

August 28, 2008

Israel
Pan-European Banks

Bank Leumi (LUMI.TA - ILS 15.41) 2-Equal weight

Earnings Review/Sales Analysis

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Signs of a Slowdown?

Investment Conclusion

□ We maintain our 2-EW rating on LUMI and drop our TP to ILS 19 from ILS 20. LUMI did a solid job executing against the challenges under its control. Expenses were flat in ILS terms and cost income ratio of 57.6% was a strong achievement in our view. Provisions of 0.63%, a level not seen since 3Q06 (though a portion was customer specific), and less robust growth in commissions made for tough comps vs. last year, and could be an indication of a slowing economy – an assessment that LUMI's own economists endorse.

Summary

- Aside from solid expense control, LUMI was able to grow its net interest income 8% in 2Q08 as its loans grew 4% y-o-y and 1.6% from YE07. Unlinked shekel growth was 10.6% compared with YE07. This growth appears to have come from the household, not the corporate segment.
- Net income was boosted dramatically by an ILS 250m one-time gain (mainly of the credit card unit) and by strong earnings at ILCO/ICL.

FY Dec Currency ILS	2007A	2008E		2009E		2010E	
	Actual	Old	New	Old	New	Old	New
Net Income (m)	3357	2841	2901	3128	3391	3421	3674
EPS (stated)	2.36	2.01	2.05	2.21	2.40	2.42	2.60
EPS (adj.)	2.03	1.96	1.99	2.13	2.31	2.33	2.50
PE (adj.)	7.6	9.0	7.7	8.3	6.7	7.6	6.2
ROE (stated %)	19.2	13.9	14.8	14.1	16.1	14.3	16.2
ROE (adj. %)	15.3	13.9	14.0	14.1	14.9	14.3	15.0
Price/NAV	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Price/NAV (adj.)	0.9	0.8	0.8	0.8	0.8	0.8	0.8

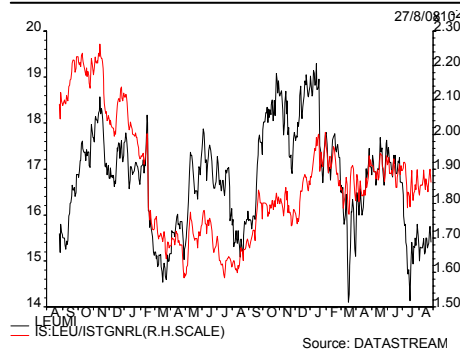
Market Data

Market Cap (m)	22665
Units Outstanding (m)	1470.8
Float (%)	75
Net Distribution Yield (%)	6.93
Convertible	No
Shares per ADR	N/A

Financial Summary

NAV/Unit FY07	N/A
NAV(adj.)/Unit FY07	N/A
Tier 1 BIS Ratio FY08 (%)	8.0
Total BIS Ratio FY07 (%)	N/A

Stock Overview


 Reuters LUMI.TA
 Bloomberg LUMI IT
 ADR

Performance	1M	3M	12M
Absolute %	-1	-7	-3
Rel. Market %	0	-1	10
Rel. Sector %	3	4	18

52 Week Range 19.29 - 14.10

Stock Rating

Target Price

New: 2-Equal weight	New: ILS 19.00
Old: 2-Equal weight	Old: ILS 20.00

Sector View: 1-Positive

2Q08 Summary

Net interest income of ILS 1,953m was up 8%, slightly below our ILS 2,017m forecast. Adding back the SCDO (mortgage backed asset) write-down of ILS 82m would have put results in line with our forecasts. Although we do see some risk that LUMI will need to take further write-downs against its MBS portfolio, given the relative "quality" of this portfolio and the fact that 97% is agency backed, we do not see this portfolio creating a significant overhang on LUMI's stock.

Provisioning trends remain positive with non-accrual loans continuing to decline. However, given the extremely tough comparable from 2Q07 (0.08% of loans), provisions at 0.63% of loans did surprise to the downside compared with our forecast of 0.45% of loans. We would not view this level of provisions, not seen since 3Q06, as negative and in fact the increase in provisions was affected by the reclassification and refinancing of debt associated with Tower semiconductor. In its reports, LUMI refers to the level of provisioning as being significantly affected by the Tower loans. If we attempt to neutralise this impact the provisioning level in the quarter was likely below 0.4% of loans.

