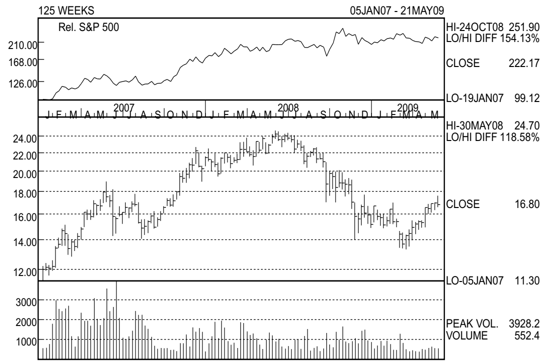
COMPANY UPDATE | COMMENT

MAY 22, 2009

Partner Communications (NASDAQ: PTNR; TASE: PTNR)

Blame Macro and Accounting On Light Revenue, Thank IFRS on Earnings



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FY Dec	2008A	2009E	2010E	
Adj EPS - FD	7.06	8.16	8.76	
Prev.	6.73	6.84	7.76	
P/AEPS	2.4x	2.1x	1.9x	
Revenue (MM)	6,302.2	5,953.0	6,182.4	
Prev.	6,329.5	6,223.9	6,571.5	
Adj EPS - FD	**Q1**	**Q2**	**Q3**	**Q4**
2008	1.87A	NA	NA	NA
Prev.	1.54A	1.57A	1.91A	1.72A
2009	1.92A	2.01E	2.20E	2.03E
Prev.	1.58E	1.66E	1.82E	1.78E
Revenue (MM)				
2008	1,581.4A	NA	NA	NA
Prev.	1,588.0A	1,544.1A	1,636.0A	1,561.6A
2009	1,412.4A	1,469.2E	1,562.7E	1,508.7E
Prev.	1,496.3E	1,545.6E	1,605.5E	1,576.5E

PTNR moved to report under IFRS accounting in January 2009.So far the company has only provided 1Q08, FY08 and 1Q09 IFRS data.

All market data in USD; all financial data in NIS.

Outperform
Average Risk

Price:	16.80	**Price Target:**	22.00
		Implied All-In Return:	41%
Shares O/S (MM):	154.2	**Market Cap (MM):**	2,591
Dividend:	1.63	**Yield:**	9.7%
Float (MM):	77.5	**Enterprise Val. ($MM):**	3,200.0
Debt to Cap:	60%	**Avg. Daily Volume (MM):**	0.19
Institutional Ownership:	49%	**3-Yr. Est. EPS Growth:**	8.00%

Investment Opinion

The move to IFRS resulted in a noisy 1Q09, with core mobile revenues down more than expected due to macro and handset amortization yet earnings, margins and dividend were better than we expected, aided by the accounting changes. Partner's margins are now ahead of peers and its dividend yield is on par. Consistent with our checks, management stated business tone is stabilizing and this should be boosted by typical favourable summer seasonality in coming quarters. We maintain Outperform given (1) solid positioning and recurring revenue base, (2) attractive dividend yield of 9.5% and (3) undemanding valuation of 5.6x FTM EV/EBITDA, below peers' 5.8x.

Light top line; Good profitability

Partner reported IFRS revenues of NIS1.41B, down 10.7%Y/Y, well below our expected 6% GAAP-based decline. Service revenues were -2.9%Y/Y, below our -1% estimate, which we'd mostly attribute to macro headwinds driving roaming revenue (~9% mix) down >20% Y/Y. Moreover, revenue was impacted by interconnect cuts and move to pay-per-second billing, somewhat offset by rate hikes. Equipment sales were more than halved Y/Y as IFRS move required capitalization of handset subsidies, and to lesser extent slower upgrades.

We were encouraged by flat Y/Y MoU, which is indicative of healthy underlying trends. As previewed, macro slowed net adds to just 5k Q/Q, yet we'd focus on profitability rather than growth given high domestic mobile penetration rates. We were encouraged by healthy earnings and profitability despite macro headwinds as we believe Partner broadly maintained Y/Y operating profitability in its core mobile business. EBITDA was up 2.6%Y/Y to NIS552m (39.1% margin), though netting IFRS impact, ISP costs and one-timers EBITDA was down 4.2%Y/Y. Improved IFRS profitability drove EPS to NIS1.92, and Partner declared NIS1.54 dividend and reiterated 80% payout policy.

