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The Insurance Sector

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The original language of this report is Hebrew.
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The Insurance Companies- Updating of recommendations and target prices
Introducing: The NAV model for the testing of the value of the insurance companies

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The evaluation of the insurance companies – the NAV model: The evaluation of the valuation of the insurance companies is one of the most complex tasks, since the profitability and the value of the insurance companies is based on a combination of complex actuarial evaluations, which test the underlying profitability of the business, together with the significant impact of the capital market. In recent years, the influence of the capital market has been more significant that the underlying profitability and it could even be said that the results that are achieved on the investments determine the companies' profits to a considerable degree.

The tremendous dependency on the capital market: In the last year we have received a reminder of the tremendous impact of the capital market on the value of the insurance companies. In the first half of 2008 the sharp falls on the capital market had a dramatic negative impact on the insurance companies. The heavy losses on investment led to significant losses in almost every field of their activities and severely reduced their shareholders' equity, with many holding companies being forced to inject capital into the insurance companies in order to comply with regulatory requirements, and also in order to improve their stability.

At the beginning of 2009 the picture reversed completely. As a result of the sharp rises in the markets the insurance companies succeeded in achieving significantly high levels of profits from their various fields of activity and in parallel their shareholders' equity also increased significantly. As a result of this a holding in insurance companies became an aggressive option on the capital market. And the companies, which had recorded sharp declines in their value, went back to presenting decent increases, well above the market indices.

The yields of the insurance companies and the market indices

	2008	The beginning of 2009
Migdal	-33.1%	43.2%
Clal	-79.2%	265.0%
Harel	-56.9%	68.4%
Menorah	-54.4%	108.4%
Phoenix	-81.7%	216%
Tel-Aviv 100 Index	-51.4%	56.7%
The Ma'of Index	-46.2%	45.6%

The variance between the current share prices and the top prices

Phoenix -56%
Clal - 38%
Harel -30%
Menorah -26%
Migdal -23%

The changes in the sector in recent years and the fact that the insurance companies are no longer operating in the traditional areas of life insurance and general insurance has led us to examine the value of the insurance companies using the NAV model, which attaches a value to each of the activities and which takes into account the debt and the shareholders' equity of the companies.

This work details the assumptions that have been used by us in the determination of the value of the operations, it summarizes the evaluations and gives updated recommendations and target prices.

Assumptions: In general terms, it can be said that we have made use of identical assumptions for most of the fields of activity of the insurance companies in the evaluation of the value of various fields and that we are satisfied that these activities are homogeneous and that there is no significant difference between the companies and accordingly we have used identical multipliers. In our evaluation, over and above the determination of the value of the operations, this also enables the making of comparisons between the companies.

The model "photographs" the value of the insurance companies as of today, and of course, it does not take into account the impact of the future fluctuations of the capital market. At the same time, one can learn the degree of leveraging on the capital market of the different companies, and accordingly it is possible to evaluate the strength of the change in the prices of the shares and in which direction it will be determined in accordance with the direction of the capital market. Clal, Phoenix, Harel, Menorah and Migdal are exposes to the impact of the capital market in accordance with that order.

The following tables show the summary of our recommendations:

	Recommendation	Target price	Discount
Clal	Buy	116	50%
Migdal	Above average yield	7.8	38%
Harel	Above average yield	217	31%
Menorah	Market yield	46	15%
Phoenix	Market yield	10.2	8%

Clal Insurance:

Clal Insurance enjoys a combination of a very large life insurance portfolio, very large general insurance activities, which include activities in Israel, Europe and in the USA, provident fund activities with the greatest volume from amount all of the insurance companies as well as a high level of exposure to the capital market. Clal's financial activities have so far caused it to incur losses, and constitute the weak link in its operations. Moreover, the provident fund activities suffer from being relatively week, but are still attractive from our perspective, despite the considerable losses, primarily because of the tremendous volume of assets and the significant advantage of size. The operations that were purchased overseas have a relatively high inherent level of risk, even though in the meantime Clal has been presenting good results from this activity, except for the operations in Romania, which have been discontinued. Moreover, Clal has a double level of gearing - a high level of financial gearing as well as the highest level of gearing in the capital market because of the composition of its holdings, and therefore in our eyes the share constitutes too aggressive an option on the performance of the capital market. For this reason, Clal was the main sufferer from the fall in the capital market in 2008 and at present it is one of the main beneficiaries. Moreover, following the recent falls in the price of its share it is still too far from its peak. We are of the opinion that in the light of the tremendous improvement against the background of the rises on the capital market and the share is being traded at a significant discount in comparison to its economic value. ***Our recommendation is buy – however we would emphasize that the share carried a relatively high risk and in the event of a decline in the market Clal would be the first to be hurt.***

Harel:

Harel is one of our preferred companies in the insurance sector. The Company's main strength lies in the health field where Harel is the undisputed leader in the field which is even expected to strengthen with the increase in its holding in Dikla. The health insurance activity has proven itself for the time being as being recession-resistant- with a high level of growth in premiums and it has very underlying profitability with a significant potential for growth, certainly in relation to general insurance, where the numbers are very modest. Moreover, this makes a considerable contribution to the value of the life insurance and long-term health insurance field, whose value, as measured using the EV is higher, where Harel's portfolio seems more immune to negative impacts. Moreover, Harel has provident fund activities on a significant scale, a small but growing pension operation as well as larger scale activity in mutual funds and basket certificates, whose profitability is expected to improve with the stabilization of the markets. Harel has a relatively lower exposure to the capital market than Clal and Phoenix and the financial gearing in it is relatively low. Harel has not incurred dramatic drops in value, and in the wake of the rises in the markets, it has risen by a lower rate by comparison with the other companies (for example, Menorah which went down by a similar rate but has gone up more), and it also has approximately 30% to go to reach its historical peak, where as of today the Company is work more. ***In our opinion, there is room for an additional rise for the share a s we recommend to hold the share as above average yield,***

Migdal:

Migdal is the insurance company with the highest market value from among the insurance companies, by a considerable difference. Migdal has the largest life insurance operations, with a portfolio that for the most part is comprise of yield assuring policies. Moreover, it holds the second largest pension fund in the Israeli economy, which continues to grow, as well as Kahal – the largest further training fund in the economy. On the other hand, Migdal has relative low scale operations by comparison to its competitors in the files of health insurance and general insurance. Migdal is outstanding for having the highest stability from among the companies, it has practically no gearing. It has no debt notes in its insurance company. This is one of the Company’s outstanding strengths and this makes it the most defensive one in the sector, which in our opinion exceeds the leveraging on the capital market, albeit to an extent that is not dramatic, but is significant (because of the activities of Migdal Capital Markets). As a result of this Migdal did not incur significant losses in 2008 and it also did not benefit from the sharp rises in 2009. Still, Migdal's share price is very close to its historical peak. ***We see Migdal as a defensive investment, and we recommend it as above average yield.***

Menorah Insurance:

Menorah's principal and main asset is its holding in the Mivtachim pension fund, which has the largest volume of assets in the economy, and this is in addition to widespread operations in the general insurance sector, which is just increasing, with the contribution made by the acquisition of Shumra. Menorah's life insurance portfolio is comprised for the most part from capital policies and it is less exposed to an increase in lifetimes, however it is more exposed to mobility. Menorah has provident fund and financial operations that are on a relatively small scale, and its exposure to the capital market is primarily on the nostro activities and life insurance, general insurance and also on the provident fund activities- some of which promise a yield. The big potential that lies in Menorah in our evaluation is the colossal pension funds that it holds, and we are of the opinion that it will benefit from considerable advantages following the entry of the banks into the field of pension consultancy and the growth of this field could lead to a dumping of value in the Company. As compared with this, in the event that Menorah does not manage to achieve this, it could impair its position. The recent provisions in respect of suspicions of retroactive transfers between investment paths and in respect of the unlawful extension of loans could cause damage to the Company’s reputation and its ability to generate new business, and it could even make its portfolio more exposed to mobility. Meanwhile, in our opinion the damage that has been incurred to Menorah is primarily to its image. ***Menorah has a low gearing in the capital market and therefore the fluctuations in the share price are also lower, we recommend the share as at market yield.***

Phoenix:

The company is facing the most numerous challenges from among the insurance companies. The company is coping and is expected to continue to cope in the near future with "digesting" the acquisition of Excellence, which did not come cheaply, both from the perspective of the operations – integrating it into Phoenix's operations and also from the financial perspective – where the Company is forced to recruit capital on a significant scale. The acquisition of Excellence does indeed make a large scale contribution in the field of provident funds, as well as in the financial field where until recently it was lacking a presence by comparison with the other insurance companies. At the same time, Phoenix will have to cope with a lack of presence in the pension field, a larger hole than its competition with regards to the collection of management fees on profit participating policies as well as a weakness in profitability in the field of general insurance. The acquisition of Excellence has dramatically increased the Phoenix's gearing on the capital market, and has also turned the company into an option on the market, in a similar way to Clal. ***At the same time, in the meanwhile, in our opinion Phoenix is costed similarly to its economic value, and therefore we recommend the company as at market yield. We would emphasize that Phoenix is the company that sustained the most***

damage and it has the potential for significant improvement, and this is in the event that the Company will succeed in leveraging its recent acquisition in order to improve its underlying profitability and to improve its stability and increase its shareholders' equity.

Methodology

We have evaluated the insurance companies using the NAV model, which provides a value for the various activities of the holding company and takes into account financial liabilities and shareholders' entity- this is how it looks:

The insurance companies
Life and health insurance
Short-term health
General insurance
Pension funds
Provident funds
Financial operations
Sundry
Total value of operations
Less net consolidated debt
Less General, administrative and head office expenses
Plus shareholders' equity after eliminating DAC and goodwill
Value of the company

Assumptions in the evaluation – life insurance and long-term health insurance

In the evaluation of the value of the life insurance and long-term health insurance operations, we have decided to bases ourselves on actuarial assumptions whilst making various adjustments. We started with the Embedded Value as of 31.12.08 and we then adjusted it in accordance with our evaluations in respect of the EV.
We determined the value of the insurance portfolio in the following manner:

1. The value of the existing portfolio

The present value of the future profits less tax and less the cost of the required capital X a factor + the reduction in the debt to insured parties from the beginning of 2008.