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However, the return to more "normal" levels of 0.5-0.6%, which the CFO made reference to on the conference call, could be a harbinger of a slowing domestic economy. This is the view of LUMI's own economists, who forecast 4.7% growth for 2008 with a reduction to 2.7% in 2009.

Operating commission trends have slowed as well. Total operating and other income dropped dramatically in the quarter to ILS 864m from ILS 1,131m in 2Q07. The reasons for the decline and the 13.4% shortfall compared with our forecast breaks down as follows:

- Operating commissions of ILS 832m compares to ILS 826m last year. This 0.7% growth is understandable in light of weakening capital markets. However, growth has trickled to a halt after achieving 11.6% growth in 2007.
- Profit from investment in shares were a major difference. A loss of ILS 44m compares with ILS 143m in 2Q07. This was attributable to the decrease in value in securities held and a decrease in dividends from Bezeq accounted for in this line item.
- Other income dropped as planned given sale of asset management units. The ILS 76m in fees compares with the ILS 80m that we had forecast.

In 1H 08 income from credit card transaction has grown 12.4% and credit handling/preparation of legal documents increased 16.4%.

In our view, expense control was strong in the quarter. Expenses were essentially flat with last year. While LUMI stated on its call that reducing ILS levels of expenses can be challenging, it feels confident that it has grown its revenue base faster than its expense base and that even looking ahead into a potential slowdown in 2009 it feels well positioned and in control on the expense side.

Net income of ILS 889m was higher than we forecast (ILS 738m). The differences compared with our forecast were twofold: 1) LUMI booked ILS 250m in one-time gains in the quarter, primarily associated with the sale of a stake in the credit card business. 2) Earnings from associated holdings added ILS 200m directly to the bottom line.

How should investors think about this non-core contribution? ROE was 18.1% for the quarter. It was 13% ex-one time items. Although it is harder to get ROE ex associated earnings, by stripping out published BV of the holdings we have calculated ROE of 10% for LUMI's banking business in 2Q08. This includes the one-time Tower provision as well.

Our view is that investors should just be aware what they are paying for. We are highly confident in the stream of earnings that ILCO/ICL will provide based on coverage and forecasts for ICL. What we are less confident of is whether this stream of dividends is a reasonable basis upon which to predicate owning a position in LUMI.

In summary, we see 2Q08 as a quarter in which LUMI did a good job controlling what it can control and dealing with the influences of CPI, interest rates and currencies. However, we do not see a catalyst for outperformance in the stock as ROE at the core level appears to be under pressure as the economy slows and provisions return to normal. We stay at 2-EW.

Figure 1: 2Q08 Results vs. Expectations

ILS m	Q208A	Q208E	% difference	Q207A	y/y
Net Interest Income	1,953	2,017	-3.2%	1,809	8.0%
Provisions for doubtful debts	-316	-226	39.8%	-38	731.6%
Net interest income after provisions	1,637	1,791	-8.6%	1,771	-7.6%
Total operating and other income	864	997	-13.4%	1,131	-23.6%
Total operating and other expenses	1,662	1,729	-3.9%	1,656	0.4%
Operating profit before taxes	839	1,059	-20.8%	1,246	-32.7%
Provisions for taxes on operating profit	-400	-402	-0.6%	-376	6.4%
Net Income (core)	889	738	20.4%	936	-5.0%
EPS excluding one offs	0.45	0.52	-13.5%	0.65	-30.0%
Reported EPS	0.63	0.52	20.4%	0.66	-5.0%
ROE	18.1%			21.6%	
Core ROE	13%			21%	
ROE ex Associated Earnings	9.9%			21.6%	
Loan Growth	4.0%			9.0%	

Source: Company data, Lehman Brothers estimates

Figure 2: Net Interest Income by Divisions

ILS m	1H08	1H07	% change
Households	1,293	1,207	7.1%
Small Businesses	444	423	5.0%
Corporate Banking	858	790	8.6%
Commercial Banking	573	531	7.9%
Construction and Real Estate	416	308	35.1%
Private Banking	197	198	-0.5%
Financial Management - Capital Markets	171	160	6.9%
Other	- 39	- 15	160.0%
Total	3,913	3,602	8.6%

