

Equities

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Israeli mobile

A Tragedy in IV Acts – Cut Cellcom to Sell; Raise Partner to Hold

- **Act I: Pre 2010** — *The rise of the Israeli operators.* We believe three data points tell you all you need to know about competition historically: 1) Market shares have been stable for the last eight years, 2) ARPU has declined by only -5% since 2005 with higher MOUs offsetting lower prices (Partner), and 3) EBITDA margins have risen by 8ppt since 2005 to high thirties (Partner). Benign competition together with increasing population and penetration has driven high and growing free cash flow and dividends.
- **Act II: 1H 2011** — *Enter the regulator.* A pro-consumer regulator takes centre stage determined to reduce operators' hold on customers and reduce high prices. ARPU is higher than the UK, Germany, and Italy despite lower GDP/capita. A mobile basket of 300 calls + 225 SMSs costs \$103 at Partner, 63% higher than the OECD average. MTR cuts of -74% and the reduction of penalty fees for early contract termination, render contracts almost meaningless, and lead to higher churn and pricing pressure.
- **Act III: 2H 2011 through 2014** — *Intense competition.* We expect competition to enter from both sides of the stage. MVNOs are expected to launch in 4Q. Two new MNOs to launch in 2012E. There should be some market share loss for the incumbents but the real action will be in pricing where we expect ARPU declines of up to -20% to <NIS100 as operators cut prices to defend share. This combined with higher retention costs should lead to margin squeeze. We cut our earnings estimates aggressively for the 2010-14 period and now estimate declines of -26% at Partner and -33% at Cellcom to NIS920m and NIS863m (2014). Partner's slower rate of decline is due to the purchase of 012 Smile from March 2011.
- **Act IV: Post 2014** — *Consolidation.* We believe the intense competition will be too much to bear in a slowing market, especially with new investments to make, leading to consolidation as is occurring today in the US and UK. We don't know how long Act IV will last – it took the UK market six years to consolidate post "3" entry in 2003.
- **Partner's stock is pricing earnings declines, Cellcom's is not** — We move from DCF to multiple based target prices given the lower visibility post 2014. We apply an 8x PE multiple to our 2014e earnings forecasts discounting back to 2012 using a 10% rate (RFR is 5.3%) and then deducting 12 month dividends. We arrive at new target prices of NIS50 for Partner from NIS65 and NIS73 at Cellcom from NIS112. Our ETRs are now +10% for Partner and -12% for Cellcom including 12 month forecast dividends. We raise our rating on Partner to Hold from Sell and cut Cellcom to Sell from Hold. With lower visibility than ever we raise our risk rating on Cellcom to High, inline with Partner.

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Ticker	Rating		Target Price		Current Year Earnings Estimates		Next Year Earnings Estimates	
	Old	New	Old	New	Old	New	Old	New
CEL.TA	2M	3H	NIS112.00	NIS73.00	NIS11.65	NIS11.28	NIS12.13	NIS9.82
PTNR.TA	3H	2H	NIS65.00	NIS50.00	NIS7.84	NIS7.59	NIS7.90	NIS6.85

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Curtain going up on Act III

Partner and Cellcom have declined -27% and -17% including dividends since peaking in early December versus -3% for SXKP and -1% for the TA-25, as competition in Israeli mobile has intensified following MTR cuts, lower penalty fees for early contract termination, and ahead of new MVNO and MNO entry.

As we enter 2H 2011 we think that the main competition, price declines and hit to earnings is still ahead of us. We estimate that Partner and Cellcom's earnings will decline by -26% and -33% over the 2010-14 period.

Whereas we see Partner's stock price as pricing in these declines, Cellcom's in our opinion is not. We cut Cellcom to Sell from Hold, and raise Partner to Hold from Sell. We cut our target prices for both – for Partner to NIS50 from NIS65 and for Cellcom to NIS73 from NIS112, on the estimate cut and changing our valuation method from DCF to multiple based. We also raise our risk rating on Cellcom to High to match Partner given the increasingly uncertain competitive environment.

New Estimates

Figure 1. Partner estimates (NISm)

	2010a	2011e	2012e	2013e	2014e	2010-14e
Partner	6,674	6,696	6,045	5,617	5,334	-16%
Smile 012	0	930	1,116	1,116	1,116	
Revenues	6,674	7,626	7,161	6,733	6,450	1%
EBITDA (CIRA)	2,570	2,605	2,424	2,235	2,090	-19%
EBITDA (Consensus)	2,570	2,254	2,270	2,504	na	
CIRA vs. Consensus		16%	7%	-11%	na	
Net income (CIRA)	1,243	1,190	1,081	962	920	-26%
Net income (Consensus)	1,243	1,005	1,044	1,221	na	-2%
CIRA vs. Consensus		18%	4%	-21%	na	

Source: Citi Investment Research and Analysis; Consensus is Bloomberg

Figure 2. Cellcom estimates (NISm)

	2010a	2011e	2012e	2013e	2014e	2010-14e
Revenues	6,662	6,173	6,028	5,846	5,575	-12%
EBITDA (CIRA)	2,667	2,394	2,179	2,086	1,951	-22%
EBITDA (Consensus)	2,667	2,380	2,315	2,219	na	
CIRA vs. Consensus		1%	-6%	-6%	na	
Net income (CIRA)	1,291	1,124	979	934	863	-33%
Net income (Consensus)	1,291	1,057	1,015	1,055	na	-18%
CIRA vs. Consensus		6%	-4%	-11%	na	

Source: Citi Investment Research and Analysis; Consensus is Bloomberg

Steep declines in EBITDA and earnings estimated as competition intensifies

We see steep declines in EBITDA and earnings at Partner and Cellcom as competition intensifies in the 2010-14e period. The main drivers of our lower revenues and profitability estimates are lower net additions, lower ARPU, and lower profitability.

At Partner the acquisition of 012 Smile should mitigate some of the EBITDA decline and there may also be some synergies and cost savings. Cellcom could also enjoy similar benefits once it merges with Netvision later this year although this is not currently in our numbers.

