Partner

Price Objective Change BUY

Equity | Israel | Telecom Services-Wireless/Cellular
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Merrill Lynch

Less is more in Q3

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Falling equipment sales boost margins

The 11.7% decline in equipment sales drives the Q3 EBITDA margin up to 38.2% from our forecast of 35.6%. The decline reflects the normalisation of the equipment market in the tail of number portability. Careful cost control is, however, creating a more enduring legacy for margins.

Service revenue growth of 4.1% highlights value of data

The advance of 3G and the non SMS data at Partner remains a beacon for the mobile industry. Non SMS data growth was 27.0% and reached 9.3% of service revenues in the quarter, up from 7.6% a year ago. With subscriber growth of 3.1% and usage up 9.6% there is still momentum in the top line and management have maintained guidance for revenues and margins despite a more challenging macro backdrop.

Share buyback stopped despite 225% FCF increase

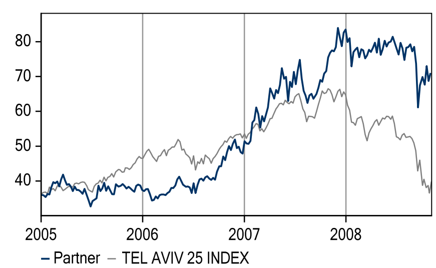
The decision to hold the buyback makes sense in our view. Market volatility both in terms of equities and in funding means a conservative stance is prudent. The decision to review the dividend policy suggests, however, that the buyback could be substituted for a more aggressive dividend policy. There is scope to raise the payout ratio and no covenants prevent a more generous approach.

BUY rating maintained, PO lowered by 1%

As part of our ongoing review of valuations we lower our PO following our decision to raise the ERP to 6.5% from 6%. This drives up the WACC to 10.35 from 9.9%. All other assumptions are left unchanged. The stock has 17% capital appreciation and a yield of 7.7%, making a total return of nearly 25% for shareholders. With scope for dividends to rise further we re-iterate our BUY.

Stock Data

Price (Common / ADR)	ILS70.00 / US$18.74
Price Objective	ILS83.50 to ILS82.50 / US$24.00
Date Established	5-Nov-2008 / 4-Aug-2008
Investment Opinion	B-1-7 / B-1-7
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	ILS60.60-ILS86.90
Market Value (mn)	ILS10,850
Shares Outstanding (mn)	155.0 / 155.0
Average Daily Volume	609,716
ML Symbol / Exchange	PTNRF / TLV
ML Symbol / Exchange	PTNR / NAS
Bloomberg / Reuters	PTNR IT / PTNR.TA
ROE (2008E)	72.1%
Net Dbt to Eqty (Dec-2007A)	118.0%
Est. 5-Yr EPS / DPS Growth	6.0% / 11.0%
Free Float	45.0%



Estimates (Dec)

(ILS)	2006A US GAAP	2007A US GAAP	2008E US GAAP	2009E US GAAP	2010E US GAAP
EPS (Reported Diluted)	4.41	5.96	6.86	7.53	7.87
EPS Change (YoY)	103.4%	35.1%	15.2%	9.8%	4.6%
Dividend / Share	2.63	4.77	5.49	6.02	6.30
ADR EPS (Reported Diluted - US$)	0.99	1.45	1.82	2.00	2.09
ADR Dividend / Share (US$)	0.59	1.16	1.46	1.60	1.67

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	15.9x	11.8x	10.2x	9.3x	8.9x
Dividend Yield	3.7%	6.7%	7.7%	8.5%	8.9%
EV / EBITDA*	7.2x	6.6x	5.9x	5.9x	5.7x
Free Cash Flow Yield*	7.4%	8.3%	10.3%	10.5%	11.2%

* For full definitions of *iQmethod* SM measures, see page 8.

