

**EARNINGS PREVIEW | COMMENT**

NOVEMBER 9, 2009

**012 Smile.Communications Ltd. (NASDAQ: SMLC)**

**Next Year I'm Gonna Play In Major League**

**Sector Perform  
Above Average Risk**

<b>Price:</b>	14.82	<b>Price Target:</b>	16.00
<b>Shares O/S (MM):</b>	25.3	<b>Implied All-In Return:</b>	8%
<b>Dividend:</b>	0.00	<b>Market Cap (MM):</b>	375
<b>Institutional Ownership:</b>	11%	<b>Yield:</b>	0.0%
		<b>Enterprise Val. (\$MM):</b>	221.0
		<b>Avg. Daily Volume (MM):</b>	0.06
		<b>3-Yr. Est. EPS Growth:</b>	15.00%

**RBC Capital Markets Corp.**

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<b>FY Dec</b>	<b>2007A</b>	<b>2008A</b>	<b>2009E</b>	<b>2010E</b>
Adj EPS - FD	2.10	3.52	4.08	4.68
P/AEPS	26.6x	15.8x	13.7x	11.9x
Revenue (MM)	1,102.8	1,107.0	1,169.1	1,229.8
<b>Adj EPS - FD</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
2007	0.86A	0.49A	0.67A	0.33A
2008	0.93A	0.77A	0.89A	0.93A
2009	0.93A	1.02A	1.07E	1.05E
2010	1.13E	1.16E	1.23E	1.15E
<b>Revenue (MM)</b>				
2007	276.0A	277.2A	280.3A	271.3A
2008	263.3A	263.6A	281.8A	298.2A
2009	284.4A	290.9A	297.1E	296.7E
2010	229.2E	304.3E	316.3E	310.0E

All market data in USD; all financial data in ILS; dividends paid in USD.

**Event**

Previewing 3Q09 numbers slated for release Nov 18, before market open.

**Investment Opinion**

We expect SMLC to report good 3Q09 numbers on favorable summer seasonality along with ongoing cost controls. Yet following the 30.6% acquisition of incumbent Bezeq for NIS 6.5B, Bezeq numbers on Nov. 5 were the key to investors while 3Q09 print on Nov. 18 becomes a showcase for ISP/ILD operations, which is up for sale for ~NIS 1.2B, likely to Partner or HOT; in essence, SMLC moves from a challenger to an investment vehicle in an established player, with limited competition as the Israeli telecom space consolidates further, benefiting from solid cash generations and high dividend yield story. We maintain Sector Perform rating as we believe growth prospects are limited and valuation seems fair.

**3Q09 preview**

We believe business tone remains good with ISP (52% mix) demand fairly resilient and VoB additions are on track while ILD benefited from summer traffic pick up. We project total revenue of NIS 297m, up 2% sequentially and 3% Y/Y. We expect mild OpEx hike to yield EBITA of NIS 70m (23.5% margin). We note bottom-line may be negatively impacted by FX shifts and higher Israeli CPI which increases financing expenses and model NIS 1.07 EPS. This compares to our two peers' average of NIS 288m/70m/1.18. Note that the Bezeq deal may only show up in P&L and balance sheet starting 4Q09.

For FY09 we model 12% growth in ISP and flattish ILD revenues for a total of NIS 1.17B, EBITDA of NIS 272m (23%; +8% Y/Y) and NIS EPS of 4.08. Peers are at NIS 1.1B/270m/4.7. FY10 estimates are NIS 1.23B/292m/4.68 (peers: NIS 1.14B/280m/4.68).

**Soon, You will be mine...**

Israeli incumbent Bezeq posted healthy 3Q09 results with mild sequential revenue uptick and record EBITDA margins (see details section). We believe deal is on track with ongoing negotiation on additional required financing, sale of current ISP/ILD operations and dialogue with the regulatory bodies. In addition, high 2H09 Bezeq dividend attributable to SMLC in essence secures ~15% of the NIS 6.5 B deal.

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

For Required Conflicts Disclosures, see Page 5.

## Details

### 3Q09 preview

We believe business tone remains good with ISP (52% mix) demand fairly resilient while ILD benefited from summer traffic pick up. We project total revenue of NIS 297m in total revenues, up 2% sequentially and 3% Y/Y. We expect mild OpEx hike to yield EBITA of NIS 70m (23.5% margin). We note bottom-line may be negatively impacted by FX shifts and higher Israeli CPI which increases financing expenses and model NIS 1.07 EPS. This compares to our two peers' average of NIS 288m/70m/1.18. Note that the Bezeq deal will only show up in P&L and balance sheet starting 4Q09.

