

Israel Banking Sector

Looking ahead to 2010 – Sector Fairly Valued Downgrading to Market Weight

In examining the 2010 outlook for Israel's bank stocks, we focus on a number of key developments:

- 1. Bank Hapoalim has renewed its aggressive marketing.** In our view, Hapoalim's working plan will be a key focus of the sector as a whole. We believe the bank will be returning to its roots with the aim of regaining its leading position in the sector.
We look for the bank to start the year with a marketing blitz in four main segments, with the aim of increasing market share in the business segment, commercial banking, retail banking in general, and the mortgage segment in particular. The upshot of this campaign is likely to be tougher competition in all the aforementioned categories, with Bank Hapoalim's peers launching counterattacks of their own.
- 2. The economy will return to growth mode.** Israel's economy is expected to generate 3.5% year-on-year growth in 2010, which can be expected to benefit the banking sector, whose operations are closely linked with macroeconomic performance. Key factors to watch are:
 - Higher demand for credit in the business sector.
 - Increased financial activity, which means growth in fees and commissions.
 - Rising interest rates from the Bank of Israel, which should generate a wider net interest margin.
 - Improved credit quality and a decline in loan-loss provisions.
- 3. The Hodak Commission's recommendations will increase demand for bank loans.** The commission's interim recommendations, even if only implemented in part, should divert credit issuance from the corporate bond market back to the banking sector, generating higher margins for the banks, following the decline in banks' share of business sector credit issuance from around 75% at the beginning of the decade to 50% today.
- 4. The banks efficiency challenge.** One of the banking sector's structural problems revolves around efficiency in general and wage expenditures in particular, owing to structurally hardwired wage increases. In 2009, we were witness to significant employee wage concessions at Bank Leumi, Discount Bank, and Bank Hapoalim.
While the wage reduction agreements were reached at Leumi and Discount at the beginning of 2009, during the height of the global financial crisis, the agreement at Hapoalim was attained near the end of the year. In consequence, employees at Leumi and Discount are already endeavoring to regain their previous wage levels, and even get compensated for the concessions made in 2009 in light of the two banks' solid 2009 results. In contrast, the agreement at Hapoalim, which entailed giving up a 2010 wage increase is still very much in place and should have a burnishing effect on Hapoalim's FY2010 results.
- 5. Selling pressure on bank stocks.** The state of Israel made the decision to sell the whole of its 25% stake in Discount Bank, of which 5% has already been sold, in addition to its 11.5% holding in Leumi. Separately, we could see selling in the private sector by the Arison Group in Bank Hapoalim, and by Discount, which may choose to reduce its stake in First International.
Additional selling pressure could come from direction of international investors, whose stakes in Israel's five largest banks are estimated at around 30% of outstanding shares. If Israel is reclassified later in the year as a developed economy, the move has to potential generate additional selling on the part of overseas investors.

6. Valuations have reached fair value

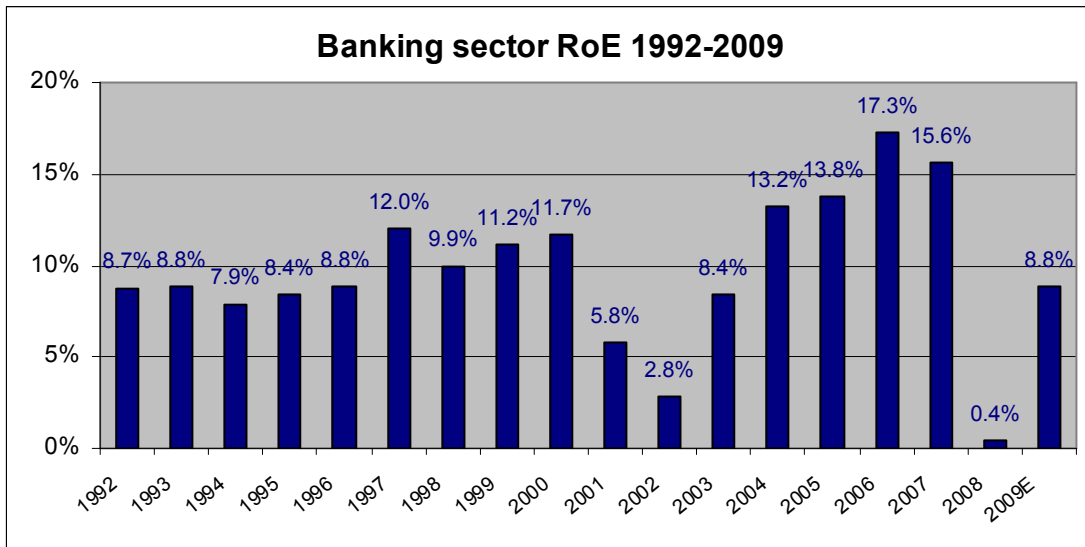
At the beginning of the week, the five main banks were trading, on average, at 1.1 times book value and 10 times expected 2010 earnings—this at a time when the banks are expected to renew dividend payouts. We believe current valuations in the sector represent fair value levels, with potential share price appreciation stemming from the economy's return to growth. That said, owing to our concern over stiffening competition in the sector, led by Bank Hapoalim, and the previously mentioned potential sources of selling pressure in coming months, we've seen fit to downgrade our rating on the sector to Marketperform.

