

**Partner Communications**  
 (Bloomberg Ticker :PTNR IT)

**PTNR: Ahead of Q3 Results  
 ARPU Still under pressure**

Following an uneventful second quarter, the company is expected to clock in with an equally calm third, with investor interest likely to focus on dividend policy—specifically, on Partner’s ongoing quarterly payout and potential one-time special dividend. The company’s shares are fully valued in our view, on the basis of anticipated cash flow in coming years. **We’re maintaining our Marketperform rating on Partner, with a per-share price target of NIS 72.**

**Two arguments for:**

- Dividends.** The company’s new controlling shareholder is expected to lift Partner’s payout ratio from 80% of net income to anywhere from 90% to 100%. We also suspect the company (subject to court approval) will reduce shareholder equity in the form of a one-time dividend disbursement of around NIS 1.5 billion, which, based on the current share price, would imply a FY2009 dividend yield of 23% (that’s no typo).
- ISP & telephony.** This new venture has not proven to be a monumental success, to put it mildly, currently comprising a drag on the company’s results in the form of NIS 100m annual expenses. When breakeven will be reached still isn’t clear (possibly by the end of 2010), but if the venture doesn’t show progress, Partner can always fold it, or acquire Smile Communications, thereby taking advantage of economies of scale (see below).

**Three arguments against:**

- Free cash flow** is expected to come in at NIS 934m for FY2009, reflecting a free cash flow to enterprise value ratio of an unimpressive 7.2% in a mature market, which faces no lack of future challenges.
- Competition**
  - A new kid in town.** Who will it be? Mirs? MNVO? A fresh-faced unknown? We expect to get indications of who the new rival is by the end of the year. Whether the newcomer will prove a success or failure can’t be answered. But what can be stated with assurance is that its presence won’t be of benefit to rivals’ results.
  - The old bruiser.** Pelephone, the new/old rival in the enterprise segment, has made concerted efforts to penetrate the high-tech company sub-segment, where Partner has been dominant, forcing the latter to lower its prices.
- iPhone.** This is the most interesting development in the mobile market. Apple has taken advantage of its strengths and strong-armed local providers into accepting its terms. But the smartphone’s success raises questions in two areas: marketing (has the hype already played itself out?) and pricing (will customers be willing to shell out NIS 250 to NIS 300 a month?). Rivals may choose to reinstate direct handset subsidies as a counter-move.

**Updates**

- Rating**
- Price Target**
- Forecast**

**Key figures**

Rating	Market Perform
<b>Price target (NIS)</b>	<b>72.00</b>
<b>Current price (NIS)</b>	<b>72.80</b>
Market Cap (Bil ILS)	11.4
12-mo. high (NIS)	74.4
12-mo. low (NIS)	53.5
52-weeks. Change	15%
52-weeks. Change TA25	34%
P/E 2009E	10.4
P/E 2009E	10.2
EV/EBITDA 2009E	5.9
EV/EBITDA 20010E	6.0
<b>Previous rating</b>	Market Perform
<b>Previous price target (ILS)</b>	72.00



### Q3 preview

Average revenue per user is expected to continue declining against the backdrop of a series of factors, including minute-per-use price erosion, the increased enrollment of low ARPU customers, the impact of roaming fees, and enterprise sector weakness (see below), which will lead to declines in service-generated revenue, despite a 40,000 increase in new subscribers (including cellular modem users).

Outlays associated with the telephony and Internet venture continue to weigh on the company's bottom line, with the unit expected to reach breakeven point by the end of 2010.

The third quarter last year was particularly strong, setting up a tough comp backdrop. We expect to see falling revenue from service provision in Q3 '09 and lower EBITDA (even factoring out the impact of accounting changes stemming from the application of IFRS reporting standards).