Introducing preliminary IFRS estimates

We're introducing our preliminary estimates, though the limited set of historic numbers may tilt our aims, and we may fine-tune model following Partner's investor event this Sunday. We now model FY09 revenues of NIS5.9B (-6%Y/Y) and expect boosted profitability with NIS2.31B EBITDA and NIS8.16 EPS. For 2Q09 we project NIS1.47/571m/2.01 in EPS. Our prior estimates were based on GAAP accounting.

Our preliminary FY10 IFRS estimates are now NIS 6.18B/2.31B/8.76. ISP business also has long-term potential in our view, though timing remains elusive.

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

For Required Conflicts Disclosures, please see Page 6.

Details

Looking Under the IFRS hood: 1Q09 in review

Light top line; mainly on changes in equipment accounting

Partner reported IFRS revenues of NIS 1.41B, down 10.7% Y/Y, well below our expected 6% decline, which was based on GAAP figures. The decline was spread across service and equipment revenue.

- Service revenues were down 2.9% Y/Y to NIS 1.30B, below our -1% estimate, on negative impacts from macro, implementation of pay-per-second billing in early 2009 and Y/Y negative trends from lower interconnect tariffs, fewer working days in the quarter due to holiday seasonality and typical competition and RPM erosion. The regulatory headwinds were well known and mostly offset by better data revenue mix and larger subscriber base as well as tariff raises. We estimate that the >20-25% decline in roaming traffic, which accounts for ~9% of Partner's mix, accounted for ~2% of the decline in revenue.
- The drop in Equipment sales was fiercer, dropping more than half Y/Y to NIS 115m (-53.3% Y/Y), reflecting NIS 45m of IFRS-driven capitalization of handset subsidies as well as persisting slower upgrade trends.

Good profitability

Service gross margins were 42.2%, down from 1Q08's 45.9% on lower top line as well as on a one-time NIS 26m provision set aside for a demand made by Israel's MoC and increased costs due to ISP/VoB operations. Netting the one-time provision gross margins would have been 44.2%. Equipment gross margins were a positive 15.8%, versus 1Q08's negative -14%, with the difference related to IFRS capitalization of subsidies and lower number of transactions.

SG&A expenses were NIS 156m, broadly in line with our expected NIS161m, and Y/Y difference accounted for about NIS 9m in IFRS capitalization of sales distributor commissions offset by ISP costs. Other income reflected a one-time NIS 9m refund by the Israeli MoC.

IFRS EBITDA was up 2.6% Y/Y to NIS 552m (39.1% margin). Nonetheless, when netting handset capitalization, other one-timers and ISP costs, EBITDA would have been NIS516 or down 4.2% Y/Y. Recall we were expecting GAAP EBITDA of NIS 504m. As mentioned in our preview, improved profitability under IFRS drove EPS of NIS1.92 and the company declared a NIS1.54 dividend, consistent with 80% payout policy. The dividend will be payable to shareholders and ADS holders of record on June 24, 2009. The dividend is expected to be paid on July 08, 2009.

The Guide for the Perplexed: Core mobile business maintains margins despite macro turmoil

We believe Partner broadly maintained Y/Y profitability in its core mobile business. We support this view as we try to gauge our way through the orange accounting mist as follows:

- Taking 1Q09 operating income and:
- Netting capitalization of NIS 45m on handset subsidy and NIS 9m of distributor commissions.
- Netting NIS 9m in one time MoC benefit, and adding back NIS 26m in MoC one-time provision.
- Netting NIS 20m of ISP/VoB costs

This yields proforma 1Q09 operating margin of 26.7% (a mere 10bps Y/Y decline), which we believe adequately reflects Partner's core mobile business.