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Refer to important disclosures on page 9 to 11. Analyst Certification on Page 7. Price Objective Basis/Risk on page 7.

iQprofile SM Partner

Key Income Statement Data (Dec)	2006A	2007A	2008E	2009E	2010E
(ILS Millions)	US GAAP	US GAAP	US GAAP	US GAAP	US GAAP
Sales	5,607	6,114	6,364	6,519	6,665
EBITDA Adjusted	1,841	2,008	2,241	2,259	2,322
Depreciation & Amortization	(622)	(603)	(657)	(590)	(610)
EBIT Adjusted	1,218	1,405	1,584	1,669	1,712
Net Interest & Other Income	(166)	(126)	(133)	(129)	(128)
Tax Expense / Benefit	(371)	(338)	(398)	(421)	(433)
Net Income (Adjusted)	682	940	1,054	1,119	1,151
Average Fully Diluted Shares Outstanding	155	158	154	149	146
Key Cash Flow Statement Data					
Net Income (Reported)	682	940	1,054	1,119	1,151
Depreciation & Amortization	622	603	657	590	610
Change in Working Capital	(61.4)	(114)	(75.2)	(22.2)	(11.3)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(19.4)	27.0	17.6	0	0
Cash Flow from Operations	1,223	1,456	1,653	1,687	1,750
Capital Expenditure	(415)	(532)	(531)	(575)	(590)
(Acquisition) / Disposal of Investments	(33.4)	(8.30)	0	0	0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(449)	(540)	(531)	(575)	(590)
Share Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(352)	(624)	(843)	(895)	(921)
Cash Flow from Financing	(701)	(846)	(1,137)	(1,112)	(1,160)
Non Cash Changes to Debt	NA	NA	NA	NA	NA
Change in Net Debt	(467)	(369)	320	(16.4)	(38.9)
Net Debt	2,252	1,953	2,257	2,240	2,201
Key Balance Sheet Data					
Property, Plant & Equipment	1,748	1,735	1,671	1,736	1,795
Goodwill	NA	NA	NA	NA	NA
Other Intangibles	1,247	1,154	1,075	995	916
Other Non-Current Assets	432	629	612	612	612
Trade Receivables	964	1,121	1,133	1,161	1,187
Cash & Equivalents	77.5	148	150	150	150
Other Current Assets	232	244	234	240	239
Total Assets	4,701	5,031	4,875	4,894	4,899
Long-Term Debt	2,289	2,073	2,073	2,073	2,073
Other Non-Current Liabilities	129	146	146	146	146
Short-Term Debt	40.2	28.3	334	318	279
Other Current Liabilities	988	1,129	1,055	1,067	1,081
Total Liabilities	3,446	3,376	3,608	3,603	3,579
Total Equity	1,254	1,655	1,266	1,290	1,320
Total Equity & Liabilities	4,701	5,031	4,875	4,894	4,899
Key Metrics					
Wireless Customers (mn)	2.67	2.86	2.92	2.97	3.02
ARPU (ILS)	158.0	158.0	161.0	160.0	161.5
EBITDA margin	32.8%	32.8%	35.2%	34.7%	34.8%
iQmethod SM **- Bus Performance***					
Return On Capital Employed	21.5%	27.2%	29.8%	31.8%	32.6%
Return On Equity	65.9%	64.6%	72.1%	87.6%	88.2%
Operating Margin	21.7%	23.0%	24.9%	25.6%	25.7%
Free Cash Flow (MM)	808	924	1,123	1,112	1,160
iQmethod SM **- Quality of Earnings***					
Cash Realization Ratio	1.79x	1.55x	1.57x	1.51x	1.52x
Asset Replacement Ratio	0.76x	1.01x	0.92x	1.13x	1.11x
Tax Rate	35.2%	26.5%	27.4%	27.3%	27.3%
Net Debt/Equity	179%	118%	178%	174%	167%
Interest Cover	8.85x	10.7x	NA	12.6x	13.1x

* For full definitions of *iQmethod* SM measures, see page 8.

