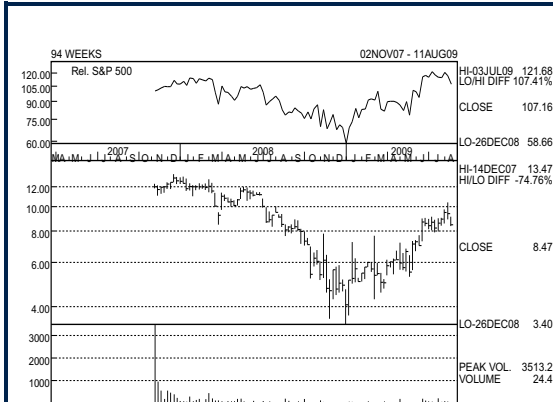




COMPANY UPDATE | COMMENT

AUGUST 12, 2009

012 Smile.Communications Ltd. (NASDAQ: SMLC)
Ongoing Execution Yet Outlook Tangled In M&A Dance



Sector Perform
Above Average Risk

Price:	8.47	Price Target:	10.00
Shares O/S (MM):	25.3	Implied All-In Return:	18%
Dividend:	0.00	Market Cap (MM):	214
Institutional Ownership:	11%	Yield:	0.0%
		Enterprise Val. (\$MM):	221.0
		Avg. Daily Volume (MM):	0.06
		3-Yr. Est. EPS Growth:	15.00%

RBC Capital Markets Corp.

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FY Dec	2007A	2008A	2009E	2010E
Adj EPS - FD	2.10	3.52	4.08	4.68
Prev.			4.01	
P/AEPS	15.6x	9.3x	8.0x	7.0x
Revenue (MM)	1,102.8	1,107.0	1,169.1	1,229.8
Prev.			1,165.9	
Adj EPS - FD	Q1	Q2	Q3	Q4
2007	0.86A	0.49A	0.67A	0.33A
2008	0.93A	0.77A	0.89A	0.93A
2009	0.93A	1.02A	1.07E	1.05E
Prev.		0.95E		
Revenue (MM)				
2007	276.0A	277.2A	280.3A	271.3A
2008	263.3A	263.6A	281.8A	298.2A
2009	284.4A	290.9A	297.1E	296.7E
Prev.		287.7E		

All market data in USD; all financial data in ILS; dividends paid in USD.

Investment Opinion

SMLC is executing well and as we expected delivered 2Q09 a tad ahead as macro headwinds are abating. However, we believe SMLC prospects hinge on Eurocom's expansion quest, as peer Scailex outbid it for a 51% stake in Partner at \$17.5/share. As we outlined yesterday, M&A premium to SMLC will likely fade; instead, Eurocom may engage more aggressively in acquiring niche mobile player Mirs, which may entail leveraging-up to finance the deal and the story will likely revolve around delivering operational synergies. We reiterate Sector Perform and see better plays: 1) M&A premium fades and burden of proof for SMLC strategic direction increases; 2) lack of fundamental catalyst other than potential dividends into 2010 if M&A efforts are exhausted; and 3) SMLC trades broadly in line with peers and we don't think industry multiples are heading higher.

2Q09 a tad ahead, as previewed; tweaking estimates higher

Revenues of NIS291m (+2% Q/Q; +10% Y/Y) bested our NIS288m as ISP (52% mix) was in line while ILD (48% mix) was ahead following a rebound from a slow 2009 start. Record EBITDA of NIS71m (24.3% margin) benefited from revenue growth, one-timers and higher D&A. "Clean" EBITDA was in line at ~NIS65m. EPS of NIS1.02, was above our NIS0.95 and strong NIS59m OCF, brought net debt to NIS177m from NIS253m.

We maintain our 2H09 revenue and EPS estimates essentially unchanged, nudging EBITDA to reflect higher D&A. For 3Q09 we model NIS297m/NIS70m/NIS1.07. We project 2009 at NIS1.17B/272m/4.08 and introduce a preliminary 2010 quarterly breakdown, maintaining revenue at NIS1.23B and EPS of NIS4.68, nudging EBITDA to NIS296m (was: NIS292m).

