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DS Brokerage Ltd.

Harel Investments
Response To Results from Q1/11

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Good results and strong embedded value data. Current pricing serves as a good entry point for the stock. Recommendation raised

May 29, 2011

Change in Recommendation	✓
Change in Price	
Change in Forecast	

Target Price	NIS 250
Recommendation	Market Perform
Current Price	177.6
Previous Recommendation	Market Perform
Previous Target Price	NIS 250

Market Value (Millions of NIS)	3,765
12 Month High	NIS 235.1
12 Month Low	NIS 163.8
Average Daily Volume (Thousands of NIS)	5,500
Floating Amount	49.7%
Weight in the Tel Aviv 100 Index	0.86%

Current Majority Capital Ratio	1.05
LTM PE Ratio	9.4

- **Harel Investments presented very strong results for the first quarter of 2011. The company recorded total earnings of NIS 78.8 m., reflecting an ROC of 9.1%**, higher than Migdal (ROC of 6.8%) and Clal (-5.3%). The results were strong mainly in the areas of life insurance, provident funds, and financing, although mixed results were recorded for health and general insurance. **EV data were also the strongest in the market to date.**
- **The company announced a dividend distribution of NIS 42.4 m., reflecting a dividend yield of 1.1%.** This dividend joins the dividend distribution for 2010, providing investors with a dividend yield of approx. 5.5%.
- **Harel is traded at a capital ratio of 1.1%.** Due to the negative returns from the beginning of the year, the second quarter may result in losses. However, the ratio at which the company is currently being traded does not reflect its growth potential and long term profitability. **In light of this, we are raising our recommendation for Harel Ltd. to outperform, with the target price remaining unchanged at NIS 250.** As a reminder, insurance stocks are sensitive to fluctuations in capital markets, and may react negatively if the market's bearish trend continues.

Harel Insurance – Total Earnings Q1-11			
Millions of NIS	Q1-11	Q4-10	Q1-10
Life insurance	53.9	95.8	164.1
Pension	8.3	8.5	5.2
Provident funds	19.1	16.1	18.1
Health	40.3	45.6	64.2
General insurance	9.6	19.8	77.6
Insurance companies abroad	(3.7)	(10.5)	(7.1)
Finance	11.0	6.9	9.5
Other	(22.4)	25.8	37.2
Earnings before tax	116.2	208.1	368.9
Tax expenses	(37.4)	(74.3)	(128.8)
Total earnings	78.8	133.8	240.1
Minority (minority losses)	(.0)	2.0	7.1
Total earnings to shareholders	78.8	131.8	233.0

- **In life insurance**, Harel presented earnings of NIS 54 m. before tax, compared to earnings of NIS 164 m. in the previous quarter. The difference is due to the collection of variable management fees amounting to NIS 5 m. in the current quarter, compared to a collection of NIS 74 m. in the parallel quarter. Harel's life insurance results were better than those of Clal and Migdal, with the company recording earnings of 0.2% from policies, compared to only 0.1% at Migdal and Clal. Most of the difference results from preferential underwriting profits, with only a small part of investment earnings being higher, resulting in slightly higher variable management fees at the end of the quarter than the other two companies (NIS 5 m. at Harel, compared to NIS 3 m. at Clal, and zero at Migdal).

Premiums grew by 12.6% compared to the parallel quarter, where after neutralization of one time premiums from the Bezeq transaction, the company recorded growth of approx. 10%. This growth rate is lower than Migdal's but higher than Clal's.