Company Description

Partner is Israel's second largest wireless operator. At the end of September 2008 Partner had 2.9mn customers and 32 percent market share. Partner operates under the Orange brand and launched 3G services in 2004. Hutchison Telecom owns 50 percent. Web site: orange.co.il

Investment Thesis

We like Partner as Israel's leading wireless brand (Orange) with a superior customer base which we believe best positions the company to benefit from growth in data usage and further regulatory pressure on opening up the residential broadband market. Valuation is supported by strong cash flow, a long history of cost discipline and committed 80 percent payout ratio combined with ILS 600mn share buy back programme.

Stock Data

Shares / ADR	1.00
Price to Book Value	8.4x

RC

Cash management dominates Q3

Impressive Q3 margin driven by cost control & lower loss making equipment sales

Data revenues continue to deliver fabulous growth

Net revenues in Q3 were up by 2.2%, although service revenues grew at 4.1% and equipment sales were down 11%. The service revenue decline was in spite of the 14% cut in interconnect rates in March. The highlight of the revenue space, in our view, is non SMS data and content which climbed 27% vs. Q3 2007 and 11.7% vs. Q2 2008. SMS revenues were up 4.9% in the same period, which is solid, but shows that value added data services are still a key driver. The 3G customer base continues to grow nicely with subscribers at the end of Q3 at 901,000, up from 834,000 in Q2. Net additions for Q3 were 36,000, with 21,000 post- paid customers. 3G customers now represent 31.2% of the total subscriber base, up from 29.3% in Q2.

Falling equipment sales brings a silver lining

The decline in equipment revenue reflects a sharp decline in the number of transactions, although 3G handset sales were up compared to 2G. The good news is that the loss on these sales is down from NIS 66mn in Q3 2007 to NIS 12.6mn in the quarter. The lower loss was also helped by exchange rate moves over the quarter. If this was adjusted for then the EBITDA margin would have matched our forecast of 35.6%. Management were quick to point out that this fall off in sales is actually more to do with the quarter on quarter comparisons than a more serious downward trend. The period after number portability was introduced at the end of last year saw a sharp increase in equipment sales.

SG&A costs rose by 15.2% partly on the back of higher subscriber numbers, but also because of the increased costs associated with the pending launch of their new non mobile data services.

The overall result for EBITDA was an increase of 15.6% in the quarter, which obviously had a positive impact on cash flow.

The fall 14% in financial expenses was because the inflation link is down on last year with just 2% in the quarter as opposed to CPI of 2.5% in Q3 2007.

Cash flow improvement must be the highlight

The cash flow for the quarter was bolstered by a number of working capital initiatives. The introduction of handset factoring was one such initiative. These are clearly working well, as would be expected for a company that has a strong reputation for careful cash management. The overall impact is a 225% increase in free cash flow in the quarter to NIS 440mn vs. NIS 135.3mn last year. Obviously part of this comes from improved margins and revenue growth, but in Q3 last year the business absorbed NIS 155mn of working capital, while in Q3 this year it was a source of NIS17mn in funds. Lower capex accounted for just NIS 21mn of the improvement.

Share buyback put on hold, dividend policy to be reviewed

The decision to stop the share buyback is somewhat surprising to us as the cash flow is very robust and the capex demands are not high. We view this as conservative, but given the dividend remains firmly intact we are not concerned about the shareholder returns. The likelihood is that the buyback may continue once we have stability in financial markets. However, the announcement that the dividend policy may also be reviewed is strong evidence to us that management may be considering other ways to return funds to shareholders. We believe that there is scope to raise the dividend from the current payout ratio of 80% and believe that management may be looking at their local rival Cellcom as a benchmark for more aggressive dividend payouts. This could be the most bullish development of the quarter.

The outlook for 2009 not unduly worrying

Management not pessimistic on usage outlook

The market share of Partner remains stable at 32% and usage is up to 376 vs. 343 in Q3 2007. This suggests that the competition is not stealing a march on them, but also that the economic slowdown is not unduly impacting usage. Management were challenged several times on the post results call about the likely areas where their business could come under pressure and the remained confident that while economic growth could come down in 2009 and that unemployment could reach 7.5% that their business with its strong business focus should be relatively immune.