2. The value of the new business

The value of the new business less the cost of the required capital X a factor X a multiplier

3. Shareholders' equity

The increase in the shareholders' equity from 31.12.08 to 30.06.09 (see the detailed comments on equity that appear further on).

<u>What are the factors?</u>

<u>The impact of risk free interest</u>

- One of the main reasons why the assumption that the EV distorts upwards is so common is the use of the risk free interest rate. In the calculation of the inherent value, we also use a risk free interest rate, <u>for the assumption of the yield that is expected on the investment</u> and also <u>for the discounting of the cash flows</u>, and this leads to an upwards distortion of the EV. In effect, when carrying out a sensitivity analysis for the EV, which is presented by the companies, <u>the impact of an increase in the interest rate is positive</u>, in other words, the more that the interest rate rises, the more the increase in the yields (which increases the cash flows) is more important that the impact of an increase in the discounting rate.
- On the interest curve that the companies use, the interest rates range between approximately 2% and 3.5%, whereas we assume that these interest rates do not reflect the existing risks in the life insurance portfolios, and also in our evaluation, the interest rates are expected to increase in the coming years. In the light of this, <u>we have made an adjustment of the interest rates in the following manner: we have increased</u> the interest rates that have been used for the assumption of the yields that are expected on the investment to approximately 5% and the interest rate used for discounting to approximately 7%. The impact of the change in the interest rate on the life insurance portfolios varies between the companies, where Migdal and Phoenix's portfolios respond more to a change that is identical for the interest whereas Menorah's file responds more weekly.

One of the changes that stands out is: the use of a higher rate of interest – both for the yield on the investment and also for the capitalization of the cash flows

The impact of the sensitivity of the file to mobility, the implementation of reforms and demographic and other parameters

- The insurance companies are differentiated by the composition of their portfolios and their quality, and therefore they are also different in their sensitivity to the various factors that impact the sector, such as the subject of mobility and the subject of the lengthening of the life expectancy, to which we related in greater detail in our previous work on the sector, which is dated 4.8.2009.

An additional change –the giving of expression to the sensitivity in the portfolios to external factors, such as mobility and so on.

- The expression for the behavior of the portfolio is given within the framework of the sensitivity analysis which the companies present in the report on the inherent value. In this analysis, the possible impact of changes on the existing life insurance portfolio and on the value of the new business, like for example a change in the interest free interest rate (which we related to above, and therefore this subject is not included here). The impact of mobility and reforms (the entry of the banks into consultancy), an increase in the cancellation rate, various demographic changes and so on. One can learn for example that Phoenix is the most sensitive company to many parameters, whereas Clal and Harel are the least sensitive.

- Expression is also given in the calculation of the factor to the sensitivity of the insurance portfolios and new business to these changes, where the average impact of all of the variables on the portfolio is taken into account.

The impact of the debt to the insured parties

In the calculation of the inherent value for 2008 that the insurance companies presented, the "hole" in the variable management fees, which was created as the result of the significant negative yields on profit-participating policies was also taken into account. What is being talked about is a loss of management fees that the Company is unable to collect before it refunds the negative yield to the insured parties. The EV was taken down by the whole amount of the hole between 2007 and 2008, however following the rises in the markets in 2009 the whole has been significant reduced and the reduction in the hole needs to be reduced to the value of the life insurance activities.

The present value of the cash flows that are expected from the existing portfolio has risen this year following the reduction in the debt to the insured parties.

In the calculation of the impact of the reduction of the hole in the management fees we have taken into account the impact of taxation and of discounting.

The value of new business

- **A factor**: the value of new business relates to the value of business that has been created since 2008. In a similar way to the way in which we have dealt with the existing portfolio, a factor has also been given to the value of new business - that is to say, that adjustment of the interest rates and in respect of the impact of the external factors. We would note that the strength of the sensitivity of the new business is much higher than in respect of the existing portfolio. The Phoenix's new business is very vulnerable to mobility as well as to an increase in the cancellation rate. On the other hand, Harel's new business is less sensitive to all of the parameters, apparently because of the higher waiting of the health insurances, which are affected differently.

A low multiple for the value of new business reflects our evaluation in respect of the low potential for growth for the life insurance field.

- **A multiple**: We have used a multiple of 6 for most of the companies, with Harel being given a multiple of 6.5 because of the higher profitability of the health portfolio, and Menorah has been given a multiple of 5.5, since we are of the opinion that the recent provisions in respect of the suspicions of the backdating and unlawful extension of loans could lead to damage to the company’s image, which is something that would find expression in the impairment of the growth of the new business.