Solid cash generation

Partner generated a healthy NIS 426m from operations and FCF was NIS 227m. Net debt was broadly unchanged sequentially at ~NIS 2B. CapEx was rather high at NIS ~200m and management guided for FY09 CapEx under NIS 600m, which was broadly in line with our NIS 528m estimate.

Operational Metrics

As previewed, macro is hindering subscriber net additions, and the company ended 1Q09 with 2.903m subs, up by a mere 5k Q/Q. During the conference call management noted it saw improving net adds trends in March-April (compared with January-February) coming from its recently opened new distribution points. Either way, we believe investors should be focusing on profitability and revenues rather than on net adds given the Israeli market's high penetration rates.ARPU was NIS 145, down 6% Y/Y from 1Q08's NIS 154. Churn was 4.8%, down from 1Q08's 5.1% and up from last quarter's 4.3%.

More importantly, MoU were NIS 358, in line with 359 in 1Q09, and MoU were actually up 4% when netting the impact of one-time promotional sales and impact of shorter work-weeks. Total minutes of use increased 9% Y/Y due to subscriber base growth.

Data continues to be a growth driver, with data revenues reaching NIS131m or 10.1% of service revenues. We note that data revenues were restated due to IFRS, resulting in lower absolute number and relate percentage of revenues. For comparison, under US GAAP 2008 data revenues were 14% of service revenues. The company continued to add 3G subs through conversion of existing customer base as well as some net addition contribution and 3G sub count reached 1.02m, or 35% of subscriber base, up 70k Q/Q.

We note that Pelephone numbers reported May 20 (subsidiary of Bezeq, TASE: BEZQ), and this may provide some room for comparison. Pelephone reported healthy 1Q09 with revenue up 8% Y/Y, with much of it coming from content growth. This may indicate that core mobile market remains healthy and tailwind was likely provided by more lucrative HSPA content packs. On the negative side MoU decreased 9% Y/Y which the company attributed to change in billing to pay-per-second. We also attended Bezeq's investor event this week in Tel Aviv, where management noted bad debt provisioning policy has been maintained, which we view as a positive. Another positive datapoint referred to Bezeq's findings according to which usage patterns of laid off Israeli hi-tech employees have remained fairly stable (note Partner has solid presence in the Israeli hi-tech corporate market).

Overall, Partner's management believes business tone has improved since the beginning of 2009 and cited net addition trends improved in the last couple of months. In addition, it seems that deterioration in traffic trends has diminished. This was supported by recent commentary from other industry players such as 012 Smile, where we believe ILD traffic has somewhat picked up in recent couple of month following the downtrend in Jan-Feb 2009, which we believe gives a certain proxy for roaming traffic.

Introducing preliminary and directional IFRS estimates

While lack of historical restated quarterly data makes it difficult to model trends ahead, we are introducing preliminary estimates for the rest of the year and beyond. We highlight our current model tries to draft a general outline of what lies ahead for Partner given move to IFRS on the one hand and the macro impact on top line on the other hand. We will be attending Partner's Investor Event this Sunday, where management intends to further elaborate and dive deeper into IFRS accounting impact. If necessary we will be fine tuning and revising our directional estimates following the event.

For 2Q09 we now project service revenue uptick by 4% to NIS 1.35 billion on better seasonality and expect more of the same from equipment revenues. Our total 2Q09 revenue estimate is now NIS 1.47 billion, up 4% sequentially. With positive equipment margins and boosted IFRS profitability, we now model NIS 571m in EBITDA and NIS 2.01 in EPS. This compares to our previous GAAP based NIS 1.55 billion / 535m / 1.66.

Looking into 2009 we're accounting for slightly lower service revenues due to macro impact and a lower growth base in 1Q09 and are also accounting for lower recognized handset sales. We now project 2% decline Y/Y in service revenues (was: 0%) and expect overall top line to decline 6% Y/Y to NIS 5.95 billion. We're accounting for ISP costs, capitalized handset subsidies and netting one timers and now estimate FY09 EBITDA of NIS 2.31 billion, or 38.9% margin and up 3% Y/Y. Our EPS estimate is now NIS 8.16, driving a 9.5% expected dividend yield. Our previous, GAAP based, FY09 estimates were NIS 6.22 billion / 2.14 billion / 6.84.