Regulatory decision to fix tariffs a touch perplexing

More uncertainty surrounded management's response to questions on the decision by the regulator to impose a fixed tariff for retail customers from January 2009. They argued that they would seek ways to avoid being stuck with an immovable tariff, possibly by having some inflationary clause. The good news is that the regulator is leaving business customers untouched for now. The move to regulate retail tariffs is interesting and somewhat surprising as the revenue per minute has fallen by 10.5% Y-o-Y in dollar terms, suggesting that voice competition is still working. We watch this space with interest.

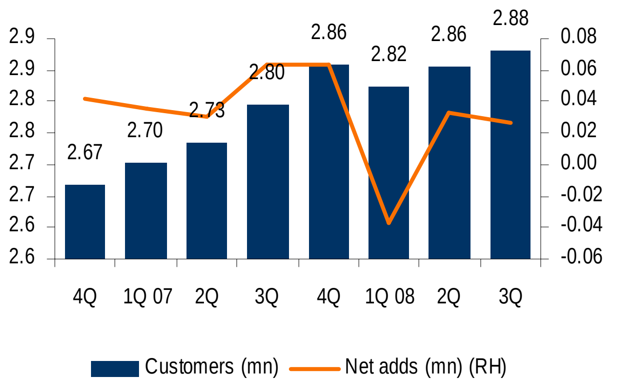
Looking forward the soft launch of their new suite of products should be a defining moment for the company. These include ISP services, mail access, WiFi, VoIP and web based entertainment. The next 12 months should certainly be interesting.

Table 1: Q3 results and KPI

	Q3 07A	Q2 08A	Q3 08A	QoQ	YoY	Q3 08E	A vs. E
Customers (mn)	2.80	2.86	2.88	0.9%	3.1%	2.89	-0.4%
Net Adds (mn)	0.06	0.033	0.026	-21.2%	-58.7%	0.037	-29.4%
ARPU (ILS)	165	158	166	5.1%	0.6%	169	-2.1%
MOU	343	368	376	2.2%	9.6%	377	-0.3%
Quarterly churn	3.3%	4.0%	3.9%	-2.5%	18.2%	4.0%	-2.5%
Revenue	1,601	1,544	1,636	6.0%	2.2%	1,641	-0.3%
EBITDA	539	541	626	15.6%	16.0%	584	7.0%
EBITDA Margin	33.7%	35.0%	38.2%	9.1%	13.5%	35.6%	7.3%
EBIT	390	378	469	24.2%	20.5%	425	10.3%
PBT	316	346	406	17.4%	28.4%	410	-1.0%
Net Income	214	247	296	19.7%	38.3%	299	-1.0%
Net Margin	13.4%	16.0%	18.1%	13.0%	35.4%	18.2%	-0.8%
EPS	1.37	1.58	1.92	21.1%	40.3%	1.91	0.2%
EPS (US$)	0.33	0.46	0.55	18.9%	68.6%	0.55	0.2%

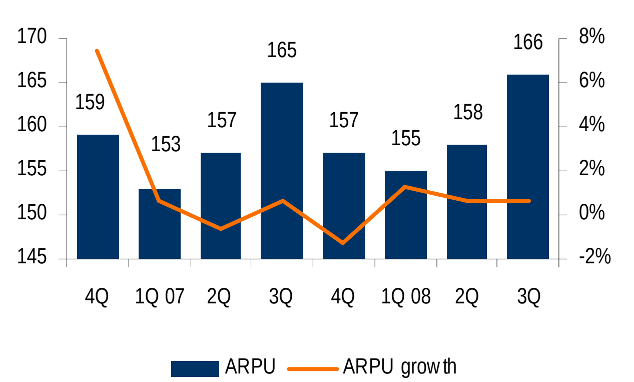
Source: Company Data, Merrill Lynch Research