  The low multiple that we have used reflects our evaluation that the potential for growth in the life insurance is low and in parallel the cash flow risk is relatively high. This is in accordance with our evaluation that the field if life insurance is likely to weaken at the expense of the provident funds and pensions, when the banks begin to provide pension consultancy services. Moreover, the competition between the companies results in the profitability rates on new business being relatively low and it is also necessary to use a higher discounting rate that relates both to the uncertainty in respect of the company's ability to reach new customers and also to the risk that we will see a continuation of the risk of a decline in profitability. We would just note that the high level of sensitivity of the new business, which is well above the sensitivity of the existing portfolio, strengthens our evaluation in respect of the potential for growth and the risk attaching to the new business in the life insurance field.

Shareholders' equity: In the calculation of the inherent value of the life insurance operations, the shareholders' equity of the insurance companies has also been taken into account. For the sake of simplicity, we have separated the shareholders' equity from the value of the life insurance operations, but we have included it in the model for the evaluation of the company. At this stage we have increased the shareholders' equity in accordance with the increase at the beginning of the year. See the detailed comments on the shareholders' equity that appear

Similarly, an increase has been recorded in the shareholders' equity from the beginning of the year and up to today.

further on.

The following is the summary of the evaluation of the life insurance field:

NIS millions	Migdal	Clal	Harel	Phoenix	Menorah
The existing portfolio:					
Present value of future profits less tax and less the cost of the required capital	5,380.0	4,256.1	2,864.7	2,541.0	1,578.0
Present value factor	0.743	0.715	0.710	0.695	0.693
Reduction of the hole in the collection of management fees	343.2	255.32	147.7	151.84	84.76
The value of the existing portfolio	**4,339.9**	**3,296.9**	**2,196.2**	**1,917.3**	**1,178.8**
New business:					
The value of new business less the capital required	216.8	1,235	18.7	68	72
Factor	0.69	0.78	0.72	0.58	0.63
Multiple	6.0	6.0	6.5	6.0	5.5
The value of new life insurance and health insurance business	**899.0**	**634.0**	**884.8**	**236.7**	**250.3**
Total value of life insurance and health insurance without shareholders' equity	**5,238.9**	**3,930.9**	**3,081.0**	**2,154.0**	**1,429.0**
Adjusted shareholders' equity after eliminating goodwill	**1,670.9**	**1,308.8**	**900.2**	**638.5**	**822.4**
Total value of life insurance and health insurance including shareholders' equity	**6,909.8**	**5,239.7**	**3,981.2**	**2,792.5**	**2,251.4**

The main component of the value comes from the existing portfolio: the main component of the value of the insurance operations is derived from the existing portfolio, whereas the value of new business makes a smaller contribution to the value, and therefore the quality of the portfolio and its sensitivity to the various affecting factors is important. The companies need to try to preserve their existing portfolios, and it would appear that the large profits from the life insurance field will come from the existing portfolio and less from new business.

The main component of the value of the insurance operations is derived from the existing portfolio and less from new business

New business: please note the low factors in the value of new business. This tells us about the ability of the companies to generate value from new activity, the sensitivity of the new business is significantly higher that the sensitivity of the existing portfolio. This emphasizes once again the importance of the existing portfolio in the insurance companies, where a company that has a more qualitative portfolio and which succeeds in preserving it well – will enjoy a considerable increase in value. We would note that the main risks facing the existing portfolio are of withdrawals and mobility (it is slightly more difficult to control falls in the capital markets). Moreover, interest rates also have a high weighting.

The strength of the response to these changes varies between the companies, where we can learn that the ability to generate the value from new business varies between the companies. Harel has a higher factor because of the health insurance operations, whereas Clal is still paying for the Maccabi transaction.

The value of the life insurance and health insurance portfolio as compared with the Embedded Value: We will try to examine the value that is received (with the addition of the shareholders' equity) as compared with the EV, as of 31.12.2008 with the addition of adjustments from the beginning of the year, in a similar manner to what we have done in our evaluation- an increase in the shareholders' equity and a decrease in the debt to insured parties.

- The results that are received reflect the quality of the portfolio as it finds expression in the sensitivity tests that the insurance companies provide.
- It arises from the results that the value of the life insurance activities that were evaluated by us constitute between 69% and 79% of the adjusted inherent value:

NIS millions	Migdal	Clal	Harel	Phoenix	Menorah
The existing portfolio:					
Inherent value as of 31.12.08	6,746	5,310	3,551	2,843	2,350
Inherent value after adjustments	7,585	6,374	4,181	3,442	2,911
The value of the life insurance and health insurance operations, including shareholders' equity	**6,011**	**4,606**	**3,096**	**2,556**	**2,001**

The ratio of the fair value of the life insurance and health insurance operations as compared with the adjusted inherent value	79%	72%	74%	74%	69%

- **Migdal**: Migdal's portfolio is very significantly affected by a change in interest rates, therefore, following our adjustments, the value that is received is high by comparison with the inherent value as compared with other companies. At the same time, Migdal's portfolio is very sensitive to an increase in life expectancy, because of the high weighting of policies having ensured annuity factors.