A summary of our updated assumptions are below:

- 132% SIM penetration by year end of 2014E equals 10.9m subs from 128% and 9.9m at year end 2010.
- New operators (MVNO and MNOs) pick up 6% of market share combined or about 1m subs by year end 2014E. This number excludes an estimated 450k subs that MIRS had on iDEN at the end of 2010.
- Old operators pick up just 60k net adds from 2010-14E. They averaged a combined 285k p.a. from 2007-10.
- ARPU declines of -20% at Partner and -17.5% at Cellcom from 2010 (ex-MTR) to 2014E to <NIS100. We believe that Partner will continue to be more aggressive on price than Cellcom as it has been in recent quarter.
- EBITDA margin contraction – Partner margin to contract to around 33% in 2014E from 37% currently post-012 Smile. Cellcom margin to contract to 35% in 2014E from 40% currently. We estimate lower margin contraction at Partner due to the aforementioned cost-savings and synergies. The European average EBITDA margin is 33-34%.

Less new additions

ARPU declines of -20% at Partner and
-17.5% at Cellcom

EBITDA margin contracts

Figure 3. Subscribers – Old Operators versus New Operators

	2010	2011e	2012e	2013e	2014e
Total	9,861	10,026	10,326	10,634	10,944
growth y/y	3.3%	1.7%	3.0%	3.0%	2.9%
penetration	128%	128%	129%	131%	132%
Partner	3,160	3,235	3,254	3,244	3,200
growth y/y	4%	2%	1%	0%	-1%
net adds	118	75	18	(9)	(44)
share	32.0%	32.3%	31.5%	30.5%	29.2%
Cellcom	3,394	3,430	3,454	3,451	3,413
growth y/y	3%	1%	1%	0%	-1%
net adds	36	24	(3)	(38)	15
share	34.2%	33.4%	32.4%	31.2%	30.4%
Old Operators	9,411	9,549	9,639	9,607	9,472
MVNOs	0	20	103	191	285
net adds	0	20	83	88	93
share	0.0%	0.2%	1.0%	1.8%	2.6%
New MNOs	450	456	584	835	1,187
net adds	6	127	251	353	288
share	4.6%	4.6%	5.7%	7.9%	10.9%
New Operators	450	476	687	1,026	1,472

Source: Citi Investment Research and Analysis; Company reports

Where we could be wrong – the fixed line opportunity?

Are we underestimating the fixed line opportunity for these players following their ISP acquisitions and once the fixed line access market is opened up to wholesale pricing? With their acquisitions of 012 Smile and Netvision, Partner and Cellcom are acquiring around 600k ISP customers each. A third of 012 Smile's subs are also voice over broadband or VoIP customers.

Competition is likely to intensify for the
ISPs as well

We currently model flat fixed revenues at 012 Smile from 2011-14e. The issue for us is that the ISP market, a regulatory creation whereby Israeli customers pay a separate fee for both internet access (say \$19 for 5MB) and then an additional fee to an ISP (say \$11), is not likely to escape the competitive mood. Cable operator HOT already has an (inactive) license. Given the asset-light nature of the business, there are likely to be other newcomers too, as the fixed market is opened up to competition. Assuming that the ISPs can grow their top lines seems overly optimistic in our view.

New Target Prices

We move from DCF to multiple based target prices given the reduced visibility of earnings beyond 2014 (Act IV). We think that the market will consolidate as it has done in the US and the UK recently, but do not know how long it will take Israel to get there. In the meantime we expect a ramp up in competition and material EBITDA and net income declines.

We apply 8x multiples for both Partner and Cellcom to 2014e earnings

We apply an 8x PE multiple to our 2014e earnings estimates, discount this back to 2012 using a 10% discount rate and then subtract the 12 month DPS to arrive at our new price targets – NIS50 for Partner from NIS65, and NIS73 for Cellcom from NIS112. With ETRs of +10% at Partner and -12% at Cellcom we raise Partner to Hold from Sell and cut Cellcom to Sell from Hold. We also raise our risk rating given the increasingly uncertain competitive environment..

Figure 4. Israeli mobile versus European incumbents and wireless

	2010a	2011e	2012e	2013e	2014e
Cellcom					
PE	7.3	8.4	9.7	10.1	11.0
EV/EBITDA	4.8	5.4	5.9	6.2	6.6
Dividend yield	14.6%	11.3%	9.8%	9.4%	8.7%
Partner					
PE	6.5	6.8	7.5	8.4	8.8
EV/EBITDA	5.0	5.0	5.3	5.8	6.2
Dividend yield	15.3%	14.1%	13.3%	11.9%	11.4%
Europeans					
PE		12.2	9.7	9.3	
EV/EBITDA		5.3	5.1	5.0	
Dividend yield		7.3%	7.9%	8.6%	
CEEMEA					
PE		11.6	10.4	9.4	
EV/EBITDA		4.9	4.5	4.2	
Dividend yield		7.0%	7.9%	9.2%	

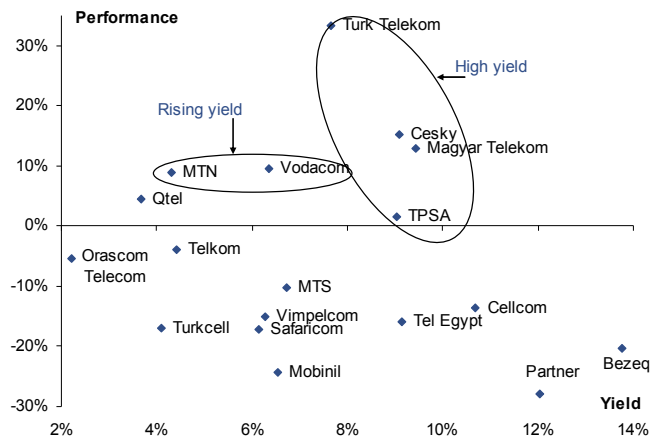
Source: Company reports, Citi Investment Research and Analysis Priced as of 5th July.

On 2011e PE Partner and Cellcom currently trade at -44% and -31% discounts to the Europeans which narrow to a -9% discount for Partner and a +9% premium for Cellcom in 2013e. We are of the view that Partner and Cellcom should still trade on a discount to the Europeans in 2013-14 but see the discount narrowing as we near the end of Act III with the major competition then behind us.

Yields above 10% are not sufficient reason to invest – especially in maturing and slower growth or more competitive markets in our view

On our new target prices, we have Partner and Cellcom yielding 10% in 2014e and 13% in 2011e vs. 14.1% for Partner and 11.3% for Cellcom, both in 2011e off current market prices. Yields above 10% are not reason enough to invest – especially in maturing and slower growth or more competitive markets in our view. CEEMEA high and rising yielders have performed well this year (Figure 5) but high yields have not saved many European telcos from underperformance in 2011 (Figure 6).