Chart 1: Mobile subscribers and net adds



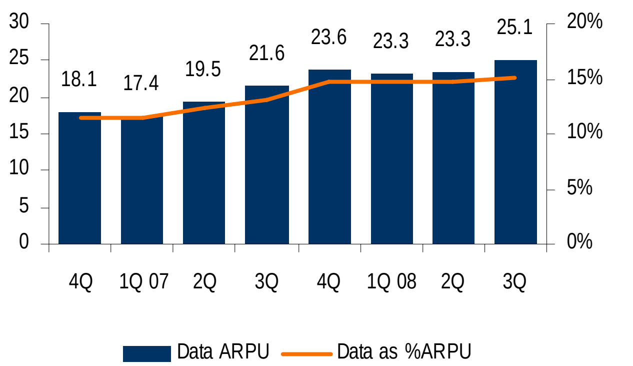
Source: Merrill Lynch Research

Chart 2: ARPU and ARPU growth %



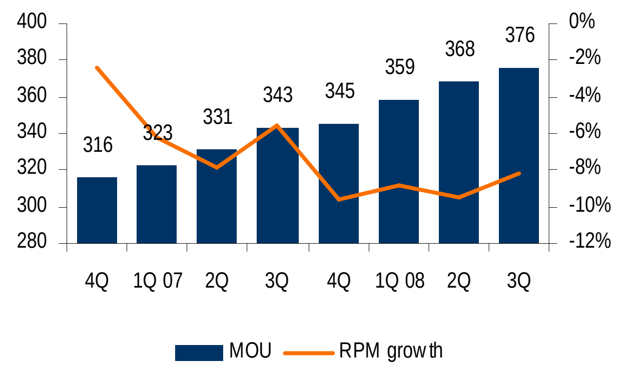
Source: Merrill Lynch Research

Chart 3: Data ARPU and data ARPU as % of total ARPU



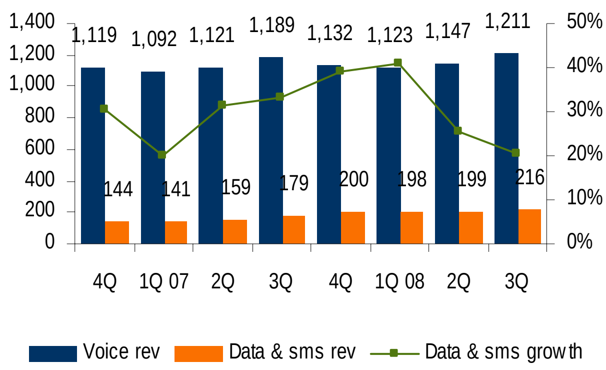
Source: Merrill Lynch Research

Chart 4: MOU and RPM growth



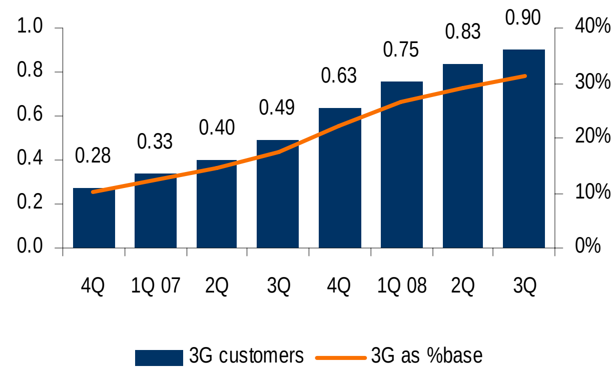
Source: Merrill Lynch Research

Chart 5: Voice revs, data & sms revs and data growth



Source: Merrill Lynch Research

Chart 6: 3G customer as % of total base



Source: Merrill Lynch Research

Price objective basis & risk

Partner (PTNRF / PTNR)

Our DCF-driven 12-month price objective is ILS82.5 (ADR: US$24). Key assumptions to our DCF model are an 10.3% discount rate, underpinned by an 13% cost of equity, a 35% terminal EBITDA margin, 10% LT capex/sales and 1% perpetuity growth. Risks to our price objective are macro economic and regulatory. We believe a sharp slowdown in economic growth would impact mobile demand. Furthermore, we believe revenue and margins could be impacted by any increase in regulatory pressures. This could become relevant if the regulator pursues any additional revenue reduction measures, now that the last scheduled interconnect happened in March.

