March 25, 2002

Directors' Report on the State of the Company's Affairs
for the Year ended December 31, 2001

We are pleased to present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (hereinafter collectively referred to as "the Group") for the year ended December 31, 2001 (hereinafter: "the Directors' Report"). The Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970.

The financial data in the Directors' Report are presented in adjusted shekels of December 2001.

1. The Corporation and its Business Environment

A. The Company, together with its wholly or partially owned subsidiaries, is the main supplier of telecommunications services in Israel. The Group operates and provides a wide range of telecommunications activities and services, including domestic and international telephone services, mobile radio-telephone (cellular) services, satellite television services, laying, maintenance and development of infrastructures, communications services to other communications providers, Internet and data communications services, leased lines, satellite services, distribution of radio and television services to the public, supply and maintenance of equipment and services on customer premises.

B. The field of telecommunications in which the Group operates is subject to changes of a technological nature as well as with regard to the business structure of the sector. It is also a field in which competition has intensified in recent years, as a result of the Government's policy of opening up areas which were once exclusive to the Group, to competition.

C. The Group and its activities are subject to close supervision by different government authorities whose policies have changed and continue to change significantly from time to time. This supervision is reflected, *inter alia*, in each of the following:

(1) Most of the Company's tariffs are set and updated in accordance with the provisions of the Telecommunications Law, 5742-1982 (hereinafter: "the Telecommunications Law") and the regulations promulgated thereby (see Note 1B to the financial statements).
In addition, some Company tariffs are supervised and arranged in accordance with the provisions of the Supervision of Prices of Products and Services Law, 5756-1996.

(2) A duty to pay royalties to the State is imposed on most of the Group's revenues (see also Note 1C to the financial statements).

(3) As a government company, the Company is subject to the Government Companies Law, 5735-1975 and other laws.

(4) The Company's activities are subject to the provisions of a General License that was granted to it under the Telecommunications Law. In some segments of activity, the Company was permitted to operate through subsidiaries, in which the Company's control is limited.

(5) The Company was declared a monopoly in certain areas of its activities, and is therefore subject to supervision and restrictions under the Anti-Trust Law, 5748-1988 (see also Note 1D to the financial statements).

(6) Some of the activities of the Company and of the subsidiary Pelephone Communications Ltd. involve the use of wireless frequencies, and are therefore

subject to the Wireless Telegraph Ordinance (New Version), 5732-1972. The Wireless Telegraph Regulations stipulate the fees to be paid for the use of the wireless frequency.

The governmental supervision restricts the freedom of action of the Group as a business entity, its ability to compete successfully in markets which are opening up to increasing competition, its ability to deal with the changes occurring in the field of telecommunications and to exploit new business opportunities.

D. During the period of the Directors' Report and the period immediately subsequent thereto, a number of events and changes took place in the state of the Group's affairs and business environment, the most noteworthy of which are these:

1. Following the cancellation of Section 50 of the Telecommunications Law, effective from June 1, 1999, which had granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network, the Ministry of Communications embarked upon a series of actions designated to enable additional operators to provide domestic telecommunication services, as follows:

   a. In December 1999, the Ministry of Communications granted a special license to Israel Railways for providing communication services by the optical fibers it owns. In July 2001 Israel Railways published a tender for the lease of its infrastructure for providing telecommunication services. The tender proceedings are currently suspended, following a petition filed by the Company.

   b. In October 2000 the Ministry of Communications published a tender for the provision of domestic communication services by means of a wireless access network to the homes of subscribers (LMDS). In the absence of bids, the tender was cancelled.

   c. At the beginning of February 2001 the Ministry of Communications granted a license for operating domestic fixed-line communications to another company. To the best of the Company's knowledge, that company has since ceased it activities in the field.

   d. As explained in Note 1(e)(3) to the financial statements, in July 2001 the Telecommunications Law was amended so as to enable, inter alia, the Ministry of Communications to grant licenses to the cable television companies for providing domestic fixed-line communication services on the cable infrastructure.

   e. In March 2000 the Ministry of Communications started awarding licenses to the cable companies for providing domestic fixed-line communications services. At this stage, the license is valid for providing broadband Internet services via the cable infrastructure. The application of the cable companies to merge has not yet been approved by the regulatory authorities.

   f. The Ministry of Communications has enabled the start of operations of several entities in transmission services. These entities offer their services to the Company's customers.

2. The anticipated opening of fixed-line domestic telecommunications services to full competition and the award of licenses for fixed-line domestic communication services, in addition to the existing competition in the cellular and international communications segments, is expected to have a material adverse effect on the Company's business results which cannot yet be estimated.

