May 23, 2000

Directors' Report on the State of the Company's Affairs
for the Three Months ended March 31, 2000

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 three months ended March 31, 2000 (hereinafter: "the Directors' Report"). The Directors' Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970 and the Securities Regulations (Rules for reporting on preparations for solving the Y2K bug problem) (Temporary Order), 5759-1998.

The Directors' Report contains a review of its subject matter, in condensed form, and has been prepared assuming that the reader also has access to the Directors' Report of December 31, 1999.

The financial data in the Directors' Report are presented in adjusted shekels of March 2000.

1. The Business Environment

During the period of the Directors' Report and immediately following the date of the report, several events and changes occurred in the Group's affairs and its business environment, the most noteworthy of which are described below:

a) In February 1999, as part of the Arrangements Law, Section 50 of the Telecommunications Law, 5742-1982 was canceled. Section 50 granted the Company exclusivity in providing fixed national telecommunications services in a nationwide telephone network under the general license. The cancellation took effect on June 1, 1999, although the activities of the new operators in the domestic fixed telecommunications field will become possible only from the date on which they are granted a general license by the Ministry of Communications. In May 2000, the Ministry of Communications sent a draft of new regulations to the Knesset Economics Committee, for its information, which are designed to regulate the proceedings and conditions for receipt of general licenses for the provision of nationwide fixed domestic telecommunications services. Concurrently, the text of the draft was conveyed for the comments of the Ministry of Justice. Approval of the regulations will enable the awarding of licenses to new operators to begin, and with it, competition in domestic communications. Regarding the decision of the Attorney General in the matter of awarding licenses to the cable broadcasting franchisees - see Note 1B to the financial statements.

   The anticipated opening of fixed domestic communications services to competition, in addition to the growing competition in cellular and international communications sectors, is expected to have a materially adverse effect on the Company's business results which cannot be estimated at this stage. Furthermore, the decision of the Attorney General is likely to have a material effect on the communications market in a way which the Company is unable to evaluate.

b) Pursuant to the decision of the Knesset Finance and Economics Committee of March 13, 2000, the Company's tariffs were lowered, effective May 1, 2000, by an average of approximately 2.43%, and a change was made in the method of charging for calls, principally by changing from charging by meter pulses to charging by time (subject to minimum tariff per call). In addition, a number of tariff baskets were offered, mainly for Internet users, which entail lower tariffs.

c) In March 2000, the Company's management presented a plan to the Board of Directors which is based on a material change in its organizational and functional concept, in a pattern similar to the change already made in a number of similar companies in other countries, as part of the transition to operating in a competitive environment. The Board of Directors approved the plan after receiving clarification from Management. It is estimated that the retirement of approximately 500 to 600 employees is needed for implementation of the plan, where the estimated cost of such retirement, pursuant to an agreement whose term ends on June 30, 2000, will be approximately NIS 288 million, a sum which was included in the financial statements for 1999. Up to March 31, 2000, 122 employees retired under the plan. The Company approached the Companies Authority for its consent to extend the term of the agreement to March 31, 2001, a request which has not yet been granted. The Company's management is remaining in contact with the Companies Authority, in order to receive its consent. It should be noted that pursuant to the agreement which was validated as a decision by the Labor Tribunal as described below in section (e), the term of the agreement has been extended, at this stage, to July 15, 2000.

d) Bezeq International ended the first quarter of 2000 with an operating loss and a material net loss, inter alia as a result of the costs it bore due to the allocation plan, the decrease in tariffs, and the rise in expenses relating to the Internet sector. The Company, based on the assessment of Bezeq International, estimates that following changes in Bezeq International's business environment since the start of competition, there are likely to be additional changes in the field of international communications, inter alia in tariffs, market share and traffic ratio. As a result, there may be a material worsening in the Group's financial results.

In April 2000, Bezeq International signed a memorandum of understanding for the establishment of a joint company, the object of which will be to set up an undersea fiber optic cable in the Mediterranean region. Bezeq International's capital investment in the project is supposed to be in the region of 75 million dollars, where the entire project value is an estimated 400 million dollars. The transaction is subject to various approvals and the signing of a detailed contract.

e) The representatives of the Company's workers demanded from the Government that before privatizing the Company and opening the communications market to full competition, an agreement will be signed concerning the retirement of employees, and that securities will be given by the State for fulfillment of obligations towards the employees.

The State directed the Company's management in respect of the principles of negotiation with the workers relating to pay arrangements and non-voluntary retirement after the privatization. There is a difference between these directives and the demands of the workers, and the parties are working to close that gap.