- **ISP (52% mix):** We model 3Q09 revenues of NIS 155m (+3% Q/Q ;+10% Y/Y). Partner's picked up the heat in ISP in recent months, yet SMLC's attractive offer to double bandwidth speeds at the same price helped customer retention. In addition, we believe VoB additions seems healthy and on track towards drafted market share targets.
- **ILD (48% mix):** Summer seasonality helped traffic, though economic headwinds may have muted some of that, and we conservatively project model NIS 142m (+1% Q/Q ; flat Y/Y).

### SMLC - 3Q09 Conference Call

SMLC will hold a conference call November 18, at 9am EST.

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### Bezeq's 3Q09 Recap:

Israeli incumbent Bezeq posted healthy 3Q09 results with mild sequential revenue uptick and record EBITDA margins, highlighting the expected transformation of SMLC from a challenger to a platform of a major telecom group. In addition, the expected deal consolidates the Israeli telecom space and will likely further diminish the already-low level of competition. We believe deal is on track and that negotiation on additional required financing, sale of current ISP/ILD operations and regulation are progressing. In addition, high 2H09 Bezeq dividend attributable to SMLC in essence secures ~15% of the NIS 6.5 B deal. Still, we maintain Sector Perform rating on SMLC and the group as we believe growth prospects past the top are limited and valuation seems fair.

- **Bezeq 3Q09 at a glance: continued solid execution:** reported total consolidated revenues of NIS 2.9B (+1.8%Q/Q;4.2% Y/Y), with record EBITDA profitability of NIS 1.24B, up an impressive 3.4% Q/Q and 8.4% Y/Y to a record margin of 42.3%, FCF was strong at NIS 657m and Net debt is a comfortable 0.9x TTM EBITDA. Management reiterated 2009 guidance calling for Y/Y improvement in revenue, net profit, EBITDA and operating cash flows.
- **Fixed Line (~78.5% market share in consumer segment; 46% mix):** As expected, Fixed Line revenues continued gradual downward trend to NIS 1.34B, with record EBITDA margins of 50% resulting from on track headcount reductions and cost control.
- **Pelephone (47% mix):** revenues were up 1.9% Q/Q with muted seasonality to NIS 1.34B though up 13% Y/Y following successful early-2009 GSM. Net adds were 27k, and ARPU was good at 136 (+4% Q/Q; +5% Y/Y). Still operating margin declined to 23% (2Q09:23.8%; 3Q08:24.1%). EBITDA margins were also 34.2%, below industry average on incurred increased costs associated with the transition to the new network and operating dual networks.
- **Other:** ISP/ILD subsidiary Bezeq International (~33% market share; 11% mix) and Satellite TV provider YES (13% mix) posted flattish sequential revenue trends.

**Healthy dividend backs SMLC/Bezeq deal:** Bezeq posted net profit of NIS 2.09B (586m from operations + NIS 1.5B from YES deconsolidation), which should translate to NIS 639m in dividend to SMLC (Bezeq has 100% payout policy). We estimate 4Q09 dividend at NIS0.6B.

### The fly rides the elephant: SMLC becomes investment vehicle for Bezeq

SMLC announced it finalized the deal to acquire 30.6% of Bezeq shares from Apax-Saban-Arkin Group for 6.5B NIS (~\$1.8B, reflecting Bezeq value of \$5.7B). The deal is expected to close by April 25, 2010, mostly pending regulatory approvals. The 6.5B NIS deal will be financed using a debt and cash combination which we estimate as follows:

- NIS ~4B bank loans and / or bonds
- Sale of ISP and ILD operations (the "012 Smile" brand) for ~1.2B NIS
- NIS 380m SMLC cash;
- NIS ~800m dividends (half from ongoing dividend, rest in special payments to account for YES)
- NIS 300m NIS of cash from Internet Gold in loans of rights.

*Please refer to our note titled "0 1 2 Adds Up to a Big Smile As Fly Takes Over An Elephant Called Bezeq" issued October 26, 2009 for further details regarding the acquisition implications*

## Valuation

We believe SMLC shareholders are set to benefit from the new entity that takes shade under the SMLC ticker as Bezeq is a full-blown telecom group, unlike the niche 012 Smile brand and as the local scene is set to become less competitive and more cash-flow/dividend focused.