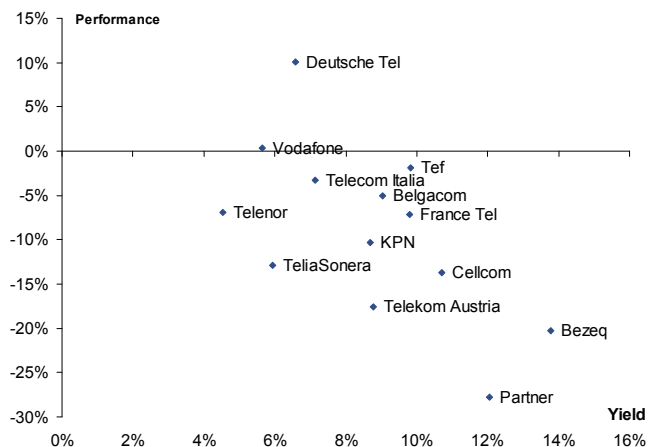
Figure 5. Performance vs. 2011e Yield - CEEMEA



Source: Datacentral; Israelis 2011e yield is consensus

dataCentral is CIRA's proprietary database, which includes Citi estimates, data from company reports and feeds from Reuters, Datastream, First Call, IBES and Toyo Keizai

Figure 6. Performance vs. 2011e Yield – Europeans



Source: Datacentral; Israelis 2011e yield is consensus

A Tragedy in IV Acts

Act I: Pre 2010

The rise of the Israeli operators

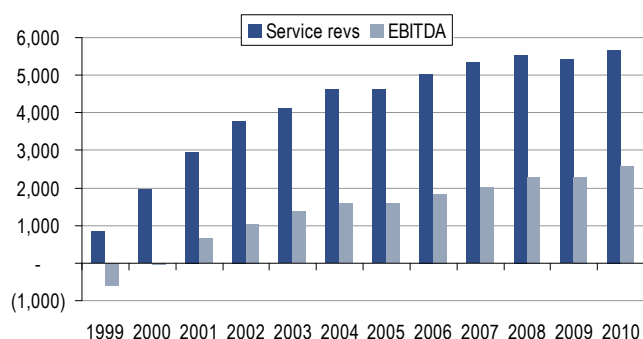
Service revenues at Partner – the only company for which we have data going back to 1999 – grew at 11% p.a. in the ten years to 2010 with sub growth of 14% p.a. offsetting ARPU declines of -7% p.a. over the period. Partner had launched as the third operator and the first in Israel on GSM in 1999. EBITDA went positive in late 2000 growing to NIS2.6bn in 2010 or a margin of 39% in that year.

We believe three data points (Figure 8) tell you all you need to know about competition historically:

- Partner's market share has been flat at 32% since 2003 – for eight consecutive years.
- ARPU has declined by only -5% in the last five years to 2010 with price elasticity maintained – since 2005 APPM including data has declined at -5.3% p.a. but MOU has increased at a rate of 4.5%.
- The EBITDA margin has risen by 8ppts from 31% in 2005 to 39% in 2010 (the move to IFRS from US GAAP in 2008 added 70bps).

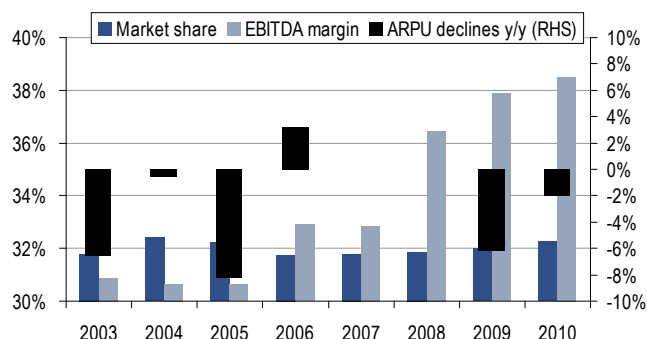
Since 2000 annual capex has never surpassed NIS600m. Since 2004 it has averaged 8.4% of total sales supporting high free cash flow generation.

Figure 7. Partner service revenues and EBITDA (NISm)



Source: Citi Investment Research and Analysis; Partner Annual Reports

Figure 8. Stable market share, little pressure on ARPU, rising margins



Source: Citi Investment Research and Analysis; Partner Annual Reports

Act II: 1H 2011

Enter the regulator

Figure 9. 1Q11 y/y trends

	Cellcom	Partner**	Peledphone
Total revenues	0.4%	6.2%	4.1%
Service revenues	(14.8%)	(17.1%)	Not disclosed
Operating income	3.1%	(13.5%)	23.9%
EBITDA	0.2%	(9.2%)	14.4%
Churn	1.70%	2.10%	0.40%
ARPU (ex-MTRs)	-2.0%*	-5.0%	0.0%

Source: Citi Investment Research and Analysis; *Cellcom ARPU decline is CIRA estimate; **Partner is excluding 012 Smile

1Q11 was a difficult operating quarter for all operators as competition intensified following 74% MTR cuts from 1st January and the cancellation of early contract exit fees from 1st February. We believe high handset sales and profitability, which led to higher y/y operating income at both Cellcom and Pelephone, only plastered over the weaker operating trends. Indeed KPI data such as churn and ARPU which are a better indicator of the underlying health of these businesses in our view were weak, and this is pre-new competition.

- Higher churn – rose above 7% at Cellcom and Partner in 1Q, up 170bps and 210bps y/y as early contract termination fees were cut significantly from 1st February 2011 rendering service contracts almost meaningless. We expect churn to remain at elevated levels through the end of 2011 and into 2012 with high gross additions and low net additions.
- Lines between data and voice becoming blurred – there is a clear trend in the market towards unlimited voice, SMS and data plans. Today all three operators are offering plans at NIS250/month (\$73) or less. MOU and APPM have effectively become meaningless.
- ARPU pressure – ARPU continues to come under pressure as customers re-price on cheaper all-inclusive monthly plans. Higher handset sales are short-term gain for long-term pain as handset costs are rebated back to the customer over the contract length. We expect ARPU ex-MTR cuts to be lower in 2011 even ahead on new entrant launch. Indeed, one only needs to look at France to see how a market can react even in anticipation of a new operators' entry.