Our preliminary FY10 estimates are now NIS 6.18 billion / 2.44 billion (39.4% margin) /8.76. Our prior, GAAP based estimates were NIS 6.57B / 2.35B / 7.76.

Maintain Outperform

While there are a lot of moving parts related to the move to IFRS, which are compounded by macro uncertainty, we remain comfortable with the overall outlook for Partner as a value company. We maintain Outperform given recurring business model, boosted profits, attractive dividend yield of ~9.5% our 2009 estimate and 10.2% for 2010E, undemanding valuation at 5.7x EV/EBITDA for 2009E and 5.4x for 2010E (broadly in line with peers) and healthy balance sheet.

Valuation

PTNR trades at 5.7x and 5.4x EV/EBITDA our FY09 and FY10 estimates, broadly in line with peers. We believe that EV/EBITDA multiples fail to capture the inherently lower CapEx spending in Israel. PTNR is currently trading at 9x and 8x our FY09E and FY10E EPS, broadly in line with peers. The company also trades below our DCF derived valuation.

Our $22 target price is based on a 5-year DCF model that employs a 10% WACC, a beta of 1.0, and 10x terminal-year FCF multiple. We project 1.5% perpetual growth rate, slightly below the expected population growth. We reiterate our Outperform rating given our assessment of Partner's defensive appeal with predictable earnings stream and 80% dividend payout, which provides ~9.5% expected dividend yield. We expect the discount to our target to close with continued execution backed by good market positioning, and what we believe is an ability to tackle regulation and competition.

Price Target Impediment

Partner is a rather defensive player in Telecom, hence we have an Average Risk qualifier. Nonetheless, risks to our price target may come from a heavily regulated telecom market, crowded competitive landscape, management execution, technological changes, operating in a fairly mature market, and the macro economic picture.

Heavily regulated telecom market – Future price erosions may be caused by further decreases in interconnect and roaming fees, the move to a 1-second charging unit as of January 2009, and a future possible reduction in SMS fees.

- **Competition** – Partner's market share may be impacted by Pelephone's UMTS network launch, or by MVNO services. Moreover, Partner's competitive positioning may be negatively affected as its peers Pelephone and Cellcom start bundling services with their related companies.
- **Mature Market and Dependence on Data Revenue Growth** – Partner currently successfully offsets eroding Voice ARPU operating in a highly penetrated market. Nonetheless, revenue growth may be impeded if data ARPU remains flattish.
- **CPI** – Partner's current bonds are linked to the Israeli CPI and the recent rise in inflation may increase financial expenses. Moreover, a higher CPI may harm purchasing power, affecting revenue streams.
- **ForEx fluctuations** – Almost all of Partner's revenues are denominated in New Israeli Shekels and 25% of the expenses are in non-NIS currency, mainly handset procurement costs. A depreciation of the New Israeli Shekel vs. the US dollar may increase procurement costs as well as Capital Expenditures.
- **Legal** – Partner is constantly fending off different litigations and class action suits, and is involved in various legal proceedings. While we currently do not view any of these lawsuits as immediate risks, penalties might be ruled against the company, impeding financial execution.
- **Health** - The Ministry of Health issued cellular usage guidelines that may impact subscriber patterns in the future.

Company Description

Partner Communications is a leading Israeli mobile communications operator providing GSM / GPRS / UMTS / HSDPA services and wire-free applications under the Orange brand. As of 4Q08, the Company has 2.9 million subscribers, commanding ~31% of Israel's mobile market.