- **Pension** activities provided fair results, which despite the improvement compared to the parallel quarter, represented a continuation of the profitability recorded for the three preceding quarters. Management fees grew to 22% compared to the parallel quarter, in accordance with a growth of 30% in total managed assets. During the current quarter, assets grew by approx. 6% (compared to the beginning of the year).
- **Provident fund** activities recorded a strong quarter, with management fees 1.6% lower than the parallel quarter, though a decrease of 0.5% in expenses raised total earnings by 6.6%. The decrease in income occurred in spite of an increase of approx. 5% in assets. However, the trend of decreased income compared to growth in assets – a trend which the company displayed throughout all of 2010 – was stopped, and compared to the previous quarter, an increase in management fees was recorded at a higher rate than the increase in assets.
- **Health insurance** activities provided mixed results, with the company's total earnings amounting to NIS 40 m., compared to NIS 64 m. in the parallel quarter. The decrease in earnings resulted mainly from the decrease in investment earnings and the index increase, and also from an increase in nursing insurance claims. However, premiums for health insurance grew at a high rate of 23.7%, which is significantly higher than the data other companies have published to date (Clal 12.3%, Migdal 10%), and Harel continues to establish its position as the market leader.
- **General insurance in Israel** provided fair results this quarter, with the company presenting earnings of approx. NIS 10 m., compared to earnings of approx. NIS 77 m. in the preceding quarter. The decline in results was caused by low investment profits due to the index increase, resulting in larger insurance provisions. **Compared to the other companies, these are better results**, with Migdal recording losses of NIS 7 m., and Clal recording a balance at the level of total earnings.

However, gross premiums for general insurance at Harel shrunk by 5.6%, compared to an increase of 0.7% at Migdal and a decrease of 2% at Clal. This decline resulted from a decrease in Harel's share in vehicle insurance for government employees, from 85% to just 33%, after the results of the last tender in October 2010. In parallel to the decrease in income, the competition in vehicle areas also reduced the premium average.

- **General insurance abroad** presented a decrease in total earnings to NIS 3.7 m., compared to NIS 7 m. in the parallel quarter, and compared to over NIS 8 m. during 2010.

Premiums grew by 36.6% compared to the parallel period, and reached 1.5% of total company premiums, compared to 1.2% in the parallel period and throughout all of 2010.

- **Financing activities** recorded another strong quarter, with revenues from management fees growing by 22% compared to the parallel quarter, in accordance with an increase of 31% in total managed assets. Earnings from these activities amounted to NIS 11 m., compared to NIS 9.5 m. in the previous quarter.
- **The index increase and capital market declines during the quarter** were expressed in high financing expenses, which were not covered by investment earnings. As a result, the company recorded losses of NIS 22 m. under the other sector.
- **Harel's capital requirements** - Harel Insurance Ltd. currently has a surplus of approx. NIS 569 m., and of just NIS 57 m. relative to the requirements for the end of 2011. In the event that the Commissioner permits a decrease of 35% in goodwill from the requirements for provident funds, the capital surplus will amount to approx. NIS 300 m. Dikla currently has a capital surplus of NIS 93 m., and of NIS 70 m. relative to the requirements for the end of 2011. EMI fulfills the requirements, including for the end of 2011.
- **The company announced a dividend distribution of NIS 42.4 m., reflecting a dividend yield of 1.1%.** Dikla distributed dividends amounting to NIS 50 m., which helped execute the insurance company's dividend distribution.
- **The embedded value results are the strongest among all companies which have published to date.** The EV of Harel Insurance Company amounted to NIS 6.34 billion at the end of 2011, an increase of 12.4% compared to the embedded value for 2009. After neutralization of distributed dividends, growth of 16.7% was recorded. This is the highest growth rate among the companies – at Migdal, growth amounted to 9%, and at Clal to 14% (after neutralization of dividend distribution).
- The change in the current value of future earnings from life insurance (VIF), which was the main weak point in the EV's of Clal and Migdal, amounted to 3.8%, compared to an increase of just 0.5% at Clal, and a decrease of 5.1% at Migdal. The change in capitalization rate, which was the central factor in the decrease of VIF in the life and health insurance areas, had less of an effect on Harel, due, in our estimation, to a relatively high rate of activity in health insurance, which is less affected by capital market performance.
- EV from pension activities amounted to NIS 993 m., an increase of 37% compared to the end of 2009. The embedded value of pension activities already constituted 15% of total embedded value, compared to 12% at the end of the previous year.
- The value of new business (VNB) in life and health insurance grew by just 7%, compared to growth of 24% at Clal and 49% at Migdal. However, the VNB of Harel in these activities is still higher than its competitors, and reflects growth of 6.1% in these activities at Harel, compared to 4.5% at Clal and just 3.5% at Migdal.