Bottom line

We're lowering our rating on Israel's banking sector to Marketperform. For investors interested in making commitments to the industry, our top picks are Discount Bank and Bank Mizrahi.

Recommendation summary: the shares are at fair value

Before we repeat our comments made two months ago on the sector, investors might want to take a glance at the banking sector's return on equity performance over time:



Sources: Bank of Israel, the banks' financial statements, and estimates by Clal Finance Brokerage.

In our judgment, when examining Israel's banking sector with the aim of setting fair value share prices, average ROE of 10% to 12% should be considered the benchmark. The range takes into account developments in the sector's risk management and implementation of efficiency measures. Assuming a 10% cost of capital and the aforementioned ROE range, the sector should be trading at a price-to-book multiple of 1.0 to 1.2.

As of January 2010, the sector's components are trading at the midpoint of that range—namely, 1.10.

We're concerned over heightened competition in the sector, led by Bank Hapoalim, and worry about selling pressure from the aforementioned sources in coming months. In consequence, we've downgraded the sector to Marketperform.

The following table sets forth the multiples individual banks are currently trading at and our revised ratings.

Stock	Multiples					Dividend yield		
	P/E 09E	P/E 2010E	P/E 2011E	P/BV	P/BV Adj.	2009E	2010E	2011E
Hapoalim	16.7	9.9	8.4	1.0	1.0	0%	0.0%	6.0%
Leumi	12.8	10.3	9.2	1.2	1.1	0%	5.8%	6.5%
Discount	8.1	8.7	7.5	0.9	0.8	0%	0.0%	5.3%
Mizrahi	12.0	9.2	8.2	1.2	1.2	0%	7.6%	8.5%
First Intl 5	10.7	10.2	8.3	1.0	1.0	0%	6.9%	6.0%
Weighted avg	13.1	9.9	8.5	1.1	1.0			

Stock	Rating	Price tgt (ILS)	Current price	Upside	P/B at price tgt	Previous rating	Previous PT
Hapoalim	Market Perform	17.5	16.3	8%	1.15	Outperform	17.5
Leumi	Market Perform	18.5	16.9	9%	1.30	Outperform	17.5
Discount	Market Perform	10.0	8.8	14%	1.02	Outperform	9.5
Mizrahi	Market Perform	39.0	34.2	14%	1.36	Outperform	34
First Intl 5	Market Perform	70.0	63.4	10%	1.16	Outperform	70

1. Bank Hapoalim's working plan will be a key element impacting the sector

In coming weeks, Bank Hapoalim is expected to publish the main points of its 2010 working plan, as well as its revised multi-year strategic program. On the face of it, one could argue these plans focus on Bank Hapoalim alone. In our view, that would be a misconception. The bank's plans can be expected to affect the industry as a whole, at least in 2010.

