Flashnote

HSBC Global Research

Global Emerging Markets
Wireless Telecoms Services
Equity – Israel

Partner Communications

Regulation is the name of the game; raising target price

- **Our recent meeting with the MoC suggests an MVNO competitive threat is still valid but unlikely in the near term**
- **Data and content revenues continue to be a growth driver, offset by new voice-mail regulation impact and decline in interconnect tariffs**
- **We are raising our DCF-based target price to NIS68.30 from NIS63.30 mainly due to lower WACC; we reiterate our Neutral rating in light of limited upside potential to our valuation**

Neutral

Target price (NIS)	**68.30**
Share price (NIS)	**65.21**
Potential total return (%)	**5.00**

Performance	1M	3M	12M
Absolute (%)	0.6	10.8	65.3
Relative^ (%)	-5.0	0.6	47.3

Index^	TA 100
RIC	PTNR.O
Bloomberg	PTNR IT
Market cap (USDm)	2,578
Market cap (NISm)	10,267
Enterprise value NISm	12,383
Free float (%)	49.0%

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Mobile virtual network operator? Unlikely in short term

We met with the Israeli Ministry of Communications (MoC) earlier this week to understand better the competitive threats and opportunities ahead of recommendations from the regulatory agency's Grunau committee and the Nera consulting team. The committee may submit its recommendations around October on the fixed-line market's competitive landscape. The MoC hired Nera, an international consulting group, to examine the mobile market and suggest whether it is competitive (efficient), and if not, examine ways to improve the situation. Among the questions Nera is expected to answer are: Is the mobile sector competitive in Israel? If not, can a mobile virtual network operator (MVNO) increase competitiveness? If so, what would be the right way to present an MVNO to the market? Nera is expected to provide its recommendations in June 2007.

Our understanding is that the regulator has not decided on the matter, which means the MoC would wait for Nera's recommendations before making any decision. If Nera should find that an MVNO would benefit the market (ie consumers/businesses), it is not clear how one could be imposed (ie legislation or MoC decree). As the mobile market is highly saturated and the players are well-established (ie brand name, positioning, and customer reach and support), it seems to us that the MVNO option would be less valid to current Israeli market conditions. Yet mobile operators today have more than 55% of Israel's communications pie in terms of revenue, with EBITDA margins topping 30%. One may conclude that the profitability indicator is supportive for an MVNO (ie reducing margins and enhancing subscribers' pricing).

The number portability regulation is likely to commence before year-end, and the regulator has stated that it is not likely to go into an MVNO initiative before the market stabilizes (post-number portability). Thus, we believe it is likely that an MVNO, if any, would not take effect before year-end 2008.

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Partner Communications: Financial summary

(NISm)	Q1 07	Q1 06	Q4 06	Y-o-Y	Q-o-Q	FY07e	Y-o-Y	FY08e	Y-o-Y
Revenues	1,418	1,327	1,445	7%	-2%	5954.7	6%	6189.4	4%
Gross profit	446	374	447	19%	0%	1793.3	5%	1831.2	2%
Operating expenses	145	101	133	44%	9%	511.9	4%	525.4	3%
Operating income	301	274	314	10%	-4%	1281.4	5%	1305.4	2%
Financial income	-20	-39	-22	-49%	-11%	-130.1	-22%	-114.4	-12%
Taxes	-86	-76	-129	13%	-34%	-334.0	-10%	-334.0	0%
Net income	196	160	163	22%	20%	817.4	20%	874.2	7%
Gross margin	31%	28%	31%	11%	2%	30%	-1%	30%	-2%
EBIT margin	21%	21%	22%	3%	-2%	22%	-1%	21%	-2%
Net margin	14%	12%	11%	14%	22%	14%	13%	14%	3%

/All figures are non-GAAP.
Source: HSBC estimates, Company data

Key regulatory risks ahead of the cellular operators, and the expected impact on Partner

- *Interconnect tariff cut:* When? Every March 1 until 2008, according to defined tariff road map. Risk: Low risk to earnings, offset by increased tariff and bundle minute packages to subscribers.
- *Voice mail regulation:* Providing subscribers the ability to terminate calls without getting billed when transferred to voice mail. When? Started in early 2007. Risk: Low to medium risk to earnings, offset by increased tariff and bundle minute packages to subscribers.
- *Rounding billing unit*: Reducing the rounding billing unit from the current 12 seconds to one second. When? During 2009. Risk: Low risk to earnings. We believe that the gross ARPU impact can reach about 5% of current ARPU, but offset via bundled minute packages, which will eliminate part of this effect by charging a fixed amount for a given amount of minutes per call.
- *Number portability:* Allowing subscribers to keep their mobile numbers when shifting between operators. When? Year-end 2007. Risk: High risk to increasing subscriber acquisition cost (SAC), yet offset by potential increase (though marginal) of market share, winning high ARPU profiled subscribers.