Analyst Certification

I, Tom Chadwick, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Emerging EMEA - Telecoms Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Comstar UTS	XCSMF	CMST RU	Tom Chadwick
	Comstar UTS-GDR	JSTKY	CMST LI	Tom Chadwick
	Mobily	XEHTF	EEC AB	Stephen Pettyfer, CFA
	MTS	MBT	MBT US	Stephen Pettyfer, CFA
	Partner	PTNR	PTNR US	Tom Chadwick
	Partner	PTNRF	PTNR IT	Tom Chadwick
	Telecom Egypt	TEGPF	ETEL EY	Stephen Pettyfer, CFA
	Telefonica O2 CZ	TFAOF	SPTT CP	Tom Chadwick
	TP SA	PTTWF	TPS PW	Tom Chadwick
	Turk Telekom	XTKLF	TTKOM TI	Tom Chadwick
	Turkcell	TKC	TKC US	Stephen Pettyfer, CFA
	Turkcell	TKCZF	TCELL TI	Stephen Pettyfer, CFA
	VimpelCom	VIP	VIP US	Stephen Pettyfer, CFA
	Wataniya	XNNMF	NMTC KK	Stephen Pettyfer, CFA
NEUTRAL				
	Cellcom	CEL	CEL US	Tom Chadwick
	Cellcom	XLECF	CEL IT	Tom Chadwick
	ECMS Mobinil	EGYMF	EMOB EY	Stephen Pettyfer, CFA
	MTN Group	MTNOF	MTN SJ	Stephen Pettyfer, CFA
	Qatar Telecom	XTQQF	QTEL QD	Stephen Pettyfer, CFA
UNDERPERFORM				
	Magyar Telekom	MTA	MTA US	Tom Chadwick
	Magyar Telekom	XTMMF	MTEL HB	Tom Chadwick
	Maroc Telecom	MAOTF	IAM FP	Stephen Pettyfer, CFA
	MTC Zain	XOMBF	ZAIN KK	Stephen Pettyfer, CFA
	Orascom Telecom	ORSTF	OTLD LI	Stephen Pettyfer, CFA
	Orascom Telecom	XORSF	ORTE EY	Stephen Pettyfer, CFA
	Telkom SA	TKMJF	TKG SJ	Stephen Pettyfer, CFA
REVIEW				
	BEZEQ	BZQIF	BEZQ IT	Stephen Pettyfer, CFA

iQmethod SM Measures Definitions

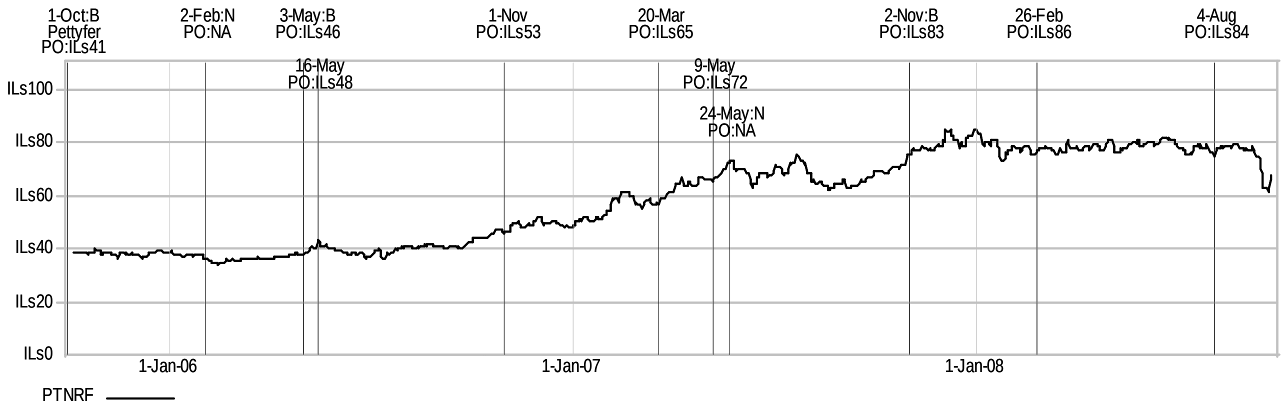
Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod SM is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

