

May 22, 2008

Israel

European Telecom Services

Bezeq (BEZQ.TA - ILS 6.37) 1-Overweight

Earnings Review/Sales Analysis

David Kaplan
972 3 623 8747
dakaplan@lehman.com
LBIE, London

Seeing Past the Overhang

Investment Conclusion

Bezeq reported solid 1Q 08 results. Revenues of ILS 3,100m were -2% vs. our estimates, EBITDA of 1,093m and net income of 398m were +9% and +8% vs. our estimates respectively. We continue to focus on three short-term catalysts that we believe will provide potential upside to current share price. Bezeq is our top pick in Israeli Telecoms.

Summary

- The nearest term catalyst is a potential resolution to the share overhang revolving around the sale of up to 17% of Bezeq's shares. Recent press reports (Haaretz and Globes) have spurred speculation that this will occur in the short term.
- The second catalyst is the potential changes to the regulatory environment expected at the end of the summer. We expect the Minister of Communications decisions will remove uncertainty surrounding the future of Bezeq's NGN.
- Lastly, the upgrade of Bezeq's wireless network expected to be operational in 1Q 09. The upgrade is the only catalyst that we have included in our financial model and is the main source of upside.

Stock Rating

New: 1-Overweight
Old: 1-Overweight

Target Price

New: ILS 9.00
Old: ILS 9.00

Sector View: 3-Negative

FY Dec	2007A	2008E		2009E		2010E	
		Actual	Old	New	Old	New	Old
Revenues (Cons.)	12400	12657	12636	12927	12961	N/A	13206
EBITDA (Cons.)	4124	3949	4186	4252	4289	N/A	4415
Free Cash Flow	1820	1547	471	1948	1381	N/A	965
Net Income (m)	1361	1447	1604	1752	1752	N/A	1867
EPS (Adj.)	0.51	0.56	0.62	0.67	0.67	N/A	0.70
Net Debt (m)	4023	4092	5184	3735	5736	N/A	6807
EV/EBITDA	5.0	N/A	5.1	N/A	5.2	N/A	5.4
P/E	12.5	11.0	9.7	9.5	9.5	N/A	9.0

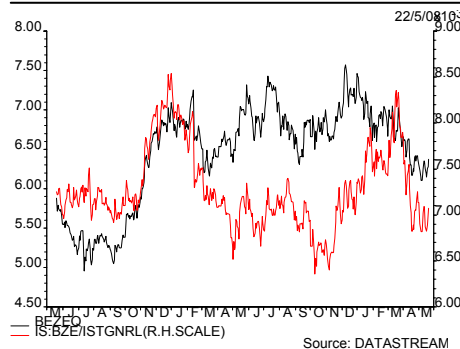
Market Data

Market Cap (m)	16594
Units Outstanding (m)	2605.0
Float (%)	36
Net Distribution Yield (%)	17.27
Convertible	No
Shares per ADR	N/A

Financial Summary

5-Year EPS CAGR (%)	N/A
3-year EBITDA CAGR (%)	N/A
Net Debt/EBITDA FY07	N/A
Dividend Yield (%)	17.27

Stock Overview



Reuters: BEZQ.TA
Bloomberg: BEZQ IT
ADR: 64063

Performance

	1M	3M	12M
Absolute %	2	-7	-9
Rel. Market %	1	-7	-4
Rel. Sector %	0	0	0

52 Week Range 7.57 - 6.10

Share Overhang

Recent press reports have implied that the receiver responsible for the 17% of Bezeq owned by Zeevi holdings is getting close to distributing the shares to the debt holders or to the market. The exact method by which the shares would be distributed is unclear but we believe that once the method is found that the stock will respond positively.

A little background:

- In October 1999 The Zeevi Group purchased a 19.6% stake in Bezeq for \$733 million. The acquisition was financed by the local Israeli banks whose share of the debt is shown in the chart below.
- In December 2001 Zeevi defaulted on a \$40 million payment to the banks, which triggered the banks to call redemption of all the debt, according to the credit agreement.
- In December 2002 the Israeli court appointed Alex Hartman as the official receiver of shares representing a 17.0% stake in Bezeq.