Neutral rating supported by valuation and regulatory pressure

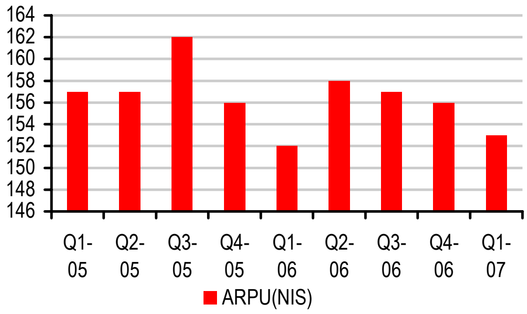
Our Neutral rating on Partner Communications, in our view, is supported by limited potential upside to our DCF-based valuation, negative regulatory pressure, improvement in data and content revenues offset by decline in revenues from interconnect tariffs and implementation of voice mail regulation, and increase in churn rates following implementation of number portability towards the end of 2007, thereby leading to higher subscriber retention costs. Among upside risks, we believe, are that a potential one-off dividend would not change our upside valuation but may generate positive investor sentiment on the shares; number portability would increase churn but, net-net, may turn positive for Partner (ie increased market share).

Higher subscriber usage drives Q1 07 growth

Partner's financial performance for the quarter was driven by improved gross margins (31.5%, the best in last 14 quarters) from increasing subscriber usage (minutes of usage, or MOU -323 minutes per subscriber), and lower financial expenses due to lower interest expenses and reduced foreign exchange expenses.

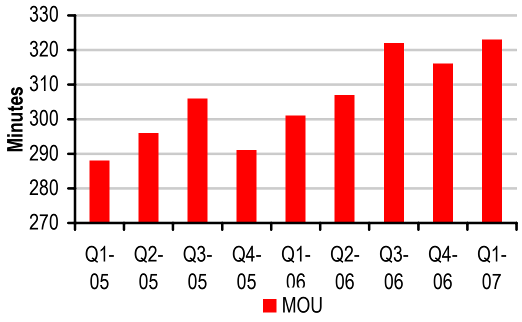
Partner posted quarterly revenues of NIS1,418m (-2%, q-o-q, +7% y-o-y) for Q1 07, marginally lower than our expectation. Operating margins improved to 21.2% from 20.6% in Q1 06, brought about by a larger subscriber base (5.6% Y-o-Y), increased minutes of use, and a surge in data and content revenues that were offset by larger selling and marketing expenses. Net income grew 22% to NIS195.8m y-o-y, translating into diluted EPS of NIS1.25 (19% y-o-y), or NIS0.06 higher than our expectation.

Partner Communications: ARPU



Source: HSBC, Company reports

Partner Communications: MOU



Source: HSBC, Company reports

Operational key performance indicators (KPIs) overall improving

Average revenue per user

Partner's ARPU increased 0.7% to NIS153 in Q1 07 from NIS152 in Q1 06, and decreased 3.8% from the last quarter of 2006. The declining trend of ARPU in the last four quarters can be attributed to increasing competition amongst the mobile operators and lowering inter connect tariffs.

Minutes of usage

Lower tariffs and a growing number of 3G subscribers (333,000 till Q1 07) led to MOU's showing an increasing trend in the last six quarters. The average monthly usage per subscriber was 323 minutes for Q1 07, an increase of 7.3% from 301 in Q1 06 and an increase of 2.2% from 316 in Q4 06.

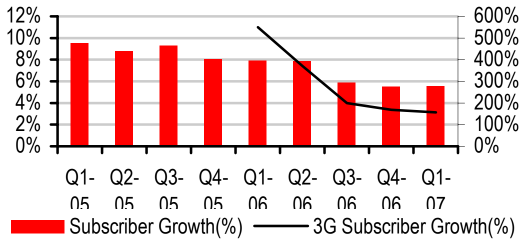
Subscriber growth

Partner's subscriber base grew to 2.703m (5.6% Y-o-Y, 1.3% Q-o-Q) at the end of Q1 07. The 3G subscriber base constituted 12.3% of total subscribers. On a Y-o-Y basis; the 3G subscriber base jumped 1.56 times.

Churn rate

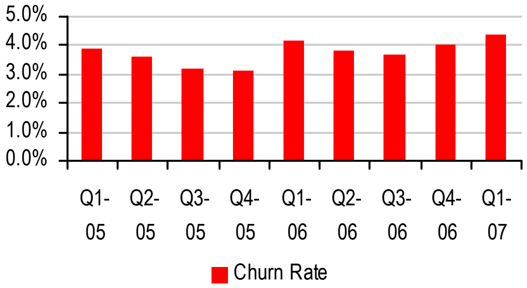
Churn rate increased to 4.4% in Q1 07 from 4.2% in Q1 06 and 4% in Q4 06. The increase was attributed to higher amount of churn amongst pre-paid subscribers. Churn rate is expected to increase further after the implementation of number portability by the end of 2007. However, we believe that Partner will be the least affected by introduction of number portability, as it has a strong brand image and it was the last player to enter the market, in 1999, and thus its captive base is the smallest among the three major operators.