- **Phoenix**: Phoenix's portfolio is also affected to a great extent by a change in the interest rates, and an increase in the interest rate acts in the company's favor. At the same time, approximately half of the Phoenix's life insurance portfolio is comprised of policies having an assured annuity factor and therefore it is very sensitive to demographic changes, whereas the other half is comprised of capital policies, which it also very sensitive to mobility. Moreover, the Phoenix's portfolio is extremely sensitive to all of the factors in the sensitivity analysis, which offsets the positive impact of the interest rates.

- **Clal and Harel**: Are affected a lot less by an increase in interest rates, however Harel enjoys a relatively higher value for its portfolio and this is because of the significant volume of its health insurance operations, with the higher contribution of the field to profitability is also marked in the value of the existing portfolio as well as in the contribution to the value of the new business. Clal's portfolio is the least sensitive to external changes; however, the contribution of the new business is weaker.

- **Menorah**: is almost completely insensitive to changes in the interest rate. Moreover, Menorah's portfolio is very sensitive to mobility because of the high weighting of capital policies, whereas it is less sensitive than the other companies to the other changes.

General insurance and short-term health insurance

Assumptions in general insurance: the general insurance operations have been valued by us using a multiple of 7.4 on the representative post-tax profit. The representative profit is the average profit for the year 2002 – 2009 (2009- in accordance with the results for the first half of 2009). Those years also include the good periods and the not so good periods from the perspective of the performance of the capital markets and also from the perspective of the underlying profitability of the various companies. Of course, so long as there are no exceptional changes in the scale of activity such as an acquisition or the sale of operations.

A multiple of 7.4 on the average post-tax profit for the years 2002 – 2009.

The profit multiple: 7.7, which reflects a growth rate of 0% and a discount rate of 13.5%

The assumptions in short-term health insurance: The value of the nursing care health insurance is included in the inherent value of the life and health insurance field, and so we are relating here to the short-term health field – sickness, hospitalization and so on. In a similar way to general insurances, the health insurance operations have also been valued by us using a multiple for the representative post-tax profit, which is the average profit for the year 2002 – 2009 (2009- in accordance with the results for the first half of 2009).

A multiple of 9.1 on the average post-tax profit for the years 2002 – 2009.

The profit multiple: 9.1, which reflects a growth rate of 2% and a discount rate of 13%. In our evaluation, the potential for growth in the health insurance is higher than for the general insurance operations, however it is still not high in the long-term.

There are significant volumes at Harel, Clal and Phoenix, with an immaterial volume at the other companies.

The following is a summary of the value of the general and short-term health insurance operations:

NIS millions	Migdal	Clal	Harel	Phoenix	Menorah
The value of the general and short-term health insurance	396.5	1,228.8	1,001.2	406.4	491.1

The provident fund and pensions operations

We have evaluated the provident fund and pensions operations in accordance with a percentage of the value of the assets: 2% - 2.5% for provident funds and 5% - 6% for pensions. These rates were determined in accordance with purchase transactions for provident funds and pension funds in the market place, together with our evaluation in respect of the risks and the growth in these sectors as well as the profitability of the various companies.

Pensions: 5%- 6% on the assets.

Pensions: The high rate at which we value the pension fund operations is based upon the tremendous potential for growth that is inherent in the sector, where we are talking about a field with low risks of mobility (which justify a lower discount rate) and in addition, it has been enjoying a sharp increase in the volume of activity (see the graph) which is expected to increase further in our evaluation because of the regulatory support (the Compulsory Pensions law, Amendment 3 to the Provident Funds Law), and the simplicity and relative cheapness of the product for the customer, which could turn it into something that is easier to distribute by means of the pension consultancy at the banks. The significance of this is that assuming this assumption in the model produces a higher multiplier which leads to a higher value for the assets.

The volume of the assets in the new pension funds (In NIS millions) and the annual rate of growth

Graph not translated

The rate of growth The overall assets

Source: The Ministry of Finance

Provident funds: The provident fund activities have been valued by us using a lower rate, since we are of the opinion that the risks in the provident fields are higher than for pensions. The provident fund assets are more sensitive to withdrawals by the public, and an example of this would be to mention the second half of 2008, when the low yields that were achieved in this channel of investment lead the public to make withdrawals, which worsened the reduction in the volume of the assets in the sector. Moreover, the growth in the sector is lower by comparison with pensions (see the graph) and in addition Amendment 3 to the Provident Funds Law cancels the outstanding advantage that the provident funds had over the pension funds and in our opinion this is likely to lead to weaker growth in the field.

Provident funds: 2% -2.5% on the assets.

It should be noted that in contrast to the life insurance field and the pensions field, there is no significant advantage in the management of provident funds for the insurance companies as compared with the private provident fund companies, and we assume that the phenomena of a reduction of the market share of the insurance companies in the provident fund field will continue. As compared with this, the mobility in the life insurance sector may actually have a restraining affect on the decline in the growth in the provident fund operations, in the light of the fact that it is possible to move capital savings onto another capital path – we are of the opinion that the provident funds may be the main beneficiaries of the moving of the capital element of the life insurance policies onto a cheaper path, which is what a provident fund is.

These assumptions result in a lower multiple in respect of the provident fund operations as compared with the pensions field.