Privatisation efforts and other issues prevented the exercise of the shares in favor of debt redemption but it now seems that appears most issues have been resolved.

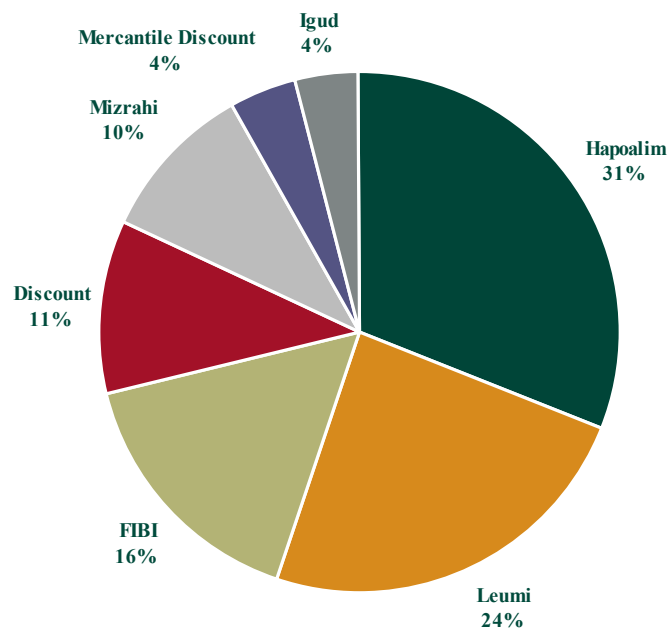
Lehman Brothers does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.

Investors should consider this report as only a single factor in making their investment decision.

This research report has been prepared in whole or in part by research analysts that are not registered/qualified as research analysts with FINRA.

PLEASE SEE ANALYST(S) CERTIFICATION(S) ON PAGE 4 AND IMPORTANT DISCLOSURES INCLUDING FOREIGN AFFILIATE DISCLOSURES BEGINNING ON PAGE 5

Figure 1: Local Bank's share of Zeevi Debt



Source: Israeli Securities Authority

Results review

Bezeq's 1st quarter results were better than market expectations. Group revenues of ILS 3,100m were flat vs. last year and -2% vs. LEH estimates, EBITDA was 1,093 (+1% and +9%) and net income of 398m was flat y-o-y and +8% vs. our estimates. EBITDA margins at each of the business proved more resilient to competition than we expected with particular strength in the fixed line business, Pelephone and YES.

Figure 1: Key Group Financials

ILS m	Q1 07	Q2 07	Q3 07	Q4 07	2007	Q1 08	Q1 08 Est
Net Revenue	3,089	3,053	3,139	3,120	12,400	3,100	3,159
% Growth	2.5%	1.1%	1.8%	0.1%	1.4%	0.4%	2.3%
Underlying EBITDA	1,083	1,010	1,041	1,062	4,215	1,093	1,005
% Growth	11.0%	0.8%	1.5%	45.6%	12.9%	0.9%	-7.2%
% Margin	35.1%	33.1%	33.2%	34.0%	34.0%	35.3%	31.8%
Underlying EBIT	6,047	571	596	513	2,336	664	577
Net Income	399	361	255	315	1,330	398	368
Underlying Net Income	-174	376	253	343	1,414	-124	384
Capex	128	138	194	352	1,073	334	258
Capex / Revenue	4.1%	4.5%	6.2%	11.3%	8.7%	10.8%	8.2%
Underlying EBITDA - Capex	955	872	847	710	3,142	762	747
% Change	15.6%	2.3%	-7.5%	4914.5%	20.4%	-20.2%	-21.9%

Source: Company reports; Lehman Bros

Pelephone

Pelephone had a solid Q1 in-line with its peers. Revenues of ILS 1,173m were slightly below our estimates of ILS 1,205m while EBITDA of 343m was ahead of our expectations by 5%. Number portability had an impact on inventory and cash flow but was not a significant factor in subscriber additions or ARPU. Pelephone added 118k 3G customers (most of these were upgrades of existing Pelephone subscribers). Average revenue per user (ARPU) was down significantly to 126 from 132 while minutes of use (MOU) were up (355 vs.