3. Following the accelerated growth in cellular services which has occurred with the addition of cellular operators, this service has become a direct competitor in the fixed-line and transmission services provided by the Company, and has frozen growth and even led to a decrease in the volume of fixed-line services provided by the Company.

Pursuant to the directives of the Ministry of Communications to the cellular companies to disconnect direct connections which bypass the Company's network, a cellular company filed a petition in the High Court of Justice, demanding that the directive be cancelled, and the Court issued an Interim Order whereby the existing status is to be maintained. As a result of this order, guidelines were issued by the Ministry of Communications to all the cellular companies not to make any more direct connections.

4. Bezeq International ended 2001 with an operating loss considerably lower than that of last year. This improvement is derived from the reduction of operating and marketing costs, an increase in effective prices and the expansion of Internet activities, which enabled it to take advantage of economies of scale and the synergy potential with its other operations. The Minister of Communications decided to allow the grant of a general license for providing international communication services to additional applicants, starting from 1 January 2003.

   The Company, based on the assessment of Bezeq International, estimates that following the changes in Bezeq International's business environment since the start of competition, there are likely to be additional changes in regulation and the business environment, including the opening of the market to additional competitors. These changes are liable to have an adverse effect on the financial results of Bezeq International, *inter alia* on its tariffs, market share and traffic ratio.

5. The increasing competition in the cellular communications market has led to an increase in the costs of Pelephone (mainly the amortization of capitalized costs in respect of subscriber acquisition), and to the erosion of its tariffs. Consequently, the operating loss of Pelephone increased substantially in the Report Period. The amortization of assets which will not be used by Pelephone in the future for providing its services, also led to a considerable increase in the net loss of Pelephone.

6. Concerning the exercise of the right of first refusal to purchase an additional 50% of the share capital of Pelephone, see Note 8 to the financial statements.

7. In December 2001, the Minister of Communications notified Pelephone that it had won additional frequency bandwidth, which it will use for third generation cellular communications. As a result of the win, Pelephone's license is expected to be amended so that its existing term is extended (along with the term of the new frequencies awarded) until 2017. The grant of the frequencies and the changes in the license are subject to preconditions which include, *inter alia*, payment of an advance for the new frequencies ranges (NIS 225 million) plus a guarantee of NIS 20 million. The payment must be made in six installments until 2006. Two other cellular operators were also allocated new frequencies.

8. D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS") started to provide satellite broadcasting services in July 2000. In so doing, DBS accumulated losses in which the Company's equity as at December 31, 2001 amounts to approximately NIS 443 million, of which approximately NIS 252 million were incurred during the Report Period. DBS expects to incur considerable loses and a negative cash flow from current operations in the first years of its operation. On increased exposure and holdings in DBS, see Note 8(f) to the financial statements.

9. In the Report Period, the Company expanded its broadband Internet services with ADSL technology and increased the number of subscribers to the service.

10. As part of the implementation of its strategic plan and preparations for competition, the Company invested in several companies and venture capital funds in the Report Period. Among these investments were $9.5 million in Xpert Integrated Systems Ltd. ("Xpert") in consideration of 16.26% of that company's capital, together with an option to increase its holding to 20.33% (15.98% at full dilution). Xpert is an Israeli company that builds and integrates IP networks. The Company also invested about NIS 19 million in Adanet for Business Group Ltd. ("Adanet") in consideration of 50% of its share capital, and about NIS 21 million to acquire a shareholders' loan given to

Adanet by Clal Information Technologies Ltd. In addition, the Company has undertaken to invest $20 million in a venture capital fund, of which it invested $3 million in the Report Period. (See also Note 8 to the financial statements.)

11. Following amendment of the Law for Employment of Workers by Personnel Contractors, the Company took on as employees most of the workers who were formerly hired through employment agencies. This has increased the number of Company employees compared with last year.

12. In view of Government decisions in the past and directives of the Government Companies Authority, the Company and its subsidiaries are precluded from making donations. The Company recently approached the Government Companies Authority, requesting it to consider allowing it to make a donation as part of its policy of commitment to Israeli society and the community and out of business considerations. However, the request was refused. The Company therefore acts for the benefit of the community by means of involvement in social institutions and organizations such as the education system in development areas and on the front lines.

