

Buy for superior yield

Raising opinion to Buy

We are raising our opinion on Cellcom from Neutral to Buy, having reviewed our forecasts following strong Q3 results. Our DCF-driven 12-month price objective is US\$ 33, providing a total return of 21%.

Upgrading despite recent rally

Despite the share price rallying by 17% in the past month, we see two reasons to recommend purchase. First, we find a prospective 7.6% dividend yield compelling and, second, we see scope for additional cash returns with current net debt only 1.3x EBITDA and well below management comfort levels of 2.5x.

Raising DPS forecasts

Following strong Q3 results, we are raising 07E EBITDA and EPS by 2% and 20% respectively, the latter rise principally driven by a tax provision reversal. While non-cash, this has a material +ve impact on our DPS forecast, which we are also raising by 20%.

Data growth provides ARPU optimism

We see two potential catalysts for further possible upgrades. We believe Israel should see similar data-driven ARPU support as witnessed in the US. Furthermore, we are optimistic that Cellcom can be a net beneficiary of MNP.

An attractive dividend in difficult times

We find Cellcom's combination of strong dividend yield with resilient robust top line growth compelling. At US\$ 29, Cellcom trades on a P/E (09E) of 11.2x and FCF yield (09E) of 10.3% with prospective dividend yield (07E) of 7.6%. This compares favourably to local bond yields at 5.7%.

Estimates (Dec)

(ILS)	2005A		2006A		2007E		2008E		2009E	
	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP
EPS (Reported Diluted)	4.95	5.30	9.11	9.21	9.21	10.2				
EPS Change (YoY)	-21.7%	7.0%	71.9%	1.1%	10.4%					
Dividend / Share	34.9	4.41	8.65	8.75	9.66					

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	26.3x	24.4x	12.6x	12.4x	11.2x
Dividend Yield	30.5%	3.9%	7.6%	7.7%	8.4%
EV / EBITDA*	8.7x	7.7x	6.6x	6.5x	6.2x
Free Cash Flow Yield*	6.2%	8.5%	8.3%	9.0%	10.3%

* For full definitions of *iQmethod*SM measures, see page 7.



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Stock Data

Price	US\$28.75
Price Objective	US\$33.00
Date Established	19-Nov-2007
Investment Opinion	C-2-7 to C-1-7
Volatility Risk	HIGH
52-Week Range	US\$17.50-US\$29.54
Mrkt Val / Shares Out (mn)	US\$2,803 / 97.5
Average Daily Volume	176,806
ML Symbol / Exchange	CEL / NYS
Bloomberg / Reuters	CEL US / CEL.N
ROE (2007E)	107.5%
Net Dbt to Eqty (Dec-2006A)	526.1%
Est. 5-Yr EPS / DPS Growth	4.0% / 4.0%
Free Float	23.0%



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Refer to important disclosures on page 8 to 9. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.

iQprofileSM Cellcom Israel

Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(ILS Millions)	Other GAAP	Other GAAP	Other GAAP	Other GAAP	Other GAAP
Sales	5,114	5,622	6,002	6,293	6,537
EBITDA Adjusted	1,643	1,864	2,154	2,215	2,319
Depreciation & Amortization	(941)	(883)	(770)	(785)	(801)
EBIT Adjusted	702	981	1,384	1,429	1,518
Net Interest & Other Income	13.0	(160)	(185)	(199)	(159)
Tax Expense / Benefit	(232)	(304)	(310)	(332)	(367)
Net Income (Adjusted)	483	517	888	898	992
Average Fully Diluted Shares Outstanding	97.5	97.5	97.5	97.5	97.5

Key Cash Flow Statement Data

Net Income (Reported)	483	517	888	898	992
Depreciation & Amortization	941	883	770	785	801
Change in Working Capital	0	(135)	(121)	(26.0)	(28.1)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(152)	212	0	0	0
Cash Flow from Operations	1,272	1,477	1,537	1,657	1,765
Capital Expenditure	(576)	(526)	(611)	(656)	(621)
(Acquisition) / Disposal of Investments	(43.0)	(107)	31.0	31.0	31.0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(619)	(633)	(580)	(625)	(590)
Share Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	0	(3,830)	(430)	(844)	(853)
Cash Flow from Financing	1,114	(2,560)	(613)	(582)	(1,125)
Non Cash Changes to Debt	NA	NA	NA	NA	NA
Change in Net Debt	(653)	2,986	(527)	(189)	(321)
Net Debt	331	3,141	2,614	2,425	2,104