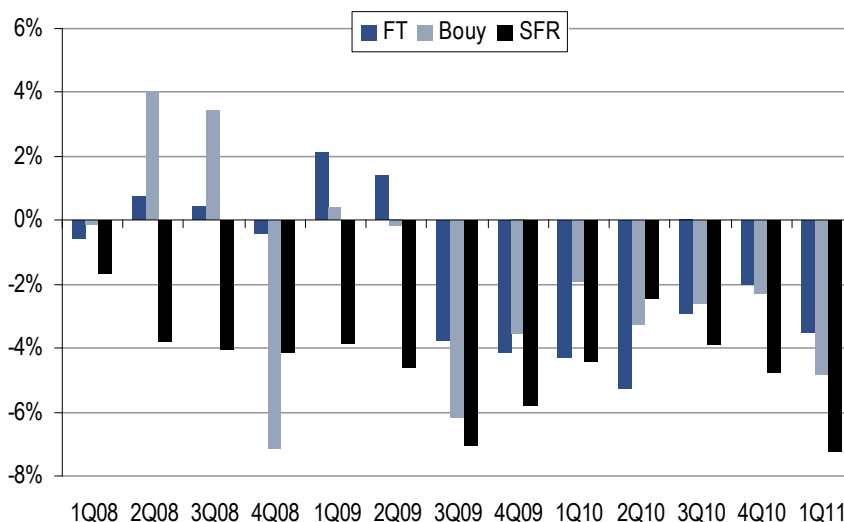
Figure 10. Unlimited plans at the Mall

	Price (NIS)	Voice (mins)	SMSs	Data
Pelephone	249	1,100	1,100	2GB
Partner	250	1,000	1,000	2GB
Cellcom	214	1,100	1,100	unlimited

Source: Citi Investment Research and Analysis; as of 20th June

ARPU is under pressure in France in anticipation of Iliad entry in 4Q11/1Q12 as well as increased MVNO competition

Figure 11. y/y ARPU declines in France ahead of Iliad entry



Source: Company reports, Citi Investment Research and Analysis

- Higher working capital cost – higher handset sales are a drain on working capital as suppliers are paid within 30 days but revenues from customers are received in 36 installments. We estimate most of the hit to working capital comes in 2011 with some stretching into 2012.
- Costs to rise at gross and operating levels – as operators beef up their sales, customer service and marketing efforts to deal with increased churn and maintain share ahead of new MVNO and MNO entry.

Act III: 2H 2011 through 2014

Intense competition

The tough operating environment is only likely to intensify through the end of 2011 and 2012 in our view, and especially once new MVNO and MNO competition enters the market. Two new MVNOs, discount retailer, Rami Levi, and Free Telecom, are due to launch in 3Q, both on Pelephone's network. We see MVNO entry having more of an impact on the type of plans – bundled and data focused – and on expenses – marketing etc – than on churn and pricing. For example Cellcom with the largest pre-paid subscriber base currently plans to launch its own "MVNO" brand in 3Q to compete with the new players which could add NIS40-50m to sales and marketing in 2H11 in the form of branding and promotional campaigns.

And this is before competition heats up in 2012 with the entry of one and perhaps two new network operators. MIRS, the iDEN operator and sister company of Cable Company HOT, is currently building out its new network and should launch on UMTS in early 2012 – when it reaches the required 10% network coverage. Given the embedded mechanism in the terms of the license that they get 1/7 of their license fee for each 1% share they gain within five years, up to 5%, they can effectively subsidize each subscriber new subscriber up to \$345 or NIS1,200 versus or more than five months of an unlimited voice, SMS, and data plan including iPhone rebate at one of the incumbents. We expect a serious step-up in competition even should a 5th new operator not materialize.

The apparent failure of two of the UMTS bidders to secure bank guarantees is a mild positive against a barrage of negatives but two new entrants remains the most likely scenario in our view

There is currently some uncertainty whether a 5th new operator will emerge. The license was won at the auction in April by Marathon Xfone at a \$200m cost, although they were disqualified at the end of May after failing to provide bank guarantees for that amount. That license has now been offered to the third highest bidder in the auction, Select Communications, the group of US investor Michael Gelfand, who has until July 15th to secure bank guarantees. The local press (Globes) reports that Select is having difficulty obtaining the necessary guarantees. Should they be unable to secure them, the license will be offered to the lowest bidder in the auction, Golan Telecom, who bid \$120m although it's likely that the price and terms (and those for MIRS) would have to be re-adjusted lower – taking into account that original bids were artificially high from the participation of four bidders.

Description of new operators:

MVNOS:

- Rami Levi is a fast growing discount retailer that will launch MVNO services on Pelephone's network on 1st September. Rami Levi (Bloomberg: RMLI IT) had 20 stores and 250k club members at the end of 2010 with plans for 31 stores by the end of 2012. Their MVNO strategy is based on an "MVNO light" model where all hardware, operating technology, and billing services are provided by the network operator per use. Rami Levi is targeting 100k subscribers within 12 months of launch.
- Free Telecom is an MVNO set up by local businessman Mr. Shlomo Shmeltzer and will also operate on Pelephone's network.
- Alon Cellular is an MVNO set up by food and general retailer Alon Holdings Blue Square (Bloomberg: BSI IT) and while it has an agreement with Partner to use their network its MVNO plans seem to be early stage with no concrete plans to launch in the near term. Alon Holdings Blue Square operates 210 supermarkets, 100 non-food retailers, and 188 petrol stations (with 177 convenience stores) in Israel.

Network operators:

- MIRS is an iDEN (push-to-talk) operator with a 4-5% market share (<500k subs) mostly made up of small and mobile business. MIRS was bought by HOT owner Patrick Drahi from Motorola for \$170m in late 2009, and is currently in the process of being merged into its sister company, creating a full mobile and fixed operator. MIRS/HOT looks well placed to become a successful GSM operator as it already has a customer base (HOT's 740k internet access households in addition to existing mobile subs) and base station sites (about 500 of the required 2,500).
- Select Communications led by Michael Gelfand of Blue Wireless NY as the third highest bidder in the April auction has been offered the second new network license and has until mid-July to accept and provide bank guarantees. Blue Wireless NY is currently offering unlimited talk, SMS, and web nationwide in the US for \$28/month according to their website (www.blueunlimited.com).
- Golan Telecom is the group of Michael Golan a former CEO at Iliad in France and backed by Xavier Niel, founder and controlling shareholder of Iliad. Should Select Communications decline the second license it will be offered to Golan Telecom. Iliad has just entered the French mobile market promising to cut prices significantly as it has already done in broadband. The cut-price strategy is likely to be similar should it get the second new network license in Israel.