13. The privatization of the Company, which was scheduled for completion during the year, has not yet been completed. During the Report Period, the State took some actions to advance the process, such as publication of notice of its intention to sell its holdings in the Company. The Government Companies Authority received several offers from groups expressing interest in the sale. On January 13, 2002 a framework agreement was signed between the State and the Company, whereby capital will be raised in a sale of the Company's shares by the State by way of a private placement, in accordance with Sections 15A and 15C(b) of the Securities law, with a concurrent allotment of shares to the State by the Company (see Notes 1(f) and 21 to the financial statements).

2. Details concerning exposure to and management of market risks

The Company and each of the consolidated companies manages its own market exposure, each according to its own vision. The risks and their management at the Company are these:

The individual responsible for risk management in the company

The person responsible for risk management in the Company is the Chief Financial Officer, Mr. Oren Lieder. For details of his education and experience, see Periodic Report – Regulation 26A.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment, and the prices of the securities.

Interest rate – Most of the Company's loans are in foreign currency bearing variable interest at LIBOR plus a margin. The Company is exposed to changes in the LIBOR rate. This is a book exposure, and can affect the finance expenses borne by the Company, as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value, thereby eliminating this possible exposure.

Loans and debentures of the Company which are CPI-linked usually bear fixed interest, and therefore a change in the interest rate will affect the fair value rather than the book value. This characteristic also exists with regard to the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company invested in negotiable bonds that are stated in its books at their market value. This market value is influenced by changes in the interest rates in the economy.

As of the date of this report the Company does not hedge against the above exposures. It is no inconceivable, however, that hedging will be carried out in future market circumstances. The Company also takes into account such influences when considering the types of loans it takes.

Exchange rates – A change in the shekel exchange rate constitutes, of itself, financial exposure, in that it can affect the Company's future profit and cash flows, particularly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.
The Company also has accounting exposure deriving from the rate of change in the shekel exchange rates compared with the rate of change in the CPI in the report period. Such exposure generates erosion or an increase in the value of currency-linked liabilities, which could, in turn, have a considerable effect on the Company's real finance expenses.

In order to minimize this exposure, the Board of Directors decided that the Company should take hedging actions so that the balance of the unhedged exposure would not exceed 150 million dollars. This was accomplished in the Report Period by means of forward currency transactions with banking corporations. As part of the policy for minimizing exposure, all of the Company's exposure as at December 31, was hedged (for details of positions in derivatives, see below). We note that inherent in some of the Company's hedging transactions is a high nominal shekel interest that constitutes, in a period of low inflation, high real interest. Conversely, the Company receives a parallel nominal interest on its shekel deposits, thereby neutralizing the cost of the high real interest.

The Company had no material costs in making hedging transactions since they were made as forward transactions. The financial statements include finance interest of NIS 109.4 million from hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year. The Company's tariff updating mechanism as set out in the Regulations, allows tariffs to be updated by the same rate as inflation (less a fixed efficiency factor) once a year or when the rate of inflation reaches 8.5% . As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs. On the other hand, the influence of the rate of inflation on the Company's real expenses is lessened, since part of these expenses have direct or indirect linkage mechanisms. In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and mutual funds, which are exposed to changes in their real yield as a result of a change in the rate of inflation. The low rate of inflation in Israel in recent years has greatly reduced the financial significance of his risk.

The Company's loans are linked to the "known index", while accounting measurement is according to the "actual index". Differentials in the rise in the known index compared with the actual index create an increase in value or erosion of loans in book terms. In a period of high inflation, this differential had a material effect on the book measurement of the Company's finance expenses, since a considerable part of the Company's liability is linked to the CPI. The Company cannot protect itself against this exposure.

The Company invests part of its cash balances in unlinked shekel deposits and mutual funds. These deposits are exposed to changes in the rates of inflation, which affects their real yield.

Prices of raw materials and equipment – The cash flow from the Company's operations is used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral indices, exchange rates and global prices. The Company does not protect this exposure.

Prices of securities – The Company invests some of its financial surpluses in securities. The composition and amount of the securities portfolio is determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors laid down investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments (dollar and basket only), while the share component will not exceed 15% of the investment portfolio and will be TASE 100 shares. The types of bonds and their proportional part in the portfolio was also determined, according to criteria based on linkage, redemption date and a division between government and non-government bonds. A ceiling was also set for the various types of investment.

Supervision and implementation of risk management policy

The Finance Committee of the Company's Board of Directors discussed the risk management policy of the Company and its preparations for reporting in accordance with the amendment to the Securities Regulations (Periodic and immediate reports) on the subject of market risks and their management. Following that discussion, a sub-committee of the Finance Committee was established, with a mandate to discuss the Company's risk management policy and bring recommendations to the Finance Committee and the Board of Directors of the Company.