Key Balance Sheet Data

Property, Plant & Equipment	2,739	2,550	2,391	2,262	2,082
Goodwill	NA	NA	NA	NA	NA
Other Intangibles	493	695	664	633	602
Other Non-Current Assets	433	526	526	526	526
Trade Receivables	1,237	1,242	1,315	1,379	1,433
Cash & Equivalents	1,772	56.0	400	850	900
Other Current Assets	342	254	249	252	252
Total Assets	7,016	5,323	5,546	5,902	5,795
Long-Term Debt	1,783	3,197	2,190	2,971	2,679
Other Non-Current Liabilities	142	214	214	214	214
Short-Term Debt	320	0	824	304	324
Other Current Liabilities	1,122	1,315	1,262	1,303	1,329
Total Liabilities	3,367	4,726	4,490	4,792	4,546
Total Equity	3,649	597	1,055	1,110	1,249
Total Equity & Liabilities	7,016	5,323	5,546	5,902	5,795

Key Metrics

iQmethodSM - Bus Performance*

Return On Capital Employed	10.3%	13.0%	24.7%	23.8%	24.9%
Return On Equity	14.2%	24.4%	108%	83.0%	84.1%
Operating Margin	13.7%	17.4%	23.1%	22.7%	23.2%
Free Cash Flow (MM)	696	951	926	1,001	1,144

iQmethodSM - Quality of Earnings*

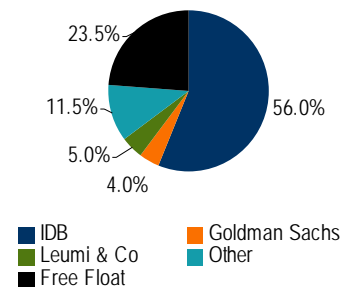
Cash Realization Ratio	2.63x	2.86x	1.73x	1.85x	1.78x
Asset Replacement Ratio	0.61x	0.60x	0.79x	0.84x	0.78x
Tax Rate	32.4%	37.0%	25.9%	27.0%	27.0%
Net Debt/Equity	9.07%	526%	248%	218%	168%
Interest Cover	14.9x	5.08x	NA	6.56x	8.18x

* For full definitions of iQmethodSM measures, see page 7.

Company Description

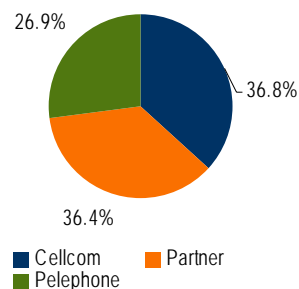
Cellcom is Israel's leading wireless operator with 3.0mn GSM and TDMA customers and a 34% market share. Cellcom operates under the Cellcom brand and launched 3G services in 2006. Principal shareholder is the IDB Group which owns 59%. Cellcom was listed on the NYSE in February 2007.

Chart 1: Shareholder Structure



Source: Company Data

Chart 2: Israeli Revenue Share (June-07)*



Source: Merrill Lynch estimates

* revenue share of three principal operators

Stock Data

Price to Book Value

10.5x

Yield protection

- **We are upgrading our opinion on Cellcom, Israel's leading wireless operator, to Buy. Having re-worked our model following the November 8th Q3 results, we are raising forecasts and, despite the share price rally over the past two weeks, still see significant further upside potential.**

Investment thesis

We see three reasons to buy Cellcom today.

1. **Valuation.** For quite some time, Israeli wireless stocks have not fit the usual growth profile more common to the emerging market wireless sector. High wireless penetration – 124% if you believe official customer and population figures – combined with relatively high average monthly usage of 342 minutes has led to muted growth projections. Accordingly, and in our view, this has led to a group of telecom stocks being driven by yield considerations, a lot like traditional fixed line stories.

We forecast Cellcom to pay a dividend yield of 7.6% based on 2007 earnings, supported by a FCF yield (08E) of 9.0%. We believe this attractive.

2. **Data growth.** We estimate that data is 12% of market service revenue when aggregated across all operators. This compares to 14% in the US and 18 % in Europe. In contrast, Cellcom lags both Partner (13%) and Pelephone (15%) with only 9% of service revenue from data.

We project Cellcom's data ARPU to rise by 15% in 2008 to ILS 15.3 compared to ILS 21.6 recorded by Partner *last quarter*. If Cellcom could close that differential next year, this would raise our EBITDA forecast by 4%.