- 1) **Bank Hapoalim will try to regain its legitimate place as Israel's leading bank.** Use of the word 'legitimate' may sound odd, seeing that the bank's credibility isn't in doubt. However, in our view, the recapturing of that credibility will be a key implicit factor in the bank's 2010 working plan, even if it goes unstated.
The bank has hit a two-year rough patch, during which it lost its pole position status to Bank Leumi. Hapoalim underwent a crisis in 2008 associated with massive losses in its securities portfolio. In 2009, there was a major personnel shakeup at the top echelons of the bank, which was resolved near the end of the year.
The bank starts 2010 with renewed vigor, and its main goal is likely to be recovering its image. Hapoalim wants to return to center stage, reoccupying the industry's top spot. It wants to portray itself as entrepreneurial and dynamic, and regain the confidence of clients, investors, and regulators.
- 2) **Returning to roots.** In our view, the key element lying behind the bank's strategy will be enhancing its traditional areas of strength—namely, traditional banking, as defined in this country, in the following segments in particular:
 - **The business sector.** In our view, Hapoalim will strive to be the leading player in all of 2010's large credit-issuance transactions in Israel, as a full-throated declaration that the bank is once again open for business. Examples of this are already evident in, amongst others, the Bezeq acquisition, the financing of a highway in Azerbaijan (being constructed by Housing & Construction), and the financing extended for the power station being put up by Dorad.
 - **Commercial banking.** As early as two years ago the bank set its sights on the mid-level business segment, in which it has a market share of less than 25% compared with Leumi's 40%. We look for Hapoalim to launch a major campaign to expand its presence in this area in 2010.
 - **Mortgages.** The bank's market share in this segment fell beneath the 20% level in 2009, while Bank Mizrahi's mortgage division, Tefahot, sailed unhindered through the 35% level. We look for Hapoalim to put the full force of its retail division, which commands a 30% market share, behind the effort to expand the bank's presence in mortgage issuance.
 - **Retail banking.** Over the last two years, Bank Hapoalim has lost market share in the segment, partially because of its divestiture of Yahav Bank, Bank Otsar HaHayal, and Bank Massad, but also because of the aggressive marketing campaign launched by the mid-tier banks. In 2010, we look for Hapoalim to put the full weight of its marketing power behind the goal of maintaining its retail segment market, if not increasing it.
- 3) **Quantitative targets.** In the strategic plans the bank made public in 2004 to 2008, management set an ROE target range for continuing operations of 14% to 15%, with the aim of attaining a sustainable level of 15% or higher. The 2008 crisis pulled the rug out from under this goal, and at the outset of 2009 management set itself the cautious, not to mention highly modest, target range of 4% to 7% ROE for 2010. We expect the bank to come in at the high end of this range. Still, the claim can be made that the bank may choose to keep reserves for 2010, and take a conservative approach with its Q4 '09 financial statement.
In our view, Hapoalim will generate FY2010 ROE of 10% to 11%, and we believe the targets the bank will issue for the current year will come in somewhere around this range.
As to long-term sustainable targets, we believe the bank can achieve ROE of 12% to 13%. Anything in excess of that would be a worrying indication of a willingness to take on excess risk.
- 4) **Bank Hapoalim's strategy could generate rough-and-tumble competition.** We believe the bank's working plan will indicate that Hapoalim intends to roll up its sleeves and raise the level of competition in the banking sector. Its peers can be expected to respond with their own counter-attacks.
We anticipate that Hapoalim will launch competitive initiatives, on the one hand, and place downward pressure on prices, on the other.

2. Return to growth

The year 2009 was one in which the banks shifted direction. They increased capital ratios during the period, with the aim, amongst others, to reach the targets set forth in the Basel 2 guidelines.

At the outset of 2010, it appears Israel's economy is set to generate year-on-year growth in GDP of 3.5% to 4.0%, and the banks, whose operations are closely linked to the economy's overall performance, can be expected to benefit from this uptrend in a number of ways:

- **Demand for credit will rise.** GDP growth of 3.5% should generate year-on-year growth for credit of around 5%. That doesn't represent rapid growth, but it's a definite improvement over the stagnation seen in 2009.
- **Revenue from fees and commissions should rise.** GDP growth should translate into stepped up financial activity, which in turn means more fees and commissions for the banking sector.
- **A widening net interest margin.** The Bank of Israel is expected to hike its key lending rate in 2010, which will mean a higher deposit margin. BoI's benchmark 2009 interest rate averaged around 0.7%, and we look for the level to increase to a range of 2.0% to 2.5% in the current year. This will generate hundreds of millions of shekels in additional revenue for the banking sector.
- **Credit quality improvement.** We look for the economy's resumption of growth to enhance the condition of businesses, which should thereby reduce the banks' loan-loss reserves. By our estimate, provisions for the sector in 2009 came in at 0.7% to 0.8% of the banks' aggregate loan portfolio. In 2010, we look for this to edge down to 0.6% to 0.7%.

3. The Hodak Commission will redirect loan demand to the banking system

The Hodak Commission, which was established to set parameters for financial institutions that provide credit to companies via the purchase of their bonds, issued an interim report in September of last year. It contained a number of observations regarding institutional investor purchases of corporate bonds, which can be summarized by stating that the institutions improperly matched up risk and anticipated returns.