Report of linkage bases

Note 30 to the financial statements includes information about the linkage terms of the Company's monetary balances as at December 31, 2001.

Positions in derivatives as at December 31, 2001
(the following amounts are in NIS thousands)

Dollar / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognised for accounting	1,068,672	220,800	-	-	54,942	(6,488)	-	-

Euro / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognised for accounting	933,326	39,075	316,840	-	18,234	(505)	6,514	-

CPI / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging recognised for accounting	570,000	-	25,000	-	(1,242)	-	(1)	-

3. **Financial Position**

a. The Group's assets as at December 31, 2001 amount to approximately NIS 17.16 billion, compared with NIS 17.1 billion at December 31, 2000. Of these, approximately NIS 10.24 billion (approximately 59.7%) are fixed assets, compared with approximately NIS 11.77 billion (68.4%) on December 31, 2000. The decrease in total assets derived mainly from the decrease in the depreciated cost of fixed assets as a result of the difference between depreciation expenses and the investment made in the Report Period, from a decrease in deferred expenses and deferred taxes, and from a decrease in materials and spare parts. This decrease was offset mainly by the increase in investments and long-term debt.

b. The Group's shareholders' equity as at December 31, 2001 amounted to approximately NIS 7.18 billion, which comprise 41.8% of the total balance sheet, compared with approximately NIS 6.99 billion on December 31, 2000, which comprised approximately 40.6% of the balance sheet. The increase in shareholders' equity derived mainly from the net profit of the Group and from the conversion of debentures during the Report Period.

c. Total Group debt to financial institutions and to the holders of its debentures as at December 31, 2001 amounted to approximately NIS 6.2 billion, compared with approximately NIS 6.4 billion on December 31, 2000.

d. The balances of the Group's cash and short-term investments as at December 31, 2001 amounted to approximately NIS 1.74 billion, similar to December 31, 2000.

e. The Group's surplus of monetary liabilities over monetary assets in or linked to foreign currency as at December 31, 2001 amounted to approximately NIS 2.056 million. The Company's investment in dollar-linked convertible debentures (in connection with the Pelephone transaction) contributed to reduction of the dollar exposure. During the Report period, the Company made forward currency transactions to reduce exposure deriving from this surplus. As at December 31, 2001, there were no net dollar liabilities that are not hedged by such forward transactions.

f. The Group's surplus of monetary liabilities over monetary assets linked to the CPI as at December 31, 2001 amounted to approximately NIS 1.73 billion (forward transactions).

4. Results of Operations

Comparison of the results for 2001 with those for 2000

a. Principal results

Net profit for the year 2001 amounted to approximately NIS 121 million, compared with a net loss of approximately NIS 557million last year.
The difference between the results was caused mainly by a decrease of approximately NIS 1,190 million (before tax) in the other expenses / income item. In 2000, this item included an expense of approximately NIS 1,290 million (before tax), mainly for the early retirement scheme, which amounted to approximately NIS 1,467 million. In 2001, this item included of an expense of NIS 101 million, mainly the depreciation of other assets that will not be used by Pelephone in providing its services. Eliminating the effect of the other expenses / income items in the two periods, net earnings in 2001 would be approximately NIS 185 million, compared with NIS 268 million in 2000.

Earnings per share in 2001 were NIS 0.050 per NIS 1 par value, compared with a loss of NIS 0.229 per share last year.

b. Revenues

Group revenues for 2001 amounted to approximately NIS 8.15 billion, compared with approximately NIS 8.52 billion last year. Revenues last year include Company revenues from airtime for two months, whereas airtime is not included in the Report Period due to the change in the Company's method of settlement arrangements with the cellular operators. Eliminating this component, revenues for last year were only approximately NIS 8.23 billion.
Revenues from domestic fixed-line communications traffic decreased as a result of tariffs being lowered in May 2000 and in March 2001, and a decrease in call traffic, the effects of which were partially offset by an increase in Internet access traffic. Revenues from international communications decreased with the 30% reduction in access fees and the decrease in the revenues of Bezeq International. Revenues from installations and sales of equipment decreased as a result of various discount campaigns. The decrease in revenues was offset mainly by a rise in revenues from fixed fees.

c. Operating and general expenses

The Group's operating and general expenses for 2001 amounted to approximately NIS 4.47 billion, compared with approximately NIS 4.34 billion last year.
Expenses are influenced, on the one hand, by the change in the Company's settlement arrangements with the cellular companies since March 2000, following which the Company's expenses do not include airtime. Conversely, the implications of the arrangement with the cellular companies, as presented in Note 1(e)(1) to the financial statements, increased the Company's expenses.
In addition, the operating expenses of Pelephone increased, as did wages expenses, general expenses and expenses for materials and spare parts. In contrast, sub-contractor expenses and international communications expenses decreased. Most of the increase in wage expenses and the decrease in sub-contractor expenses are derived from taking on employment agency workers as *bona fide* Company employees.