Reshuffling the landscape

We're somewhat puzzled that Eurocom didn't outbid Scailex for PTNR as we believe it could have gained more from possible synergies of merging subsidiary SMLC under Partner's umbrella. Eurocom is likely to continue its quest for mobile foothold with several possible scenarios: (1) Race for Mirs likely heats up, yet while MoC may favor Eurocom/SMLC or HOT; deal entails financial and operational risks. (2) SMLC pursues MVNO, a 2010 story where the business case may be challenging; concurrently, Eurocom may seek international opportunities. The prospects for SMLC shares hinge on the acquisition targets and deal structure, as some outcomes may benefit shareholders as Eurocom pulls dividends upstream while others may require SMLC to lever-up and increase execution risk.

Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Conflicts Disclosures, see Page 5.

Details

2Q09 beat

As we previewed, SMLC delivered a modest beat to our revenue, EBITDA and EPS estimates and execution is on track in both ISP and ILD segments. Revenues of NIS291m were up 2% Q/Q and 10% Y/Y and bested our NIS288m estimate.

ISP (Internet Service Provider, 52% mix) revenues of NIS150m (+1% Q/Q;+14% Y/Y) were in line with our estimate. The upside was provided again from ILD (International Long Distance, 48% mix) revenues of NIS141m (+4% Q/Q;+7% Y/Y), which came in above our conservative 1% Q/Q growth estimate of NIS136m. The company reported local telephony lines were 120k, implying VoB additions are on plan to meet the stated 5% market share goal of 150K subscribers by year-end 2009.

OpEx was down sequentially as 012 Smile benefited from a NIS3.8m one-timer and EBITDA of NIS71m (24.3% margin), was better than our conservative estimate of NIS65m (22.5% margin). Netting the one-timer and D&A which was NIS1m higher than expected, "clean" EBITDA was in line at ~NIS65m. EPS was NIS1.02, above our cash EPS estimate of NIS0.95. Operating cash flow was strong at NIS59m and net debt decreased to NIS177m from NIS253m in 1Q09.

Improving backdrop; tweaking estimates higher

Management noted macro headwinds are easing up and end markets are back on the growth path. This was supported by the recovery in ILD and on-track results in ISP. This is concurrent with positive commentary from mobile peer Partner and ILD/ISP peer Netvision. Recall, Israeli MoC noted ILD minutes were up 2%. Elsewhere, we believe competition from Partner will increase into 2010 on the ISP front.

We maintain our 2H09 and revenue and EPS estimates while nudging up our EBITDA estimate to reflect higher D&A. For 3Q09 we maintain revenues of NIS297m and cash EPS of NIS1.07, and nudge EBITDA to NIS70m (23.5% margin) up from NIS69m. For FY09 we now model NIS1.17B/272m/4.08 a tad above our prior NIS 1.17B/264m/4.01. We are introducing our preliminary FY10 quarterly breakdown and maintain revenues/EPS at NIS1.23B/4.68 and nudge EBITDA to NIS 296m from NIS292m.

Reshuffling the landscape

We are somewhat puzzled Eurocom did not outbid Scailex for PTNR as we believe it could have gained more from possible synergies of merging subsidiary SMLC under Partner's umbrella. With Scailex winning the Partner bid, Eurocom and its subsidiaries are left to continue their quest for mobile foothold. As we noted yesterday we now see three possible scenarios for SMLC:

1. The race for niche iDEN player Mirs (5% market share) will likely heat up. While we believe the regulator will favor SMLC or HOT winning the deal; it still entails financial, operational and headline risks to SMLC/ IGLD. On the flip side, we note Mirs M&A can fit well with MVNO plans, especially as the buyer gets a bunch of cellular sites.
2. SMLC may continue working towards MVNO license, though we see this as a 2010 story, and the long-term business case may be challenging.
3. Lastly, the Eurocom group may decide to give up Israeli efforts and seek investments outside Israeli borders.

Binary options of future deal financing

We believe runner-ups for Mirs are Eurocom/SMLC, Hot, Pelephone and Cellcom while PTNR is less likely to get aggressive given ownership changes. Our sense is that Motorola, which is Mirs' 100% owner, may find it difficult to obtain the \$300-400m price tag quoted in the press it was looking for, and we believe a more realistic valuation would bracket this at \$220-300m or 4x-5.5x EBITDA.