Lessons from Europe

Figure 12. Case Study Summary

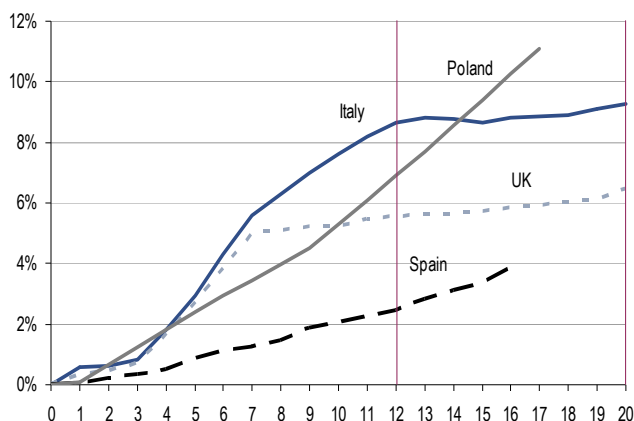
	New entrant	Year	Penetration of market on new player entry
UK	"3"	2003	85%
Italy	"3"	2003	93%
Spain	Yoigo	2006	100%
Poland	P4	2006	97%

Source: Citi Investment Research and Analysis

We looked at four case studies from Europe – the UK, Italy, Spain and Poland – to try to assess the potential impact of new network operators on a) incumbent shares and b) on pricing. Our two main takeaways are as follows:

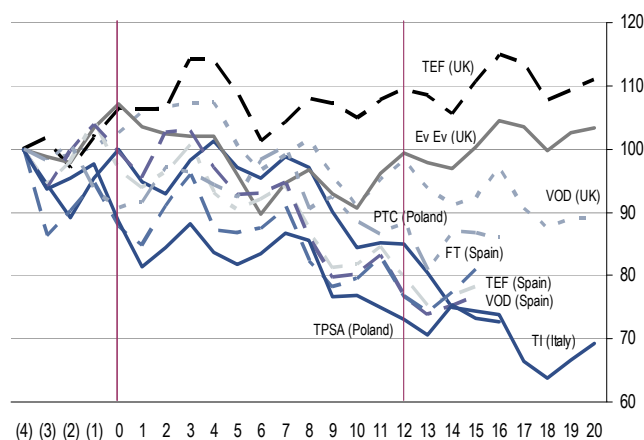
- New MNOs market share gains average 6% by the end of year 3.
- ARPU declines averaging c-20% in Spain, Italy and Poland by the end of year 3 although the UK experience does offer the Israeli incumbents some grounds for optimism in our view.

Figure 13. Quarterly market share gains for new operators from launch



Source: Company Reports; Citi Investment Research and Analysis

Figure 14. Quarterly ARPU development from four quarters ahead of new entrant launch



Source: Company Reports; Citi Investment Research and Analysis

Impact on market share

Market share gains for new operators are to a large extent dependant on new operators' preparedness to take short-term losses. In the UK and Italy "3" was able to pick up lots of share quickly investing heavily in subsidized handsets and discounting. In Poland, P4 has gained share very quickly benefitting from steep and asymmetric MTR cuts, easier migration between operators (regulator-enforced) and cheaper mobile operator costs. In Spain Yoigo launched in 2006 after a six year delay and with less appetite for losses has picked up share at a slower pace, although its simple and discounted plans are gradually starting to have an impact.

In terms of the read-through for Israel it is worth bearing in mind the following:

- Penetration in Israel (128% at the end of 2010) is far higher than any of the European examples giving the new operators far less scope to pick up new subscribers. As a result we may see even more price and ARPU competition.
- In Israel there is a high likelihood in our view that we will see two new operators entering the market at the same time following the April UMTS auction as opposed to one new operator in our case studies. Again we see this having more of an impact on pricing than market share losses.

Impact on ARPU

ARPU declines averaged -20% from 12 months ahead of new operator entry to three years after in the Spanish, Italian and Polish examples, although declining MTRs also played their part. Relatively high pricing meant the Spanish market was susceptible to a discounting strategy and Yoigo with its simple and discounted plans (€0.12/min anytime, anywhere nationally) has gradually started to make an impact, along with a number of MNVOs who are making value offers in a recessionary Spanish economy. ARPU declined by c-20% at TEF and VOD in Yoigo's first three years until the end of 2009. These declines continued in 2010 although at a more moderate pace. In Poland ARPU declined by -27% at TPSA and by -12% at PTC in the three years post P4's launch in 2006. Pre-P4 the big three had enjoyed a stable oligopolistic environment. P4 also enjoyed the benefit of asymmetric MTRs on launch with connections terminating at P4 net 2-3x higher than those terminating at the other operators. In Italy TI ARPU declined by 'only' -15% in the first three years post "3" launch in 2003 perhaps aided by 'market growth (penetration of 'only' 93%) and a wish to maintain profitability. ARPU declines picked up in years 4 and 5 (-19% over two years).

The UK is the only market where ARPU has not declined post new operator entry. "3" entered the market in 2003. Perhaps the carriers took the view that the margin hit from price cuts would be too large and that the regulator would interfere should they try to put "3" out of business. Penetration in 2003 was 'only' 85% and the market was still growing at the time. The fact that 02 (TEF) received its independence from BT at around the time that "3" launched and started to target Vodafone's higher spending, driving higher ARPU, is also relevant. Later when "3" got larger and the market growth slowed the need to react became greater, although ARPU declines in the last two years were "only" -3% (TEF and VOD) to -11% (EvEv).

In terms of the read-through for Israel we make the following observations:

- High penetration combined with multiple new entrants (MVNOs and MNOs) mean that ARPU is likely to come under severe pressure in 2012-13 as new entrants cut prices aggressively to pick up share in our view.
- We estimate this will be exacerbated by the terms of the new network licenses that allow new operators to subsidize each new subscriber up to \$345, more than five months of an "unlimited" voice, SMS, and data plan.

Figure 15. Cost of Israeli mobile services versus other OECD countries

	Rank	US\$ PPP		
		Israel	Average	Premium
30 calls + 100 SMS	5 th	23	17	+35%
100 calls + 140 SMS	4 th	49	33	+48%
300 calls + 225 SMS	4 th	103	63	+63%
900 calls + 350 SMS	5 th	195	123	+59%
40 calls pre-paid	10 th	26	22	+20%
400 SMS	1 st	66	23	+190%

Source: Citi Investment Research and Analysis;
OECD Communications Outlook 2011

- We believe that the existing operators are likely to defend their market shares aggressively taking the view that short-term pain in the form of lower prices, ARPU and profitability is a price worth paying in order to see the newcomers struggle to make money and ultimately exit the business.
- We view Israeli ARPU even in 1Q11 as high in both absolute and relative terms. Recently released OECD data shows Israel ranking as the 4th or 5th (out of 34) most expensive country for a range of mobile services (Figure 15). For example, a mobile basket of 300 calls and 225 SMSs at Partner (Orange Special) cost \$103 in Israel, 63% higher than the OECD average. While the OECD data is from August 2010 and prices have come down since then due to competition, the premium is still healthy. Our own analysis of Vodafone's ARPU in 7 European markets shows Israeli ARPU as higher than Germany, Italy and the UK and at 1.3% of GDP per capita versus a 1.1% average (Figure 16). We see new operator and network competition as driving Israeli ARPU lower to more 'normal' levels. Based on the Vodafone analysis, a decline of -19% in Israeli ARPU to \$27.0 or NIS92 (from NIS113 in 1Q) would not be unjustified.