344) implying growing data revenues. Capex was only 9% of revenues, somewhat surprising given the ongoing network upgrade. The UMTS upgrade will bring Pelephone in-line with peers in terms of services, ARPU and EBITDA margin.

Figure 2: Telephone

ILS m	Q1 07	Q2 07	Q3 07	Q4 07	2007	Q1 08	Q1 08 Est
ARPU	132	129	135	130	131	126	139
MOU	344	350	363	358	354	355	347
Revenues	1,147	1,151	1,203	1,182	4,684	1,173	1,205
EBITDA	330	355	340	258	1,283	343	325
EBITDA Margin %	28.8%	30.8%	28.3%	21.8%	27.4%	29.2%	27.0%
Capex	75	75	81	117	376	103	203
Capex/Revenue %	6.5%	6.5%	6.7%	9.9%	8.0%	8.8%	16.9%

Source: Company reports; Lehman Bros estimates

Bezeq Fixed Line

In no real surprise Bezeq's fixed line business continued to lose market share to HOT (the cable operator) although the rate at which customers are switching has begun to slow. We believe that Bezeq's market share in the residential market will fall below 85% during the next quarter but that falling much below 80% is not a likely scenario. HOT telecom has offered a triple-play (multi-channel television, broadband Internet and fixed line telephony) ever since December 2005. The triple play is priced at close to a 20% discount to what Bezeq charges for the same services without bundling. We believe that the introduction of LNP removed the last excuse for consumers who had not yet moved to HOT and wanted to and gave HOT a significant boost in market share in 4Q 07 and 1Q 08. In our view, the market is now in a position where the consumers that wanted to switch to HOT have done so and the significant changes in market share are behind us. Furthermore, once Bezeq's market share falls below 85% it will be able to be more competitive on pricing and potential compete with HOT on a bundled service offering.

Figure 3: Fixed

ILS m	Q1 07	Q2 07	Q3 07	Q4 07	2007	Q1 08	Q1 08 Est
Fixed Subs	2,797	2,778	2,767	2,761	2,761	2,713	2,751
ADSL Subs	912	924	942	963	963	970	0
ARPU	86	83	84	83	84	85	78
MOU	348	356	383	388	280	394	280
Revenues	1,442	1,393	1,425	1,453	5,713	1,408	1,442
EBITDA	607	478	563	573	2,221	586	534
EBITDA Margin %	42.1%	34.3%	39.5%	39.4%	38.9%	41.6%	37.0%
Capex	0	0	0	118	351	124	0
Capex/Revenue %	0.0%	0.0%	0.0%	8.1%	6.1%	8.8%	0.0%

Source: Company reports; Lehman Bros estimates

Bezeq International

Bezeq International's revenues and EBITDA were slowed by a highly competitive long distance (ILD) and Internet service provider (ISP) markets. Revenues were 314m and EBITDA margin was 24% a mixed result.

Figure 4: Bezeq Int'l

ILS m	Q1 07	Q2 07	Q3 07	Q4 07	2007	Q1 08	Q1 08 Est
Revenues	323	322	326	334	1,304	314	323
EBITDA	73	77	76	65	291	75	71
EBITDA Margin %	22.6%	23.9%	23.3%	19.5%	22.3%	23.9%	22.0%
Capex	8	18	29	36	91	28	13
Capex/Revenue %	2.5%	5.6%	8.9%	10.8%	7.0%	8.9%	4.0%

Source: Company reports; Lehman Bros estimates

YES

Bezeq's multi-channel television business (49% owned and fully consolidated) saw EBITDA margin jump to 24% from 20.5% in 1Q 07. In the event that the regulator permits a second company to offer a triple-play YES would in all likelihood be the main beneficiary.

Figure 5: YES

ILS m	Q1 07	Q2 07	Q3 07	Q4 07	2007	Q1 08	Q1 08 Est
Subscribers	542	543	545	549	549	549	547
Revenues	354	354	360	347	1,415	381	375
EBITDA	73	100	62	75	329	92	75
EBITDA Margin %	20.6%	28.2%	17.2%	21.6%	23.3%	24.1%	20.0%
Capex	45	45	84	81	255	79	41
Capex/Revenue %	12.7%	12.7%	23.3%	23.3%	18.0%	20.7%	11.0%

Source: Company reports; Lehman Bros estimates

Analyst Certification:

I, David Kaplan, hereby certify (1) that the views expressed in this research Company Note accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

Company Description:

The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international communications services, transmission to the public of satellite multi-channel television broadcasts, internet access services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, satellite services, transmission to the public of television and radio broadcasts, provision of services and maintenance of equipment on customer premises (network end point services).

