grew 50% in the quarter with operating margin rising to 19.5% from the FY07 average of 8.3% and the 1Q08 result of 11.3%.

Updates to model

We have adjusted our model as appears below. These adjustments have limited impact on our DCF and we reiterate our 1-OW and ILS 100 target. ICL also continues to trade a discount to its global peers, offering good value in our view.

Figure 3: Divisions Results

	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	
	07	07	07	07	07	08	08	08E	08E	08E	09E	09E	09E	09E	09E	10E	10E	10E	10E	10E	
Fertilizers																					
Potash Sales	276	304	358	449	1,386	581	854	984	1,285	3,705	1,260	1,418	1,346	1,690	5,714	1,488	1,447	1,227	1,495	5,657	
Pricing+											167%					54%					-1%
Volume Growth																					
Potash Op. Profit	62	79	107	157	406	281	488	441	797	2,145	806	936	861	1,116	3,719	982	955	786	986	3,709	
Phosphate Sales	184	191	196	242	813	392	536	570	593	2,090	607	627	663	679	2,576	567	579	612	626	2,384	
Pricing+											157%					23%					-7%
Volume Growth																					
Phosphate Op. profit	9	32	38	44	123	132	244	269	266	911	304	308	342	333	1,287	242	238	268	253	1,002	
Total	452	481	539	677	2,149	953	1,350	1,399	1,722	5,423	1,712	1,890	1,853	2,214	7,669	1,99	1,871	1,684	1,965	7,419	
Fertilizer Op. Profit	71	110	145	201	527	407	731	709	1,062	3,050	1,110	1,243	1,203	1,448	5,004	1,224	1,193	1,053	1,239	4,709	
Industrial Products																					
Sales	197	350	293	287	926	290	361	376	344	1,371	310	387	327	368	1,391	325	406	343	386	1,461	
Op. Profit	44	50	27	20	142	29	45	37	41	152	38	45	39	44	166	40	48	42	46	1756	
Performance Products																					
Sales	249	278	301	273	1,102	316	418	416	388	1,538	364	431	428	400	1,623	375	444	441	412	1,671	
Op. profit	20	26	29	16	91	36	82	75	70	262	66	78	77	72	292	56	67	66	62	251	
Total Revenues	883	963	1,043	1,214	4,103	1,528	2,080	2,115	2,382	8,105	2,424	2,730	2,565	2,940	10,660	2,644	2,749	2,428	2,725	10,547	

Source: Company reports, Lehman Brothers estimates

Figure 4: Comp. Table

Aug 24th 2008

	Currency	Price (local)	Mkt Cap US\$m	P/E 08e	P/E 09e	EV/Sales 08e	EV/Sales 09e	EV/EBITDA 08e	EV/EBITDA 09e
Agrium	\$	84.51	13,345	8.9	7.0	1.6	1.4	6.6	5.2
Albemarle	\$	40	3,657	14.5	12.4	1.7	1.5	9.7	8.4
Bunge	\$	91.43	11,119	8.9	8.9	0.3	0.3	6.3	5.6
Chemtura	\$	6.47	1,565	13.1	10.6	0.7	0.6	5.6	5.3
K+S	€	76.51	18,605	11.8	7.1	2.6	2.2	7.9	5.3
Potash Corp	\$	180.21	55,276	14.2	8.4	5.1	3.4	9.3	5.7
Uralkali	\$	9.20	2,124	11.5	9.0	6.9	5.0	9.6	6.7
Israel Chemicals	ILS	58.71	21,743	9.8	6.3	3.1	2.4	7.9	5.3
ICL @ 100	ILS	100.00	38,708	16.9	11.0	4.6	3.5	10.2	6.7

Source: Lehman Brothers, IBES

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Company Description:

ICL is the number-five global producer of potash (fertiliser) with about 9-10% market share. It delivers about 5.5 million tons annually from its Dead Sea, UK and Spanish sources. ICL's two other key businesses are its bromine business, which is used for flame retardants and in oil exploration applications, and its phosphate business (also in the fertiliser segment). ICL is the number-one global producer of elemental bromine. The phosphate business has been growing in significance since early 2007 as pricing trends have been strong.