Figure 16. Vodafone* ARPU by market

	Germany	Italy	Spain	UK	Greece	Netherlands	Portugal	Average	Israel
Total (US\$)	21.1	27.6	37.8	28.8	21.7	43.0	21.3	28.8	33.3
Contract (US\$)	40.0	59.8	47.9	49.9	52.2	62.9	56.0		na
Prepaid (US\$)	5.6	22.2	12.4	9.1	6.2	12.0	13.0		na
Prepaid/total subs	56%	85%	38%	50%	59%	38%	81%	58%	<20%
GDP per capita (US\$, PPP)	35,700	30,500	29,400	34,800	29,600	40,300	23,000		29,800
Annual ARPU vs. GDP per capita	0.7%	1.1%	1.5%	1.0%	0.9%	1.3%	1.1%	1.1%	1.3%

Source: Citi Investment Research and Analysis; * except Israel which is based on 1Q11 Company Reports; Vodafone ARPU is 12 months to Q4 10/11 and uses EUR/USD conversion at 1.36; GDP per capita data is from CIA fact book

Act IV: Post 2014

Consolidation

And so to Act IV of this tragedy where we see blue skies appear after a tough storm the night before. Following the pricing pressure of Act III, we believe operators and shareholders will find the going too tough in a lower growth market leading to market consolidation as we have seen in the US and the UK in recent years, and lifting the pressure on pricing and revenues after a tough 2010-14e.

In March AT&T announced that they were buying T-Mobile USA from Deutsche Telecom – a deal driven by large investments needed for 4G licenses, crowded radio bands, and slower market growth in our view.

In late 2009 the 3rd and 4th operators in the UK, Orange and T-Mobile, announced a JV, we believe in an attempt to alter unfavorable market dynamics that had led to severe price pressure and high sales and marketing costs.

We see this scenario playing out in Israel too at some point, although only once Act III has come to an end.

Company Focus

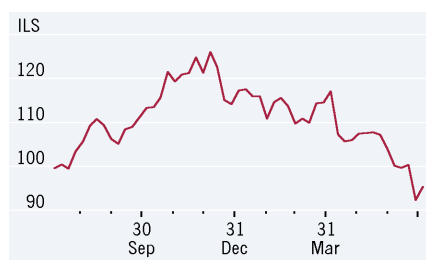
Cellcom Israel Ltd. (CEL.TA) A Tragedy in IV Acts – Cut Cellcom to Sell

■ Please see front cover bullets

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

Sell/High Risk	3H
<i>from Hold/Medium Risk</i>	
Price (06 Jul 11)	NIS95.15
Target price	NIS73.00
<i>from NIS112.00</i>	
Expected share price return	-23.3%
Expected dividend yield	11.2%
Expected total return	-12.0%
Market Cap	NIS9,464M
	US\$2,770M

Price Performance (RIC: CEL.TA, BB: CEL IT)



Cellcom Israel Ltd. (ILS)

Year to 31 Dec	2009A	2010A	2011E	2012E	2013E
Sales (NISM)	6,483.0	6,662.0	6,173.4	6,028.3	5,846.2
Net Income (NISM)	1,182.0	1,291.0	1,123.6	979.0	934.5
Diluted EPS (NIS)	11.90	12.98	11.28	9.82	9.37
Diluted EPS (Old) (NIS)	11.96	12.36	11.65	12.13	na
PE (x)	8.0	7.3	8.4	9.7	10.2
EV/EBITDA (x)	4.9	4.7	5.3	5.8	6.2
DPS (NIS)	11.91	13.85	10.76	9.36	8.92
Net Div Yield (%)	12.5	14.6	11.3	9.8	9.4

Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	8.0	7.3	8.4	9.7	10.2
EV/EBITDA adjusted (x)	4.9	4.7	5.3	5.8	6.2
P/BV (x)	25.0	27.6	23.8	21.2	19.3
Dividend yield (%)	12.5	14.6	11.3	9.8	9.4
Per Share Data (NIS)					
EPS adjusted	11.90	12.98	11.28	9.82	9.37
EPS reported	11.90	12.98	11.28	9.82	9.37
BVPS	3.80	3.45	4.00	4.48	4.94
DPS	11.91	13.85	10.76	9.36	8.92
Profit & Loss (NISM)					
Net sales	6,483	6,662	6,173	6,028	5,846
Operating expenses	-4,715	-4,724	-4,452	-4,512	-4,403
EBIT	1,768	1,938	1,722	1,516	1,443
Net interest expense	-219	-230	-242	-245	-245
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	1,549	1,708	1,480	1,271	1,198
Tax	-367	-417	-356	-292	-264
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	1,182	1,291	1,124	979	934
Adjusted earnings	1,182	1,291	1,124	979	934
Adjusted EBITDA	2,526	2,664	2,395	2,179	2,086
Growth Rates (%)					
Sales	1.0	2.8	-7.3	-2.4	-3.0
EBIT adjusted	4.6	9.6	-11.2	-11.9	-4.8
EBITDA adjusted	0.4	5.5	-10.1	-9.0	-4.3
EPS adjusted	19.5	9.0	-13.1	-13.0	-4.6
Cash Flow (NISM)					
Operating cash flow	1,871	2,134	1,844	1,743	1,647
Depreciation/amortization	758	726	674	663	643
Net working capital	5	75	5	59	28
Investing cash flow	-575	-619	-476	-467	-507
Capital expenditure	-404	-441	-340	-333	-362
Acquisitions/disposals	-171	-178	-137	-134	-146
Financing cash flow	-189	-1,327	159	-380	-88
Borrowings	997	-8	1,227	550	800
Dividends paid	-1,186	-1,319	-1,068	-930	-888
Change in cash	1,107	188	1,526	895	1,052
Balance Sheet (NISM)					
Total assets	6,379	5,996	6,838	6,922	7,659
Cash & cash equivalent	903	533	1,509	1,625	1,611
Accounts receivable	1,914	1,946	1,803	1,761	1,708
Net fixed assets	2,096	2,063	1,957	1,849	1,809
Total liabilities	6,005	5,655	6,441	6,476	7,167
Accounts payable	1,278	1,227	1,161	1,182	1,155
Total Debt	4,535	4,261	5,179	5,194	5,994
Shareholders' funds	374	341	397	446	492
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	39.0	40.0	38.8	36.2	35.7
ROE adjusted	nm	nm	nm	nm	199.3
ROIC adjusted	39.7	42.1	37.9	34.5	30.2
Net debt to equity	971.1	nm	924.8	801.1	890.7
Total debt to capital	92.4	92.6	92.9	92.1	92.4

