

Q209 first glance: strong quarter

Strong Q2 2009, thanks to lower LLPs and lower costs

Bank Leumi (LUMI) reported better-than-expected Q2 results, with NI totaling ILS 507mn vs. BAS-MLe ILS 449mn (+11%) thanks primarily to lower-than-expected loan loss provisions (LLP) and lower costs, and despite higher-than-expected losses at the bank's equity investments (ILCO). ROE averaged 9.4% inline with our 9% projections despite substantial MTM gains on the bank's AfS portfolio.

Main focus: asset quality improves

LLPs came in well below our expectations and at ILS 339mn averaged a modest 66bps over loans (vs BAS-MLe 0.8%), well below the 1% reported at Bank Hapoalim. And while we continue to model for substantially higher LLPs in H2 (approx. 1%, see [Lower LLPs might be temporary, 12 August](#)) as we worry about potential fall-outs from the global crisis/recession (eg AFIL), adjusted NPLs and PLs declined by 1.4% and 2.4% QoQ, theoretically indicating asset quality might be improving earlier than expected at LUMI. Likewise, recoveries were substantial (reducing net LLP by some 50bps) and we expect LUMI is likely to continue to see notable recoveries in coming quarters, if the local real estate markets remains strong, thanks to its conservative provisioning policy in H208.

P&L analysis: lower loan provisions and lower costs

Revenues were strong and at ILS 2,939mn were bang inline with BAS-MLe (ILS 2,934mn), while opex came in lower at ILS 1,640mn (BAS-MLe ILS 1,721mn) as LUMI once again benefited from gains on its severance payment fund. PPop totaled ILS 1.3bn (vs BAS-MLe ILS 1.2bn), while lower than expected LLPs left PBT at 960mn, some 20% higher than BAS-MLe.

Credit drops; CAR =12.8%; CT1>8% highest in the sector

As expected, the bank shrunk its loan book by 2.7% QoQ, primarily due to a 4.1% QoQ decline in LSE credit, improving the bank's CAR (retail credit grew by 1.5%). CAR reached 12.8% in Q2, while CT1 totaled 8.1%, well above that of POLI (7.1%) and reducing any fears over potential need for capital injections.

LUMI remains our top pick among Israeli banks; Buy

We continue to favor Bank Leumi and it remains our only Buy, as we expect it will continue to deliver above-average returns and superior capital ratios. Inline with strong Q2 results (highest ROE & CAR in sector), we continue to see marked upside to our numbers from potential loan loss recoveries; notable gains on the bank's AfS portfolio and upside from higher rates. LUMI's high CAR and relatively high NPL coverage remains a comfort in light of potential fall-outs from the global crises, although we expect AFIL's financial stress will only have limited impact on H2 earnings, while gains from BEZQ and HOT will more than offset higher taxes.

Equity | Israel | Banks-Retail
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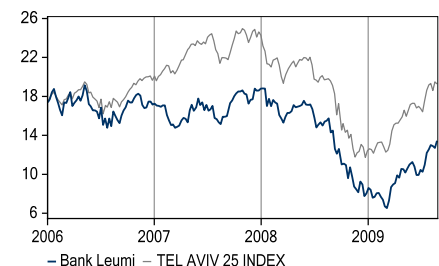
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Stock Data

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Bloomberg / Reuters	LUMI IT / LUMI.TA



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Quarterly variance table

Table 1: Bank Leumi: 2Q09A income statement summary

	2Q09A	2Q08A	1Q09A	YoY (%)	QoQ (%)	2Q09e %	Vs MLe	Comments
Net Interest Income	1,926	1,953	1,362	-1.4%	41.4%	1,904	1.1%	Core NII=1,771mn; MTM -156mn; CPI +53mn; Bonds +177mn; FX hedge +50mn
Non Interest Income	1,013	864	1,003	17.2%	1.0%	1,030	-1.6%	
-Fees and Commissions	840	882	831	-4.8%	1.1%	837	0.4%	
-Other Operating Revenue	90	-44	95			41		Translation gains -ILS 60mn; Union Bank +25mn; Mastercard +7mn
-Management and Distribution Fees	83	26	77	219.2%	7.8%	152	-45.4%	Severance payment gains ILS +58mn
Total Banking Revenues	2,939	2,817	2,365	4.3%	24.3%	2,934	0.2%	
Operating Expenses	1,640	1,662	1,564	-1.3%	4.9%	1,721	-4.7%	
Salary and Other Personnel Costs	929	975	883	-4.7%	5.2%	1,015	-8.5%	Includes ILS 79mn in severance & pension fund gains
Non-Salary Operating Costs	380	344	364	10.5%	4.4%	360	5.6%	
Depreciation and Maintenance Costs	331	343	317	-3.5%	-9.1%	346	-4.3%	
Pre-Provision Profit	1,299	1,155	801	12.5%	62.2%	1,213	7.1%	
Loan Provision Charge	339	316	354	7.3%	-4.2%	415	-18.3%	Recoveries of ILS 255mn; We expect AFIL default will have very limited impact
Profit Before Tax	960	839	447	14.4%	114.8%	798	20.3%	
Tax Provision	409	400	42	2.3%	873.8%	342	19.7%	ILS appreciation inflated taxes. Likely to revert in Q3
Net Income	551	439	405	25.5%	36.0%	457	20.6%	Q3 will see ILS 153mn in tax loss (increase) due to corp tax reform
Income (Expenses) from investee earnings	-64	193	34	-133.2%	-288.2%	-20	220.0%	Some ILS 100mn losses from ILCO
Minority Interest	-7	7	-11			1	-1033.3%	
Attributable Group Net Income	480	639	428	-24.9%	12.1%	437	9.7%	
Extraordinary Income	27	250	1			12		Q3 will include ILS 55mn for BEZO & ILS 120mn for HOT CATV
Reported Group Net Income	507	889	429	-43.0%	18.2%	449	12.8%	

