04 February 2008

TMT
Wireless Telecoms
Equity – Israel

HSBC Global Research

Short-term Trading Strategy

Strategy: Buy Cellcom

- **Debt refinancing increases likelihood of one-off dividend of up to ILS600m, or 6% yield, on top of 8.2% ongoing yield expected for 2008**
- **MNP related costs may decline sooner than expected in our view, supporting faster margins recovery while providing an upside to our 31.2% EBITDA margin for 1H-08**
- **On the back of potential newsflow including results announcements (PTNR and CEL) providing more colour on MNP related expenses, a one-off dividend announcement and positive read on expected regulatory committee publication, we expect share to close valuation gap with Partner over next couple of months, implying c15% upside**

Overweight

Target price ILS			**133.0**
Share price ILS			**106.5**
Potential total return (%)			**25**
Performance	**1M**	**3M**	**12M**
Absolute (%)	-14.0	1.2	NA
Relative^ (%)	-0.9	16.8	NA
Index^			TA-100
RIC			CEL.O
Bloomberg			CEL IT
Market cap (USDm)			3001
Market cap (ILSm)			10384
Enterprise value (ILSm)			12857
Free float (%)			26

A classic mispriced story

Refinancing of Cellcom's debt (Citigroup's) with longer term bonds of ILS600m will eliminate the covenants of Citi's debt which do not permit for non-operational dividend distribution. Cellcom's enhanced debt structure with longer duration debt (from one to six years average duration) and lower average rate of 4.77% (CPI linked, for the long bond series) should also reduce quarterly financial expenses. With no loan covenants and unlevered balance sheet (net debt/EBITDA of 1.1x) the likelihood of a one-off dividend during 2008 increases materially in our view, thus acting as a potential short-term catalyst.

Alternatively, if we assume the company only distributes its retained earnings (ie without any balance sheet lever) which as of Q3-07 were 637m, this would add an additional 6.1% yield to our 8.2% 2008 yield expectations, resulting with a respectable total dividend yield potential in excess of 14% for 2008.

MNP (Mobile Number Portability) related expenses may decline faster than expected in our view. After two months of implementation of portability, we believe that the mobile market is gradually pulling the plug on MNP related expenses.

The time frame for our short-term trading call is the next two months. **Triggers:** Results due by mid March (Partner in early Feb). What should happen? New information re lower than expected MNP related expenses would support faster margin recovery; news on one-off dividend from Cellcom would be more likely by mid-March in our view. Grunau's committee recommendations should be released before the end of Q1-08 and have a positive general read for mobile operators, which would be allowed to offer additional services under certain conditions. We think the beaten-down share allows potentially good gains.

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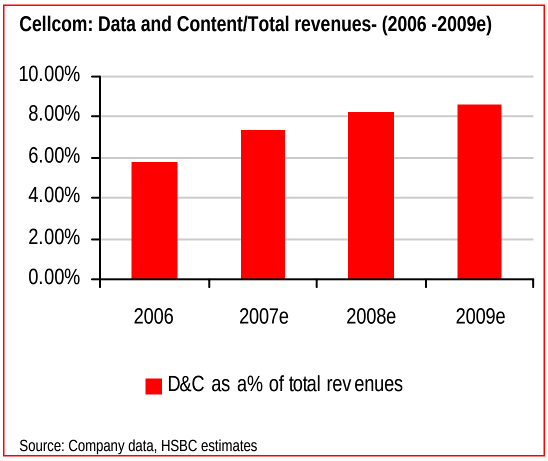
Why do we think MNP related expenses may decline faster than expected?

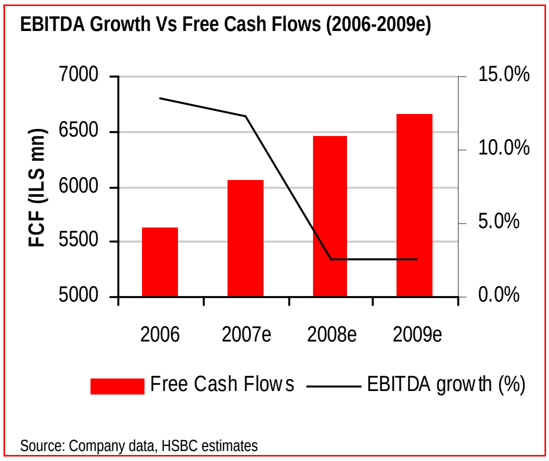
Cellcom, the largest mobile operator, is pushing the breaks on S&M expenses. The next big player followed suit. We think that as long as rational behaviour is demonstrated by the mobile players, MNP impact on expenses may turn lower than previously expected by us. We are not changing our opex estimates as we await the first set of official numbers post MNP launch (Partner results due February 6, Cellcom's mid March). Yet at this point we believe that the publicly available evidence (ie extent and magnitude of promotions) points towards a clear upside to our current H1-08 expenses estimates, which in turn triggers potential upside to our H1-08 EBITDA margin estimates of 31.2%.

Long-term rating – Overweight, target price ILS133

We remain Overweight on Cellcom on a one-year view with a target price of ILS133 (dividend excluded). We use a DCF model to arrive at our target price for Cellcom, applying an 8.8% discount rate (beta of 0.8, RFR of 4.8%, equity risk premium of 5.5%) and long-term growth rate of 0%. Key risks to our rating include introduction of MVNO that would increase price competition and hence affect margins and increasing competition in the 3G space.

The valuation has turned attractive following the recent market plunge – Cellcom's share is down 27% since December 5, 2007. The current share price presents over 33% total return upside to HSBC's DCF based valuation (including dividend of ILS8.7 per share). On a comparative basis, Cellcom trades at EV/EBITDA of 6.0x and 5.8x our 08e and 09e estimates. This represents a discount of 12%/13% for 08/09 versus Partner (Neutral, current price ILS76.99, target price ILS84.00) without any operational justification in our view (ie Cellcom's presently favourable EBITDA and FCF performance versus Partner during most of 2007). Cellcom trades at 15%/10% discount versus our peer group average. In addition Cellcom enjoys a high FCF yield of 10.3% for 08e and 09e and presents a strong dividend yield of 8.2% and 8.7 % for 08e and 09e based on a 95% payout ratio assumption.





We believe that Cellcom is a clear quality defensive play given its stable FCF, lower macro environment-dependency and high dividend yield. Even though Israel's mobile market is not a top line growth story, there are a few driving engines which should support FCF growth such as data revenue growth (the fastest growing operator), decreasing capex/sales and further margins expansion based on increased efficiencies (already underway). Our model excludes flat rate based mobile internet as this service has yet to be announced. However we believe that given the extended network capacity of Cellcom and ongoing regulatory reform, this key service may be offered already during 2008.

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Disclosure appendix

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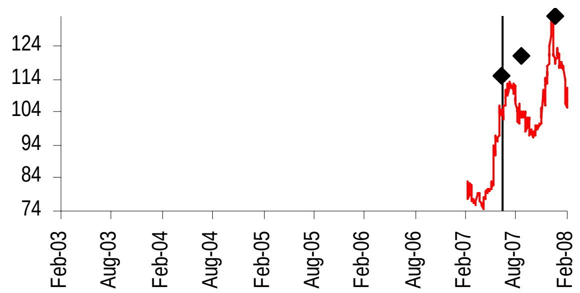
Underweight (Sell)	15%	(15% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Cellcom Israel Ltd Share Price performance ILS Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	07 June 2007
Target Price	**Value**	**Date**
Price 1	115.10	07 June 2007
Price 2	121.00	20 August 2007
Price 3	133.00	21 December 2007

Source: HSBC

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