On May 11, 2000 the workers started sanctions and work disruptions against the background of the labor dispute which they announced in February 2000. The issue in dispute is the workers' above demand. On May 21, 2000 the Company, the workers, the Histadrut and the State reached agreement which was validated as a decision by the Labor Tribunal. The main points of the agreement are that intensive negotiations will take place in an attempt to end the dispute, representatives from the Ministry of Finance and the Companies Authority will join those negotiations, and the workers will return to normal work until the next session, which will take place approximately one month hence.

f) On October 20, 1999, the Ministerial Committee for Privatization decided to impose upon the Government Companies Authority, in coordination with the pertinent government ministries, the submission to that Committee of a proposed resolution for the privatization of all of the State's holdings in the Company, together with a document setting out the considerations in determining the percentage of core control to be sold. In response to the proposed resolution which was submitted to the Company, the Board of Directors conveyed its position in accordance with the Government Companies Law. The Ministerial Committee for Privatization has not yet discussed approval of the above proposal.

g) The intensifying competition in the cellular communications market and its effects on the increase in costs and on tariff erosion at Pelephone, as well as the effect of depreciation of the capitalized costs of subscriber acquisition, caused a decreases in the operating income of Pelephone in the reported period. Ongoing investments in expansion of the CDMA system also increased Pelephone's finance expenses. Due to the cumulative effects of the above factors, Pelephone ended the first quarter of 2000 with a net loss.

   The Ministry of Communications is considering making changes in the method of calculating the tariff for incoming calls, which if carried out, are likely to have a materially adverse effect of the future operating results of Pelephone.

h) On March 23, 2000, the Cable and Satellite Broadcasting Council passed resolutions concerning policy on the subject of various arrangements connected with regulation of the content market. In the wake of these resolutions, DBS Satellite Services (1998) Ltd. (hereinafter: "DBS") intends to start providing satellite broadcasting services at the beginning of the second half of 2000. In so doing, DBS accumulated losses in the period prior to starting to provide services, in which the Company's equity as at March 31, 2000 amounts to approximately NIS 40 million, of which approximately NIS 16 million were incurred during the reported period.

i) The Company and the Ministry of Communications are discussing the provision by the Company of broadband communications services using ADSL technology.

   The Ministry has presented new requirements which the Company finds unacceptable as a condition for giving its consent to approval of the final version of the service portfolio. The Company intends to act in a way which will enable it to start providing the service as soon as possible.

   The service is currently being provided on a trial basis. At the same time, the Company is investing in the requisite infrastructure in preparation for providing the service to the general public, and is therefore entering into agreements with vendors for the supply of equipment at material cost.

2. Details concerning exposure to and management of market risks

Further to that described in the Directors' Report for 1999, as a result of hedging transactions against market risks relating to exposure to changes in the exchange rate, the Company incurred additional interest expenses during the reported period. In addition, finance expenses were influenced by real exchange rate differentials in periods when the protection of surplus foreign currency liabilities was not comprehensive. Due to these factors, the Company's finance expenses increased in the quarter by approximately NIS 40 million.

3. Financial Position

a. The Group's assets as at March 31, 2000 amount to approximately NIS 15.90 billion, compared with approximately NIS 17.81 billion as at March 31, 1999. Of these, approximately NIS 12.17 billion (approximately 76.6%) are fixed assets, compared with approximately NIS 13.47 billion (approximately 75.6%) at 31.3.99. The decrease in total assets derived mainly from the decrease in the depreciated cost of the fixed assets caused by the differential between depreciation expenses and the investment made in the reported period and the decrease in the cash balances and short-term investments of the Group.

b. The Group's shareholders' equity as at March 31, 2000 amounted to approximately NIS 7.43 billion, which comprise 46.7% of the total balance sheet, compared with approximately NIS 7.26 billion on March 31, 1999, which comprised approximately 40.8% of the total balance sheet.

c. Total Group debt to financial institutions and to the holders of its debentures as at March 31, 2000 amounted to approximately NIS 6.27 billion, compared with approximately NIS 7.72 billion on March 31, 1999. The data relating to debt as at March 31, 2000 do not include convertible debentures in the approximate amount of NIS 82 million, the conversion of which is probable.

The decline in the amount of financial debt resulted from a positive cash flow from current operations, of which only part was used for investing activities.

d. The balances of the Group's cash and short-term investments as at March 31, 2000 amounted to approximately NIS 569 million, compared with approximately NIS 1.2 billion at March 31, 1999.

e. The Group's surplus of monetary liabilities over monetary assets in foreign currency or linked thereto as at March 31, 2000 amounted to approximately NIS 3.19 billion.

This exposure adversely affects the Group's profitability due to the costs involved in hedging it. During the reported period, the Company carried out forward exchange contracts to reduce its exposure, and it intends to continue with this policy.