Accordingly, the report, as part of its interim conclusions, issued a number of recommendations regarding the decision-making process for investing in corporate debt (such as requirements that proper analyses be conducted, that a minimal time schedule be set for reaching decisions, and that definitions of what comprises relevant information be established before investing in new issues), in addition to contractual stipulations and financial standards that debt issuers must maintain compliance with.

This isn't the place to pass judgment over the recommendations. But Clause 6.7C is worth noting. The clause elaborates on minimal contractual stipulations and standards that debt issuers should be required to live up to.

While the commission hasn't yet issued its final recommendations, we're of the opinion that even the partial implementation of recommendations already made would reset the parameters by which credit is issued to the business sector. A more accurate match up between risk to anticipated returns is likely to result in some of the potential issuers preferring to raise part of their capital needs from banks rather than the corporate debt market.

At the end of 2001, loans issued by banks made up about 75% of total credit to the business sector. At the outset of 2010, the figure stands at only 50%--similar to the level last seen at the end of 2007.

Even if only part of the recommendations issued by the Hodak Commission are eventually implemented, it's a reasonable assumption that the aggregate level of bank loans to the business sector won't fall below the 50% level, and may well exceed that figure.

Bank Leumi (Marketperform / NIS 18.50)

The issue of who, in the end, will gain the controlling stake in Bank Leumi is likely to be a point of primary interest in 2010. The state is interested in selling its 11.5% holding, and Shlomo Eliyahu, one of Israel's highest profile businessmen, who currently holds a 9.6% stake in Leumi, is trying to organize a group aimed at garnering a controlling stake in the bank.

With the struggle for control over the bank close to being settled, the tenure of board chairman Eitan Raff is nearing its end. It's not clear who will replace him or how the process of choosing a successor will take place. The request by Shlomo Eliyahu that the former head of Israel's central bank, Dr. David Klein, be appointed as a director at Leumi, could be part of the maneuvering in the ownership struggle.

Another focus of attention will be the return of Bank Hapoalim as a major contender for the industry's No. 1 status, which it ceded to Leumi in the wake of the global crisis.

We've downgraded our rating on Bank Leumi from Outperform to Marketperform, while raising our per-share price target from NIS 17.50 to NIS 18.50. Key points in our valuation model appear below.

Valuation Model

	2008	2009E	2010E	2011E	Representative yr
Financing revenues	6,380	7,011	7,832	8,324	
Operating revenues	2,800	4,488	4,029	4,179	
Total revenues	9,180	11,499	11,861	12,503	
Provision for doubtful debts	2,145	1,686	1,400	1,400	1,285
% of issued credit	1.08%	0.79%	0.69%	0.65%	0.60%
Operating expenses	7,003	6,732	7,041	7,294	
Cost/Income	76.3%	58.5%	59.4%	58.3%	
Pre tax profit	32	3,081	3,420	3,809	
Tax	421	1,188	1,217	1,303	
Net profit	92	1,917	2,372	2,676	2,750
ROE	0.5%	9.5%	10.7%	11.6%	12.5%

Fair value model

Rf	4.3%
Risk premium	6.50%
Beta	1.00
Re	10.8%
G	0.0%
2009-2011 value	4,394
Residual value	19,207
Real holdings, tax deducted	3,698
Total	27,299
Market cap	24,962

Share value	18.5
Current share price	16.9
Upside to target price	9.40%

Target P/B	1.30
Adjusted target P/B	1.18

Bank Hapoalim (Marketperform / NIS 17.50)

As mentioned, we deem the bank's working plan as the main axis around which the sector will orient itself in 2010. We believe that reclaiming its lost credibility in the public's eyes and legitimate right to regain the title of Israel's leading bank, as well as renewing the central bank's confidence in Hapoalim's management, will be top priorities in 2010.

At the same time, the bank will attempt to expand its market share in traditional home-base banking, geared to making further progress in four segments: loan issuance to the business sector, commercial banking, mortgage issuance, and retail banking. We believe the bank's efforts will be rewarded with an expanded market share. Implementation of the strategy is likely to create a tougher competitive environment for the sector as a whole.

We've downgraded our rating on Bank Hapoalim from Outperform to Marketperform, while leaving our per-share price target unchanged at NIS 17.50. Key points in our valuation model appear below.