Source: Company data, Lehman Brothers research

Figure 3: Net Interest Income by Divisions

ILS m	1H08	1H07	% change
Households	515	471	9.3%
Small Businesses	200	142	40.8%
Corporate Banking	237	512	-53.7%
Commercial Banking	203	211	-3.8%
Construction and Real Estate	223	162	37.7%
Private Banking	64	71	-9.9%
Financial Management - Capital Markets	- 83	261	-131.8%
Total	1,359	1,830	-25.7%

Source: Company data, Lehman Brothers research

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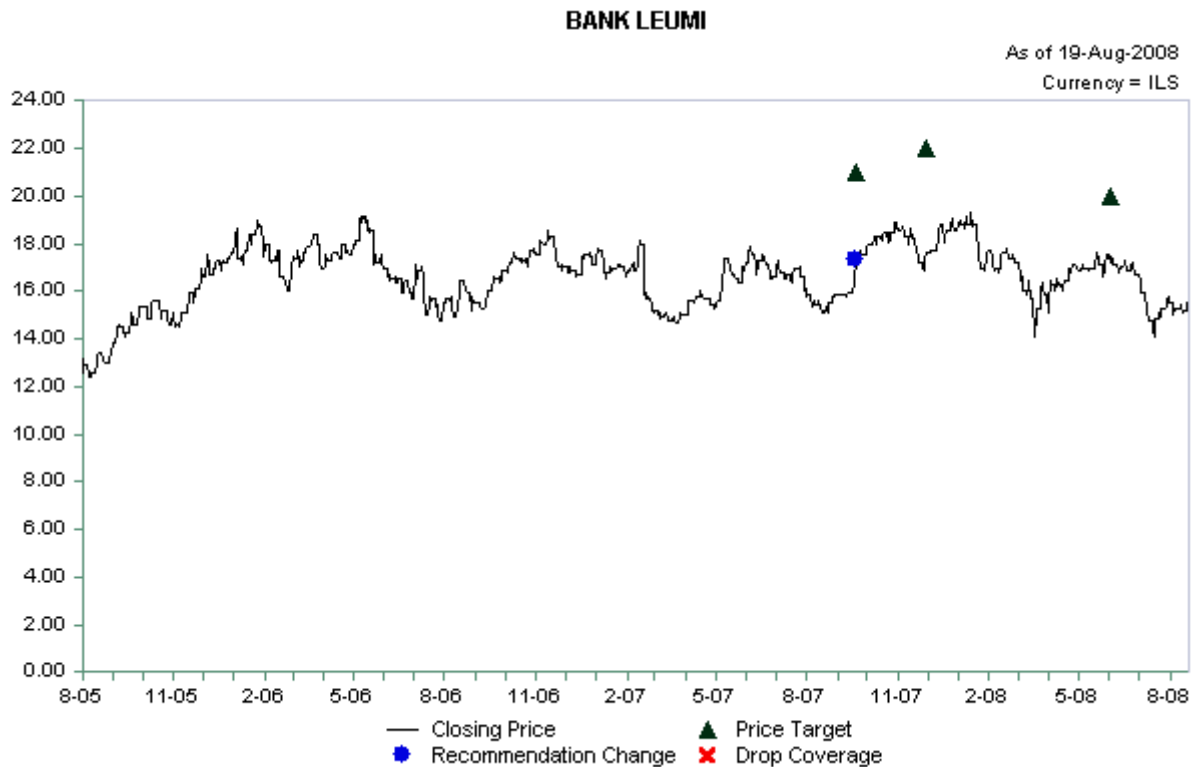
Important Disclosures:

Bank Leumi (LUMI.TA)

ILS 15.41 (26-Aug-2008)

2-Equal weight / 1-Positive

Rating and Price Target Chart:



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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Valuation Methodology: We value Bank Leumi at 1.1x book value based on a growth model that assumes ROE of 13%, growth of 3% and cost of equity of 10.5%. We apply a 15% discount to reach our target P/B based on historical trading ranges and current sentiment towards the Israeli banks.

Risks Which May Impede the Achievement of the Price Target: Israeli Banks are high-beta ways of investing in the local economy and results are influenced by changes in interest rates and CPI. LUMI's own economists are forecasting a decline in GDP growth in 2009 to 2.7% from 4.7% in 2008.