### Key negatives

1. **Lower roaming fees.** Revenue generated by in- and out-going tourism is traditionally higher in Q3 (the summer months). While tourism experienced a second quarter 25% year-on-year decline, we expect to see a more moderate falloff in Q3. That said, Q3 tourism is expected to have fallen by single digits compared with a year ago, and French visitors, a strong contingent in recent years, have finally learned the ropes for saving on phone expenses.
2. **Enterprise sector.** This line of Partner's business still hasn't fully revived. The environment has improved from a year ago, but salary cuts have been implemented by many corporations and have a direct impact on Partner's results. Nor do we anticipate full rejuvenation in the short term. Corporations have been using the services of communications consultants, who've abetted their clients' efforts to get better prices from suppliers generally, and cellular providers amongst them.
3. **Minute-per-use revenue erosion.** This is an ongoing trend in the phone call segment, resulting from the one-two punch of increased customer haggling power and current marketing programs. The end of the 12-second unit charge and onset of billing on a per-second basis has also weighed on all providers in the industry.
4. **New customer mix.** In the saturated Israeli marketplace, new subscribers tend to be individuals with more than one handset, including grade school kids utilizing cellular modems. For all these new enrollments, ARPU is lower than the levels that currently prevail.

### Regulation

No new developments in Q3 transpired compared with the previous three months, nor are any anticipated by the end of the year. However, dangers lurk, coming from the direction of the Finance and Communications Ministries, and are likely to impact all cellular providers in 2010.

Some of the central risks include:

1. The Minister of Communications' intention to bring a fifth cellular provider into the marketplace (or fourth, if Mirs is excluded). This development may include price setting, under certain scenarios. The issue of price and whether it will cause an additional provider to enter the fray remains an unanswered question, which won't be resolved in coming months. The acquisition of Mirs by HOT or Smile Communications could potentially offset the impact of a new player entering the field, but, in any case, all scenarios imply tougher competition.
2. Interconnect fees are shortly expected to come under review by the Communications Ministry.

### Telephony & Internet access

Partner continues to market bundled offerings in the local market, placing particular emphasis on the telephony segment, for which enrollment rates have proven unsatisfactory. In the meantime, we continue to see NIS 25m in expenses per quarter. That said, capex remains subdued.

With the slow current enrollment rate, despite highly attractive deals, breakeven point is expected to be put off until the end of 2010. Nor is any major positive impact from this business line on a company this size expected even in 2011 or 2012.

One possibility is that Partner's new controlling shareholders will try to extract as hefty a dividend as possible, and won't feel constrained by past business decisions, potentially resulting in the closure of this division, and refocusing Partner on its traditional mobile business.

A second possibility, which we deem more likely, is that Partner will acquire Smile Communications and with it the latter's Internet and telephony customers, enabling Partner to exploit economies of scale and the synergies stemming from such a move.