Partner Communications (NASDAQ: PTNR)

Income Statement

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

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	2008A	1Q09A Mar	2Q09E Jun	3Q09E Sep	4Q09E Dec	2009E	2010E
Reporting Method	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Service revenue		1,297,800	1,351,000	1,436,000	1,378,000	**5,462,800**	**5,647,000**
Q/Q			*4%*	*6%*	*-4%*		
Y/Y		*-3%*	*-2%*	*-2%*	*-2%*	*-2%*	*3%*
mix %		91.9%	92.0%	91.9%	91.3%	91.8%	91.3%
Equipment revenue		114,580	118,200	126,700	130,700	**490,180**	**535,400**
Q/Q			*3%*	*7%*	*3%*		
Y/Y		*-53%*				*-35%*	*9%*
mix %		8.1%	8.0%	8.1%	8.7%	8.2%	8.7%
Revenue	**6,302,195**	**1,412,380**	**1,469,200**	**1,562,700**	**1,508,700**	**5,952,980**	**6,182,400**
Q/Q		*-10%*	*4%*	*6%*	*-3%*		
Y/Y		*-11%*				*-6%*	*4%*
Cost of Services		749,600	763,000	808,000	781,000	**3,101,600**	**3,140,000**
Q/Q			*2%*	*6%*	*-3%*		
Y/Y		*4%*					*1%*
Cost of Equipment		96,502	101,100	109,000	112,400	**419,002**	**460,400**
Q/Q			*5%*	*8%*	*3%*		
Y/Y		*-66%*				*-50%*	*10%*
Cost of revenues	**3,868,089**	**846,102**	**864,100**	**917,000**	**893,400**	**3,520,602**	**3,600,400**
Gross Profit - Services		548,200	588,000	628,000	597,000	**2,361,200**	**2,507,000**
Margin		*42.2%*	*43.5%*	*43.7%*	*43.3%*	*43.2%*	*44.4%*
Gross Profit - Equipment		18,078	17,100	17,700	18,300	**71,178**	**75,000**
Margin		*15.8%*	*14.5%*	*14.0%*	*14.0%*	*14.5%*	*14.0%*
Gross profit	**2,434,106**	**566,278**	**605,100**	**645,700**	**615,300**	**2,432,378**	**2,582,000**
Gross profit margin	*38.6%*	*40.1%*	*41.2%*	*41.3%*	*40.8%*	*40.9%*	*41.8%*
Selling and market expenses	**387,833**	83,353	86,700	89,100	88,300	**347,453**	**354,900**
% of Revenue	*6.2%*	*5.9%*	*5.9%*	*5.7%*	*5.9%*	*5.8%*	*5.7%*
Y/Y		*-19%*				*-10%*	*2%*
General and administrative expenses	**283,869**	72,948	77,000	77,400	76,900	**304,248**	**309,100**
% of Revenue	*4.5%*	*5.2%*	*5.2%*	*5.0%*	*5.1%*	*5.1%*	*5.0%*
Y/Y		*21%*				*7%*	*2%*
Other Income	64,028	23,959	10,000	10,000	10,000	53,959	40,000
Total operating expenses	607,674	132,342	153,700	156,500	155,200	597,742	624,000
Y/Y						*-2%*	*4%*
Operating Income	**1,826,432**	**433,936**	**451,400**	**489,200**	**460,100**	**1,834,636**	**1,958,000**
% of revenue	*29.0%*	*30.7%*	*30.7%*	*31.3%*	*30.5%*	*30.8%*	*31.7%*
Y/Y		*2%*				*0%*	*7%*
Depreciation & Amortization	653,475	120,058	120,000	120,000	120,000	480,058	480,100
EBITDA	**2,256,622**	**552,481**	**571,400**	**609,200**	**580,100**	**2,313,181**	**2,438,100**
EBITDA margin	*35.8%*	*39.1%*	*38.9%*	*39.0%*	*38.5%*	*38.9%*	*39.4%*
EBITDA/Service revenue margin	*40.5%*	*42.6%*	*42.3%*	*42.4%*	*42.1%*	*42.3%*	*43.2%*
Y/Y		*3%*				*3%*	*5%*
Financial expense (income), net	184,174	25,963	29,700	30,100	32,600	118,363	135,000
Income before taxes	1,642,258	407,973	421,700	459,100	427,500	1,716,273	1,823,000
Tax on income	444,528	111,530	110,900	119,400	112,900	454,730	455,800
% of pre tax income	*27%*	*27%*	*26%*	*26%*	*26%*	*26%*	*25%*
Accounting principles changes							
Net Income	**1,197,730**	**296,443**	**310,800**	**339,700**	**314,600**	**1,261,543**	**1,367,200**
% of revenue	*19%*	*21%*	*21%*	*22%*	*21%*	*21%*	*22%*
Y/Y						*5%*	*8%*
EPS	**7.06**	**1.92**	**2.01**	**2.20**	**2.03**	**8.16**	**8.76**
Q/Q			*5%*	*9%*	*-8%*		
Y/Y		*3%*				*16%*	*7%*
Shares Out	156,520	154,170	154,500	154,700	155,200	154,643	156,000
Y/Y	-0.8%					-1.2%	
EBITDA	**2,256,622**	**552,481**	**571,400**	**609,200**	**580,100**	**2,313,181**	**2,438,100**
CapEx	522,130	199,648	125,000	133,000	128,000	585,648	606,000
Capex as % of revenue	*8.3%*	*14.1%*	*8.5%*	*8.5%*	*8.5%*	*9.8%*	*9.8%*
Less(Plus): Change in working capital	-330,504	-230,756	2,300	3,700	-2,200	-226,956	11,500
% of revenue change			4%	4%	4%		0
Less (Plus) Tax	444,528	111,530	110,900	119,400	112,900	454,730	455,800
Nominal Free Cash Flow	**1,645,732**	**472,059**	**333,200**	**353,100**	**341,400**	**1,499,759**	**1,364,800**