d. Depreciation

The Group's depreciation expenses are decreasing as a result of the end of depreciation of the Company's fixed assets and a decrease in investments in new assets. This trend is expected to accelerate in the future, with the end of depreciation of assets which were transferred from the State to the Company at the time of its establishment.

e. Royalties to the Government of Israel

The decrease in royalties, as noted on Note 1(c) to the financial statements, has led to a decrease in the royalties obligation of the Group, mainly at Pelephone, which in the past had paid royalties at 8% of its revenues.

f. Operating income

The Group's operating income in 2001 amounted to approximately NIS 817 million, compared with approximately NIS 1,119 million last year, a decrease of approximately NIS 302 million. The decrease in operating income results from the changes described above in operating income and in operating and general expenses items, and from a decrease in depreciation and royalties to the Government of Israel. The decrease in operating income was recorded mainly at the Company and at Pelephone. The decrease for the Group was moderated by the decrease in the operating loss of Bezeq International.

g. Financing expenses

The Group's financing expenses in 2001 amounted to approximately NIS 144 million, compared with approximately NIS 348 million last year. The decrease is derived from a decrease in interest expenses following the reduction in financial liabilities, increased interest income from investments, and interest income from income tax (about NIS 75 million) as a result of the assessment arrangement for preceding years. The effects of changes in exchange rates were largely eliminated by hedging transactions.

h. Company's equity in the losses of affiliates

The increase in the Company's equity in the loses of affiliates was due to the increase in the losses of DBS Satellite Services (1998) Ltd. and due to the increase in the losses of Pelephone Communications Ltd. This increase was offset mainly by the Company's equity in the proceeds from the disposal of the Company's indirect holding in Hungary and by the decrease in the losses of Bezeq International – see also Notes 8(d), 8(e) and 8(f) to the financial statements.

i. Other expenses, net

In the year 2000, an expense of approximately NIS 1,467 million was recorded in this item, for early retirement – see Note 25 to the financial statements. In 2001 this item includes an expense of approximately NIS 101 million, most of which is depreciation of assets which will not be used by Pelephone for providing its services.

j. Quarterly data – Consolidated statements – In NIS millions

	2001					2000
	Total	Q4	Q3	Q2	Q1	Q4
Revenues	8,152	2,032	2,027	2,024	2,069	2,101
Costs and expenses	7,335	1,863	1,806	1,863	1,803	1,863
Operating income	817	169	221	161	266	237
Financing expenses	144	45	47	(1)	53	56
Other expenses (income)	101	100	24	(7)	(16)	(33)
Company's equity in earnings (losses) of investee companies	(227)	(86)	(65)	(16)	(60)	(78)
Net profit (loss)	121	(42)	7	84	72	44

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2001 amounted to approximately NIS 3,216 million, compared with approximately NIS 3,311 million last year. The cash flow generated by operating activities is the principal source for financing the Group's financing, and was used during the Report Period, *inter alia*, for the investment of approximately NIS 1,264 million in the development of telecommunications infrastructures, approximately NIS 524 million in investee companies and approximately NIS 1,103 million in convertible debentures in connection with the Pelephone transaction, as described in Note 8(d)(2) to the financial statements. Investments that were not financed by cash flow from operating activities were financed by a reduction in the Group's cash balances. In 2001, the Company repaid approximately NIS 1,584 million of debts, of which about NIS 1,035 million in long-term loans, NIS 227 million of debentures and NIS 322 million of short-term credit. Conversely, the Group raised new debt in a total amount of approximately NIS 1,245 million, of which approximately NIS 734 million in new long-term loans and NIS 511 million in issues of debentures.

The average monthly short-term credit for the period was approximately NIS 609 million. The average monthly of long-term liabilities in the period was approximately NIS 5,913 billion.

Working capital as at December 31, 2001 was positive and amounted to approximately NIS 272 million, compared with positive working capital of about NIS 14 million on December 31, 2000. The improvement in the Group's working capital derived from a decrease in current liabilities to banks and debenture-holders, a decrease in liabilities to suppliers and in liabilities in connection with financing the early retirement plan.

We thank the managers of the Group's companies, its employees and the shareholders.

Ido Dissentshik
Chairman of the Board

Ilan Biran
CEO