**SEE P&L MODEL ON NEXT PAGE.**

Partner	2007	2008	1Q09	2Q09	3Q09E	4Q09E	2009E	2010E	2011E	2012E
<b>Revenues</b>	<b>6,113.6</b>	<b>6,329.5</b>	<b>1,412.4</b>	<b>1,514.0</b>	<b>1,578.0</b>	<b>1,502.3</b>	<b>6,007.2</b>	<b>5,917.1</b>	<b>5,971.6</b>	<b>6,035.7</b>
Services	5,328.7	5,573.2	1,297.8	1,360.0	1,415.7	1,348.9	5,422.4	5,366.5	5,423.6	5,494.2
YoY	6.0%	4.6%	-2.9%	-0.7%	-2.4%	-2.9%	-2.7%	-1.0%	1.1%	1.3%
Equipment	784.9	756.3	114.6	154.0	162.3	153.4	584.8	550.6	548.0	541.5
YoY	35.5%	-3.6%	-53.3%	-8.9%	-8.8%	-6.5%	-22.7%	-5.9%	-0.5%	-1.2%
<b>Gross Profit</b>	<b>2,010.5</b>	<b>2,250.4</b>	<b>566.3</b>	<b>590.0</b>	<b>627.7</b>	<b>544.8</b>	<b>2,329.3</b>	<b>2,284.9</b>	<b>2,306.5</b>	<b>2,305.2</b>
Gross margin	32.9%	35.6%	40.1%	39.0%	39.8%	36.3%	38.8%	38.6%	38.6%	38.2%
YoY	17.6%	11.9%	-2.1%	-0.3%	-6.5%	-8.1%	3.5%	-1.9%	0.9%	-0.1%
S&M	370.2	389.3	83.4	102.0	101.0	90.3	376.6	370.9	368.4	372.3
% from revenues	6.1%	6.2%	5.9%	6.7%	6.4%	6.0%	6.3%	6.3%	6.2%	6.2%
G&A	235.9	255.9	72.9	69.0	69.4	73.8	285.2	275.0	271.6	268.5
% from revenues	3.9%	4.0%	5.2%	4.6%	4.4%	4.9%	4.7%	4.6%	4.5%	4.4%
<b>OPEX</b>	<b>606.1</b>	<b>645.2</b>	<b>132.3</b>	<b>156.0</b>	<b>157.5</b>	<b>151.1</b>	<b>597.0</b>	<b>620.0</b>	<b>614.0</b>	<b>614.9</b>
% from revenues	9.9%	10.2%	9.4%	10.3%	10.0%	10.1%	9.9%	10.5%	10.3%	10.2%
<b>Operating Income</b>	<b>1404.5</b>	<b>1605.2</b>	<b>433.9</b>	<b>434.0</b>	<b>470.3</b>	<b>393.7</b>	<b>1732.3</b>	<b>1664.9</b>	<b>1692.4</b>	<b>1690.3</b>
Operating margin	23.0%	25.4%	30.7%	28.7%	29.8%	26.2%	28.8%	28.1%	28.3%	28.0%
YoY	15.3%	14.3%	2.4%	-2.9%	-9.9%	-9.1%	7.9%	-3.9%	1.7%	-0.1%
Financial expenses	(126.3)	(157.9)	(25.9)	(48.0)	(60.1)	(33.7)	(167.7)	(134.7)	(134.7)	(134.7)
Income before tax	<b>1,278.2</b>	<b>1,447.2</b>	<b>408.0</b>	<b>386.0</b>	<b>397.2</b>	<b>347.0</b>	<b>1,499.8</b>	<b>1,504.2</b>	<b>1,531.8</b>	<b>1,529.6</b>
Taxes	(338.4)	(395.8)	(111.5)	(98.0)	(107.2)	(93.7)	(410.5)	(391.1)	(382.9)	(382.4)
Taxes %	26.5%	27.3%	27.3%	25.4%	27.0%	27.0%	27.4%	26.0%	25.0%	25.0%
<b>Net Income</b>	<b>939.7</b>	<b>1,051.5</b>	<b>296.5</b>	<b>288.0</b>	<b>289.9</b>	<b>253.3</b>	<b>1,089.3</b>	<b>1,113.1</b>	<b>1,148.8</b>	<b>1,147.2</b>
Net margin	15.4%	16.6%	21.0%	19.0%	18.4%	16.9%	18.1%	18.8%	19.2%	19.0%
YoY	37.7%	11.9%	0.0%	2.1%	-12.1%	-12.6%	3.6%	2.2%	3.2%	-0.1%
<b>EBITDA</b>	<b>2,014.7</b>	<b>2,258.7</b>	<b>549.2</b>	<b>569.7</b>	<b>611.3</b>	<b>534.9</b>	<b>2,263.1</b>	<b>2,224.9</b>	<b>2,270.7</b>	<b>2,279.4</b>
EBITDA margin	33.0%	35.7%	38.9%	37.6%	38.7%	35.6%	37.7%	37.6%	38.0%	37.8%
YoY	8.9%	12.1%	3.1%	5.2%	-3.4%	-3.2%	0.2%	-1.7%	2.1%	0.4%
EPS (diluted)	5.96	6.73	1.92	1.86	1.87	1.62	7.03	7.15	7.34	7.29
shares -diluted (millions)	157.58	156.35	154.17	154.46	155.24	156.01	154.97	155.74	156.52	157.31
<b>Partner</b>	<b>2007</b>	<b>2008</b>	<b>1Q09</b>	<b>2Q09</b>	<b>3Q09E</b>	<b>4Q09E</b>	<b>2009E</b>	<b>2010E</b>	<b>2011E</b>	<b>2012E</b>
Working Capital					(11.3)	33.7	67.4	53.7	43.4	44.0
Depreciation					141.0	141.2	530.8	560.0	578.2	589.0
CAPEX					192.5	192.5	823.0	742.3	686.4	689.2
FCF	916.2	1,308.3	200.2	222.8	322.9	215.0	962.3	1,037.8	1,157.9	1,163.7

g/wacc	0.5%	1.0%	1.5%	2.0%	2.5%
8.2%	76.5	81.6	87.6	94.5	102.6
8.7%	70.7	75.2	80.3	86.1	92.9
9.2%	65.6	69.5	73.9	78.9	84.6
9.7%	61.0	64.5	68.3	72.6	77.5
10.2%	57.0	60.0	63.3	67.1	71.4

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**Tsahi Avraham**

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