The volume of the assets in the provident funds (In NIS millions) and the annual rate of growth

Graph not translated

The rate of growth The overall assets

Source: The Ministry of Finance

The advantages in the field of long-term saving: in general terms, many changes are expected to take place in the long-term savings sector, including many regulatory changes, the entry of the banks into the field of pensions consultancy, mobility and more, whose impact is not clear at this stage and in the meantime, our evaluations rely on assumptions, where it is difficult to know what will actually happen. At the same time, there can be almost no doubt about one thing – **the insurance companies that enjoy a combination of strength in three paths of long-term savings are not expected to be significantly harmed by any possible scenario.** This is something that could find expression in the strengthening of the reputation and the brand, the possibility of a transfer between the various savings channels and also in distribution.

The following is the summary of the evaluation of the provident fund and pensions field:

NIS millions	Migdal	Clal	Harel	Phoenix	Menorah
The volume of pension fund assets	16,800	9,905	7,300	23,777	2,667
Income on 2009 (on an annualized basis)	191	128	106	285	41.2
Post tax profit in 2009 (on an annualized basis)	30.7	27.3	7.4	70.9	5.9
Profit rate after tax on the overall revenues	10%	14%	5%	16%	9%
Profit rate by comparison to the volume of assets	0.18%	0.28%	0.10%	0.30%	0.22%
The rate on the assets	5.5%	5.5%	5.0%	5.5%	5.0%
The value of the pensions operations	**924**	**545**	**365**	**1,308**	**133**
Derived profit multiple	30.1	20.0	49.3	18.5	22.7
The volume of provident fund assets	11,854	29,289	19,800	10,273	786
Income on 2009 (on an annualized basis)	125.6	398	205.6	414	8.2
Post tax profit in 2009 (on an annualized basis)	12.61	54.6	52	46.54	0
Profit rate after tax on the overall revenues	10%	14%	25%	11%	0%
Profit rate by comparison to the volume of assets	0.11%	0.19%	0.26%	0.45%	0.00%
The rate on the assets	2.0%	2.5%	2.5%	2.5%	2.0%
The value of the provident fund operations	**237.1**	**732.2**	**495.0**	**256.8**	**15.7**
Derived profit multiple	18.8	13.4	9.5	5.5	

Phoenix stands out for the wrong reasons with an insignificant volume of pension fund operations, whereas it has filled the gap caused by the absence of provident fund operations by means of the acquisition of Excellence

As can be learned from the table, the profitability is higher in the pension operations – and this is so both in an analysis of the profit rate on the overall revenues and also in respect of the profit rate by comparison to the overall assets. Our evaluation derives a multiple for profit that is higher in respect of pension operations than in respect of provident funds. Moreover, in both of these spheres of operation the advantage of size is outstandingly clear.

Pensions: Menorah has the largest pension fund and it also has the largest value, approximately NIS 1.4 billion. At the same time, the multiple for profit in respect of it is relatively low and reflects our evaluation of a lower potential growth. By comparison, in Harel and Phoenix, the pension assets are on a lower scale by comparison with their competitors and they also have lower profit rates and therefore we have valued the pension operations in those companies in accordance with a lower rate on the overall assets.

- **Menorah and Migdal** are the main beneficiaries from having very large scale pension operations, where in our evaluation, the potential in the pension operations is the highest, in the field of long-term saving field. Meanwhile, Migdal is showing higher growth rates that Menorah. However on the other hand it has lower profitability (Menorah has the advantage of size). Menorah's greatest challenge is to preserve the volume of the assets that it holds and to try to grow while its competitors succeed in growing more. Meanwhile, the value of Mivtachim is derived from the volume of the assets and in the event that Menorah does not succeed in leveraging this with the entry of the banks into the field of pension consultancy, this could create a problem for it.

- **Phoenix** stands out with a relatively low volume of pension operations by comparison with its competitors. The absence of significant pension operations causes a certain inferiority for the company opposite the other insurance companies, which offer a more diverse basket of long-term savings instruments, and accordingly, this has a negative impact on its value.

Provident funds: Clal has the most significant volume of assets from among the insurance companies, which also the highest value, approximately NIS 730 million. The main operations in the provident fund field at Migdal are in the further training fund sector where as can be seen from the table, the profitability is also apparently lower and therefore we have evaluated the operations using a lower rate in the assets,

- **Clal and Harel** are the main beneficiaries from having significant provident fund operations, where even though that have absorbed sharp losses in the volume of the assets, their provident fund operations continue to generate profits and enjoy the advantage of size.

- **The Phoenix** – the provident fund operations at Phoenix itself are relatively small, while the acquisition of Excellence has contributed large scale provident fund operations to the company. The Phoenix's own provident fund operations are not profitable, and therefore they are valued by us using a lower rate on the assets. (Excellence, including its provident fund operations has been valued separately by us, at market value. See further explanations below).