As at March 31, 2000, the net balance of foreign currency liabilities which are not hedged by such forward contracts, amounted to approximately NIS 156 million.

f. The Group’s surplus of CPI-linked liabilities in excess of linked monetary assets as at March 31, 2000 amounted to approximately NIS 2.64 billion. This exposure is partly covered by a mechanism for updating tariffs which takes into account price increases in the economy.

4. Results of Operations

a. Principal results

Net earnings for the first quarter of 2000 amounted to approximately NIS 93 million, compared with a net loss of approximately NIS 30 million in the corresponding period last year.

The difference between the results was caused mainly by a decrease of approximately NIS 363 million (before tax) in the other income / expenses item. In the first quarter of 1999 this item included an expense of approximately NIS 274 million (before tax) for the change of organizational structure. In the first quarter of 2000, this item includes income of approximately NIS 89 million (before tax), mainly from recording earnings from calling in the bond of a billing software vendor, and from recording a debt in connection with the Company's investment in India. Removing the effects of the other income / expenses items in both periods would bring the net earnings for the first quarter of 2000 to approximately NIS 36 million, compared with NIS 146 million in the corresponding period last year.

The decline in operating income by approximately 31% compared with the corresponding period last year was caused by the deterioration in the business results of the Company and the principal companies in the Group starting from the second quarter of 1999, mainly as a result of intensification of competition as noted in the description of the business environment above, and as a result of the tariff reductions starting from April 1, 1999.

Earnings per share for the first quarter of 2000 amounted to NIS 0.12 per NIS 1 par value share, compared with a loss of NIS 0.04 per share in the corresponding period last year.

b. Revenues

Group revenues for the first quarter of 2000 amounted to approximately NIS 2.23 billion, compared with approximately NIS 2.32 billion in the corresponding period last year, a decrease of approximately 4.1%. The decline in revenues is primarily the result of the reduction in the Company's tariffs by an average of 8% as of April 1, 1999, which was reflected in a decline in revenues from domestic calls, interconnect fees from international operators and access fees from cellular operators, tempered by an increase in revenues from the fixed usage fees. In addition, as of January 1, 2000, the access fees paid to the Company by the international operators were lowered. Due to changes in the Company's accounting arrangements with the cellular communications companies, since March 2000 the Company's revenues do not include revenues for airtime. The decrease in the revenues of Bezeq International was primarily the result of lower prices and international settlement fees.

c. Operating and general expenses

The Group's operating and general expenses for the first quarter of 2000 amounted to approximately NIS 1.22 billion, compared with approximately NIS 1.2 billion in the corresponding period last year, a decrease of approximately NIS 18.8 million. The stability in total expenses resulted mainly from a decline in expenses for materials, spare parts and sub-contractors and an increase in general expenses.

d. Operating income

The Group's operating income for the first quarter of 2000 amounted to approximately NIS 256 million, compared with approximately NIS 371 million in the corresponding period last year, a decrease of approximately NIS 115 million. The decrease in operating income resulted from the changes described above in income and operating and general expenses items.

e. Financing expenses

The Group's financing expenses for the first quarter of 2000 amounted to approximately NIS 130 million, compared with approximately NIS 128 million in the corresponding period last year. There was a decrease in interest payments during the reported period, owing to the significant decrease in the Group's total interest-bearing debt. Conversely, there was a decrease in Group interest income on cash balances and short-term investments.

f. Other income (expense)

In the first quarter of 2000, income of approximately NIS 89 million (before tax) was recorded in this item, which consisted mainly of NIS 82 million income from calling in the bond of a billing software vendor and approximately NIS 23 million income in respect of a debt in connection with the Company's investment in India. This item also included the costs which Bezeq International bore in connection with allocation of subscribers. The above income is compared with the first quarter of 1999, in which this item included an expense of approximately NIS 274 million in respect of the restructuring plan.

5. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first quarter of 2000 amounted to approximately NIS 700 million, compared with approximately NIS 347 million in the corresponding period last year. The increase in cash flows resulted primarily from a transition to net earnings compared with a loss in the corresponding quarter, a rise in expenses not involving cash flows (mainly deferred taxes and amortization), and changes in the current assets and liabilities items. The rise was partly offset due to payment of the Company's obligations in connection with the restructuring plan. The cash flow generated by operating activities is the principal source of the Group's financing, and is earmarked mainly for financing investments in developing telecommunications infrastructures, amounting to approximately NIS 502 million. Most of the remaining cash flow was used during the reported period to reduce the Group's financial debt and for payment of a dividend. The above included repayment of approximately NIS 242 million in long-term loans, approximately NIS 127 million in debentures and approximately NIS 234 million of government bonds - a total of approximately NIS 603 million during the first quarter of 2000. Conversely, the Group received long-term loans in a total amount of approximately NIS 303 million, and short-term bank credit of approximately NIS 179 million, so that approximately NIS 482 million was raised in total.