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Company Focus

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

Partner Communications Co Ltd (PTNR.TA) A Tragedy in IV Acts – Raise Partner to Hold

■ Please see front cover bullets

Hold/High Risk	2H
<i>from Sell/High Risk</i>	
Price (06 Jul 11)	NIS52.37
Target price	NIS50.00
<i>from NIS65.00</i>	
Expected share price return	-4.5%
Expected dividend yield	13.7%
Expected total return	9.2%
Market Cap	NIS8,151M
	US\$2,385M

Price Performance (RIC: PTNR.TA, BB: PTNR IT)



Partner Communications Co Ltd (ILS)

Year to 31 Dec	2009A	2010A	2011E	2012E	2013E
Sales (NISM)	6,079.0	6,674.0	7,556.4	7,086.5	6,658.1
Net Income (NISM)	1,141.0	1,243.0	1,190.1	1,080.7	961.8
Diluted EPS (NIS)	7.37	7.95	7.59	6.85	6.06
Diluted EPS (Old) (NIS)	5.78	7.96	7.84	7.90	na
PE (x)	7.1	6.6	6.9	7.6	8.6
EV/EBITDA (x)	4.3	4.0	4.5	5.1	5.4
DPS (NIS)	6.86	16.99	7.37	6.90	6.10
Net Div Yield (%)	13.1	32.4	14.1	13.2	11.7

Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	7.1	6.6	6.9	7.6	8.6
EV/EBITDA adjusted (x)	4.3	4.0	4.5	5.1	5.4
P/BV (x)	4.1	13.0	13.8	13.9	14.0
Dividend yield (%)	13.1	32.4	14.1	13.2	11.7
Per Share Data (NIS)					
EPS adjusted	7.37	7.95	7.59	6.85	6.06
EPS reported	7.37	7.95	7.59	6.85	6.06
BVPS	12.76	4.04	3.79	3.76	3.74
DPS	6.86	16.99	7.37	6.90	6.10
Profit & Loss (NISM)					
Net sales	6,079	6,674	7,556	7,086	6,658
Operating expenses	-4,378	-4,814	-5,715	-5,371	-5,089
EBIT	1,701	1,860	1,842	1,716	1,569
Net interest expense	-176	-181	-269	-312	-336
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	1,525	1,679	1,573	1,404	1,233
Tax	-384	-436	-383	-323	-271
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	1,141	1,243	1,190	1,081	962
Adjusted earnings	1,141	1,243	1,190	1,081	962
Adjusted EBITDA	2,278	2,570	2,605	2,424	2,234
Growth Rates (%)					
Sales	-3.5	9.8	13.2	-6.2	-6.0
EBIT adjusted	-6.8	9.3	-1.0	-6.9	-8.5
EBITDA adjusted	-0.5	12.8	1.4	-7.0	-7.8
EPS adjusted	-3.7	7.9	-4.6	-9.8	-11.6
Cash Flow (NISM)					
Operating cash flow	1,618	680	1,998	1,790	2,588
Depreciation/amortization	577	710	764	709	665
Net working capital	-186	-1,300	20	1	0
Investing cash flow	-502	-361	-688	-638	-599
Capital expenditure	-526	-361	-688	-638	-599
Acquisitions/disposals	24	0	0	0	0
Financing cash flow	-1,092	753	-1,146	-1,081	-962
Borrowings	-131	1,978	0	0	0
Dividends paid	-986	-1,231	-1,146	-1,081	-962
Change in cash	24	1,072	164	71	1,027
Balance Sheet (NISM)					
Total assets	5,623	5,627	7,372	6,803	6,346
Cash & cash equivalent	329	321	19	71	67
Accounts receivable	1,275	1,402	2,324	2,136	1,824
Net fixed assets	2,064	2,058	2,102	2,026	1,960
Total liabilities	3,661	5,001	6,783	6,244	5,787
Accounts payable	1,163	1,198	1,379	1,303	1,236
Total Debt	2,431	3,716	5,322	4,859	4,469
Shareholders' funds	1,962	626	589	589	589
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	37.5	38.5	34.5	34.2	33.6
ROE adjusted	61.8	96.1	195.9	183.5	163.3
ROIC adjusted	37.4	39.9	33.9	28.5	28.9
Net debt to equity	107.1	542.3	900.3	812.9	747.5
Total debt to capital	55.3	85.6	90.0	89.2	88.4

For further data queries on Citi's full coverage universe please contact CIRA Data Services Europe at CIRADataServicesEMEA@citi.com or +44-207-986-4050



Cellcom Israel Ltd.

Company description

Cellcom is the largest mobile operator in Israel. It has a 34% market share of subscribers and 3.4m subscribers. Cellcom started its operations in 1994 using a TSMA network. GSM was launched in 2002. Subsequently, Cellcom introduced EDGE, and launched UMTS in 2006. Cellcom has over 1,430km of fibre-optic infrastructure.

Investment strategy

We have a Sell/High Risk (3H) rating as we see Israeli mobile becoming more competitive in 2010-14 as new MVNOs and MNOs enter the market putting pressure on pricing and ARPU.

Valuation

We apply an 8x PE multiple to our 2014e earnings estimates, discount this back to 2012 using a 10% discount rate and then subtract the 12 month DPS to arrive at our price target - NIS73.

Risks

With intensifying competition and entry now into the ISP and residential fixed markets, the future is looking a whole lot less certain and we have a High Risk rating. Negative risks are: 1) More intense mobile market share and price competition than we are currently forecasting, and 2) increased competition in the ISP market – Cellcom is currently in the process of acquiring ISP player Netvision. Positive risks are: 1) Only one new UMTS license being granted, and 2) less aggressive market share and price competition than we are currently forecasting.