Proforma numbers. Note that Partner switched reporting from US GAAP to IFRS 1Q09.
Source: RBC Capital Markets, Company reports.

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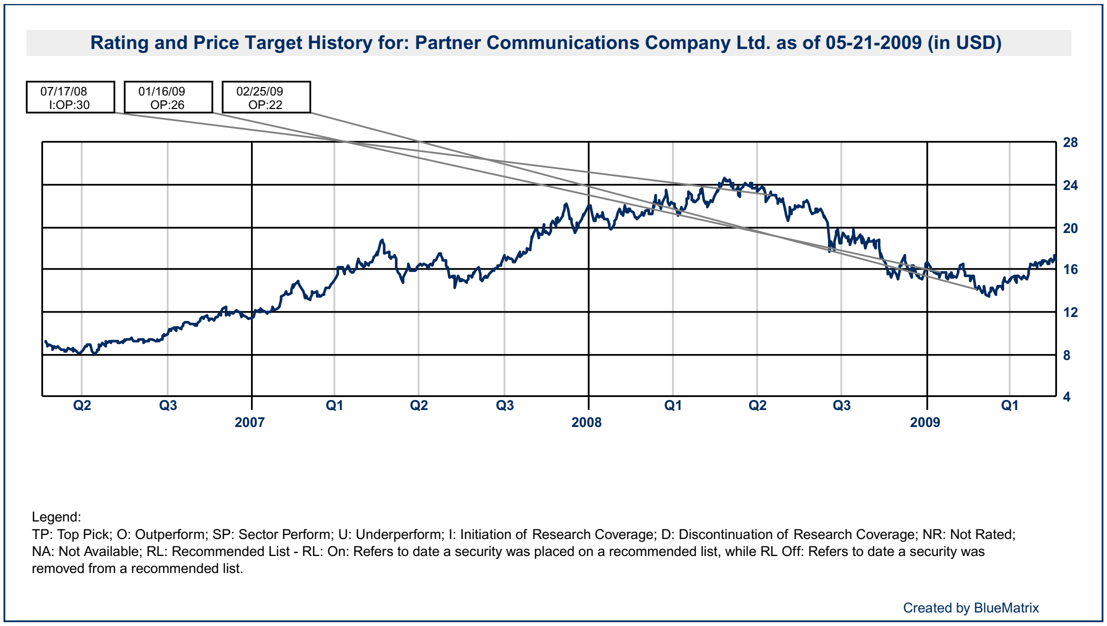

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