The monthly average of short-term credit for the period was approximately NIS 706 million. The monthly average of long-term liabilities for the period was approximately NIS 5.85 billion.

The Group recycles part of the payments for past debts and uses its surplus cash flow for the gradual reduction of its debt burden. Due to limitations on a single borrower in the local market, the Company is required to borrow considerable sums from foreign sources.

Working capital as at March 31, 2000 was negative and amounted to approximately NIS 1,252 million, almost unchanged compared with the corresponding period in 1999, which was approximately NIS 1,275 million. The negative working capital does not restrict the Group in its operating activities, since the cycle of collection of revenues from customers is short.

6. **Details of preparation plans for solving the Year 2000 issue.** See attached appendix in accordance with Regulation 2 of the Securities Regulations (Rules for reporting on preparation for solving the Y2K bug problem) (Temporary Order), 5759-1998.

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

Israel Tapoohi Chairman of the Board	Ilan Biran CEO

May 23, 2000

Pursuant to Regulation 2 of the Securities Regulations (Rules for reporting on preparations for solving the Y2K bug problem) (Temporary Order), 5759-1998, below are details of the Company's preparations for solving the Year 2000 problem:[1] [2] [3]

1. **Details of preparation plans for solving the Y2K problem**

   a. No change.

   b. The Group has identified the critical systems.

   c.+d. Operation of the Group's computer systems and computer-integrated systems is carried out by the Group, except for the salaries system of the Company which is operated by an outside supplier and that of a subsidiary which is based on software acquired from an external supplier. The companies have maintained contact with these suppliers to ascertain their readiness for the year 2000.

   e.+f. No change.

   g. Not relevant.

   h. No change.

2. **Cost of preparation for solving the Y2K problem**

   Below are details of the investments in preparation for solving the Y2K problem, by fiscal year:

Fiscal year	Have costs or budgets been earmarked	Activities included in planned costs	Amounts, in NIS millions
1998	Yes	Advisory services, systems conversion and adaptation	38
1999	Yes	Advisory services, systems conversion and adaptation, acceleration of investments, integration tests and preparation of emergency plans	207
2000	No (at this stage)	---	---

In addition to the above, other indirect costs exist relating primarily to staff engaged in conversion work.

As at the report date, the Company does not expect to exceed the planned investment budget.

(1) This report refers to the Company and its subsidiaries, each of which is making independent preparations for solving the Y2K problem.

(2) The changes described in this report are as compared with the Directors Report of December 31, 1998.

(3) This report is presented in accordance with the Securities Regulations mentioned above, which require continued reporting on this matter until the end of the fiscal year 2000.

3. Human resources involved in the preparation

As a change from previous reports, the Company's steering committee is headed by its CEO, Mr. Ilan Biran, who replaced Mr. Ami Erel.

4. Outside professional assistance

The Group's companies have hired outside professional assistance - for each company the kind of help it required - including: problem evaluation, performing system modification, systems replacement, internal control, training, supplier evaluation, testing communication systems for third parties, project management, preparation and implementation of compliance tests and performance of adaptation verification.

5. Progress assessment

a. Method of assessing progress of preparation

(1) No change.

(2) No change.

(3) The internal audit units of the Group's companies also monitored the progress of the preparation, as did the outside consultants appointed by some of the Group's companies. On August 10, 1999 the Office of the State Comptroller published a report on the Company's preparations for the Y2K computer problem. The report referred to a number of shortcomings which the Company acted to correct.

b. No change.

6. Adherence to timetable

In most cases, the Company and its subsidiaries adhered to the timetables they set for themselves for solving the Y2K bug problem.

7. Plan in the event of systems failure

The Group's companies completed preparation of plans for an event of systems failure brought about by the Y2K bug problem. These plans relate to the possibility of uninterrupted provision of vital services to the Company's customers, the activities of the companies on the transition date to the year 2000, and plans in the event of non-provision of vital services to the Company by other suppliers (such as electricity, fuel, etc.). Failure in one of the main operating systems of the Company is liable to prevent it from continuing to provide services.

The Company set up a central body to formulate the emergency plans.

8. Third party systems

No change.

9. Additional information

As at the date of signing this Report, the Group's companies made the transition to the year 2000 without noteworthy malfunctions deriving from the transition, as far as they know. Nevertheless, the companies of the Group cannot guarantee that all aspects of the Y2K problem which affect them, including and in particular those which relate to the readiness for the Year 2000 of its customers, suppliers and other outside entities, including infrastructure suppliers, whose activities affect the companies, have been fully solved.