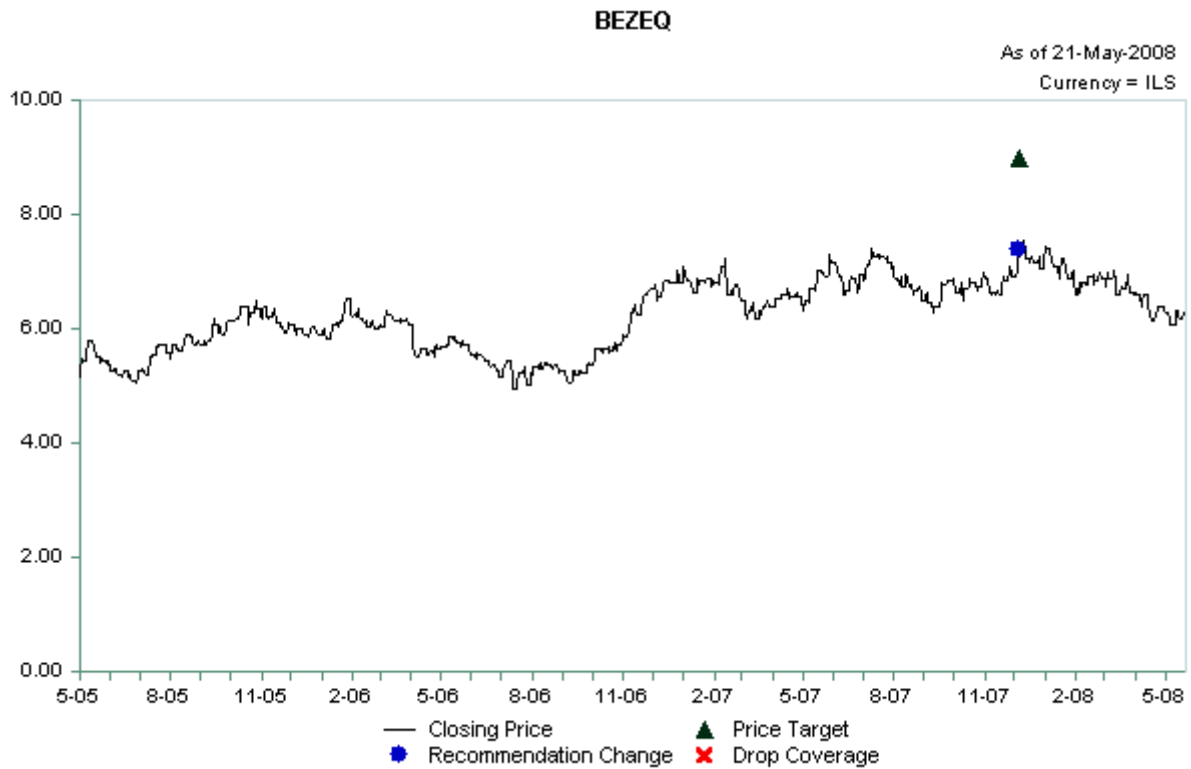
Important Disclosures:

Bezeq (BEZQ.TA)

ILS 6.37 (21-May-2008)

1-Overweight / 3-Negative

Rating and Price Target Chart:



Currency=ILS

Date	Closing Price	Rating	Price Target
06-Dec-07	7.39		9.00

Date	Closing Price	Rating	Price Target
06-Dec-07	7.39	1 -Overweight	

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

Lehman Brothers Inc. and/or an affiliate has received compensation for investment banking services from the subject company within the past 12 months.

Lehman Brothers Inc. and/or an affiliate expects to receive or intends to seek compensation for investment banking services from the subject company within the next three months.

Lehman Brothers Inc. and/or an affiliate trades regularly in the subject company's shares.