- The VNB of pension activities amounted to NIS 111 m.: an increase of 44% compared to 2009. The pension VNB reflects a growth of 15.3% in these activities, compared to 9.3% at Clal and 5.5% at Migdal.
- The embedded value of Dikla amounted to NIS 580 m., an increase of 6.9%.
- The total embedded value of the Harel Group amounts to NIS 6.9 billion, **and the company is currently traded at an EV ratio of 0.54.**

Bottom Line:

- **Notwithstanding the single-digit yield, the first quarter results are very strong** - the strongest published to date in the sector for the current quarter. The EV data for Harel is also the strongest in the field.
- **Harel is currently traded at a capital ratio of 1.05.** Due to negative yields from the beginning of the year, the second quarter may result in losses. However, the ratio at which the company is currently traded does not reflect its growth potential and long term profitability. **In light of this, we are raising our recommendation for Harel Ltd. to outperform, with the target price remaining unchanged at NIS 250.**

Notes, Warnings and Full Disclosure Regarding the Analysis Report

Notes Regarding the Analysis Report

1. Recommendation Index

- **Buy** – The stock is expected to outperform the Tel Aviv 100 Index by 20% or more during the coming 12 months.
- **Outperform** – The stock is expected to outperform the Tel Aviv 100 Index by 10% - 20% during the coming 12 months.
- **Market perform** – The stock is expected to produce results ranging between outperform of 10% and underperform of 10% relative to the Tel Aviv 100 Index during the coming 12 months.
- **Underperform** – The stock is expected to underperform the Tel Aviv 100 Index by 10% - 20% during the coming 12 months.
- **Sell** – The stock is expected to underperform the Tel Aviv 100 Index by 20% or more during the coming 12 months.

2. The method used to assess the value of insurance companies and to determine target prices included the use of two models in parallel: The dividend discount model (DDM) and the net asset value model (NAV), while also incorporating evaluation using capital ratios and P/E ratios, and comparing between the different stocks in the sector.

3. Main risks which may significantly affect the target price of insurance companies:

- Declines in capital markets in Israel and around the world.
- Decline in the state of the economy.
- Decline in the health of individuals in the economy.
- Decline in the economic situation of individuals in the economy.
- Increase in life expectancy.
- Increase in the severity of the global economic crisis.
- Financial risks – exchange rate changes, interest changes, inflation.
- Changes in legislation and regulation which may adversely affect the business activities of insurance companies.

4. Graph of company stock and changes in recommendations during the last three years. Target prices per share refer to the 12 month period following the date each recommendation was given.



Date	Share Price	Target Price	Recommendation
May 29, 2011	177.6	250	Outperform
January 12, 2011	235.2	250	Market perform
November 25, 2010	204.5	228	Outperform
June 17, 2010	181.0	228	Buy
March 1, 2010	193.8	265	Buy

* Note – Stock graphs are displayed after adjustment for dividend distributions, while target prices are not retroactively adjusted for dividend payments, and refer to the situation as it existed on the date each recommendation was given.

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Full Disclosure of the Analysis Report Preparer

The analysis report preparer is not aware of any conflict of interest existing as of the date of publication of the analysis report.

Full Disclosure of DS Brokerage Ltd. (hereinafter: the “Authorized Corporation”)

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Declaration of Independent Judgment

I, Meir Slater, holder of license number 9421, hereby declare that the opinions presented in this analysis report accurately reflect my personal opinion about the securities discussed herein, and about the corporation that issued these securities.

May 29, 2011

Publication Date of the Analysis Report

Meir Slater