Bank Leumi: 2Q09A balance sheet summary

	2Q09A	2Q08A	1Q09A	YoY (%)	QoQ (%)	Comments
Cash, CB Reserves & Interbank Balances	39,390	31,229	38,712	26.1%	1.8%	
Marketable Securities	58,025	44,236	47,906	31.2%	21.1%	
Net Loans	207,214	201,717	212,878	2.7%	-2.7%	LSE loans -4.1% QoQ; SME loans -5.1 QoQ; Retail +1.5% QoQ
Government Loans	452	531	500	-14.9%	-9.6%	
Interest Earning Assets	305,081	277,713	299,996	-99.3%	1.7%	
Investment in Subsidiaries	1,862	1,895	2,048	-1.7%	-9.1%	
Fixed Assets	3,528	3,317	3,513	6.4%	0.4%	
Other Assets	8,875	9,077	12,495	-2.2%	-29.0%	
Total Assets	319,346	292,002	318,052	9.4%	0.4%	
Customer Deposits	253,254	221,752	254,565	14.2%	-0.5%	
Interbank Deposits	4,078	6,338	3,374	-35.7%	20.9%	
Deposits from the Government	741	833	852	-11.0%	-13.0%	
Bonds and Notes	22,917	21,920	20,567	4.5%	11.4%	
Other Liabilities	17,871	17,506	19,603	2.1%	-8.8%	
Minority Interest	263	225	255	16.9%	3.1%	
Total Group Equity	20,222	20,428	18,836	-1.0%	7.4%	Increased by a net ILS 879mn from MTM gains on the bank's AFS portfolio

Source: Company data & Banc of America Securities - Merrill Lynch

Price objective basis & risk Bank Leumi (BLMIF)

Our price objective for the company (ILS 14.90/s) is based on the lower outcome of two valuation models (1) a simple Gordon growth model (ILS 15.0s) and a dividend discount model (which generates a fair value of ILS 15.1/s). We prefer to be conservative and use the lowest outcome. We use a simple target price-book model (a single-stage Gordon Growth Model) with a mid-term sustainable ROE target of 12.0% a 11.3% cost of equity and a 3.5% nominal terminal growth rate. Our COE uses 36 month rolling average 10 year nominal government bond yield of 5.8% and a 1.1 beta (a 36 month rolling adjusted Beta vs. the TA-100). Our perpetual growth rate of 3.5% is nominal and assumes a real long term growth rate of 1.5% and a 2% long term inflation rate target.

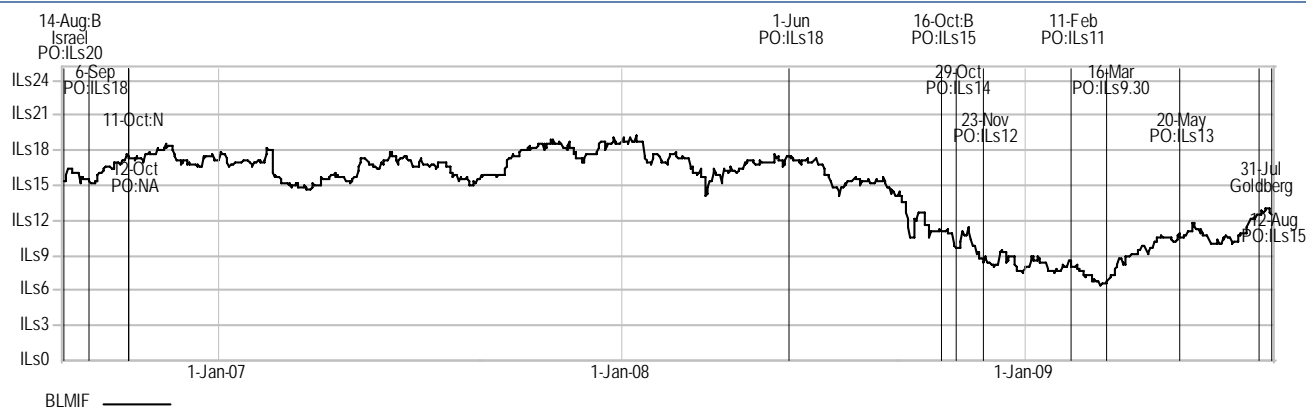
We group the risks into two categories macroeconomic and microeconomic. On the macro level the economy could slide into a longer than anticipated recession due to prolonged slowdown in the US economy and/or due to deterioration in Israel's security situation. This could put the banking sector under pressure for both growth and asset quality. A default of one of the larger European banks could also potentially significantly impair the bank as it carries notable deposits in overseas banks primarily European banks. The bank's ability to contain costs, sustain its net interest margin and maintain prudent risk management is the microeconomic risk, in our view.

Analyst Certification

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BLMIF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

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Buy	70	29.29%	Buy	30	52.63%
Neutral	57	23.85%	Neutral	29	58.00%
Sell	112	46.86%	Sell	64	64.65%

Investment Rating Distribution: Global Group (as of 01 Jun 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1303	40.83%	Buy	602	51.10%
Neutral	807	25.29%	Neutral	362	51.49%
Sell	1081	33.88%	Sell	394	39.96%

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