The subject company is or during the past 12 months has been an investment banking client of Lehman Brothers Inc. and/or an affiliate.

Valuation Methodology: Our price target is derived from a sum of the parts DCF based valuation. Our assumptions include a 9.5% cost of capital. European peer valuations use 8% and we add 3% for country specific risk. We use terminal growth rates of 1.5% for the wireless, 1% for the multi-channel television business and 0.5% for the fixed line telephony business.

Risks Which May Impede the Achievement of the Price Target: Upcoming regulatory decisions provide the greatest risks for the telcom industry. Any regulatory decisions that hold up unbundling of services, rolling back of corporate separation and require full access to infrastructure by competitors would hurt Bezeq's ability to improve profitability.

Important Disclosures Continued:

The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by investment banking activities.

With the exception of analysts who publish for either LBI or a branch of LBI, research analysts may not be associated persons of the member and therefore may not be subject to Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Company Name	Ticker	Price (21-May-2008)	Stock / Sector Rating
Bezeq	BEZQ.TA	ILS 6.37	1-Overweight / 3-Negative

Guide to Lehman Brothers Equity Research Rating System:

Our coverage analysts use a relative rating system in which they rate stocks as 1-Overweight, 2-Equal weight or 3-Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry sector (the "sector coverage universe"). Below is the list of companies that constitute the sector coverage universe:

Belgacom (BCOM.BR)	Bezeq (BEZQ.TA)
Bouygues (BOUY.PA)	BT Group plc (BT.L)
Cable and Wireless (CW.L)	Carphone Warehouse (CPW.L)
Cellcom (CEL.TA)	Comstar UTS (CMSTq.L)
Deutsche Telekom (DTEGn.DE)	Elisa (ELI1V.HE)
Eutelsat (ETL.PA)	France Telecom (FTE.PA)
Iliad (ILD.PA)	Inmarsat (ISA.L)
KPN (KPN.AS)	Magyar (MTEL.BU)
Mobistar (MSTAR.BR)	MTS (MBT.N)
Neuf Cegetel (NEUF.PA)	OTE (OTEr.AT)
Partner (PTNR.TA)	Portugal Telecom B (PTC.LS)
SES Global (SESFd.PA)	Sistema (SSAq.L)
Swisscom (SCMN.VX)	Tele2 AB (TEL2b.ST)
Telecom Italia (TLIT.MI)	Telecom Italia Savers (TLITn.MI)
Telefónica (TEF.MC)	Telefonica O2 Czech Republic (SPTT.PR)
Telekom Austria (TELA.VI)	Telenet (TNET.BR)
Telenor (TEL.OL)	TeliaSonera (TLSN.ST)
Vimpelcom (VIP.N)	Vodafone (VOD.L)

In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating

1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

RS-Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity in a merger or strategic transaction involving the company.

Sector View

1-Positive - sector coverage universe fundamentals/valuations are improving.

2-Neutral - sector coverage universe fundamentals/valuations are steady, neither improving nor deteriorating.

3-Negative - sector coverage universe fundamentals/valuations are deteriorating.

Distribution of Ratings:

Lehman Brothers Equity Research has 2152 companies under coverage.

39% have been assigned a 1-Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as Buy rating, 30% of companies with this rating are investment banking clients of the Firm.

46% have been assigned a 2-Equal weight rating which, for purposes of mandatory regulatory disclosures, is classified as Hold rating, 36% of companies with this rating are investment banking clients of the Firm.

11% have been assigned a 3-Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as Sell rating, 22% of companies with this rating are investment banking clients of the Firm.

Lehman Brothers Inc. and Its Foreign Affiliates Involved in the Production of Equity Research