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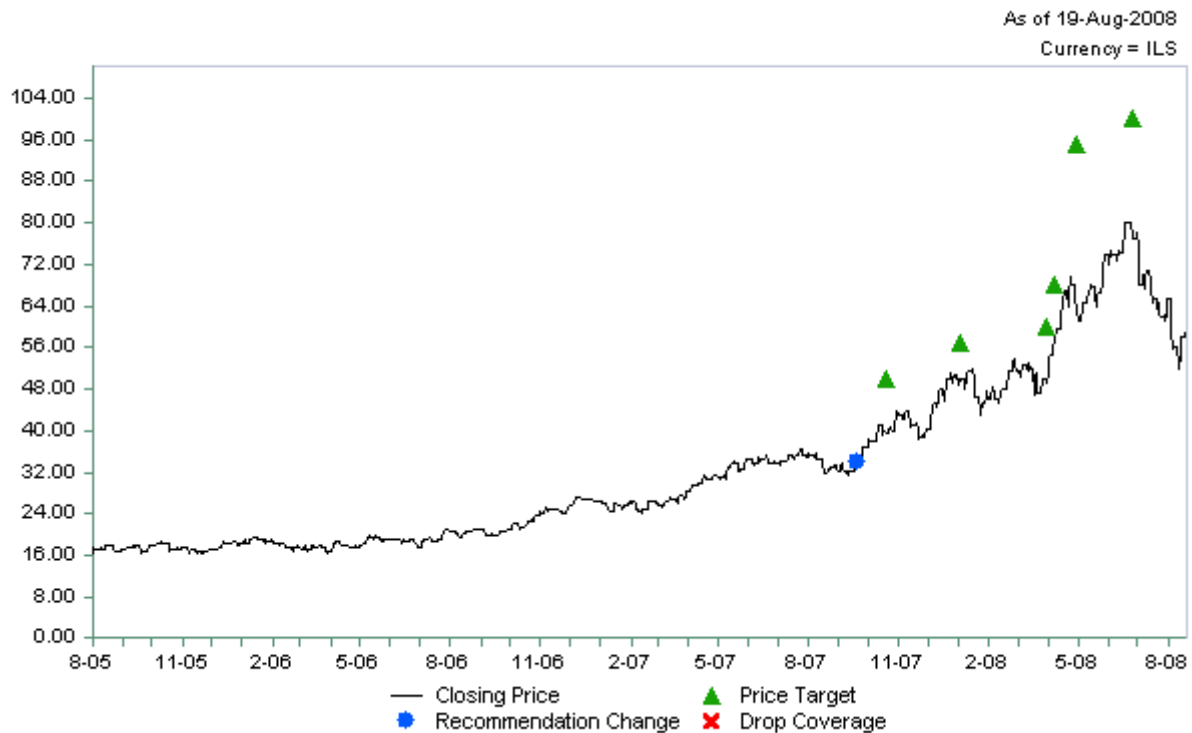
Israel Chemicals (ICL.TA)

ILS 60.50 (25-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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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
Bank Leumi	LUMI.TA	ILS 15.41	26-Aug-2008	2-Equal weight / 1-Positive

Mentioned Company	Ticker	Price	Price Date	Stock / Sector Rating
Israel Chemicals	ICL.TA	ILS 60.50	25 Aug 2008	1-Overweight / 2-Neutral

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Banco Popolare (BAPO.MI)	Banco Popular (POP.MC)
Banco Sabadell (SABE.MC)	Banesto (BTO.MC)
Bank Hapoalim (POLI.TA)	Bank Leumi (LUMI.TA)
Bank Millennium (BIGW.WA)	Bank of Ireland (BKIR.I)
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Barclays (BARC.L)	BBVA (BBVA.MC)
BCP (BCP.LS)	BNP Paribas (BNPP.PA)
BPI (BBPI.LS)	Bradford & Bingley (BB.L)
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EFG Eurobank Ergasias (EFGGr.AT)	EFG International (EFGN.S)
Erste Bank (ERST.VI)	Espirito Santo Financial Group (ESF.LS)
Fortis (FOR.AS)	Garanti Bank (GARAN.IS)
Halkbank (HALKB.IS)	Halyk Bank (HSBKq.L)
HBoS (HBOS.L)	HSBC Holdings (HSBA.L)
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Raiffeisen International Bank (RIBH.VI)	Royal Bank Of Scotland (RBS.L)
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