Partner Communications Co Ltd

Company description

Partner is one of three major UMTS operators in Israel. It has a 32% market share or around 3.2m subscribers. Partner started operations in 1999 by offering services over GSM 900 and 1800, and 3G on UMTS was launched in 2004. Partner also has fibre-optic transmission network acquired in July 2006 and was granted domestic fixed licence in January 2007.

Investment strategy

We have a Hold/High Risk (2H) rating as we think that the current share price is already discounting the intensifying competition from 2H through 2014e.

Valuation

We set out target price at NIS50 applying an 8x PE multiple to 2014e earnings and then discounting this back to 2012 using a 10% rate before deducting a NIS7.2/shr 12 month dividend.

Risks

We have a High Risk rating given the uncertain competitive environment as new MVNOs and MNOs enter the market in 2011-12. Negative risks are: 1) More intense mobile market share and price competition than we are currently forecasting, 2) increased competition in the ISP market where Partner recently acquired 012 Smile, and 3) we dislike the leverage at controlling shareholder level seeing Partner free cash flow supporting a large amount of debt. Positive risks are: 1) Only one new UMTS license being granted, and 2) less aggressive market share and price competition than we are currently forecasting.

Other companies mentioned: Belgacom SA (BCOM.BR; €23.78; 3L); Deutsche Telekom AG (DTEGn.DE; €10.57; 1L); Mobinil (EMOB.CA; E£123.68; 1M); France Telecom (FTE.PA; €14.33; 2L); KPN NV (KPN.AS; €9.68; 1L); Mobile Telesystems OJSC (MBT.N; US\$18.73; 1M); Magyar Telekom (MTEL.BU; Ft571; 2M); MTN Group Limited (MTNJ.J; R143.98; 1H); Orascom Telecom (ORTEq.L; US\$3.40; 1H); Qatar Telecom (QTEL.QA; QR155.30; 1M); Turkcell Iletisim Hizmetleri AS (TCELL.IS; TL8.82; 2M); Telefonica SA (TEF.MC; €16.54; 2M); Telenor ASA (TEL.OL; NKr87.00; 1M); Telekom Austria (TELA.VI; €8.60; 2M); Telkom (TKGJ.J; R36.29; 1M); Telecom Italia SpA (TLIT.MI; €0.92; 1M); Telecom Italia SpA (TLITn.MI; €0.78; 1M); TeliaSonera AB (TLSN.ST; SKr45.67; 3M); Telekomunikacja Polska SA (TPSA.WA; ZL16.50; 1M); Türk Telekomünikasyon AS (TTKOM.IS; TL8.54; 1M); Vodafone Group PLC (VOD.L; £1.65; 1L); Vodacom Group Limited (VODJ.J; R84.26; 1M)

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Cellcom Israel Ltd. (CEL.TA)

Ratings and Target Price History Fundamental Research

Analyst: Michael Klahr

Covered since May 17 2010



Chart current as of 5 July 2011

	Date	Rating	Target Price	Closing Price
[1]	28-Jan-10	1L	*150.00	120.30

* Indicates change

	Date	Rating	Target Price	Closing Price
[2]	3-Nov-10	*2M	*112.00	118.20

Rating/target price changes above reflect Eastern Standard Time

Cellcom Israel Ltd. (CEL.TA)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Michael Klahr

Covered since May 17 2010

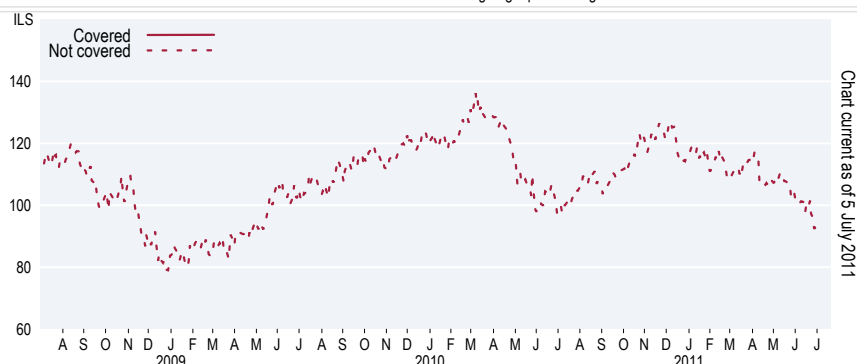


Chart current as of 5 July 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Partner Communications Co Ltd (PTNR.TA)

Ratings and Target Price History Fundamental Research

Analyst: Michael Klahr

Covered since May 25 2010



Chart current as of 5 July 2011

	Date	Rating	Target Price	Closing Price
[1]	28-Jan-10	1L	*100.00	77.46

* Indicates change

	Date	Rating	Target Price	Closing Price
[2]	3-Nov-10	*3H	*65.00	72.35

Rating/target price changes above reflect Eastern Standard Time

**Partner Communications Co Ltd
(PTNR.TA)**

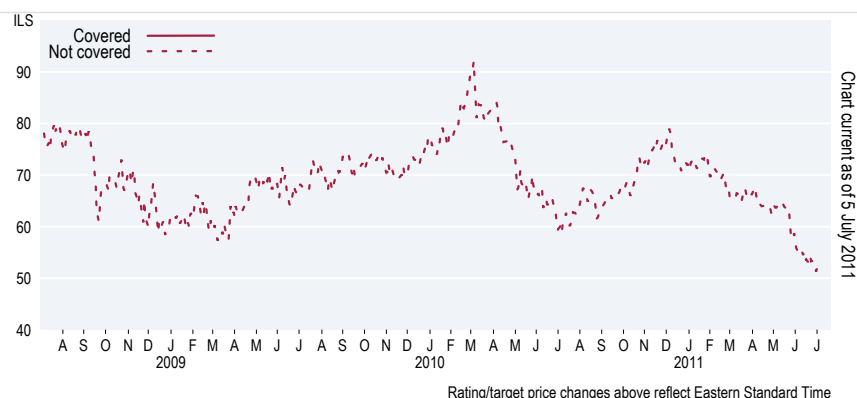
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Michael Klahr

Covered since May 25 2010



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Citi Investment Research & Analysis Ratings Distribution

Data current as of 30 Jun 2011

Citi Investment Research & Analysis Global Fundamental Coverage

12 Month Rating			Relative Rating		
Buy	Hold	Sell	Buy	Hold	Sell
54%	36%	11%	10%	81%	10%

% of companies in each rating category that are investment banking clients 45% 41% 42% 50% 42% 44%

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Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

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