Our \$16 target reflects the value of SMLC's future holdings in Bezeq, after the sale of current operations and net of current and expected liabilities.

Key risks to our target price include mostly regulation and anti-trust issues that might be associated with the deal in addition to the amount of debt that will be undertaken to finance the deal. We may revisit our target as deal unfolds and we roll out our working model for Bezeq.

## Price Target Impediment

While we believe SMLC's risk profile is lower than most of the names in our universe we assign an Above Average Risk qualifier compared to other equities due to the following:

- Execution on strategy as company enters VoB and WiMax.
- Merger synergies of 012 and Smile may not be realized to full extent.
- Potential changes in competitive landscape: Fiercer competition from NetVision, Bezeq and Hot with the latter two capable of service bundling or from Partner's entry into ISP/VoB in early 2009.
- Changes in regulatory environment - VoB, Bezeq restrictions, WiMax.
- 012 Smile is dependent on the infrastructure of Bezeq and Hot to provide its services.
- Company exposed to Macro economy slowdown, currency changes.

Additional risks related to Bezeq deal: Anti-trust and regulation, financing the deal, finding buyer at a suitable price for current operations.

## Company Description

012 Smile Communication is a leading innovative service provider in Israel, offering International Long Distance (roughly half of mix) and Broadband Access and related Voice over Broadband services (roughly half of revenue). The company commands roughly 1/3 market share in its key business lines. 012 Smile is 72% owned by Internet Gold and related to the Eurocom Communications Group and its shares trade on the NASDAQ and the Tel Aviv Stock Exchange.