3. **MNP potential.** We believe Cellcom should be a net beneficiary of number portability. Israel is to introduce number portability (both mobile and fixed) on December 1st with some of the most aggressive requirements we have seen anywhere. For example, mobile operators have to port a number within three hours after the customer contacts the new operator.

Q3 results point to which operators have momentum going into this process – service revenue growth accelerated at Cellcom and Partner but slowed at Pelephone.

Preference for Partner

Investors have a choice of two wireless stocks in Israel: Cellcom and Partner, both of which we now rate as a Buy. Of the two, we would prefer Partner. Valuations are very close with both trading at near identical 08 dividend yields although Cellcom does trade at a marginally cheaper FCF yield (08E) of 9.0% vs 8.8% at Partner.

Our rationale for the preference for Partner is brand and strategy. We believe Partner's Orange brand and focus on the post paid SME market will lead to superior performance post MNP implementation and better enable the operator to drive data ARPU growth. We do note, however, having greater confidence in Cellcom's ability to return excess cash to shareholders in the near term.

Forecast changes

Having reviewed our model following Q2 results, we have fine tuned forecasts, the most notable revision being a 20% rise to our 07 EPS and DPS forecast, driven by the change in a tax ruling thus allowing a provision reversal.

We summarise the changes to our forecasts in the table below.

Table 1: Forecast changes

	2007 New	2007 Old	Chg	2008 New	2008 Old	Chg
Subscribers	3.07	3.03	1.1%	3.18	3.13	1.9%
ARPU (ILS)	150	149	1.0%	151	152	-0.6%
Revenues	6,002	5,882	2.0%	6,293	6,204	1.4%
EBITDA	2,154	2,117	1.7%	2,215	2,180	1.6%
EBITDA margin	35.9%	36.0%		35.2%	35.1%	
Op Profit	1,384	1,326	4.3%	1,429	1,478	-3.3%
PBT	1,199	1,129	6.1%	1,230	1,311	-6.2%
Net Income	888	740	20.1%	898	912	-1.5%
EPS	9.11	7.59	20.1%	9.21	9.36	-1.5%
Capex	580	580	0.0%	625	560	11.6%
DPS	8.65	7.21	20.1%	8.75	8.89	-1.5%
Capex / Sales	9.7%	9.9%		9.9%	9.0%	

Source: Merrill Lynch estimates

Q3 results summary

Q3 results were highlighted by better than expected revenue growth primarily driven by strong customer growth. Cellcom took a 34% share of Q3 net market additions, adding 57k net new customers after adding 32k in Q2. ARPU was broadly in line with our forecasts at US\$ 37.1 (ILS 156), -2.2% yoy.

EBITDA margin on the other hand slipped to 35.6%, below our 37.2% forecast, driven by higher sales and marketing costs ahead of MNP. Interestingly, and in contrast to Cellcom, rival Partner's marketing costs remained unchanged as a percentage of sales while both operators added broadly similar incremental service revenues.