Either way, any potential deal would require a seal of approval from the anti-trust commission and more importantly the Ministry of Communications. Having Mirs under the arm of an incumbent cellular provider may get in the way of MoC's aim to "invigorate" competition. That said, we believe mobile competition will heat up if Mirs is acquired by a non-cellular player like Eurocom or Hot, as they will seek to increase market share, which would raise the competitive flames and may pressure margins.

We believe the prospects for SMLC shares hinge on the acquisition targets and deal structure, as some outcomes may benefit SMLC shareholders as Eurocom pulls dividends upstream and others may require SMLC to lever-up and increase execution risk. In addition, we note Mirs may weigh on SMLC's margins as Mirs EBITDA margins are just over half of other mobile peers at ~21% due to its legacy Push-to-Talk customer base, including the Israeli Defense Forces and may be required to upgrade the network, which may entail CapEx injections.

Valuation

SMLC trades at a 4.8x and 4.6x our EV/EBITDA on FY09E and FY10E, respectively. This is below peers at ~5.7 and ~5.5x. 012 Smile also trades at discount P/E of 8x P/E our FY09 cash EPS estimate, below telecom peers which garner P/E of ~10x.

Our \$10 target is based on ~5x EV/EBITDA and 11x P/E on our FY09 estimates, broadly in line with domestic and international telecom peers.

Price Target Impediment

While we believe SMLC's risk profile is lower than most of the names in our universe we assign an Above Average Risk qualifier compared to other equities due to the following:

- Execution on strategy as company enters VoB and WiMax.
- Merger synergies of 012 and Smile may not be realized to full extent.
- Potential changes in competitive landscape: Fiercer competition from NetVision, Bezeq and Hot with the latter two capable of service bundling or from Partner's entry into ISP/VoB in early 2009.
- Changes in regulatory environment - VoB, Bezeq restrictions, WiMax.
- 012 Smile is dependent on the infrastructure of Bezeq and Hot to provide its services.
- Company exposed to Macro economy slowdown, currency changes.

Company Description

012 Smile Communication is a leading innovative service provider in Israel, offering International Long Distance (roughly half of mix) and Broadband Access and related Voice over Broadband services (roughly half of revenue). The company commands roughly 1/3 market share in its key business lines. 012 Smile is 72% owned by Internet Gold and related to the Eurocom Communications Group and its shares trade on the NASDAQ and the Tel Aviv Stock Exchange.

012 Smile Communications (NASDAQ: SMLC)

Income Statement

(000 of NIS -- New Israeli Shekel except per share, FY Dec)