## 012 Smile Communications (NASDAQ: SMLC)

## Income Statement

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

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	2006A	2007A	1Q08A Mar	2Q08A Jun	3Q08A Sep	4Q08A Dec	2008A	1Q09A Mar	2Q09A Jun	3Q09E Sep	4Q09E Dec	2009E	1Q10E Mar	2Q10E Jun	3Q10E Sep	4Q10E Dec	2010E
Internet Services Revenue	428,023	486,765	129,700	131,507	140,300	148,000	549,507	148,700	150,000	154,900	161,000	615,000	160,900	163,500	166,900	166,600	657,900
Q/Q			-1%	1%	7%	5%		0%	1%	3%	4%		0%	2%	2%	0%	
Y/Y	17%	14%	14%	10%	15%	13%	13%	15%	14%	10%	9%	12%	8%	9%	8%	3%	7%
% mix	41%	44%	49%	50%	50%	50%	50%	52%	52%	52%	54%	53%	54%	54%	53%	54%	53%
International Long Distance Voice	610,427	615,968	133,657	132,100	141,503	150,000	557,260	135,700	140,905	142,200	135,700	554,505	138,300	140,800	149,400	143,400	571,900
Q/Q			-5%	-1%	7%	6%		-10%	4%	1%	-5%		2%	2%	6%	-4%	
Y/Y	21%	1%	-16%	-16%	-10%	7%	-10%	2%	7%	0%	-10%	0%	2%	0%	5%	6%	3%
% mix	59%	56%	51%	50%	50%	50%	50%	48%	48%	48%	46%	47%	46%	46%	47%	46%	47%
<b>Revenue</b>	<b>1,038,450</b>	<b>1,102,888</b>	<b>263,357</b>	<b>263,607</b>	<b>281,803</b>	<b>298,226</b>	<b>1,106,993</b>	<b>284,400</b>	<b>290,905</b>	<b>297,100</b>	<b>296,700</b>	<b>1,169,105</b>	<b>299,200</b>	<b>304,300</b>	<b>316,300</b>	<b>310,000</b>	<b>1,229,800</b>
Q/Q			-3%	0%	7%	6%		-5%	2%	2%	0%		1%	2%	4%	-2%	
Y/Y	20%	6%	-5%	-5%	1%	10%	0%	8%	10%	5%	-1%	6%	5%	5%	6%	4%	5%
Cost of revenue	753,672	760,705	176,690	177,367	193,156	206,203	753,416	198,973	201,821	203,200	203,500	807,494	204,400	206,900	213,800	211,200	836,300
% of Revenue	72.6%	69.0%	67.1%	67.3%	68.5%	69.1%	68.1%	70.0%	69.4%	68.4%	68.6%	69.1%	68.3%	68.0%	67.6%	68.1%	68.0%
<b>Gross profit</b>	<b>284,778</b>	<b>342,183</b>	<b>86,667</b>	<b>86,240</b>	<b>88,647</b>	<b>92,023</b>	<b>353,577</b>	<b>85,427</b>	<b>89,084</b>	<b>93,900</b>	<b>93,200</b>	<b>361,611</b>	<b>94,800</b>	<b>97,400</b>	<b>102,500</b>	<b>98,800</b>	<b>393,500</b>
Gross profit margin	27.4%	31.0%	32.9%	32.7%	31.5%	30.9%	31.9%	30.0%	30.6%	31.6%	31.4%	30.9%	31.7%	32.0%	32.4%	31.9%	32.0%
Selling and market expenses	165,145	157,304	38,516	36,048	40,742	43,129	158,435	37,793	35,304	39,400	39,200	151,697	38,100	39,100	41,000	39,500	157,700
% of Revenue	16%	14%	15%	14%	14%	14%	14%	13%	12%	13%	13%	13%	13%	13%	13%	13%	13%
General and administrative expenses	48,936	57,984	12,802	15,479	14,118	13,514	55,913	12,621	12,739	13,100	13,100	51,560	12,900	13,200	13,400	13,500	53,000
% of Revenue	5%	5%	5%	6%	5%	5%	5%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Impairment, merger and other charges	18,833	10,433	4,802	1,903	0	0	6,705	0	0	0	0	0	0	0	0	0	0
Total operating expenses	232,914	225,721	56,120	53,430	54,860	56,643	221,053	50,414	48,043	52,500	52,300	203,257	51,000	52,300	54,400	53,000	210,700
Y/Y	#DIV/0!	-3%	11%	0%	-5%	-11%	-2%	-10%	-10%	-4%	-8%	-8%	1%	9%	4%	1%	4%
<b>Operating Income</b>	<b>51,864</b>	<b>116,462</b>	<b>30,547</b>	<b>32,810</b>	<b>33,787</b>	<b>35,380</b>	<b>132,524</b>	<b>35,013</b>	<b>41,041</b>	<b>41,400</b>	<b>40,900</b>	<b>158,354</b>	<b>43,800</b>	<b>45,100</b>	<b>48,100</b>	<b>45,800</b>	<b>182,800</b>
% of revenue	5.0%	10.6%	11.6%	12.4%	12.0%	11.9%	12.0%	12.3%	14.1%	13.9%	13.8%	13.5%	14.6%	14.8%	15.2%	14.8%	14.9%
Y/Y	8%	125%	1%	9%	9%	30%	14%	15%	25%	23%	16%	19%	25%	10%	16%	12%	15%
Depreciation & Amortization	120,970	110,243	26,543	29,816	28,789	30,238	110,054	27,337	28,405	28,400	28,400	112,542	28,400	28,400	28,400	28,400	113,600
<b>EBITDA</b>	<b>191,667</b>	<b>237,138</b>	<b>61,892</b>	<b>62,626</b>	<b>62,576</b>	<b>65,618</b>	<b>252,712</b>	<b>62,350</b>	<b>70,685</b>	<b>69,800</b>	<b>69,300</b>	<b>272,135</b>	<b>72,200</b>	<b>73,500</b>	<b>76,500</b>	<b>74,200</b>	<b>296,400</b>
EBITDA margin	18%	22%	23.5%	23.8%	22.2%	22.0%	23%	21.9%	24.3%	23.5%	23.4%	23%	24.1%	24.2%	24.2%	23.9%	24%
Y/Y	15%	24%	7%	6%	2%	7%	7%	1%	13%	12%	6%	8%	16%	4%	10%	7%	9%
Financial income (expenses), net	-60,514	-52,043	-4,587	-10,758	-7,966	-4,100	-27,411	-3,800	-5,222	-5,200	-5,200	-19,422	-5,200	-5,200	-5,300	-5,300	-21,000
Income before taxes	-8,844	64,486	25,960	22,052	25,821	31,280	105,113	31,213	35,819	36,200	35,700	138,932	38,600	39,900	42,800	40,500	161,800
Tax on income	8,084	23,462	2,278	2,486	3,300	7,800	15,864	7,600	9,853	9,100	8,900	35,453	9,700	10,000	10,700	10,100	40,500
% of pre tax income	-91%	36%	9%	11%	13%	25%	15%	25%	25%	25%	25%	26%	25%	25%	25%	25%	25%
<b>Net Income</b>	<b>-16,928</b>	<b>40,957</b>	<b>23,682</b>	<b>19,566</b>	<b>22,521</b>	<b>23,480</b>	<b>89,249</b>	<b>23,613</b>	<b>25,966</b>	<b>27,100</b>	<b>26,800</b>	<b>103,479</b>	<b>28,900</b>	<b>29,900</b>	<b>32,100</b>	<b>30,400</b>	<b>121,300</b>
% of revenue	-2%	4%	9%	7%	8%	8%	8%	8%	9%	9%	9%	9%	10%	10%	10%	10%	10%
Y/Y	NA	NA	50%	117%	83%	213%	118%	0%	33%	20%	14%	16%	22%	15%	18%	13%	17%
<b>EPS</b>	<b>-0.92</b>	<b>2.10</b>	<b>0.93</b>	<b>0.77</b>	<b>0.89</b>	<b>0.93</b>	<b>3.52</b>	<b>0.93</b>	<b>1.02</b>	<b>1.07</b>	<b>1.05</b>	<b>4.08</b>	<b>1.13</b>	<b>1.16</b>	<b>1.23</b>	<b>1.15</b>	<b>4.68</b>
Q/Q			185%	-17%	15%	4%		1%	10%	4%	-1%		7%	2%	6%	-7%	
Y/Y	NA	NA	9%	57%	33%	182%	67%	0%	33%	20%	14%	16%	21%	13%	15%	9%	15%
Shares Out	18,370	19,493	25,360	25,360	25,360	25,360	25,360	25,356	25,346	25,346	25,446	25,373	25,600	25,850	26,100	26,450	25,900