Valuation Model

	2008	2009E	2010E	2011E	Representative yr
Financing revenues	3,256	6,506	7,760	8,248	
Operating revenues	4,655	5,122	5,008	5,150	
Total revenues	7,911	11,628	12,768	13,398	
Provision for doubtful debts	1,520	2,081	1,700	1,600	1,588
% of issued credit	0.71%	0.94%	0.73%	0.65%	0.65%
Operating expenses	8,147	7,433	7,770	7,982	
Cost/Income	103.0%	63.9%	60.9%	59.6%	
Pre tax profit	(1,756)	2,114	3,298	3,816	
Tax	(397)	881	1,174	1,305	
Net profit	(895)	1,265	2,134	2,521	2,528
ROE	-4.8%	6.4%	10.2%	11.7%	11.7%

Fair value model

Rf	4.3%
Risk premium	6.50%
Beta	1.00
Re	10.8%
G	0.0%
2009-2011 value	4,394
Residual value	19,045
Total	23,440
Market cap	21,467
Share value	17.8
Current share price	16.3
Upside to target price	9.20%

Target P/B	1.15
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Discount Bank (Marketperform / NIS 10.00)

We look for Discount to have ended 2009 with a bang, not only in the form of sterling results, but also by beating consensus numbers for net income, boosted by significant non-recurring margin levels, and impressive top-line growth.

We project the bank will generate higher revenue in 2010 as well. Discount will endeavor to continue increasing its market share in loan issuance to businesses and in the retail banking segment.

The bank has two main challenges:

- 1) Improving efficiency. Discount has the lowest efficiency rating in the sector, with a costs-to-revenue ratio of 70%, far exceeding the average rate for the sector. Management has long attempted to address the problem, ranking it as a strategic objective. At the outset of 2009, Discount employees reached an agreement with management whereby they would give up NIS 60m in wages in FY2009.

As 2010 gets under way, management faces a triple challenge. The wage reduction in 2009 was a temporary agreement. Wages are scheduled to return to their previous level in 2010. Moreover, at the outset of this year the 'automatic pilot' wage-increase mechanism is again set to kick in. Additionally, employees have been demanding that they be compensated for the wage sacrifices made in 2009.

A critical development in enhancing efficiency is the new computer system, whose installation was completed at the end of last year, and which is expected to generate annual savings of tens of millions of shekels.

- 2) Raising fresh capital. While Discount is already compliant with the minimal capital requirements established by the sector's regulator, management has decided it needs to raise fresh capital aimed at rejuvenating the bank's growth prospects. We estimate Discount will raise NIS 400m to NIS 500m. Worth noting: the state's sale of its holding in the bank will provide no financial benefits to Discount itself.

We've downgraded the bank's stock from Outperform to Marketperform, while lifting our per-share price target from NIS 9.5 to NIS 10.00, representing the biggest gap in the sector between the current share price and our target price. Key points in our valuation model appear below.

Valuation Model

	2008	2009E	2010E	2011E	Representative yr
Financing revenues	4,127	4,765	5,076	5,359	
Operating revenues	2,490	3,101	2,840	2,923	
Total revenues	6,617	7,866	7,917	8,283	
Provision for doubtful debts	780	1,029	900	850	851
% of issued credit	0.77%	0.88%	0.78%	0.70%	0.70%
Operating expenses	5,265	5,352	5,567	5,753	
Cost/Income	79.6%	68.0%	70.3%	69.5%	
Pre tax profit	572	1,485	1,449	1,679	
Tax	169	621	516	574	
Net profit	245	1,043	973	1,135	1,134
ROE	2.7%	11.0%	9.7%	10.6%	10.6%

Fair value model

Rf	4.3%
Risk premium	7.00%
Beta	1.00
Re	11.3%
G	0.0%
2009-2011 value	2,064
Residual value	8,091
Total	10,155
Market cap	8,600
Fair value	10.1
Current share price	8.8
Upside to target price	15.20%

Target P/B	1.02
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Bank Mizrahi (Marketperform / NIS 39.00)

The bank coasted through the global financial crisis with barely a scratch, thanks to its focus on the retail segment, which represents 65% of the bank's total operations. Moreover, the bank increased its market share in the mortgage segment in 2009, in which it already held pole position. Its share of the segment currently exceeds 35%.

Implementation of the Basel 2 guidelines will offer a hefty boost to the bank by substantially lifting its capital adequacy ratios. At the end of last year's third quarter, management estimated that based on the Basel 2 guidelines, the bank's overall CAR stood at about 14%, while tier 1 capital was around 7.8%.