Financial activities

The evaluation of the value of the financial activities has been done in two ways:

- **The insurance companies that have an investment house that is traded on the Stock Exchange** – the value of the financial operation has been calculated in accordance with the market value. This relates to Clal (the market value of Clal Finances) and also to The Phoenix (Excellence).
- **The insurance companies that do not have an investment house that is traded on the Stock Exchange** – the value of the financial operation has been calculated in accordance with the components of the operations:
    - Mutual funds – 1.5% on the volume of the assets.
    - Portfolio management – at 0.75% on the volume of the assets.
    - All other operations – at their value in the balance sheet.

The market value or a percentage of the managed assets

1.5% for mutual funds and 0.75% for portfolio management

The following is the summary of the evaluation of the financial operations:

NIS millions	Clal	Phoenix
Investments house	Clal Finances	Excellence
Market value	292.2	939.4
Holding rate	82.0%	81%
Value of the financial operations	**239.0**	**1,030.6**

Phoenix: apart from Excellence, the Phoenix's financial operations include, holdings in Mehadrin and also in Gama (clearing operations. Their value will be added to the value of the Phoenix's holdings in Excellence.

The Phoenix stands out with significant financial operations, and Menorah because it has relatively small scale financial operations

NIS millions	Harel	Migdal	Menorah
Volume of the mutual fund assets	13,238	11,182	5,307
Value of the mutual funds (1.5%)	198.6	167.7	79,605
Value of the portfolio management operations (0.75%)	15.8	27.9	22.5
Other	117.0	25.6	-
Value of the financial operations	**331.3**	**221.2**	**102.1**

Sundry matters

Within the NAV model a value is also attached to the significant operations of the holdings company, which have not been included in the insurance related operations. Thus for example, a value has been attached to the Phoenix, Clal and Migdal's agency operations and similarly, we have added the value of Menorah's real estate operations, which are held under the holdings company. The value that has been attached is the carrying value in the accounting records. In general terms, we are not talking about material amounts.

The value of other outstanding holdings – in accordance with their carrying values in the accounting records

Shareholders' equity and debt

The components of the debt: the insurance companies have three main types of debt:

- The bonds of the holdings company
- The debt notes of the insurance company
- Various bank loans.

The consolidate debt of an insurance holding company includes bonds, debt notes and bank loans

In contrast to the bonds and the bank loans, which are loans for all intents and purposes, and which are classified under liabilities, this is not exactly the same for in respect of the debt notes, The debt notes are a debt of the insurance company to banks or to institutional investors, however in a similar way to what happens in banks, they also serve as shareholders' equity for the purposes of the calculation of the capital adequacy of the insurance companies. <u>We see the debt notes as debt for all intents and purposes and therefore we have taken them into account in the calculation of the consolidated debt of the insurance companies.</u>

Net debt: in effect, in the calculation of the net consolidated debt of the holdings company and of the insurance company, we have related primarily to the total of the various liabilities (bonds, debt notes and so on), where the volume of cash in the holdings company (as recorded in their solo financial statements as of 31.12.2008, subject to changes from then and up to now) is insignificant in most cases.

And how does one relate to shareholders' equity? We have add the shareholders' equity of the insurance company to the model:

In effect, the value of the life insurance portfolio also includes within it (together with the present value of the expected profits) the shareholders' equity of the insurance company with the required adjustments. **For the sake of simplicity, we have separated the component of the shareholders' equity from the value of the life insurance operations, but we have counted the relevant shareholders' equity in the value of the insurance company.**

We have added the value of the shareholders; equity of the insurance company in the calculation, subject to adjustments – the elimination of the DAC and of goodwill.

- **The adjusted shareholders' equity – after eliminating the DAC and goodwill:** in the calculation of the inherent value of the life insurance and health insurance operations, the adjusted shareholders' equity of the insurance company also appears. The adjustment of the shareholders' equity primarily consists of the deduction of the DAC (deferred acquisition costs).

  The shareholders equity relates to the insurance company, therefore it includes additional intangible assets, such as goodwill on the acquisition of assets. Since the value of the assets is taken into account – we deduct the goodwill in respect of them from the shareholders' equity. For example – Harel acquired Leumi's provident funds and accordingly, part of the cost of the acquisition was allocated to goodwill. We deduct the goodwill in respect of the provident funds from the shareholders' equity of the insurance company.

- **Increase in shareholders' equity**: we start with the shareholders' equity of the insurance company as of 31.12.08 and add the increase in the shareholders' equity in the wake of the rises in the capital market as of 30.6.2009. The increase is comprised primarily of the increase in profits, which are attributable to the shareholders as well as the increase in the balance of the capital reserve in respect of available for sale assets – in effect the unrealized profit.

The adjustment to the present shareholders' equity

What is the significance of the shareholders' equity in the insurance company and why do we add it to the value of the operations?

- **The shutting off of capital in order to ensure stability**: The shareholders' equity of an insurance company is intended to support the company's stability for the purpose of the existence of insurance activities with the risks that are derived from that, which that same insurance company needs to evaluate and to cost within the framework of the operating activities. Therefore, the company has to shut-off equity at a certain level in order to ensure its stability.

- **The need to comply with minimal capital requirements, which are expected to increase:** an insurance company is bound by minimal capital requirements, an amount that includes, inter alia, capital requirements in respect of deferred acquisition expenses in respect of life and health insurance, investments in consolidated companies and the management rights in provident funds and pension funds, exceptional risks on life insurance and so on.