Important Disclosures:

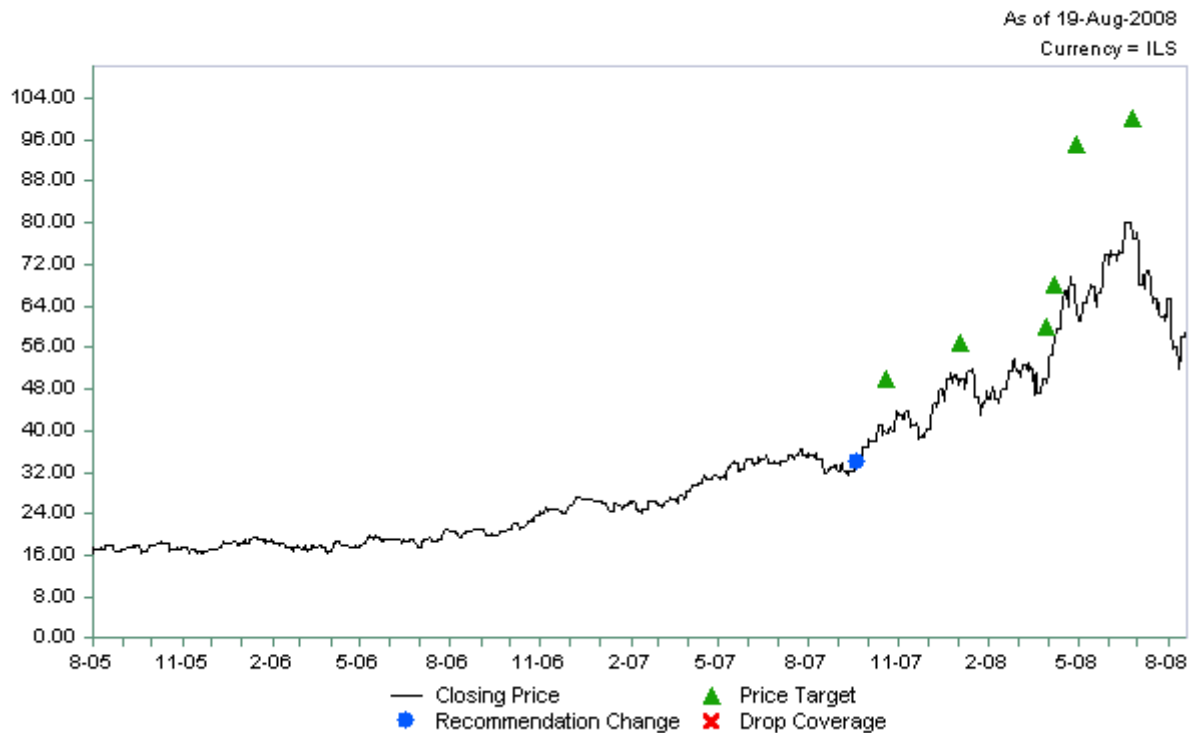
Israel Chemicals (ICL.TA)

ILS 60.00 (21-Aug-2008)

1-Overweight / 2-Neutral

Rating and Price Target Chart:

ISRAEL CHEMICALS



Currency=ILS

Date	Closing Price	Rating	Price Target
25-Jun-08	78.00		100.00
29-Apr-08	64.06		95.00
07-Apr-08	58.60		68.00
31-Mar-08	49.30		60.00

Date	Closing Price	Rating	Price Target
03-Jan-08	49.80		57.00
18-Oct-07	39.60		50.00
20-Sep-07	33.86	1 -Overweight	

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Valuation Methodology: Our price target is DCF derived and supported by peer group valuations, EV/EBITDA in particular. The major assumptions of our DCF are WACC of 9.15%, terminal growth of 3% and a long-term tax rate of 20%. At our PT, ICL would trade at P/E of 8.5x and EV/EBITA of 6.7x our 2009 estimates.

Risks Which May Impede the Achievement of the Price Target: Israel Chemicals competes in the global fertilisers market, which can be cyclical and is competitive. It also participates in the global bromine market, which is directly affected by the cyclicity of the global electronics market and is also competitive.

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Company Name	Ticker	Price	Price Date	Stock / Sector Rating
Israel Chemicals	ICL.TA	ILS 60.00	21-Aug-2008	1-Overweight / 2-Neutral

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