New York Lehman Brothers Inc. (LBI, New York) 745 Seventh Avenue New York , NY 10019 Member, FINRA	London Lehman Brothers International (Europe) (LBIE, London) 25 Bank Street London, E14 5LE, United Kingdom Regulated by FSA	Tokyo Lehman Brothers Japan Inc. (LBJ, Tokyo) Roppongi Hills Mori Tower, 31st Floor 6-10-1 Roppongi, Minato-ku, Tokyo 106-6131, Japan Regulated by FSA
Mumbai Lehman Brothers Inc., India Branch (LBI, India) Winchester, Off High Street, 9th Floor Hiranandani Business Park, Powai, Mumbai 400 076, India	Seoul Lehman Brothers International (Europe) Seoul Branch (LBIE, Seoul) Hanwha Building, 12th Floor 110, Sokong-dong Chung-Ku Seoul 100-755, Korea Regulated by FSC	Hong Kong Lehman Brothers Asia Limited - Hong Kong (LBAL, Hong Kong) Two International Finance Centre 8 Finance Street, 26th Floor Central, Hong Kong Regulated by SFC
Mumbai Lehman Brothers Securities Private Limited (LBSPL, India) Ceejay House, 11th Level, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai 400018 Regulated by SEBI	Taipei Lehman Brothers Securities Taiwan Limited (LBSTL, Taiwan) Cathay Financial Center 12F 7 Sungren Road - Shin-Yi District Taipei, Taiwan Regulated by FSC	Sydney Lehman Brothers Australia Securities Pty Limited (LBAUL, Sydney) Level 33, 264 George Street Sydney NSW 2000, Australia Regulated by ASIC

This material has been prepared and/or issued by Lehman Brothers Inc., member SIPC, and/or one of its affiliates ("Lehman Brothers") and has been approved by Lehman Brothers International (Europe), authorized and regulated by the Financial Services Authority, in connection with its distribution in the European Economic Area. This material is distributed in Japan by Lehman Brothers Japan Inc., and in Hong Kong by Lehman Brothers Asia Limited. This material is distributed in Australia by Lehman Brothers Australia Securities Pty Limited, and in Singapore by Lehman Brothers Singapore Pte Ltd. Where this material is distributed by Lehman Brothers Singapore Pte Ltd, please note that it is intended for general circulation only and the recommendations contained herein does not take into account the specific investment objectives, financial situation or particular needs of any particular person. An investor should consult his Lehman Brothers' representative regarding the suitability of the product and take into account his specific investment objectives, financial situation or particular needs before he makes a commitment to purchase the investment product. This material is distributed in Korea by Lehman Brothers International (Europe) Seoul Branch, and in Taiwan by Lehman Brothers Securities Taiwan Limited. Where this material is distributed by Lehman Brothers Securities Taiwan Limited, please note that recommendations expressed herein are for reference only. Investors should carefully evaluate the investment risks and are reminded that they are solely responsible for their investment decisions. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. With the exception of disclosures relating to Lehman Brothers, this research report is based on current public information that Lehman Brothers considers reliable, but we make no representation that it is accurate or complete, and it should not be relied on as such. In the case of any disclosure to the effect that Lehman Brothers Inc. or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company, the computation of beneficial ownership of securities is based upon the methodology used to compute ownership under Section 13(d) of the United States' Securities Exchange Act of 1934. In the case of any disclosure to the effect that Lehman Brothers Inc. and/or its affiliates hold a short position of at least 1% of the outstanding share capital of a particular company, such disclosure relates solely to the ordinary share capital of the company. Accordingly, while such calculation represents Lehman Brothers' holdings net of any long position in the ordinary share capital of the company, such calculation excludes any rights or obligations that Lehman Brothers may otherwise have, or which may accrue in the future, with respect to such ordinary share capital. Similarly such calculation does not include any shares held or owned by Lehman Brothers where such shares are held under a wider agreement or arrangement (be it with a client or a counterparty) concerning the shares of such company (e.g. prime broking and/or stock lending activity). Any such disclosure represents the position of Lehman Brothers as of the last business day of the calendar month preceding the date of this report. This material is provided with the understanding that Lehman Brothers is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Lehman Brothers and are subject to change without notice. The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. If an investor has any doubts about product suitability, he should consult his Lehman Brothers representative. The value of and the income produced by products may fluctuate, so that an investor may get back less than he invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income. © 2008 Lehman Brothers. All rights reserved. Additional information is available on request. Please contact a Lehman Brothers entity in your home jurisdiction.

Lehman Brothers policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy. Complete disclosure information regarding companies covered by Lehman Brothers Equity Research, including ratings, earnings per share forecasts and price targets contained in reports covering U.S. companies is available at www.lehman.com/disclosures.