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	2006A	2007A	1Q08A Mar	2Q08A Jun	3Q08A Sep	4Q08A Dec	2008A	1Q09A Mar	2Q09A Jun	3Q09E Sep	4Q09E Dec	2009E	1Q10E Mar	2Q10E Jun	3Q10E Sep	4Q10E Dec	2010E
Internet Services Revenue	428,023	486,765	129,700	131,507	140,300	148,000	549,507	148,700	150,000	154,900	161,000	615,000	160,900	163,500	166,900	166,600	657,900
Q/Q			-1%	1%	7%	5%		0%	1%	3%	4%		0%	2%	2%	0%	
Y/Y	17%	14%	14%	10%	15%	13%	13%	15%	14%	10%	9%	12%	8%	9%	8%	3%	7%
% mix	41%	44%	49%	50%	50%	50%	50%	52%	52%	52%	54%	53%	54%	54%	53%	54%	53%
International Long Distance Voice	610,427	615,968	133,657	132,100	141,503	150,000	557,260	135,700	140,905	142,200	135,700	554,505	138,300	140,800	149,400	143,400	571,900
Q/Q			-5%	-1%	7%	6%		-10%	4%	1%	-5%		2%	2%	6%	-4%	
Y/Y	21%	1%	-16%	-16%	-10%	7%	-10%	2%	7%	0%	-10%	0%	2%	0%	5%	6%	3%
% mix	59%	56%	51%	50%	50%	50%	50%	48%	48%	48%	46%	47%	46%	46%	47%	46%	47%
Revenue	1,038,450	1,102,888	263,357	263,607	281,803	298,226	1,106,993	284,400	290,905	297,100	296,700	1,169,105	299,200	304,300	316,300	310,000	1,229,800
Q/Q			-3%	0%	7%	6%		-5%	2%	2%	0%		1%	2%	4%	-2%	
Y/Y	20%	6%	-5%	-5%	1%	10%	0%	8%	10%	5%	-1%	6%	5%	5%	6%	4%	5%
Cost of revenue	753,672	760,705	176,690	177,367	193,156	206,203	753,416	198,973	201,821	203,200	203,500	807,494	204,400	206,900	213,800	211,200	836,300
% of Revenue	72.6%	69.0%	67.1%	67.3%	68.5%	69.1%	68.1%	70.0%	69.4%	68.4%	68.6%	69.1%	68.3%	68.0%	67.6%	68.1%	68.0%
Gross profit	284,778	342,183	86,667	86,240	88,647	92,023	353,577	85,427	89,084	93,900	93,200	361,611	94,800	97,400	102,500	98,800	393,500
Gross profit margin	27.4%	31.0%	32.9%	32.7%	31.5%	30.9%	31.9%	30.0%	30.6%	31.6%	31.4%	30.9%	31.7%	32.0%	32.4%	31.9%	32.0%
Selling and market expenses	165,145	157,304	38,516	36,048	40,742	43,129	158,435	37,793	35,304	39,400	39,200	151,697	38,100	39,100	41,000	39,500	157,700
% of Revenue	16%	14%	15%	14%	14%	14%	14%	13%	12%	13%	13%	13%	13%	13%	13%	13%	13%
General and administrative expenses	48,936	57,984	12,802	15,479	14,118	13,514	55,913	12,621	12,739	13,100	13,100	51,560	12,900	13,200	13,400	13,500	53,000
% of Revenue	5%	5%	5%	6%	5%	5%	5%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Impairment, merger and other charges	18,833	10,433	4,802	1,903	0	0	6,705	0	0	0	0	0	0	0	0	0	0
Total operating expenses	232,914	225,721	56,120	53,430	54,860	56,643	221,053	50,414	48,043	52,500	52,300	203,257	51,000	52,300	54,400	53,000	210,700
Y/Y	#DIV/0!	-3%	11%	0%	-5%	-11%	-2%	-10%	-10%	-4%	-8%	-8%	1%	9%	4%	1%	4%
Operating Income	51,864	116,462	30,547	32,810	33,787	35,380	132,524	35,013	41,041	41,400	40,900	158,354	43,800	45,100	48,100	45,800	182,800
% of revenue	5.0%	10.6%	11.6%	12.4%	12.0%	11.9%	12.0%	12.3%	14.1%	13.9%	13.8%	13.5%	14.6%	14.8%	15.2%	14.8%	14.9%
Y/Y	8%	125%	1%	9%	9%	30%	14%	15%	25%	23%	16%	19%	25%	10%	16%	12%	15%
Depreciation & Amortization	120,970	110,243	26,543	29,816	28,789	30,238	110,054	27,337	28,405	28,400	28,400	112,542	28,400	28,400	28,400	28,400	113,600
EBITDA	191,667	237,138	61,892	62,626	62,576	65,618	252,712	62,350	70,685	69,800	69,300	272,135	72,200	73,500	76,500	74,200	296,400
EBITDA margin	18%	22%	23.5%	23.8%	22.2%	22.0%	23%	21.9%	24.3%	23.5%	23.4%	23%	24.1%	24.2%	24.2%	23.9%	24%
Y/Y	15%	24%	7%	6%	2%	7%	7%	1%	13%	12%	6%	8%	16%	4%	10%	7%	9%
Financial income (expenses), net	-60,514	-52,043	-4,587	-10,758	-7,966	-4,100	-27,411	-3,800	-5,222	-5,200	-5,200	-19,422	-5,200	-5,200	-5,300	-5,300	-21,000
Income before taxes	-8,844	64,486	25,960	22,052	25,821	31,280	105,113	31,213	35,819	36,200	35,700	138,932	38,600	39,900	42,800	40,500	161,800
Tax on income	8,084	23,462	2,278	2,486	3,300	7,800	15,864	7,600	9,853	9,100	8,900	35,453	9,700	10,000	10,700	10,100	40,500
% of pre tax income	-91%	36%	9%	11%	13%	25%	15%	25%	25%	25%	25%	26%	25%	25%	25%	25%	25%
Net Income	-16,928	40,957	23,682	19,566	22,521	23,480	89,249	23,613	25,966	27,100	26,800	103,479	28,900	29,900	32,100	30,400	121,300
% of revenue	-2%	4%	9%	7%	8%	8%	8%	8%	9%	9%	9%	9%	10%	10%	10%	10%	10%
Y/Y	NA	NA	50%	117%	83%	213%	118%	0%	33%	20%	14%	16%	22%	15%	18%	13%	17%
EPS	-0.92	2.10	0.93	0.77	0.89	0.93	3.52	0.93	1.02	1.07	1.05	4.08	1.13	1.16	1.23	1.15	4.68
Q/Q			185%	-17%	15%	4%		1%	10%	4%	-1%		7%	2%	6%	-7%	
Y/Y	NA	NA	9%	57%	33%	182%	67%	0%	33%	20%	14%	16%	21%	13%	15%	9%	15%
Shares Out	18,370	19,493	25,360	25,360	25,360	25,360	25,360	25,356	25,346	25,346	25,446	25,373	25,600	25,850	26,100	26,450	25,900