The sector's regulator is expected to make recommendations in coming weeks regarding minimal tier 1 levels for the banks. At the first stage, there won't be any reference to risk levels of the various banks. But our own take is that going forward, the capital levels required of Mizrahi will be lower than those of its peers, owing to the nature of its operations. Assuming a 7.0% tier-1 requirement, this would free up NIS 800m on Mizrahi's balance sheet. The challenges facing the bank relate to the way it chooses to use that excess capital:

- **Dividend payouts.** One possibility for the excess capital is, of course, a dividend disbursement. But we believe such a move would raise the regulator's ire. Nor is it clear, in any case, this is the step management would like to take.
- **Expanding loan issuance.** Here the bank is definitely faced with an opportunity. But we anticipate that Bank Hapoalim's return to this arena will deter Mizrahi on this front.
- **Acquisitions.** This, in our judgment, is the direction management is likely to take. Its aim: to expand the bank's revenue-generating potential. The idea of acquiring Discount Bank looks overly ambitious. But the acquisition of a small bank (e.g., Union Bank, Dexia Israel, or even Jerusalem Bank), or some other investment in the financial sector (a natural candidate might be a minority stake in a credit-card company like CAL) seem definite possibilities.

We've downgraded Mizrahi's stock from Outperform to Marketperform, while hiking our per-share price target from NIS 34.00 to NIS 39.00. Key points in our valuation model appear below.

Valuation Model

	2008	2009E	2010E	2011E	Representative yr
Financing revenues	2,289	2,330	2,600	2,780	
Operating revenues	1,229	1,469	1,504	1,561	
Total revenues	3,518	3,799	4,104	4,341	
Provision for doubtful debts	395	368	370	390	440
% of issued credit	0.53%	0.42%	0.40%	0.40%	0.45%
Operating expenses	2,153	2,435	2,435	2,508	
Cost/Income	61.2%	64.1%	59.3%	57.8%	
Pre tax profit	970	996	1,300	1,443	
Tax	356	348	455	505	
Net profit	602	629	825	918	886
ROE	10.5%	10.0%	12.2%	13.3%	13.1%

Fair value model

Rf	4.3%
Risk premium	6.00%
Beta	1.00
Re	10.3%
G	0.0%
2009-2011 value	1,715
Residual value	7,063
Total	8,778
Market cap	7,620

Fair value	39.4
Current share price	34.2
Upside to target price	15.20%

Target P/B	1.36
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First International Bank (Marketperform / NIS 70.00)

First International has undergone a major transformation over the last six years. The key area of change involved the lowering of the bank's risk profile. With the acquisition of Bank Otsar HaHayal and Bank Massad, First International's retail operations now comprise around 50% of its banking activity.

In our judgment, the key factor facing the bank in 2010 will involve straightening out its relations with Discount Bank. This would entail the latter reducing its stake in First International, consolidating the two-share capital structure under a single stock, and the distribution of a dividend. These moves would enable the bank to enter the blue chip TA-25 Index and by increasing the share's trading volume, gaining exposure to foreign investors.

At the same time, the bank will be making efforts to improve its efficiency by, inter alia, integrating the computer systems of its subsidiaries, and generating synergies between various components comprising the group.

We've downgraded the bank's stock from Outperform to Marketperform, while leaving our per-share price target unchanged at NIS 70.00. Key points in our valuation model appear below.

Valuation Model

	2008	2009E	2010E	2011E	Representative yr
Financing revenues	1,857	2,161	2,293	2,481	
Operating revenues	1,357	1,748	1,628	1,673	
Total revenues	3,214	3,909	3,921	4,153	
Provision for doubtful debts	238	310	300	300	303
% of issued credit	0.43%	0.51%	0.47%	0.45%	0.45%
Operating expenses	2,635	2,680	2,676	2,727	
Cost/Income	82.0%	68.6%	68.2%	65.7%	
Pre tax profit	341	923	895	1,083	
Tax	213	367	319	370	
Net profit	161	586	616	758	756
ROE	2.9%	10.0%	9.8%	11.8%	12.0%

Fair value model

Rf	0.0%
Risk premium	6.50%
Beta	1.00
Re	10.8%
G	0.0%
2009-2011 value	1,343
Residual value	5,695
Total	7,038
Market cap	6,398
Fair value	70.1
Current share price	63.6
Upside to target price	10.20%

Target P/B	1.16
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