Partner Communications: Subscriber growth



Source: HSBC, Company reports

Partner Communications: Churn rate



Source: HSBC, Company reports

Valuation and rating

We have marginally adjusted our model to reflect Partner's Q1 07 results. We slightly decreased our EBITDA margin estimate, by 10bp to 31.8%, reflecting slightly higher subsidies and S&M expenses in light of approaching number portability. Due to valuation matrix changes, we are raising our end-2007, DCF-based target price to NIS68.3 from NIS 63.6, implying a 5% potential total return. To derive our target price, we adjusted our risk-free rate to 4.8% from 5.7%; we use an equity risk premium of 5.5% with a beta of 0.7, and we reduced our long-term growth rate to 0% from 1% to reflect the increased long-term regulatory risk. Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below our hurdle rate for Israeli stocks of 10.3%, or 5.3-15.3%. As our new target price suggests a 5% potential total return, within the Neutral band, we reiterate our Neutral rating on the stock. Partner shares trade at 12.3x and 11.7x FY07e and FY08e earnings, which represent 36% and 24% discounts to the company's faster-growing peers, and at 6.5x FY07 and FY08 EV/EBITDA (HSBC).

Risk factors

Upside risks: *Number portability.* Partner's results may be positively affected by number portability, exposing the company to a potentially large captive client base of its competitors. This may result in increased market share for Partner beyond our expectations for flat market-share growth in 2007.

One-off dividend. Although a dividend payment will not impact our valuation, it may affect investors' sentiment about the shares. The company can leverage its balance sheet and potentially distribute a substantial one-off dividend (ie ~10% yield assuming net debt/EBITDA of 1.7x-1.8x) on the discretion of its shareholders.

Downside risks: *Increased 3G competition.* 3G subscribers are one of the main growth engines for Partner. If competitors decide to accelerate their current 3G subscriber growth rates, it may hurt Partner's 3G market share and force the company to increase its handset subsidies, thereby impacting gross margin and earnings.

MVNO as the fourth operator. The local regulators would like to see an MVNO step in and accelerate competition levels, while enhancing consumer pricing for mobile services. A fourth operator could create new competitive threats to the current operators, including Partner. We believe that there are many barriers to an MVNO entry, and we assume low probability of such a risk.

Pelephone's GSM network. Pelephone has said it is aiming to build a new GSM-based (WCDMA) network to replace its 1X (CDMA) network. We do not believe this would take effect before 2H-08. Yet if Pelephone is quicker with its deployment, we believe that Partner could be more likely to risk losing some of its high-margin roaming revenues.

Peer group comparison

				EV/EBITDA		PE		P/Sales	
Company	**Ticker**	**Price**	**Rating**	**2007e**	**2008e**	**2007e**	**2008e**	**2007e**	**2008e**
Cosmote	COSr.AT	23.54	Overweight	12.20	10.30	18.61	15.08	2.52	2.31
Bouygues	BOUY.PA	62.08	Neutral	9.30	8.40	16.00	14.40	0.73	0.69
Tele2	TEL2b.ST	115	Overweight	8.40	7.20	39.50	25.50	0.87	0.81
Vodafone Group	VOD.L	1.448	Overweight	5.90	5.70	10.50	10.10	2.37	2.28
Elisa Communications	ELIV.HE	21.41	Overweight	7.66	6.96	17.57	15.25	2.23	2.15
Mobistar	MSTAR.BR	65.75	Overweight	6.20	5.80	13.50	12.60	2.62	2.53
Average				8.28	7.39	19.28	15.49	1.89	1.80
Partner (HSBC est.)	PTNR.TA	65.21	Neutral	6.50	6.43	12.30	11.70	1.70	1.67
(Disc.)/prem. to peers				-21%	-13%	-36%	-24%	-10%	-7%

Priced as at close at 7 May 2007.
Source: HSBC, Datastream

Disclosure appendix

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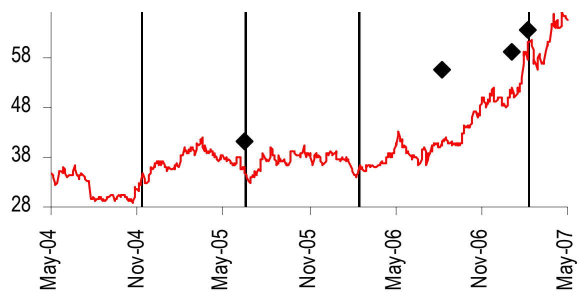
Share price and rating changes for long-term investment opportunities

Partner Share Price performance ILS Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	N/R	15 November 2004
N/R	Neutral	24 June 2005
Neutral	Overweight	21 February 2006
Overweight	Neutral	13 February 2007
Target Price	**Value**	**Date**
Price 1	N/R	15 November 2004
Price 2	41.00	24 June 2005
Price 3	55.40	15 August 2006
Price 4	59.10	12 January 2007
Price 5	63.60	13 February 2007

Source: HSBC

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