Proforma numbers.

Source: RBC Capital Markets, Company reports.

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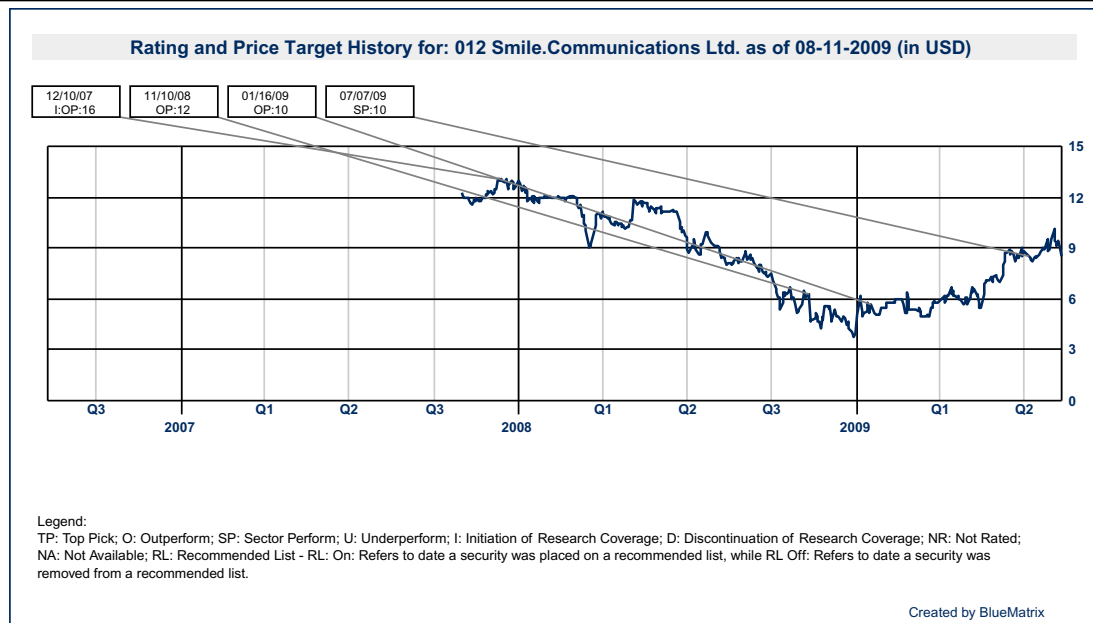
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			Count	Percent
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SELL[U]	79	7.00	5	6.33



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