Important Disclosures

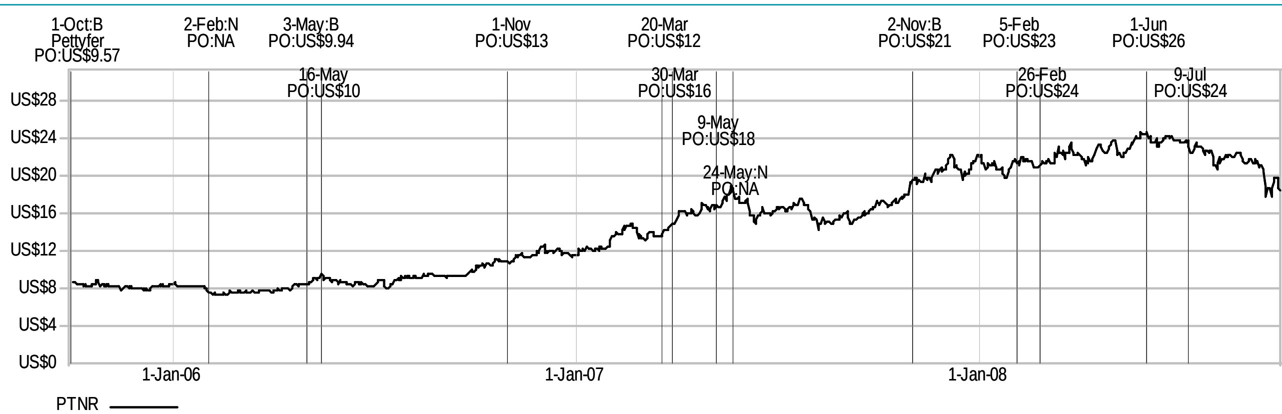
PTNRF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of September 30, 2008 or such later date as indicated.

PTNR Price Chart



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Investment Rating Distribution: Telecommunications Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	86	47.25%	Buy	17	24.64%
Neutral	51	28.02%	Neutral	14	35.00%
Sell	45	24.73%	Sell	6	15.38%

Investment Rating Distribution: Global Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1647	45.31%	Buy	429	28.83%
Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. *VOLATILITY RISK RATINGS*, indicators of potential price fluctuation, are: A - Low, B - Medium and C - High. *INVESTMENT RATINGS* reflect the analyst's assessment of a stock's: (i) absolute total return potential and (ii) attractiveness for investment relative to other stocks within its *Coverage Cluster* (defined below). There are three investment ratings: 1 - Buy stocks are expected to have a total return of at least 10% and are the most attractive stocks in the coverage cluster; 2 - Neutral stocks are expected to remain flat or increase in value and are less attractive than Buy rated stocks and 3 - Underperform stocks are the least attractive stocks in a coverage cluster. Analysts assign investment ratings considering, among other things, the 0-12 month total return expectation for a stock and the firm's guidelines for ratings dispersions (shown in the table below). The current price objective for a stock should be referenced to better understand the total return expectation at any given time. The price objective reflects the analyst's view of the potential price appreciation (depreciation).

Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure), 8 - same/lower (dividend not considered to be secure) and 9 - pays no cash dividend. *Coverage Cluster* is comprised of stocks covered by a single analyst or two or more analysts sharing a common industry, sector, region or other classification(s). A stock's coverage cluster is included in the most recent Merrill Lynch Comment referencing the stock.

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