Proforma numbers.

Source: RBC Capital Markets, Company reports.

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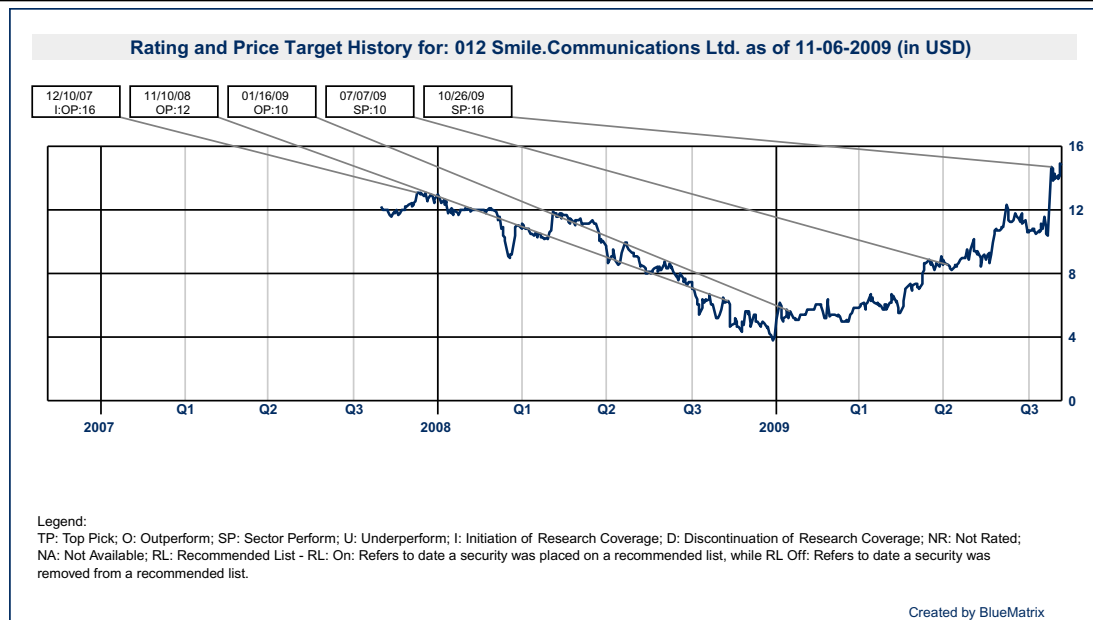
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			Count	Percent
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