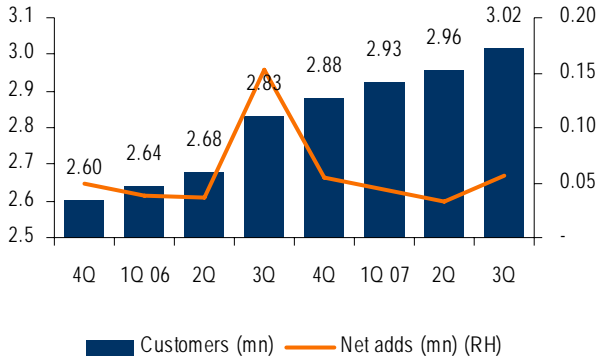
Table 2: 3Q 07 results summary

	Q3 06A	Q2 07A	Q3 07A	QoQ	YoY	Q3 07E	A vs E
Customers (mn)	2.83	2.96	3.02	1.9%	6.6%	2.99	0.8%
Net Adds (mn)	0.15	0.032	0.057	78.1%	-62.5%	0.033	72.0%
ARPU (ILS)	159	148	156	5.1%	-2.2%	154	0.9%
MOU	359	345	354	2.5%	-1.5%	354	0.0%
Quarterly churn	3.8%	3.9%	3.6%	-7.7%	-5.3%	4.0%	-10.0%
Revenue	1,467	1,456	1,572	8.0%	7.2%	1,515	3.8%
EBITDA	503	539	559	3.7%	11.1%	563	-0.7%
EBITDA Margin	34.3%	37.0%	35.6%	-3.9%	3.7%	37.2%	-4.3%
EBIT	281	345	366	6.1%	30.2%	363	0.9%
PBT	230	325	289	-11.1%	25.7%	307	-5.8%
Net Income	120	212	270	27.4%	125.0%	218	24.0%
Net Margin	8.2%	14.6%	17.2%	18.0%	110.0%	14.4%	19.5%
EPS	1.23	2.17	2.77	27.4%	125.0%	2.23	24.0%

Source: Cellcom, Merrill Lynch estimates.

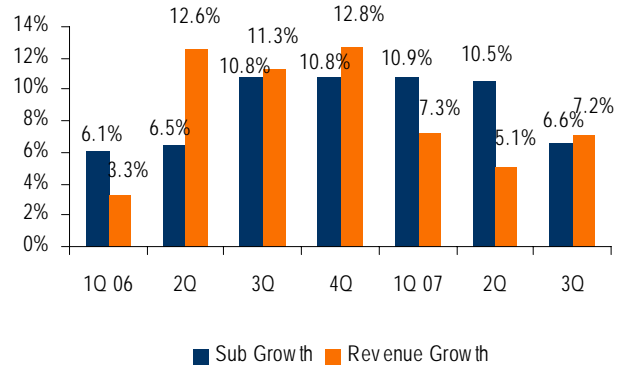
Q3 results in pictures

Chart 3: Steady sub growth



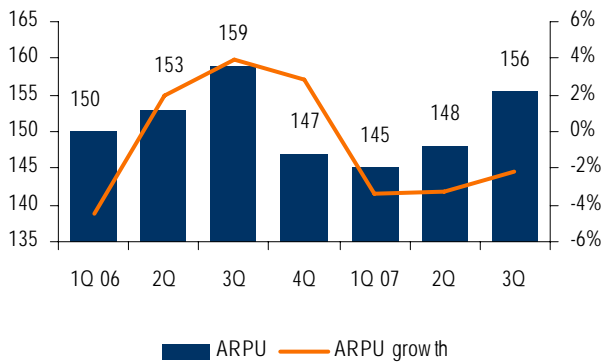
Source: Cellcom, Merrill Lynch estimates.

Chart 4: Sub and rev growth (yoy)



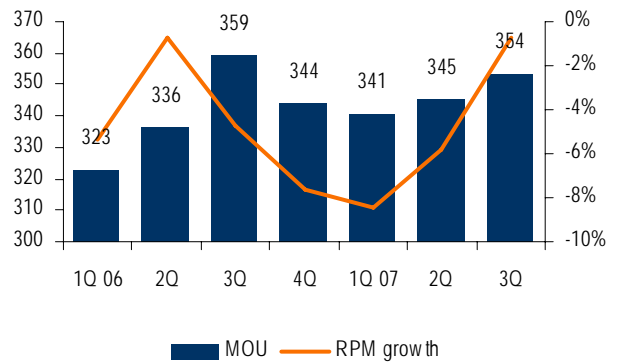
Source: Cellcom, Merrill Lynch estimates.

Chart 5: Recovering ARPU



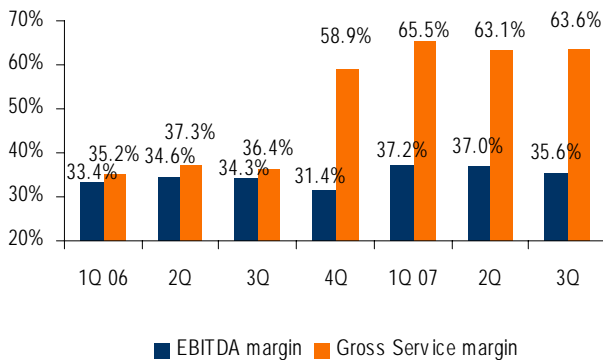
Source: Cellcom, Merrill Lynch estimates.