  Within the framework of the Solvency II Regulations, which are expected to enter force in the coming years, the insurance companies will be required tom increase the minimal shareholders' equity cushion, in order to provide a response to the additional risks that are involved in the insurance operations, in respect of which it was not required to shut-off equity up to now.

The insurance companies are required to close off a minimal shareholders' equity, which is expected to increase further

- **The impact on the value**: Profits (or losses) from self- investments that the insurance companies make against the shareholders' equity belong to the insurance companies and increase the shut-off shareholders' equity cushion. Insurance companies that have a stable equity base enjoy significant advantages, primarily in ensuring their stability, however this also has an effect on the value.

  If the insurance company does not succeed in reaching the minimal equity that is required, it must take action to increase its equity- whether this is by mean of the injection of capital from the holdings companies and whether this is by means of rising debt notes, which are counted as secondary equity. Each of these paths leads to an increase in the company’s debt and accordingly it impairs the value. Therefore there is a great advantage for the insurance companies if they have a broad equity cushion and several possibilities for topping-up their equity of the need arises.

The insurance companies that have significant surplus equity enjoy not only the strengthening of their stability but also from an addition to value.

- **The equity surpluses in 2008 and today**: The sharp declines in the prices on the capital markets led to a significant erosion in the shareholders' equity of the insurance companies, and many companies needed to top up their equity and a threat was hanging over their stability. In 2009 the capital market went back to showing good performances and thus the capital position of the companies was improved immeasurably.

The surplus shareholders' equity in excess of the minimum requirements for the insurance companies, 2006- 2009

The rises in the markets have lead to a considerable increase in the shareholders' equity in the first half of 2009 as compared with 2008, with the companies returning to the presentation of historical reserves

Graph- not translated

Phoenix Clal Menorah* Harel Migdal

Surplus capital as of 31.12.06 Surplus capital as of 31.12.07 Surplus capital as of 31.12.08 Surplus capital as of 30.06.09

- As of now, it would appear that Migdal has significant equity surpluses, and that it has many possibilities for recruiting capital in the event that the equity surpluses are insufficient for an increase in the requirements (where the capital requirements are also the highest in Migdal).

  On the other hand, in our evaluation the Phoenix presented a not inconsiderable equity surplus in the second quarter of the year, and a demand for an increase in shareholders' equity is expected to the most significant implications specifically for that company. During 2008 Phoenix was forced to make many injections of primary capital into the company, and it continued to do so in 2009 as well. The Phoenix's holdings company is currently dealing with an increasing need for equity – both in order to finance the expensive acquisition of Excellence and it also needs to watch out for a condensation on a significant scale in the equity in the event that we see falls in the markets yet again, which could lead to an impairment in the value of the acquisition and to the need to make a correction. We have recently been witnesses to the company recruiting capital for that purpose.

Summary

The following is a summary of the figures in the model

NIS millions	Migdal	Clal	Harel	Phoenix	Menorah
Total value of operations	7,072	6,924	5,274	3,588	4,045
Consolidated debt	500	2,160	1,407	1,516	2,133
Shareholders' equity after eliminating goodwill, administrative and general	1,653	1,292	687	813	613
Total value	8,225	6,056	4,553	2,885	2,525
Market value	5,962	4,049	3,488	2,499	2,343
Discount	38%	50%	31%	15%	8%
Target price	7.8	116	217	46	10.2
Recommendations	**Above average yield**	**Buy**	**Above average yield**	**Market yield**	**Market yield**

* The Phoenix's debt also includes the future liabilities in respect of the acquisition of Excellence, approximately NIS 340 million.

Full Disclosure

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Harel

Methodology: Our valuations of insurance companies are done using the NAV model, which summarizes operating value by neutralizing debt and adding equity.

Risk Factors:

- High dependency on market conditions
- High dependency on capital markets, and on the effects of changes in financial markets in Israel and around the world
- Regulation
- Reforms intended to increase competition in the pension savings market
- Longer life expectancy and exposure to demographic risks
- Preference for defined benefit pension plans

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During the preceding year, the companies of the Leader Capital Markets Group provided management and distribution and / or underwriting services for the company’s issuances.

Historical Performance of the Stock, and Changes in Recommendations and Target Prices:

Target Price, NIS			Buy, 245			Share Price, NIS
				Buy, 230		
		Outperform, 217			Market Perform, 218	
	Market Perform					

Date	**Recommendation**	**Target Price**	**Analyst**
January 1, 2009	Market Perform		
September 22, 2009	Outperform	NIS 217	Lena Itzkov
March 28, 2010	Buy	NIS 245	Lena Itzkov
September 15, 2010	Buy	NIS 230	Lena Itzkov
May 11, 2011	Market Perform	NIS 218	Lena Itzkov

Analyst Disclosure and Declaration:

I, Lena Itzkov, holder of license no. 9286, hereby declare that the opinions presented in this analysis report reflect my personal opinions about the analyzed securities, and about the corporation which issued these securities.

Lena Itzkov