Chart 6: Strong usage



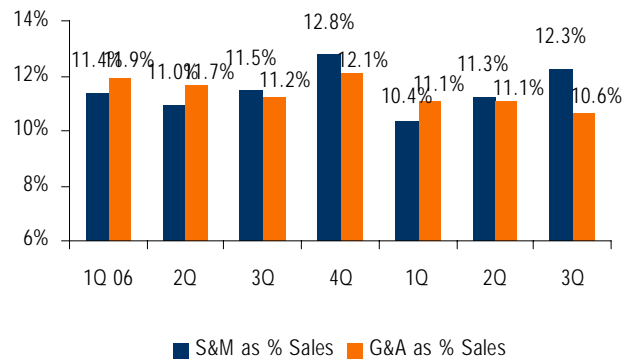
Source: Cellcom, Merrill Lynch estimates.

Chart 7: Stable EBITDA margin



Source: Cellcom, Merrill Lynch estimates.

Chart 8: SG&A under control



Source: Cellcom, Merrill Lynch estimates.

Price objective basis & risk

Cellcom (CEL)

Our 12-month price objective of US\$ 33 is driven by a DCF model with key assumptions being an 8.8% discount rate, a 34.6% terminal EBITDA margin, 10% capex/sales and a 0% perpetuity growth rate. At US\$ 33, the stock would trade on a prospective 6.3% dividend yield supported by FCF yield (08E) of 8.2%.

Risks to our opinion and price objective are a sharp increase in industry competition surrounding the December launch of mobile number portability and any further aggressive moves by the regulator to cut sector pricing.

Partner (PTNRF; ILS77.50; B-1-7)

Our DCF-driven 12-month price objective is ILS 83 (ADR: USD21). Key assumptions to our DCF model are an 8.8% discount rate, underpinned by an 11% cost of equity, a 34% terminal EBITDA margin, 10% LT capex/sales and 0% perpetuity growth.

Risks to our price objective are a sharp escalation in competitive pressure surrounding the implementation of mobile number portability in December, leading to greater than usual Q4 ARPU weakness and margin pressure. We believe, however, that the market's three major operators are all quite rational about the limited benefits of such aggressive action.

Analyst Certification

I, Stephen Pettyfer, CFA, 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.

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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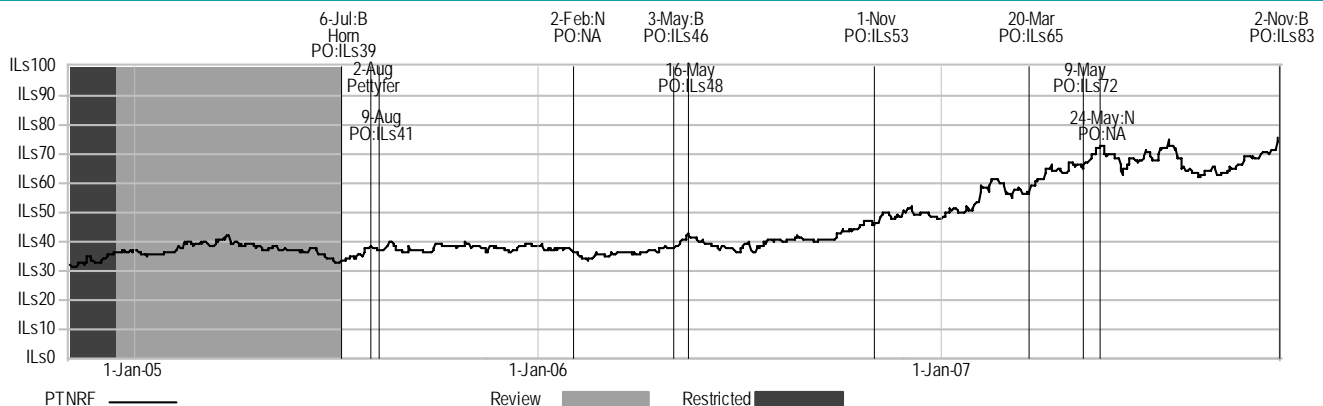
CEL Price Chart



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

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of October 31, 2007 or such later date as indicated.

PTNRF Price Chart



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

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Investment Rating Distribution: Telecommunications Group (as of 01 Oct 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	86	46.49%	Buy	19	26.76%
Neutral	81	43.78%	Neutral	18	26.09%
Sell	18	9.73%	Sell	4	30.77%

Investment Rating Distribution: Global Group (as of 01 Oct 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1701	47.03%	Buy	437	29.15%
Neutral	1611	44.54%	Neutral	425	29.11%
Sell	305	8.43%	Sell	58	21.09%

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